

HOUSE FINANCE COMMITTEE  
April 30, 2007  
1:41 P.M.

CALL TO ORDER

Co-Chair Chenault called the House Finance Committee meeting to order at [1:41:31 PM](#).

MEMBERS PRESENT

Representative Mike Chenault, Co-Chair  
Representative Kevin Meyer, Co-Chair  
Representative Bill Stoltze, Vice-Chair  
Representative Harry Crawford  
Representative Les Gara  
Representative Mike Hawker  
Representative Reggie Joule  
Representative Mike Kelly  
Representative Mary Nelson  
Representative Bill Thomas Jr.

MEMBERS ABSENT

Representative Richard Foster

ALSO PRESENT

Representative Anna Fairclough; Pat Galvin, Commissioner, Department of Revenue; Antony Scott, Commercial Analyst, Division of Oil and Gas, Department of Natural Resources; Don Shepler, Consultant, Greenberg Traurig

SUMMARY

HB 177      An Act relating to the Alaska Gasline Inducement Act; establishing the Alaska Gasline Inducement Act matching contribution fund; providing for an Alaska Gasline Inducement Act coordinator; making conforming amendments; and providing for an effective date.

HB 177 was HEARD and HELD in Committee for further consideration.

#HB177

HOUSE BILL NO. 177

An Act relating to the Alaska Gasline Inducement Act; establishing the Alaska Gasline Inducement Act matching contribution fund; providing for an Alaska Gasline

Inducement Act coordinator; making conforming amendments; and providing for an effective date.

Co-Chair Chenault pointed out that there had been an amendment passed in the House Resource Committee (HRC), which had not been incorporated into the version before the House Finance Committee. A corrected draft of the bill will be forthcoming. The change left out was to Page 15, Line 15, a conceptual amendment proposed by Representative Roses, inserting: "50% of the licensee net cost".

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PAT GALVIN, COMMISSIONER, DEPARTMENT OF REVENUE, continued his previous discussion of the bill, beginning with the section starting on Page 19, Line 10:

- Section 43.90.250 establishes the Alaska Gasline Inducement Act (AGIA) coordinator position, designed & created by amendments created in previous committee hearings. The position would continue for one year after commencement. He listed the duties of that position.
- Section 43.90.260 describes the expedited review and action of the State agencies.
- Article 3 identifies the resource inducement including Section 43.90.300, which indicate the qualifications for resource inducement.

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Commissioner Galvin continued:

- Section 43.90.310 addresses the royalty inducement on Page 20, Line 31, which might result in deductions for transportation; it is a current contractual right of the State.

Co-Chair Chenault inquired if stipulations had been included regarding the size of a gas contract. Commissioner Galvin explained that the royalty arrangements are implemented through the Department of Natural Resources and with regard to AGIA, that scenario is addressed through the actual inducement, establishing the evaluation. The Department avoids individual contracts. The price is established through the published price.

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Representative Gara pointed out the bill attempts to make the bidding process attractive to potential pipeline builders. Commissioner Galvin noted that up-stream

inducement is tied to the commitment of the value provided to the lessee in exchange for making that commitment.

Representative Gara asked the estimated revenue value. Commissioner Galvin suggested that query be directed to Mr. Scott in the Division of Oil and Gas.

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ANTONY SCOTT, COMMERCIAL ANALYST, DIVISION OF OIL AND GAS, DEPARTMENT OF NATURAL RESOURCES, advised that during the process, the Division had looked at the value associated within the State's provision and that it is estimated it is worth approximately 2% of the final destination price.

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Commissioner Galvin continued:

- Section 43.90.310 clarifies the royalty inducement aspects, which will minimize retroactive adjustments to the monthly value of the State's royalty share of gas production and provide a method for establishing a fair market value for each component of the State's royalty gas, based on pricing data from reliable and widely available industry trade publications. It uses appropriate adjustments. He addressed two aspects of the royalty commitment and highlighted the complications resulting in a change in the lease provisions.

