

ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE

May 2, 2005

3:39 p.m.

MEMBERS PRESENT

Senator Thomas Wagoner, Chair
Senator Ralph Seekins, Vice Chair
Senator Ben Stevens
Senator Fred Dyson
Senator Bert Stedman
Senator Kim Elton
Senator Gretchen Guess

MEMBERS ABSENT

All members present

COMMITTEE CALENDAR

CS FOR HOUSE BILL NO. 71(FIN) am
"An Act providing standards for the interpretation of certain terms in state oil and gas leases and unit agreements, requiring development, production, processing, and marketing of gas that is determined to meet those standards, and setting a maximum time limit on that activity; extending and amending the requirements applicable to the credit that may be claimed for certain oil and gas exploration expenses incurred in Cook Inlet against oil and gas properties production (severance) taxes, and amending the credit against those taxes for certain exploration expenditures from leases or properties in the state; and providing for an effective date."

HEARD AND HELD

PREVIOUS COMMITTEE ACTION

BILL: HB 71

SHORT TITLE: OIL& GAS EXPLORATION CREDIT & LEASE TERMS

SPONSOR(s): RULES BY REQUEST OF THE GOVERNOR

01/12/05	(H)	READ THE FIRST TIME - REFERRALS
01/12/05	(H)	W&M, O&G, RES, FIN
02/11/05	(H)	W&M AT 8:30 AM CAPITOL 106
02/11/05	(H)	Moved CSHB 71(W&M) Out of Committee
02/11/05	(H)	MINUTE(W&M)
02/14/05	(H)	W&M RPT CS(W&M) NT 3DP 1AM

02/14/05 (H) DP: MOSES, GRUENBERG, WEYHRAUCH;
 02/14/05 (H) AM: WILSON
 02/17/05 (H) O&G AT 5:00 PM CAPITOL 124
 02/17/05 (H) Heard & Held
 02/17/05 (H) MINUTE(O&G)
 03/15/05 (H) O&G AT 5:00 PM CAPITOL 124
 03/15/05 (H) Moved CSHB 71(O&G) Out of Committee
 03/15/05 (H) MINUTE(O&G)
 03/18/05 (H) O&G RPT CS(O&G) NT 1DP 5NR
 03/18/05 (H) DP: KOHRING;
 03/18/05 (H) NR: SAMUELS, GARDNER, KERTTULA,
 DAHLSTROM, ROKEBERG
 04/01/05 (H) RES AT 1:00 PM CAPITOL 124
 04/01/05 (H) Scheduled But Not Heard
 04/04/05 (H) RES AT 1:00 PM CAPITOL 124
 04/04/05 (H) Moved CSHB 71(RES) Out of Committee
 04/04/05 (H) MINUTE(RES)
 04/05/05 (H) RES RPT CS(RES) NT 3DP 5NR
 04/05/05 (H) DP: ELKINS, RAMRAS, SAMUELS;
 04/05/05 (H) NR: OLSON, GATTO, CRAWFORD, SEATON,
 LEDOUX
 04/11/05 (H) FIN AT 1:30 PM HOUSE FINANCE 519
 04/11/05 (H) Heard & Held
 04/11/05 (H) MINUTE(FIN)
 04/14/05 (H) FIN AT 1:30 PM HOUSE FINANCE 519
 04/14/05 (H) Bill Postponed To 4/15
 04/15/05 (H) FIN AT 1:30 PM HOUSE FINANCE 519
 04/15/05 (H) Moved CSHB 71(FIN) Out of Committee
 04/15/05 (H) MINUTE(FIN)
 04/18/05 (H) FIN RPT CS(FIN) NT 5DP 2NR
 04/18/05 (H) DP: HAWKER, CROFT, FOSTER, MEYER,
 CHENAULT;
 04/18/05 (H) NR: WEYHRAUCH, KELLY
 04/27/05 (S) RES AT 3:30 PM BUTROVICH 205
 04/27/05 (S) Scheduled But Not Heard
 04/28/05 (H) TRANSMITTED TO (S)
 04/28/05 (H) VERSION: CSHB 71(FIN) AM
 04/29/05 (S) RES AT 3:30 PM BUTROVICH 205
 04/29/05 (S) <Pending Referral>
 05/01/05 (S) READ THE FIRST TIME - REFERRALS
 05/01/05 (S) RES, FIN
 05/02/05 (S) RES AT 3:30 PM BUTROVICH 205

WITNESS REGISTER

BONNIE ROBSON
 Consultant on Oil and Gas Issues

Legislative Budget and Audit Committee
Alaska State Capitol
Juneau, AK 99801-1182
POSITION STATEMENT: Supported CSHB 71(FIN)am.

TADD OWENS, Executive Director
Alaska Resource Development Council
121 W. Fireweed, Suite 250
Anchorage AK 99503-2035
POSITION STATEMENT: Opposed CSHB 71(FIN)am.

LARRY HOULE
Alaska Support Industry Alliance
360 W. Benson Blvd., Suite 200
Anchorage AK 99503
POSITION STATEMENT: Opposed CSHB 71(FIN)am.

KEN CONRAD, Senior Vice President
BP Alaska
PO Box 196812
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POSITION STATEMENT: Opposed CSHB 71(FIN)am.

PATRICK COUGHLIN, Senior Counsel
BP Alaska
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POSITION STATEMENT: Opposed CSHB 71(FIN)am.

JUDY BRADY, Executive Director
Alaska Oil and Gas Association (AOGA)
121 W. Fireweed Lane, Suite 207
Anchorage AK 99503-2035
POSITION STATEMENT: Opposed CSHB 71(FIN)am.

JOE FERRELL, Counsel
ConocoPhillips Alaska, Inc.
Anchorage AK
POSITION STATEMENT: Opposed CSHB 71(FIN)am.

KEVIN TABLER
Land and Government Affairs Manager
Unocal
Anchorage AK
POSITION STATEMENT: Opposed CSHB 71(FIN)am.

ACTION NARRATIVE

CHAIR THOMAS WAGONER called the Senate Resources Standing Committee meeting to order at [3:39:11 PM](#). Present were Senators Guess, Elton, Dyson and Chair Wagoner. Senators Seekins and Stedman arrived at [3:40:15 PM](#).

CSHB 71(FIN)am-OIL& GAS EXPLORATION CREDIT & LEASE TERMS

CHAIR THOMAS WAGONER announced HB 71 to be up for consideration.

[3:41:26 PM](#)

SENATOR BEN STEVENS joined the committee.

BONNIE ROBSON, Consultant to the Legislative Budget and Audit Committee, read her testimony, which is as follows:

**"Reasonably Profitable" Legislation
HB 71, Sections 1 and 2
Testimony of Bonnie Robson, Consultant to Legislative Budget &
Audit,
Before the Senate Resources Committee
May 2, 2005**

On April 20, counsel for the Administration testified before the Legislative Budget & Audit Committee about a bargain struck when the state leased its lands at Prudhoe Bay and Point Thomson. The bargain, he said, was that the state relinquished 7/8ths of production, retaining only 1/8th to itself as royalty. In exchange, the lessees promised to develop and market the State's oil and gas when reasonably profitable to do so. However, HB 71 does not resolve any dispute the lessees may raise over whether the obligation to develop and market exists, but simply defines reasonably profitable and related terms. The definition only gets used if the obligation does, in fact, exist. Also, if the obligation does, in fact, exist, the proposed legislation sets a time clock for getting Alaska gas to market - seven years from the date of administrative decision -because time is money - substantially more than \$1 billion per year to the State at current gas prices.

This legislation is otherwise modest in its ambitions. It uses average prices and average returns. It does not create a new obligation if one does not already exist. It does not create new remedies for breach of existing obligations. It simply defines an undefined term in both old and new oil and gas leases and unit agreements rather than leaving that definition to other branches of government. It gives the administration guidance on

a tool it already has and can choose to use or not in getting North Slope gas to market. And, if and when the Administration chooses to use that tool, it sets a seven-year clock on getting gas to market. The seven-year clock, when and if used, is intended to assure not just the promise of a pipeline or an option on changes to tax and royalties terms in the event a pipeline is built, but the pipeline itself, at the earliest reasonable date, bringing jobs to Alaskans, affordable energy to Alaskans and Americans, and billions of dollars to the state and its municipalities before declining oil revenues diminish our northern way of life.

