

ALASKA STATE LEGISLATURE
SENATE SPECIAL COMMITTEE ON NATURAL GAS DEVELOPMENT

July 31, 2006

1:57 p.m.

MEMBERS PRESENT

Senator Ralph Seekins, Chair
Senator Gary Wilken
Senator Con Bunde
Senator Fred Dyson
Senator Thomas Wagoner
Senator Ben Stevens
Senator Kim Elton

MEMBERS ABSENT

Senator Lyda Green
Senator Bert Stedman
Senator Lyman Hoffman
Senator Donny Olson
Senator Albert Kookesh

COMMITTEE CALENDAR

SENATE BILL NO. 3002

"An Act relating to the Alaska Stranded Gas Development Act; relating to municipal impact money received under the terms of a stranded gas fiscal contract; relating to determination of full and true value of property and required contributions for education in municipalities affected by stranded gas fiscal contracts; and providing for an effective date."

HEARD AND HELD

SENATE BILL NO. 3001

"An Act relating to the production tax on oil and gas and to conservation surcharges on oil; relating to criminal penalties for violating conditions governing access to and use of confidential information relating to the production tax; amending the definition of 'gas' as that definition applies in the Alaska Stranded Gas Development Act; making conforming amendments; and providing for an effective date."

SCHEDULED, NOT HEARD

PREVIOUS COMMITTEE ACTION

BILL: SB3002

SHORT TITLE: STRANDED GAS AMENDMENTS

SPONSOR(s): RULES BY REQUEST OF THE GOVERNOR

07/12/06	(S)	READ THE FIRST TIME - REFERRALS
07/12/06	(S)	NGD
07/13/06	(S)	NGD AT 9:00 AM SENATE FINANCE 532
07/13/06	(S)	Heard & Held
07/13/06	(S)	MINUTE(NGD)
07/14/06	(S)	NGD AT 9:00 AM SENATE FINANCE 532
07/14/06	(S)	Heard & Held
07/14/06	(S)	MINUTE(NGD)
07/24/06	(S)	NGD AT 1:30 PM SENATE FINANCE 532
07/24/06	(S)	Heard & Held
07/24/06	(S)	MINUTE(NGD)
07/25/06	(S)	NGD AT 9:00 AM SENATE FINANCE 532
07/25/06	(S)	Heard & Held
07/25/06	(S)	MINUTE(NGD)
07/26/06	(S)	NGD AT 9:00 AM SENATE FINANCE 532
07/26/06	(S)	Heard & Held
07/26/06	(S)	MINUTE(NGD)
07/27/06	(S)	NGD AT 9:00 AM SENATE FINANCE 532
07/27/06	(S)	Heard & Held
07/27/06	(S)	MINUTE(NGD)
07/28/06	(S)	NGD AT 9:00 AM SENATE FINANCE 532
07/28/06	(S)	Heard & Held
07/28/06	(S)	MINUTE(NGD)
07/31/06	(S)	NGD AT 1:30 PM SENATE FINANCE 532

BILL: SB3001

SHORT TITLE: OIL/GAS PROD. TAX

SPONSOR(s): RULES BY REQUEST OF THE GOVERNOR

07/12/06	(S)	READ THE FIRST TIME - REFERRALS
07/12/06	(S)	NGD
07/13/06	(S)	NGD AT 9:00 AM SENATE FINANCE 532
07/13/06	(S)	Heard & Held
07/13/06	(S)	MINUTE(NGD)
07/14/06	(S)	NGD AT 9:00 AM SENATE FINANCE 532
07/14/06	(S)	Heard & Held
07/14/06	(S)	MINUTE(NGD)
07/24/06	(S)	NGD AT 1:30 PM SENATE FINANCE 532
07/24/06	(S)	Scheduled But Not Heard
07/25/06	(S)	NGD AT 9:00 AM SENATE FINANCE 532
07/25/06	(S)	Heard & Held
07/25/06	(S)	MINUTE(NGD)
07/26/06	(S)	NGD AT 9:00 AM SENATE FINANCE 532
07/26/06	(S)	Heard & Held

07/26/06 (S) MINUTE(NGD)
07/27/06 (S) NGD AT 9:00 AM SENATE FINANCE 532
07/27/06 (S) Heard & Held
07/27/06 (S) MINUTE(NGD)
07/28/06 (S) NGD AT 9:00 AM SENATE FINANCE 532
07/28/06 (S) Scheduled But Not Heard
07/31/06 (S) NGD AT 1:30 PM SENATE FINANCE 532

WITNESS REGISTER

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ACTION NARRATIVE

CHAIR RALPH SEEKINS called the Senate Special Committee on Natural Gas Development meeting to order at [1:57:51 PM](#). Present at the roll call were Senators Gary Wilken, Con Bunde, Fred Dyson, Thomas Wagoner, Ben Stevens, Kim Elton and Chair Ralph Seekins.

SB 3002-STRANDED GAS AMENDMENTS

CHAIR RALPH SEEKINS announced the committee would continue the hearings on natural gas development. He introduced Don Shepler, and Rick Harper, Consultants to the Legislature.

[1:58:58 PM](#)

DONALD SHEPLER, Greenberg Traurig, LLP, Consultant to the Legislature testified on the issue of Basin Control and provided a written memorandum outlining his views [Basin Control Issues Arising From SGDA Contract]. He said that it is essential to identify the problem up-front. The issue arises out of the concerns of the "independents" or "explorer-producers" that access to the pipeline will be limited or restricted such that they have to give up their leases or sell their gas to the producer-owners at distressed prices.