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Representative Kelly questioned the solidity of the commitment to the producer. Commissioner Galvin explained that the length of the inducement would be as long as the transportation commitment is in place. If they make a commitment, the contractual right ends. The producer will be linked in time, value and volume to the transportation commitment.

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Commissioner Galvin continued, Page 23, Line 19:

- Section 43.90.320 describes the gas production tax exemption, which provides a method for a tax exemption equal to the tax rate change, receiving a credit to lower the level they pay. The original intent was that the right be contractual. The bill has been structured to rest on the transportation commitment; however, previous committees have changed the constitutionality of the original

intent. The exemption provides a steady tax rate and remains in place for the first 10-years, gas flows. It could be changed any time in future legislatures.

- Section 43.90.330 addresses the inducement vouchers. When purchasing gas at the wellhead and through the voucher system, the producer makes a transportation commitment through obtaining a voucher and transferring it, which offers value to the party making the commitment. It is an opportunity for additional participation through maximizing the number of players.

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Commissioner Galvin discussed Page 24, Line 28 of the bill:

- Article 4, the miscellaneous provisions consisting of Section 43.90.400, the Alaska Gasline Inducement Act (AGIA) matching contribution fund, disbursements & audits.
- Section 43.90.410 identifies the regulations. The commissioner will adopt regulations for the purpose of implementing the provisions of the chapter.
- Section 43.90.420 defines the statute of limitations, clarifying that a party may not bring a judicial action challenging the constitutionality of the chapter of the license issued under the chapter, unless that action is commenced in a court, within 90-days after the date that a license is issued.

Representative Gara asked how the 90-day constitutional challenge language relates to the 30-day to 2-year challenge times within the Statute of Limitations. Commissioner Galvin advised that the producer would need to make a commitment not to challenge. The decision of the commissioners would be the final action once the Legislature had approved it, given the 30-day administrative appeal time from that point.

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Commissioner Galvin provided a quick overview on:

- Section 43.90.430 - interest
- Section 43.90.440 - the licensed project assurances.

Representative Kelly inquired if that language indicates a ceiling limiting the exposure. Commissioner Galvin responded that the limit would be the amount expended by the licensee, based on the expectation of what the licensee

might be spending and depends upon the amount matched by the State.

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Commissioner Galvin continued:

- Section 43.90.450 deals with the assignments of the license.

Representative Kelly questioned if that section would provided an "absolute right to approve". Commissioner Galvin explained it provides the right to stop action.

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Commissioner Galvin continued:

- Section 43.90.460 addresses the conflicting State and federal laws.
- Section 43.90.470 identifies State pipeline employment development.
- Section 43.90.900 elaborates the general provisions and definitions, the conforming amendments to other statutes and affects the procurement code. That language indicates a Public Records Act.

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Representative Joule referenced Section 43.90.440 and asked if the State could be gamed-taxed. Commissioner Galvin explained those provisions were intended to provide licensing debt unless there was a violation of the terms of the provision. If they abide by the terms under their license, that language clarifies that the State would not choose an alternate project. It is incumbent upon the State to assure that the licensee would fulfill their part of the agreement with the State regarding the risk gain, in order to move the project forward.

AT EASE: [2:27:45 PM](#)

RECONVENE: [2:28:23 PM](#)

DON SHEPLER, ATTORNEY & CONSULTANT, GREENBERG TRAUIG, explained his background and distributed a handout, the Alaska Gasline Inducement Act, House Finance, 4/30/07. (Copy on File).

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Mr. Shelper provided an overview of the Federal Energy Regulatory Commission (FERC) issues & highlighted the information on Slide 2:

- FERC's new mandatory expansion authority
- AGIA's rolled in rate provisions, and
- Negotiated versus recourse rates.

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Mr. Shelper noted Slide 3, FERC's authority to order expansions, which could be problematic because:

- No rate subsidy
- No adverse effect on financial or economic viability of the project
- No adverse effect on overall operations of the project
- Can not diminish the contractual rights of existing shippers to previously subscribed certificated capacity
- Finding the adequate down-stream capacity exists or will exist

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Slide 4 explains the Section 105 provisions, which could invite litigation. That statute is unprecedented and has not been tested in Court. Section 105 criteria are potentially ambiguous and fertile ground for litigation. Once litigation happens, it delays and uncertainty becomes involved and the duration of the delay would likely be measured in years, not months.