For those who wish to explore further some of the legal underpinnings of the lessees' duty to develop and market gas, the next page of these prepared remarks sets forth a sample of the explicit language contained in the state's oil and gas leases, the Prudhoe Bay unit agreement, and the Pt. Thomson unit agreement:

**Is There a Legal Obligation to Develop and Market Gas
When "Reasonably Profitable"?**

- Spencer Hosie testified that there is an obligation implied in oil and gas leases: to develop and market oil and gas when "reasonably profitable."
- The State's oil and gas lease agreements and Prudhoe Bay and Pt. Thomson unit agreements also contain explicit language to the same or similar effect. Examples follow:
- **The Leases state:**
 - The lessee is granted the exclusive right to state lands "for the sole and only purposes of exploration, development, production, processing and marketing oil, gas, and associated substances produced therewith, and of installing pipe lines and structures...to find, produce, save, store, treat, process, transport, take care of and market all such substances"(DL-1, para. 1)
 - "This lease contemplates the reasonable development of said land for oil and gas as the facts may justify."(DL-1, para. 19)
 - "DILIGENCE.... Lessee shall exercise reasonable diligence in...producing...." (DL-1, para. 20)

- **The Prudhoe Bay Unit Agreement states:**

- "To the end that Unitized Substances economically recoverable may be increased.... Working Interest Owners shall with due diligence develop the Unit Area in accordance with good...production practices. Such...production practices shall include a plan of development and operation...designed to efficiently and economically produce Unitized Substances."(Sec. 4.2)
- "Rate of Prospecting, Development and Production. The Director [of the State of Alaska's Division of Lands, i.e. DNR] is hereby vested with authority to alter or modify from time to time the quantity and rate of production . . . limited to alteration or modification in the public interest...."(Sec. 4.3)

- **The Pt. Thomson Unit Agreement states:**

- "PLAN OF FURTHER DEVELOPMENT AND OPERATION.... Any plan...shall be as complete and adequate as the Director may determine to be necessary for timely development . . . of the oil and gas resources of the unitized area...."(Para. 10)
- "Rate of Prospecting, Development and Production. The Director is hereby vested with authority to alter or modify from time to time the quantity and rate of production . . . limited to alteration or modification in the public interest" (Para. 21)

- **But this legislation does not attempt to resolve any dispute over whether the obligation to develop and market gas exists when it is reasonably profitable to do so.** This legislation simply interprets reasonably profitable and related terms where the obligation is found to exist.

Again, this legislation does not attempt to resolve any dispute over whether the obligation to develop and market gas exists when it is reasonably profitable to do so. This legislation simply interprets "reasonably profitable" and related terms where the obligation is found to exist. It allows the legislature to voice its opinion on a level of profit above which the legislature expects the oil and gas lessees who have signed a contract giving them the exclusive right to develop and market gas from state lands are expected to do just that -

develop and market the gas, even if they would prefer to defer their investment in Alaska until a later day.

How does the legislation interpret "reasonably profitable?" The short answer is a minimum of a 14 percent return on capital for production and processing operations, and the FERC-regulated rate for pipeline operations. But let us also discuss the long answer. The legislation does not use the figure "14 percent." Instead, it allows the administration to select a sample group of oil and gas companies and use a simple average of the sample group's most recent ten-year average return on capital employed. The administration has the discretion in selecting an appropriate sample group for the project under consideration, but for purposes of discussion today, we assume that the administration chooses to use a group consisting of the four largest international petroleum companies and the three largest Alaskan oil and gas companies. For this sample group, the most recent ten-year simple average of returns on capital employed is 14 percent, as the following exhibit shows:

[3:45:45 PM](#)

[Insert Excel Spreadsheet on ExxonMobil, Royal Dutch Shell, BP, Chevron Texaco, ConocoPhillips. The returns on capital employed for each of these companies from 1995 to 2004 appear by year and are averaged over 10 years individually by company and averaged again across companies. The average return on capital employed is 14 percent.]

But what does a 14 percent return on capital mean? It does not mean 14 percent return on shareholders' equity unless the North Slope producers choose to finance their operations with 100 percent equity – the most expensive form of capital. It means some rate higher than 14 percent and possibly as high as 46 percent (even higher), in light of the federal loan guarantee available on up to 80 percent of the debt used to finance not only a gas pipeline, but also North Slope production operations and a new gas treatment plant to be built at Prudhoe Bay. We turn to another graphic to demonstrate what a 14 percent return on capital may mean for an Alaska natural gas pipeline project:

How Are Investments Made?

$$\begin{array}{rcl} & X\% & \text{Debt (cheap)} \\ + & Y\% & \text{Equity (expensive)} \\ \hline & = & 100\% \text{ Capital} \end{array}$$

If Capital Earns 14%, How Much Does Equity Earn?

Debt Is Repaid At Cost

	0% Debt	
+	<u>100% Equity</u>	
=	14%	Return on Equity
	50% Debt at 6%	
+	<u>50% Equity</u>	
=	22%	Return on Equity
	80% Debt at 6%	
+	<u>20% Equity</u>	
	=	46% Return on Equity

We are accustomed to hearing that an Alaska natural gas pipeline project is a high-risk project, entitled to a high rate of return, but some may argue that the rate of return allowed under this legislation is too rich. Why? First, the federal government has significantly reduced the risks and costs of the project. The federal government will provide loan guarantees for the project, allow accelerated depreciation of the pipeline over seven years rather than fifteen years, and extend tax credits for the new gas treatment plant to be built at Prudhoe Bay.

Second, the majority of gas filling this pipeline will come from the proven reserves at Prudhoe Bay. Prudhoe gas has been explored for (and found), developed, and is being produced at the rate of 8 billion cubic feet per day (bcf) though that gas is now being reinjected into the ground. Production at Prudhoe Bay should not be considered high-risk when compared to many of the risks voluntarily undertaken by large oil and gas companies. Yet the reward – the return – included in this legislation is based on average returns earned by companies that among other things invest in exploration or wildcat operations – and sometimes lose it all, not just the return on capital, but the capital itself.

In fairness, it must be said that the rate of return allowed under this legislation may encompass not only the high exploration risk faced by vertically-integrated oil and gas companies, but the relatively low returns those same companies earn on certain downstream operations. Still, we think it

strikes the right balance, and, in fact, will be viewed as too generous by some when they recognize that the Administration may be limited in its ability to enforce the lessees' duty to develop and market gas where the return on equity is less than 46 percent.

For those who see the returns discussed today as not generous enough, remember that the administration will have discretion in selecting the sample group of oil and gas companies whose returns are included in the simple average of returns and it may choose to use only upstream companies, or only production companies, or any other grouping of companies – as long as the companies are oil and gas companies – in getting to a fair and equitable result under the particular facts then at hand.

3:51:05 PM

Some will also argue that the uncertainty as to future gas prices imposes a level of risk not adequately compensated for by the returns built into this legislation. Their argument may have been well founded in prior times. In prior times, abundant supply and slack demand made for modest commodity prices. In prior times – in fact, in 1998 when the Stranded Gas Development Act first became law, the only project then envisioned was a LNG project, without a possible Jones Act exemption, and without possible benefits of tax exempt status. In prior times, there was no federal loan guarantee for the project, accelerated depreciation for the pipeline, or tax credits for a new gas treatment plant at Prudhoe Bay.

But let us look at the current risk that future commodity prices will not cover the estimated costs for an Alaska natural gas pipeline project including a regulated rate of return on regulated assets and an adequate return at the wellhead for the lessees' gas. We could examine this risk using the administration's economic model developed under the Stranded Gas Act. That model has been built at significant expense with the assistance of outside expertise. It is tailor-made for an Alaska natural gas pipeline project and accounts for the volumes of gas at issue here, the market impacts of introducing Alaskan gas, the estimated costs of the project, the effect of future supply and demand on commodity prices, and the time value of money, among other things. Unfortunately, the administration's model is confidential at this time and neither its inputs nor outputs can be disclosed in this hearing. However, publicly available data can provide a rough sense of whether the range of uncertainty surrounding future gas prices makes the minimum rate of return included in this legislation inadequate.

First, let's look at publicly available forecasts of future gas prices. We mention here two sets of forecasts, one by government, one by industry. The government forecasts come from the federal Energy Information Administration, or EIA. The industry forecasts come from the American Gas Foundation. There are limitations on comparing these forecasts to the costs we will discuss in a moment – imperfect matches on the time value of money and the location of gas sales, among others – but the comparison will allow you to get a rough sense of the difference between projected revenues and projected costs on average over time. A single page from the American Gas Foundation forecast is included here, and additional materials from both the EIA and American Gas Foundation are included at the end of these prepared remarks:

[3:53:41 PM](#)

[Insert AGF graph of actual and projected natural gas prices]

As you can see, gas prices are expected to exceed \$4.50/mmbtu under any scenario.