CHAIR SEEKINS asked whether by "independents" he meant companies that are not part of pipeline project itself, without any implication as to the size or capital value of the company.

MR. SHEPLER responded that he meant non-owner producers as opposed to owner-producers.

He explained that the issue of access only arises when one group of competitors has ownership and control of the pipeline facility that their competitors need in order to monetize their reserves. Said another way, if there were an independent pipeline company that had no ownership interest in the upstream production activities, it would not present the issue of Basin Control that comes with ownership being held by parties competing with potential shipper-producers on the North Slope.

MR. SHEPLER advised that the access issue is paramount to the non-owner producers that compete with the owners for gas leases and reserves; but that may not be the only issue under the heading of Basin Control. It could encompass others such as how leases are administered and how they revert to the state. His experience indicates that, if the independents had assurance that the pipeline would be available for their gas in a timely fashion, Basin Control would be a non-issue.

An independent pipeline would have a different economic incentive because, for an independent pipeline, expansion is the "lifblood" of the business; its return on equity is based on how much steel is in the ground.

Econ One Research, Inc. estimated that, at a \$2.50 tariff end-to-end, the equity return dollars that the producer-owners would receive would be in the \$.20 to \$.25 per Mcf of capacity range, as opposed to the netback of perhaps \$3.00 per Mcf, assuming a market price of \$5.50. Clearly, the producer-owners have a greater stake in the upstream than the midstream segment.

He said the divergence of interests becomes more evident in expansion, because the additional incremental profit is very small. He is concerned the producer-owners would not have the financial incentive to expand the pipeline except to the extent that they had incremental gas of their own to go through it.

The question to the legislature is how can it ensure that the pipeline project, with this group of sponsors, will mimic the incentives of an independent pipeline; and how can it rely on the federal legislation (Section 105 of the 2004 statute) that gives FERC the authority to compel an expansion, when the 2004 statute has not been judicially construed or tested. Timing is also an issue. The independent producers need to know that the capacity will be available when they need it.

One alternative would be for the state to rely on Article 8.7, the state-initiated expansion provision in the contract, but that section is subject to many conditions. The party that asked for the expansion would still have to bid in open season and still have to deal with timing. Another alternative would be to rely on the FERC enforcement mechanisms, but there are issues of litigation and timing associated with that too.

[2:11:56 PM](#)

MR. SHEPLER suggested that, while the state is negotiating taxes, royalties, and other concessions with the sponsor group in exchange for commitments to build the pipeline, it insert binding commitments into the contract to expand the pipeline under reasonable terms and conditions. He recommended that these include: the pipeline would conduct periodic open seasons, binding or non-binding; the pipeline sponsors would agree to file for expansion certifications upon request by creditworthy shippers, (using Article 8.7 limits as a benchmark for a reasonable engineering increment); expansion would be predicated upon the use of rolled-in pricing.

By building the terms and conditions above into the contract, the state could replicate the motivations of an independent pipeline company. The expansion commitments should not

materially affect the producer-owners' commitment or ability to build the pipeline.

[2:16:24 PM](#)

SENATOR ELTON said that some of what Mr. Shepler said echoed the concerns of Anadarko regarding Article 8.7. He referenced the need to start over on Article 8.7 to get rid of some of the hurdles to state-initiated expansion, and substitute rolled-in pricing and periodic open seasons.

[2:17:12 PM](#)

MR. SHEPLER agreed that he is not a fan of Article 8.7, as it has too many hurdles to be a reliable expansion mechanism. He said that it might not have to be thrown out, but it should be modified. The committee has heard that there are three expansion vehicles available in this project: FERC mandated, voluntary, and Article 8.7, but the contract is completely silent on voluntary expansion. There should be a provision in the contract laying out terms for a voluntary expansion.

[2:18:49 PM](#)

SENATOR ELTON said he recalled a suggestion that the LLC may make it easier for state-initiated expansion. But he believed that the controlling document should be the contract that is before the committee and not an LLC.

[2:19:28 PM](#)

MR. SHEPLER pointed out that the LLC may be able to take care of the issue, but no one has seen the LLC and he feels it is too important an issue to leave to chance.

[2:19:54 PM](#)

SENATOR BEN STEVENS arrived.

[2:20:04 PM](#)

SENATOR WAGONER asked whether modifying Article 8.7 would be a deal-breaker.

MR. SHEPLER responded that he did not know, but he did not believe that a pipeline owner should have any objection to that type of provision. Any objection it might have would relate to its interests in the upstream and not to its interests as a pipeline owner.

[2:21:09 PM](#)

SENATOR BEN STEVENS asked if Mr. Shepler could explain footnote 8, on page 19.

[2:22:15 PM](#)

MR. SHEPLER responded that, in recent discussions, the sponsor group said that the pipeline will be expanded, and that the pipeline could be expanded from 4.5 bcf to about 6 bcf a day using low-cost compression; but the presumption is based on specific sizing in the initial design of the pipeline, and nothing in the contract commits the parties to 4.5 bcf per day design capacity or to expansion to 6 bcf per day.

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SENATOR BEN STEVENS said that he was not sure Mr. Shepler's comments explained footnote 8. He referred to a sentence in the footnote that reads:

As noted by Anadarko, the physical interest finding indicates that only the sponsor group proposed using a large diameter pipe. It may be that the other companies that discussed the project with the state had a more realistic handle on the design issue and the sponsors will eventually come around to the smaller design. In that case, of course, the economics of expansion will be much different than has been presented to date.