Mr. Shepler contrasted the federal process in regard to the proposed AGIA, taking the mandatory expansion off the table. AGIA requires testing of the market and expansion under reasonable terms. AGIA avoids the uncertainty regarding expansion issues.

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Representative Gara questioned if the AGIA contract would fall into a mandatory expansion under the intent of FERC. Mr. Shepler emphasized it would not; the mandatory expansion provision provides a situation where a pipeline company could refuse expansion at which time, the State initiates litigation.

Mr. Shepler explained that violation of the license occurs when the pipeline company refuses to expand. Representative

Gara understood there would be no recourse for the State. Mr. Shepler thought the State will have other remedies.

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Mr. Shepler discussed rolled-in rates indicated in Slide 6. He noted that in the Alaska Natural Gas Pipeline Development Authority (ANGPA) statute, open season regulations should "promote competition in the exploration, development and production of Alaska natural gas." He added that the FERC directive is "incremental pricing of expansion, which could put expansion shippers at a significant rate disadvantaged compared with initial shippers, and accordingly, could discourage exploration, development and production of Alaska natural gas." He provided members with a copy of the FERC discussion. (Copy on File.)

He added that FERC requires that any new pipeline must be based on incremental rates for expansion; however, departure from lower-48 policy is based on recognition of Alaska's unique circumstances.

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Mr. Shepler referenced Slide 8, indicating that a rate increase will not necessarily provide a subsidy. FERC left open the question of whether to allow rolled-in rates at a level that is not higher than the initial rate without subsidies. Total government contributions reduce rates by 15%.

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Mr. Shepler referenced Slide 10, explaining that AGIA would not intrude on FERC's authority. AGIA requires the licensee to propose rolled-in rates and FERC disposal. AGIA prevents producers from negotiating rates with themselves, precluding collection of the rolled-in rates. He emphasized the importance of the rolled-in pricing as it comes as a trickle down from a congressional mandate. It is a good model for the State.

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Slide 12 indicates negotiated versus recourse rates. He noted that recourse rates are old fashioned, cost-based rates, such as utility rates and are based on the cost of providing the service. FERC has stipulated that shippers must have access to recourse rates as an alternative to negotiated rates because they are a "lifeline" to the shippers. Negotiated rates are negotiated; anything can be negotiated, such as a reserve capacity, however, negotiated rates are presently the norm in the lower 48. FERC establishes the recourse rates though a regulatory process;

whereas, negotiated rates move through the commercial process.

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Mr. Shepler addressed Slide 15. AGIA requires commitment by the licensee not to enter negotiated rate contracts that preclude rate increases due to roll-in of expansion costs up to 15% above the original negotiated rates. By spreading the expansion costs over all the billing determinants, AGIA ensures that the rolled-in rate treatment can be offered to expansion shippers. The applicant is required to commit that they will not collect past that point.

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Slide 16 identifies the Rockies Express Open Season notice, a project that used negotiated rates. He provided back-up for the project. (Copy on File.)

The second page illustrates an estimated recourse rate of \$1.42 with a negotiated rate of \$1.09 and an adjustable rate of \$1.04 - \$1.14, depending on the price of steel. Those rates would be in place till the end of the project.

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Representative Kelly questioned which rate an "anchor" shipper receives. Mr. Shepler explained they get the negotiated rate. The project will occur in three phases and he referenced the third phase, the end-to-end rate used to illustrate the point.

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Representative Gara commented that the Administration had requested that pipeline owners not challenge the rolled-in rates proposed in AGIA. Mr. Shepler explained that rolled-in rates could hit AGIA twice; once as the pipeline and then again in up-stream inducements. Applicants are being asked to propose rolled-in treatment for expansions, which he did not think was fair to ask them not to oppose what they asked for. He acknowledged advantages that occur with FERC establishing the regulations, commenting that FERC has an easier time applying policy without opposition.