Next, we turn to data the three largest North Slope lessees released on costs, which include – if memory serves correctly, a 12 percent return on equity invested in the pipeline itself. After these North Slope lessees spent \$125 million studying a gas pipeline project, their best estimate was that the average toll covering a new gas treatment plant at Prudhoe Bay, new pipe not only to Alberta, but all the way to Chicago, and extraction facilities for the removal of valuable gas liquids would total \$2.39/mcf. With the +/- 20 percent uncertainty modeled by these lessees, \$2.39/mcf became a range of \$1.90 - \$2.85/mcf, as shown in the attached exhibit:

[Insert exhibit on estimated costs]

In looking at this exhibit, bear in mind that \$1.90 - \$2.85/mcf is not the same as \$1.90 - \$2.85/mmbtu, and mmbtu's are how gas is sold. Prudhoe Bay and Pt. Thomson gas is rich in liquids, and contains more than 1,000 btus per cubic foot. We do not know exactly how much more. That information is not public, but at 1,070 btus/cf, the range for tolls drops to \$1.78 - \$2.66/mmbtu. At 1,120 btus/cf, the range for tolls drops to \$1.70 - \$2.54/mmbtu. And, to repeat, that range covers a +/- 20 percent uncertainty and already includes profit on the lion's share of project costs.

Is \$1.70 - \$2.54/mmbtu or \$1.78 - \$2.66/mmbtu or \$1.90 - \$2.85/mcf the right range for project costs? We cannot tell you in total, in public. But we can tell you that those calculations were made by the lessees before tax credits for the gas treatment plant, federal loan guarantees, and accelerated depreciation on the pipeline became available, and the range should drop on that account. The calculations also assume new pipe would be built all the way to Chicago. Yet more probably, Alaska gas will travel from Alberta to the Lower 48 in existing pipelines and expansions of existing pipelines, a cheaper alternative.

In fairness, we mention that these cost-savings undoubtedly are offset to some degree by increased steel prices. But remember the cost range given for tolls already includes a return - or profit - for the pipeline, facilities for the extraction of NGLs, and the new gas treatment plant at Prudhoe Bay. You may want to ask one of the lessees here today, but my recollection is that their figures included repayment of debt at cost - and that would be a higher cost than available with the federal loan guarantees - and a return on equity for regulated assets at 12 percent per year.

So what is the bottom line? Prices are expected to average in excess of \$4.50/mmbtu on costs of less than \$3.00/mmbtu. And the difference between prices and costs is indicative of wellhead value. Again, we caution you this is very rough math. The real math we must keep confidential, but we are not here to mislead you today.

One criticism that has been levied at the proposed legislation is that it is based on forecasts and estimates and that is true; we cannot know the future in advance of the future. The legislation is similar in this regard to the analysis contemplated under the Stranded Gas Development Act, AS 43.82, and the analysis performed by the Department of Natural Resources when examining applications for royalty reduction under AS 38.05.180(j). Oil and gas companies also base their business decisions on commodity price forecasts and cost estimates for future projects. Forecasts and estimates are the way business is done by both industry and government.

A second and related criticism is that the state rather than the lessees forecasts prices and estimates costs under the proposed legislation. However, the lessees have repeatedly indicated in other contexts that they will not share their price forecasts with the state or with each other and they will not share their

gasline economic models either. They have shared cost information from their \$125 million study and that information is reflected in the administration's gasline economic model.

This legislation allows the administration, if it so chooses, to recognize lessees' reticence to share certain information, not force that issue, but still enforce the lessees' obligation to develop and market gas when reasonably profitable. Additionally, the Administration is already the arbiter of when the Prudhoe Bay and Pt. Thomson lessees must produce gas. Both the Prudhoe Bay and Pt. Thomson unit agreements state that the director of the Division of Lands - that is the Department of Natural Resources, "is vested with authority to alter or modify from time to time the quantity and rate of production...limited to alteration or modification in the public interest...."

3:59:39 PM

Otherwise stated, DNR is the decision-maker now and remains the decision-maker under this legislation (subject, of course, to reversal by the court system for abuse of discretion). The lessees may not appreciate that DNR rather than the lessees or the court system is vested with primary responsibility for decision-making on this issue, but they granted DNR that authority decades ago when they signed the unit agreements. This legislation does nothing to alter the original bargain over the party vested with control.

Speaking of the court system, some argue that the proposed legislation promotes litigation. It does not. Understanding exactly how this legislation works should ease concerns. First, it lets the administration determine whether it thinks there is, in fact, a preexisting duty under the State's oil and gas leases and unit agreements for the lessees to develop and market gas when reasonably profitable. If the administration concludes such a duty exists, it can choose to enforce that duty or not now or later. If, say, negotiations under the Stranded Gas Development Act reach an impasse, the administration may choose to enforce the duty, subject, of course, to finding that production and marketing of the lessees' gas would return at least a reasonable profit to the lessees. The administration, because of the Stranded Gas Act negotiations, is already sitting on a large body of information from which it could draw conclusions about whether a gas pipeline project would be "reasonably profitable." However, before drawing conclusions, it is apt to wait until the next annual deadline for the lessees' submission of their proposed plan of development for the Prudhoe Bay unit. Same thing for the Pt. Thomson unit.

However, I'll continue with the Prudhoe Bay unit as my example. So, to repeat, before drawing conclusions, DNR is apt to wait until the next annual deadline for the lessees' submission of their proposed plan of development for the Prudhoe Bay unit. Or maybe DNR would immediately send a letter to the Prudhoe Bay lessees, advising them that when their next proposed plan of development is up for review, DNR intends to make a determination on whether development and marketing of Prudhoe Bay gas would be reasonably profitable. In either case, when the lessees submit their next annual proposed plan of development, that proposed plan together with supporting documentation and other information within the possession of DNR or requested from the lessees by DNR would be reviewed, analyzed, and evaluated. Assuming the lessees' proposed plan of development did not commit to produce and market gas within seven years, DNR's decision on the proposed plan would most likely condition approval of the proposed plan on a firm commitment to develop and market the gas in specified minimum quantities by a certain date. The lessees could accept DNR's conditions and proceed to develop and market their gas or they could reject the conditions. If the lessees rejected DNR's conditions, their current plan of development would expire putting the unit in default for operating without an approved plan. At this stage, litigation is likely, but no more likely because reasonably profitable has been defined as a minimum of a 14 percent return on capital than because some other standard was used by DNR in determining what constitutes a reasonable profit.

[4:03:17 PM](#)

If there is litigation, the lessees have suggested that they may claim that the legislation is unconstitutional when applied to Prudhoe Bay and Pt. Thomson because it changes preexisting contract terms. Again, we think the legislation does not change preexisting contract terms and will be constitutional as applied. As previously mentioned, the legislation simply defines in a reasonable way terms that are currently undefined. It provides guidance to DNR on what reasonably profitable means.

But I will not, as I sit here today, guarantee you that the Alaska Supreme Court will find this legislation constitutional. Still, we believe that the legislation can be applied in a constitutional manner, and in any case, it is a vehicle for sharing with the administration the Legislature's thoughts on what constitutes reasonably profitable and the time frame within which a gas pipeline should be built.

On a related note, the legislation's definition of reasonably profitable is intended to rise and fall independently of the seven-year clock contained in the legislation. Thus, on the chance a court strikes down the definition of "reasonably profitable" provided in this legislation and instead uses some other definition that is nonetheless met by the facts of the case, the seven year clock still runs from the date of DNR's initial determination. Hence, lessees are encouraged to spend their time after issuance of DNR's determination working on a gas pipeline project rather than litigating, particularly if those lessees estimate project profits that would meet any court-imposed standard of "reasonably profitable."

Before closing, the seven-year clock should be discussed in a little more detail. Seven years is the period two of the three gasline project proponents tell us they need to bring North Slope gas to market. A longer time period could be included in this legislation to encompass the preferences of the third project proponent. However, time is money - a lot of money. Every year's delay costs the State and its municipalities hundreds of millions of dollars per dollar of wellhead value. At current gas prices, the cost of each year's delay will exceed \$1 billion and could exceed \$2 billion.