He asked Mr. Shepler if that is merely speculation.

[2:25:11 PM](#)

MR. SHEPLER responded that the fiscal interest findings note that the sponsor group was the only group that committed to build the larger diameter pipeline. The other proponents proposed a smaller diameter pipeline.

[2:25:38 PM](#)

SENATOR BEN STEVENS asked how Mr. Shepler knew that.

[2:25:47 PM](#)

MR. SHEPLER replied that it is in the fiscal interest finding and is quoted in the Anadarko written comments that were filed on the contract. He said that because there is no prohibition on changing the qualified project plan, or no state veto over material changes to the qualified project plan, it may evolve over time and the pipeline that is built may not have that expansibility in the design. So it is speculative, but the assumption is that the line will be expanded to the 6 bcf per day level. He noted that the assumption is encouraging, but felt the expansion should be in the contract.

[2:27:06 PM](#)

SENATOR WAGONER commented that there are two ways to look at the expansion to 6 bcf, one is with a 52-inch pipe, the other is with a 48-inch pipe and much more expensive looping. [Looping: Increasing capacity on a pipeline system or segment by adding another pipeline running parallel to existing lines.] It is the size of the pipe that makes it easier to expand capacity.

[2:27:56 PM](#)

MR. SHEPLER responded that it is also his understanding that the smaller pipe cannot be expanded as economically as the larger one.

[2:28:54 PM](#)

CHAIR SEEKINS said he had never read through a filing for a tariff, and asked what goes into compiling the reimbursable costs for a tariff.

[2:29:27 PM](#)

MR. SHEPLER replied that there are no "reimbursable" costs per se.

CHAIR SEEKINS corrected himself to say those on which he could get the 14 percent return.

MR. SHEPLER said that the FERC reviews the detailed construction proposal filed by the pipeline and initial rates are established in the certificate order. After three years, the FERC requires the pipeline to re-justify its cost estimates and adjusts rates based on the outcome of its analysis.

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CHAIR SEEKINS asked if things like the Environmental Impact Statement (EIS) are part of that filing.

[2:30:56 PM](#)

MR. SHEPLER replied that the items are either "cost of service" or expensed items, or capitalized items, which could include a lot of the environmental work, and these go into the rate base.

[2:31:12 PM](#)

CHAIR SEEKINS asked if access, roads, and engineering costs would be included.

MR. SHEPLER replied yes.

CHAIR SEEKINS asked whether there would be a very large difference in the engineering costs between a 48 and a 52-inch pipe.

MR. SHEPLER replied that he could not answer that question.

[2:32:21 PM](#)

RICK HARPER, Econ One Research, Inc., Consultant to the Legislature, interjected that he was not sure either, because a 52-inch pipe is not usual. He noted that, when dealing with smaller increments, say the difference between an 18-inch and a 24-inch pipe, the cost difference is not great.

[2:32:42 PM](#)

SENATOR DYSON said that the committee heard testimony that no one has previously used 52-inch pipe to carry the pressure required to get to 6 bcf, and that no one is capable of doing it at this time. The transportation of the larger pipe is also a new issue. The implication was that a bigger pipe with thicker walls and a higher-pressure capacity, would ultimately be cheaper than smaller pipes.

CHAIR SEEKINS mused that he was trying to view future expandability in two ways, first as a non-producer and second as a producer. The incentive to control costs would not be as great for a non-producer whose return is based on how much steel is in the ground, as it would for a producer.

[2:36:29 PM](#)

MR. SHEPLER confirmed that is a point the sponsor group raised.

CHAIR SEEKINS commented that is because they would have to pay for it one way or the other.

MR. SHEPLER confirmed that they would. He said that, with the addition of the compression-based expansion, rates should decline. His only objection was that there is no contractual commitment. He also noted that to foster competition, capacity is key.

[2:38:00 PM](#)

CHAIR SEEKINS said that it serves the state's interests to be able to ship more gas. He wondered whether, as an owner, it could reduce its costs by shipping more.

MR. SHEPLER responded that it could, as long as it was not necessary to engage in looping.

[2:38:35 PM](#)

CHAIR SEEKINS said that his only concern, on the competitive side, would be whether it would cause an incremental cost to the shippers that are already there.

MR. SHEPLER said that could be an issue in a looping expansion. The debate is whether to charge the expansion costs to the new shipper, or spread them out among the other shippers as well. That model would cause a slight increase to existing shippers, but not as great an increase as the new shipper would have to bear individually.

[2:39:37 PM](#)

CHAIR SEEKINS asked for clarification that existing shippers would have to subsidize new shippers.

[2:39:59 PM](#)

MR. SHEPLER replied yes. According to FERC, they would have to pay a slightly higher incremental charge. FERC allows for negotiated rates, which would insulate existing shippers from those costs. He added that there are many events that can cause rates to go up, and an expansion is just one of them.

[2:41:10 PM](#)

CHAIR SEEKINS asked if someone could give him an idea of what the cost of that initial expansion might be, or whether there would be an actual reduction in costs as a result. He said it seemed that compressor expansion could actually drive costs down.

MR. SHEPLER replied yes, that should reduce rates.

[2:41:48 PM](#)

MR. WAGONER asked if access and expansion were the only issues that the committee should be considering.

MR. SHEPLER responded that access is a fundamental issue that comes under the Basin Control heading, but it may not be the only issue.

MR. HARPER said he recognized that Senator Seekins was searching for a broader understanding of the natural alignment of interests or lack thereof. He admitted that he had not reached any conclusions, but said he agreed with Mr. Shepler that the producers should have incentives to keep costs down. He pointed out however, that the three sponsors do not have enough gas to

fill the pipeline for its lifetime, so as owners they will be dependent upon the independents as well as their own efforts.

SENATOR DYSON said he read in Mr. Shepler's paper that, if there is reluctance to expand a producer-owned pipeline's capacity, it might be due to upstream incentives. He asked if either of the consultants could cite historical examples of how upstream interests might work against expansion.

[2:45:36 PM](#)

MR. SHEPLER said that he was aware of only 6 small producer-owned pipelines.

[2:46:45 PM](#)

MR. HARPER distinguished between a producer-affiliate of a pipeline and a producer-owned pipeline. The size of this project, and the fact that the three major participants control so much of the product makes it unique. The non-standard nature of this project causes him and Mr. Shepler to recommend additional caution.

SENATOR WAGONER brought up liquids and the pipeline's capacity to handle them. He noted that the contract does not address liquids except to say that there will be a study done before the date of sanction. He stressed that if the state does not address the matter now, during contract negotiations, the engineering will be done and it will lose the opportunity to process those liquids in Alaska. He asked Mr. Shepler to comment on that with regard to pipeline capacity.

MR. SHEPLER responded that he was not sure how to respond.

MR. HARPER said that it is a very important issue that, in terms of Basin Control, has not been tabled. He agreed with Senator Wagoner that it should be dealt with now, in the contract.

[2:51:39 PM](#)

CHAIR SEEKINS said that, if the market for the liquids were the Far East, there would be a natural competitive advantage to extract them in Alaska where it is closer to the market.

[2:52:27 PM](#)

MR. HARPER said that typically processing plants are more closely aligned with field production than downstream, but Alberta, Texas and Louisiana have huge infrastructures of natural gas liquid removal, with whole industry and regulatory structures surrounding them. He would be concerned about this

contract structure and want to make sure that the normal economic drivers are in place.

[2:53:57 PM](#)

CHAIR SEEKINS commented that when he was a member of the governor's advisory committee on North Slope natural gas, they were told that there were enough liquids in that envelope to accommodate two or more world-class liquid gas extraction plants.

MR. HARPER said he doesn't doubt that, and noted that Senator Wagoner's question about whether there is something attendant on the design and size of pipe and the operating regimen specified that would influence the outcome in some way, is a very good one.

CHAIR SEEKINS wanted to go back to the discussion of the cost of getting gas to market, and whether expansion would drive costs down rather than up. He related a business analogy to illustrate that cooperation between competitors to get a product to market made economic sense as long as neither would lose market share.

[2:55:46 PM](#)

MR. SHEPLER said that the analogy was valid, but used another to illustrate the independents' position regarding access. They are concerned about being at the mercy of the producer-owners.

CHAIR SEEKINS said he appreciates their position, but would feel more comfortable if he had a federal agency looking into that to be sure the state is not placed in a non-competitive situation.

MR. HARPER said that he had no reason to doubt the veracity of the sponsors, but he would recommend that the state pin down as much as possible.

[2:58:51 PM](#)

MR. SHEPLER said that he recently read two articles that relate to the point he made earlier today about the criticality of timing. The articles describe proceedings initiated in 2004 and 2005 that are just now moving to FERC's enforcement division. If a producer had a complaint related to expansion, waiting for the federal agency would not be the preferred approach.

[3:00:34 PM](#)

MR. HARPER summarized by saying that, although this is a shift structurally from the way the industry has operated in the past, it has been allowed for and considered legislatively and

according to regulation. He cautioned that the state is treading on new ground however, and he isn't comfortable recommending that the state rely solely on federal oversight or remedy. To the extent that the state can protect itself contractually relative to expansion, it should do so. He also reminded the committee that, in his opinion, the state should take delivery of the gas at the terminus rather than upstream.

He directed the committee's attention to a supplemental report that he had prepared, and to reports provided by Anadarko and BG Gas.

[3:06:12 PM](#)

SENATOR WAGONER asked Mr. Harper about taking gas in kind, and what the state might expect when marketing that gas.

MR. HARPER responded that he did not agree with the notion that it aligns the interests of the state and the producers, because at the point that the state markets the gas, it becomes a competitor against some of the fiercest competitors in the world in the areas of commodity marketing, transportation, capacity management, futures, derivative products, and all the things the state would have to understand to be successful. The producer-owners also have broad portfolios that allow them to make adjustments and marketing arrangements that the state cannot. It is a heroic step and doable, but the state now benefits directly from the sponsors' efforts and that would change the moment this went into effect.

[3:08:29 PM](#)

CHAIR SEEKINS said that there are a lot of expansions going on in the pipeline field and a lot of proposed expansion in regasification plants across the country. He asked whether the trend in regasification plants is toward producer-owned or independently owned plants.

[3:09:25 PM](#)

MR. HARPER asked Senator Seekins if he meant LNG regasification.

CHAIR SEEKINS said yes.

[3:09:45 PM](#)

MR. SHEPLER said that he does not know, but that Dr. Finizza, who did a memo for Econ One on LNG, would be part of the Port Authority presentation later in the week and he is the guru on LNG.

MR. HARPER concurred that Dr. Finizza is an LNG expert and would be able to answer Senator Seekins' question. He added that he believed the producers were taking significant positions in regasification, but not in the pipelines downstream of that.

3:10:13 PM

CHAIR SEEKINS asked whether there are additional pipelines contemplated to go with the re-gasification plants, or do they feed into existing infrastructure.