What happens then, if the lessees use their best efforts to develop and market the gas in seven years, but for some reason all of us can sympathize with, it takes them eight or nine years? First, the state and municipalities are out the hundreds of millions or billions of dollars regardless of good intent and unforeseeable circumstances. Second, the state can choose not to pursue remedies that might otherwise be available. Third, the lessees are sure to argue force majeure or "Acts of God," a term that is already defined under existing agreements and in the unit regulations.

In summary, this legislation does not create a new obligation if one does not already exist. It does not create new remedies for breach of existing obligations. It simply defines undefined terms in both old and new oil and gas leases and unit agreements, rather than leaving those definitions to other branches of government. It gives the administration guidance on a tool it already has and can choose to use or not in getting North Slope gas to market. And if and when the Administration chooses to use that tool, it sets a seven-year clock on getting gas to market. We believe the legislation is reasonable and appropriate for the current circumstances.

[4:06:58 PM](#)

CHAIR WAGONER asked if HB 71 changes the commissioner's duties.

MS. ROBSON replied no. The commissioner already has the authority to modify or alter from time to time the rate of production from both the Prudhoe Bay and unit agreement. He can do that through annual plans of development submitted for the two units. He would now have a standard for "reasonable profitability" to follow.

[4:08:21 PM](#)

SENATOR GUESS asked how she decided the best approach to use was a 10-year simple average.

MS. ROBSON replied that she has been working with Econ One Research, Inc. on a number of gas pipeline matters and the decision was that a period of time should be used to reflect the highs and lows that oil and gas companies experience to get a representation of the returns on capital that they would typically earn. Also, she looked at the definition of stranded gas at the very end of the Stranded Gas Act and it refers to using prevailing costs and prices. It is an average over a long enough period of time to accurately reflect typical returns on capital for the largest and most profitable oil and gas companies in the world.

[4:09:49 PM](#)

SENATOR GUESS said the way page 4 is written, if you don't have a large enough sample size, your average could be skewed. She asked Ms. Robson if she had a reason for using a minimum number of companies.

MS. ROBSON replied that the commissioner of DNR was vested with the discretion to come up with a methodology he felt best reflects the appropriate measure for profitability at any time.

[4:10:51 PM](#)

SENATOR GUESS asked her to explain the thought process behind overall companies' return on capital versus specific return on gas capital.

MS. ROBSON replied she looked for a standard that could be ascertained from publicly available information. Many vertically integrated oil and gas companies do not have that kind of breakdown and that information is not necessarily publicly available.

[4:12:03 PM](#)

SENATOR ELTON said Spencer Hosie talked about access the state has to risk/reward scenarios that are held by the producers and asked what information she is able to get from producers.

MS. ROBSON replied that there may be a difference between what you can obtain legally and practically. The lease agreements have existing language that entitles the state to obtain information. It's well recognized that the lessees do not want to provide that information and at various times, different administrations have been reticent to ask for it. So, this legislation allows the administration to proceed without information and an incentive is created for the lessees to share certain information with the administration if it feels its internal documents will paint a different picture.

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SENATOR ELTON said it still sounds like she is saying producers can share their information as long as it supports their case, but they may not be required to share if it would not be beneficial to their interests.

[4:13:55 PM](#)

MS. ROBSON replied that she wanted to distinguish the legal obligation, which authority she believes the administration has, to assert, because she has been involved in enough royalty litigation to know that it is not always easy to get information from oil and gas companies.

[4:14:52 PM](#)

SENATOR DYSON asked what remedy investors have if the state forced them into a deal and it "went south."

[4:15:53 PM](#)

MS. ROBSON replied there is a recognition that a party other than the lessees must make the decision about the duty to develop and market, because otherwise the obligation could not be enforced and effectively does not exist. Potential parties that could be the decision-maker are the administration, judiciary and the legislature. However, she believes DNR is already the one.

[4:17:02 PM](#)

SENATOR DYSON asked what the current definition of "reasonably profitable" is without this bill.

MS. ROBSON replied that that would be left to DNR to determine on a case-by-case basis. Lessees have to annually submit proposed plans for development and if DNR chose to press the issue of a failure to include development and marketing of the gas within a reasonable timeframe, it could evaluate whether production and marketing would be reasonable profitable. It would then look for an appropriate standard in the circumstances. Since that process has not been gone through, she could not tell them what standard would be used. She suggested that the DNR or the Department of Law perform that analysis and independently see what they think is the appropriate standard to exercise in trying to enforce a duty to develop and market. If the Legislature passes this bill, it has guidelines and lets the administration know that it is interested in seeing the duty enforced and what it thinks is a reasonable rate of return. She also suggested that the administration look at a number of different standards and write an opinion that covers all those standards.

[4:20:10 PM](#)

CHAIR WAGONER said a lot of people have been talking about a reserves tax to force development and asked what affect this legislation would have on the option of levying a reserves tax.

MS. ROBSON replied that this wouldn't impact continuing efforts either by the legislature or by voter initiative to go forward with a gas reserves tax. Typically a gas reserves tax is thought of as a property tax and typically property can only be taxed if it has value.

If gas is valueless on the North Slope, then the property tax on something that is valueless might be zero. This might be used as an indicator of whether or not there is, in fact, value to the North Slope gas reserve, but, again, it does not directly relate to and has not been intended to either advance or thwart any effort for those parties interested in progressing a reserves tax to go forward with their efforts.

[4:21:28 PM](#)

SENATOR STEDMAN asked why the return on capital was selected versus some other measure.

MS. ROBSON replied that oil and gas lessees have told her frequently that they examine and compare potential projects for investment based on a return on capital or an assumption of 100 percent equity.

It is not how they actually invest and make money. They will typically use at least some percentage debt and so their return on equity rises above the return on capital used in making decisions on investment. So, this was done in recognition of some of the practices employed by oil and gas companies in making investment decisions.

However, in that regard I need to note that if companies do, in fact, choose to compare projects or potential projects based on the assumption of 100 percent equity, that assumption may or may not have been appropriate as of September 2004. But by November of 2004 the United States government had passed legislation providing up to an 80 percent loan guarantee to the tune of \$18 billion to make this project possible. And with 80 percent debt available for this project, one has to ask whether it is appropriate for a decision to be made on whether to go forward with this project on the assumption of 100 percent equity when that's the most expensive form of capital.

[4:24:11 PM](#)

SENATOR STEDMAN asked if her chart on capital returns for each company was for the entire company or just the gas division.

MS. ROBSON replied that they are company-wide overall returns.

[4:24:46 PM](#)

SENATOR STEDMAN asked if the ACRS is factored in with the department's analysis along with the lower interest rate assumption on debt for each of the companies.

MS. ROBSON replied that the numbers she used are publicly reported return on capital employed. "There was no effort to go in and manipulate these numbers. I believe they are as published in 'Value Line.'"

SENATOR STEDMAN asked if she just used the average tax rates for comparison.

MS. ROBSON replied that the economic modeling would be used to determine the rates of profitability for specific projects to compare them to the simple average of companies' return on capital employed.

If I understand that correctly, at least with regard to the modeling that has been done now by the administration for a gas pipeline, I believe there has been extensive efforts to make sure that tax burdens and tax benefits are accurately reflected in that modeling.

CHAIR WAGONER thanked Ms. Robson for her comments and announced that he would take public comments next.

4:26:45 PM

TADD OWENS, Executive Director, Alaska Resources Development Council (RDC), said he has serious concerns with CSHB 71(FIN)am, which was radically altered on the House floor last week. New language requiring standards for interpreting existing state oil and gas leases and unit agreements signifies to him that a major policy decision was made on House floor after 10 minutes of debate and with no committee hearing. Neither the public nor the directly impacted stakeholders were given an opportunity to comment. RDC fears that the decisions may change the terms of existing state oil and gas leases and unit agreements.

If one concedes that this argument is even a debatable point, then one must also concede the bill is likely to have a detrimental effect on the state's ongoing negotiations with those parties that have filed applications under the Stranded Gas Development Act.

If a lessee questions the constitutionality of the bill or disagrees with the state's interpretation of "reasonable profitability" or other terms, litigation could follow and that does not bring Alaska closer to commercializing its natural gas resources.

MR. OWENS said this bill is inconsistent with the state's goal of identifying and encouraging the best possible gas commercialization project and in the end may create uncertainty rather than establishing certainty.