3:10:46 PM

MR. HARPER apologized for not having an answer to that question, and reiterated that the committee would get more complete information on Thursday and Friday. He did say however, that it is a combination of all of the above, and there is an incentive to site regasification plants where there is already adequate infrastructure.

CHAIR SEEKINS responded that he wondered whether a new trend is developing in ownership of the infrastructure to get the gas to market as well as to produce the gas.

MR. HARPER said he has not seen any indication that it is a mass trend, and admitted that he is troubled because he does not understand why these producers would want an ownership interest in the pipeline. The returns are good, but not as great as they are accustomed to get, so he does not understand their motivation.

MR. SHEPLER added that the Alliance Pipeline is the only other instance in North America of a large pipe that started out as a producer-owned pipeline. There were nine owner-producers, but over time they sold their interests and it is now owned and operated by Enbridge.

MR. HARPER said that, in that case, there were more participants holding fewer shares and no one else was prepared to undertake the project, so something had to be done to "de-bottleneck" the western sedimentary basin.

SENATOR BUNDE asked for clarification from Mr. Harper of his comment that, if producers were to expand their holdings to include a pipeline and then continued to hold it after production started, it would depress their stock value.

MR. HARPER responded that the pipeline's regulated rate of return would be below their expectation. There was a great

reluctance historically for major producers to own interstate pipelines, because they did not want to give federal regulators too much access to their operations.

[3:17:04 PM](#)

SENATOR BUNDE said that he was curious to know why the sponsors have expressed such an interest in building this pipeline if, as Mr. Harper suggested, it might not be in their best interests to do so.

MR. HARPER said he just could not come to terms with why they would want to own the pipeline, since the rate of return is below traditional profiles.

[3:18:07 PM](#)

CHAIR SEEKINS said that a 14 percent return risk-free sounds pretty good.

CHAIR SEEKINS called a 5 minutes recess at [3:18:37 PM](#)

[3:27:16 PM](#) call to order

SENATOR ELTON said he would ask one question in 3 parts, and hoped to draw upon Mr. Harper's previous experience as a gas pipeline executive. He asked for Mr. Harper's reaction to whether the contract is sufficient in its definition of diligence, whether it is normal when constructing a pipeline that parties would be restricted from seeking redress on contract terms through the court, and whether, as a former pipeline executive, he would have been comfortable signing a contract without knowing what the LLC agreement was.

MR. HARPER responded that his written reports address the issue of diligence at length, but went on to say that the diligence standard in this agreement is not according to industry practice and is a weak standard taken in conjunction with the limitations the arbitrators would have to deal with in making their determinations. He also pointed out that diligence, as defined in this contract, is not akin to a prudent operator standard, which is typically applied in the field, or a due diligence standard.

He was even more concerned about the state's lack of recourse to the courts, and the fact that consequential, punitive, and other damages are waived.

With regard to signing a contract without having seen the LLC, he said he would not and in fact did not feel entirely comfortable advising them without having seen it.

CHAIR SEEKINS said that, in all fairness, no one had asked the committee to ratify a contract without seeing the LLC, and that he did not think any of them would consider that.

MR. HARPER agreed.

[3:33:57 PM](#)

SENATOR DYSON commented that he was not sure Senator Seekins was correct in saying that no one was considering approval without seeing the LLC. Some of the discussions in committee referenced a pretty tight timeline in order to get the bill out before November.

CHAIR SEEKINS responded that he might have over spoken, but that he certainly was not interested in voting to ratify a contract before he had seen the entire agreement.

SENATOR DYSON asked for clarification of the last line on page 15 of Mr. Shepler's comments, which says, "expansion does not require installation of loops in excess of 100 miles...". He observed that, given that the gas line will be 2500 or 3800 miles long, it seemed that expansion would occur in longer than 100-mile segments.

MR. SHEPLER responded that page 15 is a recitation of what is in Article 8.7, and deferred to Mr. Harper for further comment.

MR. HARPER said that, based on his understanding of the overall pipeline design, he could not explain that sentence.

SENATOR DYSON asked whether, in his experience, it was common to limit the number of miles in an expansion loop.

MR. HARPER replied that he had not seen it before.

SENATOR DYSON asked whether expansion loops are often longer than that.

MR. HARPER replied yes.

SENATOR DYSON referred to the first paragraph on page 17 of Mr. Shepler's comments, and asked if he could explain it.

MR. SHEPLER said that this also was lifted directly from Article 8.7 of the contract. In the context of a state-initiated expansion, if the sponsors file a proposal for expansion with the FERC and the FERC certifies it but requires any changes, this section allows the operator of the pipeline to reject the certificate. If the FERC approves a certificate and the operator rejects what was approved, it is not authorized to expand/build a pipeline.

SENATOR DYSON asked whether that section was still referring to state-initiated expansion.

MR. SHEPLER said yes.

SENATOR DYSON commented that, if the state initiates the expansion (line 4, page 17), and the FERC certifies it, he assumes that the FERC agrees with what the state wants to do; but he wondered if Article 8.7 was saying that the project entity must reject it.

MR. SHEPLER responded that he was not sure, but he understood that if the entity files for state-initiated expansion using incremental pricing, for example, and the FERC approves the expansion but requires a different pricing method, this provision authorizes the project entity to reject it. There could be any number of other terms that the FERC might require to be changed, but this is one scenario he could see coming up.

SENATOR DYSON asked whether, if the state initiated an expansion, the other ownership partners would have to agree with the state on it.