4:30:01 PM

LARRY HOULE, Alaska Support Industry Alliance, said the Alliance supported the bill until it was amended on the House floor and stressed that it must be entirely removed.

Most apparent is that the language is totally inconsistent with and contrary to free market principles. He asked the committee

to examine whether it is the proper role of government to dictate to any industry when a market exists and what a reasonable rate of return should be. No other state government exercises that latitude and this would set precedent.

MR. HOULE said:

You need to know that the construction community represented by the Alliance membership is extremely concerned with this increasing amount of adverse legislation that appears to be coming through administrative orders and out of Juneau these days. We are concerned because we continue to see every effort to single out the State of Alaska's largest industry, an industry that employs the bulk of our membership. Even today several Alliance contractors are experiencing incredible slow-downs specifically in the area of engineering - all due to the Governor's aggregation of the Prudhoe Bay satellites. This type of legislation before us in HB 71 is nothing more than an add-on.

[4:34:41 PM](#)

KEN CONRAD, Senior Vice President, BP Alaska, strongly opposed Amendment 1 to HB 71, but liked the rest of the bill and would support it if the amendment were to be deleted. He related that the amendment was passed without prior discussion or committee work and sets an ugly precedent for gas and oil development in Alaska - and for business in general. It seeks to alter existing contracts entered between the state and leaseholders and would make the DNR the all-powerful decision-maker regarding project development, determining what level of profitability is acceptable regardless of the risks involved.

It suggests that government and government alone should be able to force investors into a multi-billion dollar project that is by all accounts a project with significant risk. Of course, the amendment does not suggest compensating investors when the government's assumptions in its all-knowing economic model are wrong. The amendment hands the critical roles of investment evaluation and field regulation directly to the commissioner of the Department of Natural Resources in an entirely one-sided process....

The HB 71 amendment violates basic state and federal constitutional prohibitions against legislative

impairment of contracts. This is a fundamental principle intended to insure the sanctity of contracts and is a cornerstone of the U.S. economic system....

The amendment seeks to strip away the lessee's ability to evaluate and act on investment decisions. Changing the rights and obligations of the lessees years after the contract was entered fails this most basic constitutional premise. This legislative effort to alter contracts after the fact sends a chilling signal to industry at the very point in time when we're looking for clarity and durability through a fiscal contract for gas development.

The amendment also violates fundamental government separation of power principles by infringing on the role of courts in adjudicating contracts. We would suggest the chairman request a balanced and thoughtful legal evaluation of this bill from the Department of Law.

Given the clear constitutional issues raised, it is safe to assume that any effort to actually invoke the amendment to challenge existing lease contracts would spark a marathon of litigation. As a matter of fact, some have suggested this bill be renamed "The Lifetime Employment For Lawyers Act...."

MR. KONRAD explained that there would be constitutional challenges through state courts, then more litigation as similar issues are addressed through a variety of federal courts. "And while the lawyers are doing fine, the gas project, itself, languishes."

[4:41:33 PM](#)

He said the amendment is in stark contrast to the sound and thoughtful approach that was previously developed by the Legislature and supported by industry under which in January 2004, BP, ConocoPhillips and ExxonMobil submitted the first Stranded Gas Act application received by the state.

Just two months after the U.S. Congress passed the gas pipeline legislation, BP, ConocoPhillips and ExxonMobil submitted a detailed and comprehensive proposal to the state that would allow a gas project to advance to the next phase of activity. The proposal embraced the Governor's desire for direct state

participation in the project. The opportunity for gas commercialization is at our doorstep. Detailed discussions with the state are, of course, ongoing. It should be clear that we are doing exactly what that legislation intended - exactly. Negotiating towards a clear and durable fiscal contract that enhances the prospects for a commercially viable Alaska gas pipeline project....

In the short period of time since this amendment crawled out of the shadows on April 28, we've had an opportunity to discuss with many legislators what this amendment actually means. It has become very clear that few members in the House appreciated the full meaning or the wide-ranging consequences of the amendment when the vote was held. This is not entirely surprising given that there was no prior debate, no prior discussion, no prior committee work in advance of the very sudden House floor vote....

Mr. Chairman, members of the committee, the amendment to HB 71 is an unworkable, unhelpful, unconstitutional approach that will at best set the stage for years of litigation. It creates an immensely dangerous precedent that has implications for all leases, all contracts, including the gas pipeline contract currently under negotiation. For all of Alaska industry, the bill casts serious doubt on the sanctity of any contract at any time. I urge this committee to strip this amendment from the otherwise sound bill....

[4:46:27 PM](#)

SENATOR ELTON thanked him for his testimony and remarked that as a former newspaper editor, a couple of things bothered him about his language - "Are we still in America? Ugly amendment - cavalier, shortsighted, an amendment that crawled out of the shadows."

He referred to the last paragraph on page 1 of Mr. Konrad's testimony and suggested the following rewrite:

It would make the resource owner a partner and decision-maker regarding project development by allowing the resource owner to help determine what level of profitability is acceptable given the risks involved.

SENATOR ELTON asked Mr. Konrad if he would agree with that.

MR. KONRAD replied that he didn't agree with the rewrite. He wanted to go back to the terms of the existing contracts.

[4:49:00 PM](#)

SENATOR ELTON said when he reads the leases, he interprets them to give the state certain rights as a resource owner and asked how he thought the bill contravened that.

[4:49:37 PM](#)

MR. KONRAD clarified:

We have a contract. We have mutually agreed over 25 to 30 years that those contracts are being met and we're saying let's not change the contract. The commissioner of Natural Resources currently has the ability to make his own judgments around that. The courts will adjudicate whose opinions around the contract may be right or wrong, but to date there has been no conflict. If there ever is a conflict, we would see it as the role of the judiciary to settle that dispute, not the role of the Legislature to presuppose that a dispute is actually going to occur or to create the probability for a dispute.

[4:50:40 PM](#)

SENATOR ELTON observed that he and Mr. Konrad might fundamentally disagree:

But it seems clear that there are obligations that the leaseholder has that the state may not have exercised as a resource owner in the past. But, I'm not sure that you help your argument by using some of the terms that you did in the course of your presentation. Because they were very loaded words; they didn't speak to the language in the leases and it just seems to me that the loaded words may have been designed to not talk about policy, but to stigmatize lease language that you didn't....

MR. KONRAD clarified that the language in the leases is fine.

I'm not suggesting in any way shape or form to change that. What we're proposing is that this is a backdoor way to try to change that at the very time we're contemplating a 35-year contract for the development

of gas to suggest that some subsequent legislature in 5 years, 10 years, 20 years, 30 years can come in and seek to reinterpret that contract is problematic from an investor's point of view. The entirety of what we're trying to seek here is clarity and durability and predictability.

[4:52:03 PM](#)

SENATOR GUESS asked him to expand on how the amendment changes the contract.

[4:52:48 PM](#)

MR. KONRAD replied that it doesn't literally change it; that's not allowed, but it is an indirect effort to tell DNR to push a button on a model to say whether the project should go forward or not and that's not in the contract today. The contract today represents balanced and reasonable judgment.

[4:53:48 PM](#)

SENATOR SEEKINS said they were now talking about contracts that were negotiated some time ago when he wasn't around and he is assuming that they were negotiated by both parties and this was not a take it or leave it contract. He asked if the terms of the lease negotiated openly between both parties.

MR. KONRAD replied that he wasn't here then either, but he believed the terms were set out and industry fit around them.

[4:54:31 PM](#)

PATRICK COUGHLIN, Senior Counsel, BP Alaska, responded that that precise question was considered by Judge Carpeneti in one of his decisions regarding the meaning of this lease. Here's what his decision said:

At the outset it should be noted that in the typical oil and gas lease, the lessee dictates the terms. This case is different from the typical case as was in the case of Davis Oil. The lease form is "take it or leave it" for oil companies who do business with the State of Alaska. Moreover, the contract is an elaborate one, which undertakes to define the respective rights and duties of the parties where contracting parties are sophisticated, represented by highly competent counsel and have demonstrated that they are capable of dealing in the written word. A court should be hesitant to go outside the written contract in search of an implied relationship. Given its authority under the lease, the

state was hardly at the mercy of its lessee as is sometimes the case.

[4:56:12 PM](#)

SENATOR SEEKINS summarized that the lease agreements were drafted by the state on a "take it or leave it" basis and the producers did not have an opportunity to define the terms.

MR. COUGHLIN replied that was right.

SENATOR SEEKINS said if any clarification of terms is necessary it wasn't because the producers, themselves, had an opportunity to define or redefine them.

MR. COUGHLIN replied that is correct.

SENATOR SEEKINS asked if the effect of this amendment is to provide a definition to a term that has already been contained in an adhesion contract.

MR. COUGHLIN replied:

It's my view that the words are in this contract and the state drafted them. The state wasn't some poor, innocent little farmer in Kansas that was taken advantage of by an oil company. The term is in the contract and the proper place to determine the meaning, if there is a dispute about this provision is in the court system. It's not for the Legislature to decide 25 or 30 years after the fact...

SENATOR SEEKINS interrupted to say that he understands that, but wanted to know if there was a definition section in the contract.

MR. COUGHLIN replied yes.

SENATOR SEEKINS asked if this definition was provided.

MR. COUGHLIN replied that it wasn't.

[4:58:33 PM](#)

SENATOR STEDMAN said he was still struggling with tying return on capital into a rate that would stimulate or motivate a global company who is subject to currency exchanges and different governmental requirements.

MR. KONRAD replied that return is a function of risk. The rewards go up for riskier projects. It's not a simple average as was proposed.

At the end of the day, people need to make judgments around the risks and rewards of this particular project and hopefully that balance will be right and, I think, we've tried to send a message as clearly as possible. We think we're on the doorstep of actually doing this. We're working very hard to bring it to reality. And if we can get that balance right, we're in the business of producing oil and gas....

[5:01:36 PM](#)

SENATOR STEDMAN asked if his company operates anywhere in the world that has something implemented like this proposal - where the government can come in and do a calculation and tell it to develop or not to develop.

MR. KONRAD replied that it is unprecedented in the United States. Globally, he is not personally aware of any that would attempt to boil it down to this simple equation. He offered to get back to him with an example if he could find one.

SENATOR ELTON said that it sounds like he is suggesting that the risk/reward analysis be done by the people who hold the lease despite the fact that the leases say:

The lessee is granted the exclusive right to state lands for the sole and only purposes of exploration, development, production, processing and marketing of oil, gas and associated substances produced therewith and of installing pipelines and structures to find, produce, save, store, treat, process, transport, take care of and market all such substances.

He asked why the risk/reward analysis stays just with the resource holder and why the owner of the resource doesn't have a role in making those determinations.

MR. KONRAD replied that the owner does have a role - he has the power to challenge the lessee, but that hasn't been done to date.

People act like we don't want to do this project. Yet, we're actually busting a gut to make it happen and we feel like we're on the doorstep of actually making it

happen with a concrete proposal. People are frustrated that 30 years ago a project didn't go ahead. The reason it didn't go ahead was because it cost \$4 to \$5 to get gas to market and gas was selling for \$2....

It didn't make people happy necessarily that it didn't go ahead, but that was the reality. As for when the risk/reward picture comes into balance, we're going to want to do it. If the Department of Natural Resources ever feels that we're not doing that, the contracts are there and they actually have more freedom to raise an issue if they feel so inclined.

SENATOR ELTON countered:

You can respond to this or not, but it just seems to me that section 1 and section 2 of this bill gives the owner of the resource the right to participate in the risk/reward analysis and that right seems to be implicit in the leases that you hold.

MR. KONRAD replied it looks like a simplistic push the button, get the answer out of a model as opposed to using good judgment.

[5:05:30 PM](#)

CHAIR WAGONER asked if the commissioner doesn't have the right already to define what is "reasonably profitable" and this just puts it in statute.

MR. COUGHLIN replied once the state enters into a private contract, if there is a dispute about what a term means, both sides go to court to present what they think it means. This bill fundamentally says the commissioner gets to decide what the standard is and to decide whether or not the producers have to build the pipeline. It fundamentally changes the balance in the leases.

[5:08:02 PM](#)

SENATOR SEEKINS said he thinks the state should enforce existing agreements.

If it has powers within an agreement to enforce it, it should do so with the full power of that agreement. However, if I'm asked whether or not I would support giving even greater power or authority to the administrative branch, which is already the most powerful administrative branch in terms of its balance

of power of any state in the nation, I would be compelled to say I'm not willing to do that.

It basically comes down to me that I have a fundamental objection, Mr. Chairman, to a party who has presented a 'take it or leave it' contract to after execution of that contract attempting to define terms within the contract especially when there's already a definition section within that contract. The entire advantage here, legal advantage, was with the state when they authored the lease and they presented it on a 'take it or leave it' basis to the oil companies. In that case, fundamentally, I would wanted to be treated as a contractor, and I believe we should be treated as a party to a contract, any terms that need to be defined relating to the performance of the lessee would properly be defined in court, not by subsequent legislation....

5:10:10 PM

SENATOR STEDMAN said the amendment might be creating motivational leverage, but it seems odd that a relationship has been built up and over 30 or 40 years and the producers are already interested. The timing seems odd.

JUDY BRADY, Executive Director, Alaska Oil and Gas Association (AOGA), agreed that there are a couple of things that are odd about the amendment. This is the biggest pipeline in the world and the state is in the middle of negotiations now.

I can't tell you how very clear it is that when anything you say, anything the Governor says, anything the Legislature says is carried in every big financial insider reporter in the world. People are interested in this pipeline, because if this pipeline goes, other things are not going to go. If this pipeline goes, pipe from Japan or Korea is going to be a huge deal. This has international interest. When an amendment comes on with this kind of affect and it comes on the way it did - from friends, from people I consider bright people - so I know they were trying to do the right thing - comes on the way it did with no hearings and people still have a lot of questions. People don't know how the system works now. A lot of the questions are how does this system work now under the terms of these leases....

She related that if Governor Hickel could have done something like this, he would have done it at the time the leases were negotiated.

There have been four serious attempts to do a gas pipeline. Every time the people who wanted it done believed it was economic and believes the companies, whoever they were, were dragging their feet. If someone could have done this in the past legally, they would have tried it and of course now we'd either have bankrupt companies or a pipeline that was half built.

We're at a time for the first time that I can see in the history of this state where we really do have a chance for a pipeline. The MacKenzie pipeline is imploding because people can't get along and they're acting like a bunch of amateurs. If we start acting like amateurs, we are going to lose this pipeline - and if there are people who believe that the company interests are not aligned with the state interests, if the companies pieces of gas up here is not as big as they are other places, which is not true, that's where the interests align, because it's so important to them and so important to us. Then I don't know what they could look at, but they shouldn't do it like this. It shouldn't be something that was passed at the last minute with people kind of giggling about, 'Boy, there's something coming that's really going to hurt you guys.' What is that about? Why would you go there for a pipeline this big? This is not a little something that is not going to make a difference in the world. This is something that is going to make a difference to us for the next hundred years. This is too important to be treating like some kind of throw away gambit. I'm not very often really unhappy with something, but I'm really unhappy with this - as an Alaskan and everything else. If people have real concerns, they need to treat it as a real concern. There need to be hearings, people need to know how it works now....

The way it works now - it was put in for a good reason. It was put in to protect the interests of the state. When there are issues, it does go to court.

[5:17:12 PM](#)

It was never intended to try to force a multi-billion dollar pipeline that a financial community also has to agree to. Some asked about risk. The financial community has said over and over again that because of the risk involved here, the internal rate of return has to be at least in the \$20s and they have said it over and over and over again.

And do you want to talk about the federal government's 80 percent, \$18 million grant? It hasn't been appropriated. The money is not there; the promise is there. People don't know how to put the package together because it has never been done before.

MS. BRADY said further that this would have the commissioner of DNR pre-guess what FERC is going to do. She explained:

FERC has a staff of 400 people. That's all they do. They spend their time on pipelines and we're going to pre-guess what RCA does? We're going to pre-guess what a return should be and that will somehow - I'm not even talking about the companies - that will somehow force the financial markets to take some action when their shareholders are going to say, 'Are you kidding me?' Do you know what a shareholder would say if a company took a \$20 billion risk because a commissioner of Natural Resources from the State of Alaska ran a model and said yeah, there's enough out there for 30 years from now? You're going to make money. Do you know what would happen with their stock?...

5:19:36 PM

She said she liked the original bill and advised them to start with the way the process works now. She said the original bill does some important things in terms of incentive.

5:20:52 PM

SENATOR STEDMAN said she mentioned a 20 percent rate of return and he has heard of different expectations - that 18 to 20 percent is in the venture capital range.