MR. SHEPLER responded that, according to Article 8.7, if a party has been turned down for expansion and asks the state to initiate an expansion under the contract, the contract obligates the project entity to seek an expansion. This section gives the pipeline company the authorization to reject the certificate, if what was approved by the FERC is not exactly the expansion it filed for.

MR. SHEPLER said that he had listed some of the many conditions that really eviscerate any value 8.7 might have, including the 100 mile looping, no rate increase to existing shippers etc.

[3:43:52 PM](#)

SENATOR DYSON clarified that if the state decides to apply for expansion on behalf of the party who was turned down...

MR. SHEPLER said that this provision does not give the state the right to do a sole-risk expansion and 8.7 is not an alternative way to create a sole-risk expansion.

SENATOR DYSON said that what he wanted to know was whether, if the state decides to apply for expansion and the other partners are not in agreement, the partners are required to file a joint application for expansion with the FERC.

MR. SHEPLER said yes, under Article 8.7 they are, and that it would be treated as a voluntary expansion.

SENATOR DYSON asked whether, if FERC found differently from the application, the project entity must reject the FERC certificate.

MR. SHEPLER replied that the wording in Article 8.7 is that the project entity "shall reject", unless the difference is minor or "all the members of the project entity vote otherwise." He said that within 30 days of getting the certificate, the project entity must file a notice of acceptance, or must reject any certificate that comes back different from what was applied for.

SENATOR DYSON observed that seems to impugn the idea that FERC is looking out for the greater good for all and can over rule for a larger purpose.

MR. SHEPLER responded that, as had been explained, the FERC puts out their certificate order subject to specific terms and conditions, and normally there are many conditions attached to a FERC certificate. The applicant can look at that and decide whether or not he is in agreement with it.

SENATOR ELTON stated that, as he understands it, assuming the state initiates an expansion and the FERC agrees, if the FERC makes any substantive change, it isn't the "project entity" that must reject the certificate, if any single part of the project entity objects, it must be rejected. So all parties in the project entity must agree or it must be rejected.

MR. SHEPLER replied yes.

SENATOR ELTON observed that if one party were reluctant, it could encourage a certificate with a change so it would have veto power as a member of the project entity.

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SENATOR WAGONER asked if Mr. Shepler or Mr. Harper have ever seen any system as rigorous as what is set out in 8.7.

MR. SHEPLER said that he is not aware of any other agreements in which the parties have had occasion to enter into anything like Article 8.7. His concern about Article 8.7 is that it is so much more restrictive than the FERC mandated expansion and covers circumstances in such a narrow window, that he doesn't see it as providing much relief for any producer.

MR. HARPER agreed and said that is the fundamental basis for the alarm they sounded over Basin Control.

SENATOR DYSON noted that in the contract, on page 94, it states that the "amicable resolution process does not apply to dispute resolution under Article 8.7".

MR. SHEPLER said Mr. Loeffler explained that, in this context, they did not want to take the time to go through intermediate dispute resolution and this provision would get the matter to arbitration more quickly.

MR. HARPER said that there has been some concern in the context of Basin Control about current gas prices, so he wanted to provide the committee with a tool to reference how the industry would normally view characterization of current prices. The industry usually looks at 12 months prices on the NYMEX (NYMEX.com, Natural Gas Futures Prices) as an indicator of what the market is doing.

SENATOR WILKEN said that it has been suggested that what the committee has before them is the "trust me" model contract. He wanted to go back to the issues of diligence and lock-in, because he was concerned that the state would sign a contract that is replete with "side boards". He recognized that the people of Alaska expect the state to give up some things in the contract, but if there are real reasons why this pipeline cannot or should not be built, the committee needs to know that timely, and know what other directions it can take.

He said that, regarding "lock in", gas contracts usually are written with a 20-year term, and wondered whether it is possible to include a "re-opener", or review period based on events, so the state is not locked in for 20 years if circumstances change. He asked if the contracts are as "hands off" as the committee has been told they are.

MR. HARPER confirmed that "trip wire" events are customary.

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MR. SHEPLER said that he wanted to focus on the shipping contract, which is the one that will pay for the pipeline. Shipping contracts are typically long term and have no re-openers. The FERC regulates the rates, terms and conditions under which the service is provided. He speculated that what Senator Wilken was referring to was the gas sales contract or, more importantly, the underlying fiscal contract, which is like a construction contract. These do tend to have trip-wire events associated with them.

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SENATOR WILKEN asked whether, if someone who is marketing Alaska's gas enters into an agreement to supply gas to a buyer for 20-years, anything that happens to effect the cost of that gas can affect the agreement.

MR. SHEPLER clarified that the 20-year term generally applies to the shipping contract rather than the gas sales contract. Gas sales contracts are usually not long-term fixed-price sales contracts any more.

MR. HARPER agreed and said they are more often market-based and market sensitive.

SENATOR WILKEN said the FT (firm transportation contract) is a part of the pipe within the pipe.

MR. SHEPLER confirmed that an FT gets you space in the pipe. He said that the state's marketing entity would probably have a whole portfolio of sales contracts that would affect the value the state gets for its royalty-in-kind (RIK) volumes, but the contracts to move those volumes through the pipeline would be 20-year contracts.

SENATOR WILKEN said that the committee needs help pre-gas to define in the contract what the state will give up and what it will get in return, rather than trusting that it will get a gas pipeline.

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CHAIR SEEKINS asked if the long-term commitment is to send a specified amount of gas down the pipe every day, or pay as if it had been sent.