5:22:42 PM

MS. BRADY responded that some venture capital people say the risk of building this pipeline is too high because if gas prices fall, the project would have to be finished anyhow. Some of them didn't believe it could ever be done anyway. She said that

Alaska hears a lot of positive things, but at big gas conferences in other places, you hear other things.

[5:23:37 PM](#)

SENATOR ELTON said he agreed with her on one issue and that is that the amendment was a surprise. There could have been more discussion of the policy implications.

[5:24:32 PM](#)

SENATOR SEEKINS agreed, but denied that sneaking anything through could happen here where finding out which rumor is true is the problem.

[5:26:45 PM](#)

JOE FERRELL, Managing Attorney, ConocoPhillips, urged the Senate to reject the last-minute changes to HB 71, because they are ill-conceived and not needed. He said the Stranded Gas Development Act (SGDA) is working as it is.

My testimony will address the following points:

1. The interpretation of lease obligations is a judicial function.
2. The substantive provisions of the amendment are not supported by the terms of the lease or general oil and gas law.
3. The substantive standards created in the legislation are inappropriate for judging the commercial viability of a pipeline project.
4. Finally, the bill is not needed. The Stranded Gas Act is working as intended and ConocoPhillips is working hard in negotiations with the state team to make the Alaska gas pipeline a reality.

The first point is that the changes to HB 71 are not a proper subject for legislative action. The interpretation of lease obligations is a judicial function. As the Alaska Supreme Court reaffirmed just this year, oil and gas leases are contracts, which become fixed when originally signed. Moreover, the contracts clause of both the federal and state constitutions prohibit the state from passing laws impairing the obligations of contracts. As a result, the state legislature is simply without power to

modify existing oil and gas leases to the detriment of the lessees by imposing any new duties upon them or decreasing any of their right under those leases.

It has been suggested that these changes are authorized because they really only restate existing contract terms under existing law. This leads to my second point: that the substantive content of these changes are not supported by the terms of the lease or general oil and gas law. The fundamental proposition proposed by these changes is that lessees must build a pipeline project based on the state's estimate of the rate of return for the pipeline project, based on the state's modeling of future costs, production and prices exceeds the historical return on capital employed (ROCE) achieved by the lessees on their worldwide activities.

The fact is that there is not a single lease term or a case that has been identified by those testifying before the legislature and we have been able to find none that support this astounding proposition.

Indeed, the attorney for the Port Authority confirmed in his testimony that no court has ever found an implied duty under an oil and gas lease to build anything more than a short connector pipeline. Nor has any proponent of this legislation shown a single case where this kind of test was applied to determine whether a lessee could be forced into risking its money in an investment for the benefit of the lessor, let alone any support for the proposition that this mechanical, but highly manipulable approach is legitimate or appropriate as a general test for when investment duties are created.

There is a good reason for the fact that the tests that appear in the revised bill are not to be found in the lease itself or in case law. The reason is that the tests put forward are not rare and do not make economic sense. There is no mathematical formula or model under the lease or general oil and gas law that determines when a duty arises. It is always fact-specific analysis and depends on all pertinent factors including risk.

This makes sense, since a prudent lessee assesses each project on the basis of its particular circumstances and risks. In that regard, it is critical that the Legislature understand that decisions to develop or construct projects cannot be determined by reference to a single financial parameter, in this case the historic Return on Capital Employed (ROCE) for a group of oil companies over the last 10 years.

First, let's address what a company ROCE represents. Each company's ROCE is the output or result of a wide variety of very separate corporate decisions. The ROCE for any given year reflects the results of past decisions over the course of many years and comprehends not just decisions to proceed with individual projects based on their intended return on investment, (which in any event, were based upon each project's unique factors, in particular the risk associated with each project), but also decisions on exploration drilling (which has a high likelihood of failure), capital projects implemented to comply with new environmental laws or for other reasons that are recognized as non-payout, for maintenance and accounting treatment on corporate mergers. All these end up blending into a ROCE output that varies for any given year and is highly dependent on upon actual market prices.

Second, let's address what factors a prudent company must take into account in making investment decisions. Any decision to invest in a major potential development project must address a wide variety of risks and uncertainties, including the potential or low prices, capital cost overruns, regulatory and permitting problems and schedule delay. No prudent operator looks at a single financial parameter such as ROCE to decide to invest. And as the cost and scale of the project increase, the risk associated increases and so does the rigor to address uncertainties, which take higher priority.

The Alaska gas pipeline project is currently estimated to cost \$20 billion. The size alone, not to mention the governmental regulatory, technical and commercial complexity, requires it to address a massive number of issues outside of a single point ROCE calculation. We have had to address the US regulatory process through

congressional acts to pass the enabling legislation. To help mitigate some fiscal issues, we worked for passage of the loan guarantee provisions, credits for the gas treatment plant similar to those for other Co2 removal facilities and depreciation provisions similar to those allowed for gas pipeline gathering systems. To address the uncertainty related to making such a long-term and unprecedented investment in Alaska, we have been working with the administration on a fiscal contract as contemplated by the Stranded Gas Act. These actions have all been undertaken consistent with analysis to address major risk elements far outside of any single economic data point.

To summarize:

This proposed amendment attempts to quantify which projects should be developed based on what would appear to be sufficient in the state's eyes to provide "an adequate rate of return."

The project's projected return is to be calculated based on estimates made by the lessor, who does not have to make the required investment. The amendment defines an "adequate return" be referenced to a single data point, an average historic ROCE.

Reliance on this single financial parameter is a gross oversimplification of the actual process that a prudent operator would use to determine to progress a project.

Given the size of major projects in Alaska, including the Alaska gas pipeline, such oversimplification could do nothing but add confusion about what is really necessary to progress the project.

I believe that what was intended through this amendment was an indication of the desire to progress the development of Alaska's resources. ConocoPhillips shares these goals and believes that they can be accomplished through prudent exploration and development of oil resources and through the development of the gas pipelines. ConocoPhillips is working hard and will continue to work hard to make the Alaska gas pipeline a reality. However, this proposed amendment will only create uncertainty and

impede progress toward attainment of that goal. We respectfully urge that the Senate eliminate sections 1 and 2 from HB 71. Thank you.

5:34:49 PM

SENATOR DYSON said earlier testimony from producers suggested that if they don't agree on the financial basis on which the DNR commissioner reached his conclusions, they could provide other information that would impeach those assumptions - or provide better information. He asked if there was a reason why that might be impractical.

MR. FERRELL replied that oil and gas leases are contracts between the state and the producers and those contracts contain rights and obligations on each of the parties.

To interpret what the parties' rights and obligations are initially the parties will discuss those things just as they would in any other contractual relationship and if they could not agree, after that exchange of information, after that exchange of views, then the proper forum to decide whether the state's interpretation or the producers' interpretation of the contract is correct would be through the courts....

SENATOR DYSON clarified his question and asked if another way to solve the situation would be to give the state better data to use in its model. He understood that his answer is that's not the way it's done; you go to court.

MR. FERRELL replied that the term that has been defined in the bill is "reasonably profitable" and he could not find that term in the DL1 lease form.

SENATOR DYSON interrupted to say that he is answering a question he didn't ask right now. He repeated his question, which is, if the state is using a model that has bad data, isn't part of the way to solve that to give the state correct data.

MR. FERRELL responded by saying again that:

You discuss it with your contract counterpart.... You try to reach agreement on what the words of the contract mean, what obligations are imposed, what rights you have under the contract and that's exactly what we're doing. We are working hard to progress the

gas pipeline project and we're trying to avoid litigation....

SENATOR DYSON sought to clarify one more time asking:

Okay, but my question was couldn't you help to get a fair process by giving the best data and I hear you saying that's - I haven't heard you say, 'Yeah, that's what we should do,' so that all the decision-makers have the best data. At first I thought you were saying, 'Well, you go to court.' Now I hear you saying, 'No, you get together and negotiate.'

But my question was is there something that keeps you from giving the state the best data you have so that they can have the best presuppositions on which to go forward.

MR. FARRELL responded:

We are in negotiations. The content of those negotiations are confidential, but we are working hard to address the enormous risks that this project represents - to try to make the Alaska gas pipeline a reality. And it's like any other negotiation and it is a long process and we're working very hard at it.