MR. SHEPLER said yes, you pay whether you ship or not.

MR. HARPER added that what the state would be dealing with is a two-part rate with a demand and a commodity component in the rate structure. The state would pay the demand charge whether or not it moved any gas. Typically all the fixed-cost components of the pipeline are loaded into the demand structure and then you pay variable costs based on when you ship the gas.

MR. SHEPLER added that the variable costs are insignificant. The demand charge is 99 percent of the rate.

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SENATOR WILKEN said he found it interesting that Mr. Harper was perplexed about why the producers would want to participate. He quoted some numbers from Mr. Shepler's presentation illustrating that the equity return that the producer-owners would receive would be only in the \$.20 to \$.25 per Mcf of capacity range, as opposed to the netback of perhaps \$3.00 per Mcf (assuming a market price of \$5.50), about \$8.50 at today's price. He asked if what Mr. Harper was saying was part of what Mr. Shepler was talking about on page 12 of his presentation.

MR. HARPER said yes, it's a question of what business you are in and what risk profile you have. Typically companies like ExxonMobile, BP and ConocoPhillips are looking for a higher-risk, higher-return potential profile and they have been very successful at that.

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CHAIR SEEKINS said maybe he'd ask the sponsors why they want to own the pipeline.

SENATOR WAGONER said when the Legislative Budget and Audit Standing Committee met in Anchorage a few weeks ago, someone made the statement that the state had made no concessions in the pipeline contract. He believed they meant that for every concession the state has made, the sponsors have made one of equal value. He said that he sent a letter to the governor outlining the value of the concessions that the state has made, and wondered if it was logical to ask the governor's office, or the sponsors, or both, to provide written documentation of what the sponsors have given up in concessions to equal the value of the state's.

MR. HARPER and MR. SHEPLER agreed that it was logical and was his job to ask for that information.

CHAIR SEEKINS welcomed the sponsors back and asked them why they want to build and own the pipeline.

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MARTIN MASSEY, Joint Interest Manager for U.S. Operations, ExxonMobil Production, said that a lot of what Mr. Harper said was true, that Exxon isn't in the pipeline business, and the returns are not as high as they are usually after, but it comes down to what is the best course to make this project commercially viable. Owning the pipe gives it the best chance for several reasons: first, Exxon is going to pay for it anyway because it is going to make the FT commitment; second, it is a matter of economics, how do you value giving that FT to someone else; third, this is a huge, risky project and will have enormous impact on everyone if it isn't done correctly, so ExxonMobile feels it should manage and own it, at least until the pipeline is built.

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DAVID VAN TUYL, Commercial Manager, Alaska Gas Group, British Petroleum (BP), agreed with the statement that Mr. Shepler made. That is, a general assertion that an independent pipeline company is primarily motivated to put steel into the ground because that expands their rate base. He said, because of that an independent pipeline company doesn't have an incentive to reduce the rate base, and that is primarily why the producers want to build this pipeline. It is certainly a prime motivation for BP.

He noted that Senator Wilken had referenced page 12 in Mr. Shepler's comments, and said that the producers' game is to target the \$3.00 notional netback. That is right. BP's game is to insure the highest netback possible, and to do that it needs to ensure the lowest capital cost project. BP has a unique motivation to do that and is actually aligned with the state in that regard. It would consider owning pipelines that are basin-opening projects to monetize its resources, and that is the case here.

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He reminded the committee of BP's previous experience in the Arctic and elsewhere and went on to say that, once the pipeline is up and running, ownership becomes a portfolio choice. He referenced the Alliance Project and said that today there is

zero producer ownership in that project. The portfolio choice was to dilute after it got up and running.

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WENDY KING, Director of External Strategies, ANS Gas Development Team, ConocoPhillips Alaska, Inc., said that, as Mr. Massey and Mr. Van Tuyl highlighted, the producers ultimately will pay the cost of this project through those shipping commitments that say to the pipeline, whether or not we ship gas on the pipeline, we will be paying a demand charge. And the way that the FERC will allow us to recover any actual costs in the pipeline tariff ensures that the shippers that sign the FT commitments are going to be carrying the risk of cost overrun. ConocoPhillips also offers skills that we feel can help mitigate the cost overrun risks. It is a shipper-owner in both the Mackenzie Delta and the Rockies Express pipeline projects and has experience on Alaska's North Slope.

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MR. MASSEY said he understands why someone might be suspicious of their desire to own the pipeline, but it isn't driven by Basin Control and he thinks those concerns have been adequately addressed.

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SENATOR WAGONER said he keeps going back to TAPS (Trans Alaska Pipeline System) and what it was supposed to bring in. That doesn't bother him too much because Alaska wasn't an owner or partner in the TAPS line; but now, as 20 percent owner of the gas pipeline, how far does that 20 percent go. The accrual of additional costs to build the pipeline could put the state in a position it didn't intend.

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MR. VAN TUYL said that BP's management is well aware of the TAPS experience also, and learned a lot from it. A key lesson learned is not to become schedule driven. That was one of the things that resulted in the cost overruns on that project. TAPS was also the project that pioneered the EIS process. The joint study that BP completed in 2002 defined the regulatory process associated with this project, to help ensure that it doesn't repeat some of the lessons that occurred then.

MR. VAN TUYL pointed out that although it may seem counter-intuitive, direct state ownership reduces the commercial impact, or commercial exposure to cost overruns, because in a Royalty-in-Value (RIV) world the state is exposed 100 percent to the

cost of the project through time, through the tariff. The state effectively pays that tariff in the netback that is realized by the producers. As a direct owner in the pipeline, the state also recovers that capital cost through the tariff. So the state actually hedges its overrun risk by being a direct owner.