[5:41:07 PM](#)

CHAIR WAGONER said he wanted to follow up on the definition of "reasonably profitable" and that the state might be using faulty data. He asked if that's the case, why don't the majors come forward with the right data. The state has said that 14 percent return on a project is reasonably profitable to it, but the producers can take their funds they were going to invest in the pipeline and go to Indonesia or someplace that has a 24 to 30 percent return on their investment.

If that the way this is going to be determined? Because if it is, I have a problem with that. Because if the state says according to our best data, this is reasonable profitable at this time to build a gasline and to produce the gas, we're entitled to that gas being produced and the income from it that we have coming by lease agreement. Is there a flaw in my...

MR. FERRELL quickly went back to the fundamental proposition that the producers have a series of contracts that impose rights and obligations on the parties.

The question would be, 'What do those contracts require the lessees to do.' Now the words 'reasonably profitable' don't appear in those contracts. That's an interpretation of what our obligations are that was put forward by one side in testimony before the Budget and Audit Committee. Now, the leases do provide certain grants of rights to the producers. I think they were enumerated earlier to explore, produce and market. It also imposes obligations including - I don't really think it's appropriate to go through that right now because that's really a judicial proceeding. Basically, what they do is it obligates the producers to drill wells to prevent drainage and to drill additional wells for if a reasonably prudent operator would do so in all the circumstances. What you have to do is you have to go back and say, 'Well, what obligations are actually under the lease.' Now the proponent of this legislation has suggested that what this legislation does is it takes away the normal course of procedure for deciding that question - which would be if there's a disagreement after the parties to the contract have discussed that, then it would be sent to court. And it said, we want the Legislature to decide that question - not only an interpretation of an undefined term, but the creation of a term and an interpretation of what the obligations are rather than leaving that definition to other branches of government.

That's not the way it works. This bill attempts to take a contract dispute and solve it in favor of one party to the contract.... That's the effect of this legislation.

[5:45:21 PM](#)

SENATOR SEEKINS asked him to explain what he thought section 2 does.

MR. FARRELL replied that section 2 purports to interpret the provisions of the existing contracts between the state and the producers in a one-sided way without an opportunity for the other party to the contract to present its views in a proper

forum. The Supreme Court has recently reaffirmed they are contracts.

[5:46:47 PM](#)

SENATOR SEEKINS asked if the contracts ConocoPhillips signed were "take it or leave it" contracts.

MR. FARRELL replied yes.

SENATOR SEEKINS asked if the oil companies were allowed to negotiate the terms or were they just allowed to accept the terms that were already in the contract.

MR. FARRELL replied to his knowledge it was a take it or leave it contract.

SENATOR SEEKINS asked if that is still a standard form of contract between the state and someone else.

MR. FARRELL replied yes.

[5:47:59 PM](#)

SENATOR BEN STEVENS said that it's fair to say the negotiations are taking place and that there are three separate models for each applicant being constructed right now - the Legislature's under Econ One Research, Inc., the Department of Revenue or the Stranded Gas application team, and the applicants.

[5:49:57 PM](#)

He observed that "Standard and Poor's" has different reports on equity on global positions than "Value Line" and there will be different outputs and different interpretations regardless of who does the models.

The question in my mind is does this amendment have an impact on who makes the determination of those results? Is it the free market? Is it the applicant? Or, in fact, is it the commissioner? So, if that's what we're contemplating, the variables circulating around this process are yet to be fully comprehended by me.... I think we need to think about the impact of what this does and fully digest it before - personally before I can make a full determination on it.

[5:51:41 PM](#)

CHAIR WAGONER asked which is the more conservative.

[5:51:54 PM](#)

SENATOR BEN STEVENS replied that "Standard and Poor's" is considered to be more conservative than "Value Line."

[5:52:39 PM](#)

SENATOR ELTON said testimony has indicated that the benefits of the loan guarantees are more ephemeral than he originally thought and asked Mr. Farrell how comfortable he was with them.

MR. FARRELL responded that he wasn't prepared to testify on that issue, but he was prepared to talk about how the bill was fundamentally flawed and would do nothing to advance the Alaska gas project.

[5:54:16 PM](#)

SENATOR ELTON countered that Mr. Farrell brought up the fact that the guarantee provisions may not be as solid as assumed and before the next hearing, he wanted an understanding of how comfortable ConocoPhillips is with that provision.

MR. FARRELL said he would follow up on that for him.

[5:5:48 PM](#)

VICE CHAIR SEEKINS thanked Mr. Farrell for his testimony.

[5:54:59 PM](#)

KEVIN TABLER, Land and Government Affairs Manager, Unocal, said that Unocal is the predominant operator in the Cook Inlet, but it also has some small interests on the North Slope in the Kuparek and Endicott fields and in TAPS. He related that Unocal and other producers participated in a Joint Senate and House Resources meeting in Kenai to discuss the need for enhanced exploration and development within Cook Inlet and other areas. The intent was to provide incentives to encourage earlier exploration of the state's oil and gas resources. The bill's original intent provided incentives to explore in the Bristol Bay area. Other bills involved incentives as well and were rolled into one - HB 71.

The amendment that was attached last week has absolutely nothing to do with the intent of that original legislation. The unintended consequences of this amendment are unknown. Due to the hasty creation of the amendment and the lack of input from those directly affected by it, we really don't know all the consequences intended or unintended. We do know that

it does create an uncertain investment environment after the investments have already been made.

It appears that the amendment is targeting certain leases. The fact is this amendment applies to all leases statewide. The amendment is not clear that it excludes oil. It speaks to oil and gas throughout sections 1 and 2, in particular page 3, line 17 at the end refers to 'at a minimum.' That language would lead us to believe that the DNR would have the unlimited authority to create their own standards.

This amendment was put on without any input from those that it will directly affect. We question the state's authority to unilaterally amend the contractual obligations with existing leases through either manipulation and/or interpretation of the unit agreements and their corresponding administration of the plan of development. By imposing an interpretation after the fact to address current legislative desires could be perceived as a constitutional taking by the state. One party to a contract cannot impose an interpretation on that contract when the contract specifically provides for consent as does the DL1 lease form.

The implied covenant to explore is part and parcel under the state's oil and gas lease and all other leases and is further offset by the payment of delay rentals. The right of the state to dictate the rate and timing of development, production and marketing is less well-defined. It is not the state's absolute right to dictate these parameters. If the state is unhappy with the proposed future plans and agreement cannot be reached between the lessor and the lessee, it is the courts that will ultimately decide the appropriate rate, timing and marketing parameters after hearing both sides of the discussion.

As written, HB 71 has producers taking all the risk while using someone else's forecast. The oil companies make a living making forecasts. I question how accurate has the state been at forecasting price of oil and gas futures. We question the state's ability to forecast these futures better than the producers.

What happens when the state's forecast is wrong? Who assumes liability then? Will the state offer up its royalty share to cover the downside of a faulty analysis?

MR. TABLER said that the amendment raises more questions than it provides answers. With the amendment this bill is no longer incentive legislation, but disincentive to future exploration and investment in Alaska and Unocal no longer supports it.

[6:00:31 PM](#)

SENATOR ELTON asked if his concerns would be mitigated if there were a process in which the state's forecast could be arbitrated. Otherwise they would be in a situation in which any other producer can, in effect, make a "no decision" based on some information that they keep internal.

MR. TABLER replied that is correct.

SENATOR ELTON stated he thought that was fundamentally unfair to the resource owner.

[6:02:57 PM](#)

MR. TABLER replied that it also seems unfair when the lease requires consent of the lessee or the lessor to establish the criteria that will force the lessee to make significant investments at the threat of taking the lease back. He related that even the working interest owners sometimes don't agree to economic models that are used in their investment profiles. They have different market constraints and different contracts they have to produce to. He thought an arbitration process might work if all the parties could agree on that approach beforehand, but reminded the committee that the lessee is the risk taker.

[6:04:24 PM](#)

SENATOR GUESS asked if this bill doesn't pass, would the Cook Inlet tax credits still be in place, but the Bristol Bay tax credits wouldn't because they were new.

MR. TABLER replied:

No, my understanding is that the Bristol Bay tax credits will be new, but the existing tax credits that are in place under statute now would be in place. This augments and changes and creates a true incentive that we didn't have when SB 185 two years ago was rolled out, when it was originally a Cook Inlet bill and then

turned into a statewide North Slope bill. Some of the provisions we tried to get in that bill we're trying to get back in through these credits here.

CHAIR WAGONER thanked Mr. Tabler for his testimony and closed the public hearing. With that, he adjourned the meeting at [6:06:18 PM](#).