MS. KING added that the state, through the contract, has some payments in lieu of taxes that are independent of commodity and are set up on a throughput basis. The state wanted to maintain those regressive tax features to be there in the event of a lower netback scenario. Payment in lieu of state corporate income taxes is another that is based upon an apportionment of formula, based upon worldwide income, so there are going to be differences in revenue sources to the state of Alaska from this project than there will be to the producers. Also, the state will not be paying federal income tax on the project, as the producers will

SENATOR WAGONER agreed with Mr. Van Tuyl about the problem of being too schedule-driven. He also said that in a workshop that he attended in Anchorage on mega-projects, he was told that one of the things that causes new projects to fail more often than anything else is using new technologies. He thought about that when the producers were talking about using a 52-inch pipe.

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SENATOR WILKEN said that his office has been using information from the FERC website and trying to get an estimate of capacity and expected first gas for all of the projects in various stages of completion around the country. He was specifically trying to deal with the issue of "the window" and all of the "hurry-up" on this project. If the state signed a contract immediately it would be five years to sanction and another five years to build, plus 15 years cap on cost recovery. He asked Ms. King whether, based on the fact that the Canadian pipeline will go before ours, this window would close more quickly than we would like because we have to wait for Canada to finish.

MS. KING replied that she does not work on the Mackenzie Valley project or follow it on a day-to-day basis, but that ConocoPhillips has teams working in Canada and there is some learning they can apply to this project. This is an independent project and she believes the timeline is realistic.

SENATOR WILKEN said we have an estimated timeline of about 5/5/15 years on this pipeline and asked whether the Mackenzie Valley project has a similar timeline.

MS. KING replied she doesn't have that information available now, but there should be a Preliminary Information Packet (PIP) on the Mackenzie Valley project website.

CHAIR SEEKINS said he heard that their anticipated first gas date has changed from 2011 to 2012.

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SENATOR WILKEN said he is concerned that this project is going to be delayed waiting for steel and people while they finish in Canada, and that would move it out to 2020. By that time, all the projects listed on the FERC website could be completed and there might not be a market for the gas.

SENATOR WAGONER said that he was going to keep harping on gas liquids, and while he had three oil representatives at the table, he wanted to ask them if they have any plans at this time for those gas liquids, other than shipping them down the pipeline to market.

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MR. VAN TUYL said that BP does not. In a study completed in 2001-2002 there was the assumption of a NGL Plant, (Natural Gas Liquid Plant) in Alberta, where there is an existing infrastructure for processing those gas liquids, an existing pipeline structure for transporting the liquids, and existing gas storage capacity, all three of which are essential for that sort of activity.

He also said that sort of a processing facility can be located anywhere along the pipeline theoretically, but the liquids leaving the North Slope are too rich to meet the Bruener Tips specifications in the lower 48 market, so at some point along the line they have to be removed. BP has not made any specific plans as far as marketing of its liquids.

The question came up earlier about the capacity of the line or the ability of the line to carry gas liquids beyond the take-off point, and maybe that needs to be designed in early on because, if we take those liquids off in Fairbanks or anywhere in Alaska versus further down stream, the design might be different.

He noted that the current pipeline design is what's called a "dense phase," which means the fluid that is in the pipeline isn't really liquid and it isn't really gas, it's super-critical. That is actually the most efficient way to transport

gas and, as such, the performance of the pipeline downstream of the liquid take-off point is not significantly modified.

SENATOR WAGONER said that he was told in confidence by an individual at the same meeting Chairman Seekins attended, that the Yukon Territories, BC, and Alberta are all battling for the opportunity to process the gas liquids because of the jobs that will create. He said he wants those jobs in Alaska if at all possible, because it needs those long-term, well-paid, technical and engineering jobs so the people of Alaska can come back home after they finish college and go to work.

MR. VAN TUYL responded that the state made that point to the producers during the course of negotiations, and that is why Article 9.5 contains a commitment to complete a study of NGL processing before the open season starts, so people will have a sense for what the business opportunity is and what the cost associated with developing that infrastructure might be.

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SENATOR WAGONER pointed out that by the time that study is completed the contract will already have been signed by the Governor and approved by the legislature, so if there isn't something definitive in the contract other than a study, the state has lost its chance. The expectation in Canada is that the gas liquids are going to go to Canada, and at least a portion of them should be processed in the State of Alaska.

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MS. KING said the NGL business has been very volatile and, over the past five years, it has actually been a cost to the project to extract some of the products such as ethane. The producers have to look at the volatility of that business and see if it is going to be a value add or a cost burden to the project.

She also pointed out that there is a clear statement in Article 24.1F, that says the hydrocarbon liquids delivered to the state at each delivery point must be of the same composition as hydrocarbon liquids delivered to the producers at each delivery point. So whatever volume of liquids are in the stream, the state will have the same proportionate composition as they would have with a 20 percent gas. She then drew the committee's attention to Article 9.5 again, which says "before the commencement of the open season, the mainline entities shall conduct a feasibility study for NGL processing and summarize it in the project summary". The project summary is the public document and is not confidential.

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CHAIR SEEKINS said he knew that there might be other questions that have been raised today, so he would be happy to entertain some of them tomorrow. The intent is to work on the stranded gas amendments tomorrow, but the committee can start the day with some brief comments regarding the discussions of today.

4:43:21 PM Adjourned