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In response to a question by Representative Kelly, Mr. Shepler noted that the recourse rate would be "whatever it is". It is impossible to determine the costs of building the pipeline because the price of steel is uncertain. Companies are estimating on the high-side. Recourse rates are based on a number of factors, which can vary while

negotiated rates remain stable. It could fall below the recourse rate, but most likely that will not happen until the end. That concluded the testimony of Mr. Shepler.

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ANTONY SCOTT, COMMERCIAL ANALYST, DIVISION OF OIL AND GAS, DEPARTMENT OF NATURAL RESOURCES, provided members with an overview of rolled-in rates. (Copy on File).

He noted several key points regarding rolled-in rates:

- Rolled-in rates are fair & everyone pays the same price for the same service.
- Rolled-in rates are effective.
- Rolled-in rates are required for Alaska.

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Mr. Scott noted that AGIA rolled-in rates promote competition, exploration and development. Rolled-in rates are in the State's interest given uncertainty of where expansion of gas will come from. He added that despite protests to the contrary, the objective evidence indicates that rolled-in rates impose relatively modest costs on producers; which are significantly off-set by AGIA's \$500 million and are unlikely to affect the producer's decision to ship.

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Mr. Scot continued, Slide 7 observes that incremental fuel costs are higher if expansion shippers have to pay them, resulting in a significant jump in the rates. The initial shippers under the lower 48 FERC policy are still paying \$1.96, but expansion shippers would be paying close to \$3 dollars. In Slide 8, it is supposed that in 2023, the pipeline would again expand and could be achieved through looping. The incremental costs of looping would be significant, but would not require extra fuel. The rolled-in fuel rate provides a benefit to the initial shippers, which could arguably be subsidized.

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Page 9 indicates rate treatment, rolling in expansion costs, exceeding the cap. In the 3<sup>rd</sup> expansion, shippers would pay slightly higher rates by rolling-in the expansion costs.

Mr. Scott commented on why information regarding determination of the rates matters to Alaska's future.

- Without rolled-in rates, it is unlikely that the 3<sup>rd</sup> looped expansion would occur;
- Expected value of generic prospect is negative under incremental rate treatment (-\$15.7 million for the OCS prospect & -\$19.7 million for the on-shore prospect)
- Expected value of generic prospect is positive under the AGIA rate treatment (\$18.1 million for OCS prospect & \$6.4 million for the on-shore prospect)

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Mr. Scott stated that the State does not know where gas from an expansion would come from. The State is better off accepting the provisions of AGIA. Slide 14 provides examples of background scenarios (\$5.50 gas) identifying expansion costs.

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Mr. Scott continued with the stylized examples of three cases contrasting different values, which might occur:

- Case A: State gas comes first through the expansion from State lands
- Case B: All gas comes from National Petroleum Reserve-Alaska (NPR-A) lands
- Case C: All gas comes from the outer continental shelf

It is not known how it will play out; however, presenting the scenarios allows for assessment of the basic interests. Without rolled-in rates, it is unlikely that all expansions could occur. Assuming real constant prices, the expected value will be negative. However, what has been identified is that without rolled-in rates, the last expansion could not occur; hence, a loss to the State. Rolled-in rates allow expansions to occur and prove to be a significant return to the State. Due to the uncertainties, the State would be better off using rolled-in rates.

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Mr. Scott addressed the relative burden, which rolled-in treatment imposes on the producers, affecting their investment measures. The assumption is that producers do not own the pipeline. The required investment is at about \$4 billion dollars and assumes inclusion of Pt Thompson. The scale of investment would be different if the pipeline were owned. Slide 20 illustrates a worse case scenario if none of the producers were carrying gas to the expansions. The producers would received only the negative affects of

the rates from rolled-in rate treatment and none of the benefits of the increased gas flow. That scenario is unlikely.

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Mr. Scott stated that if producers do not own the pipeline, they could invest as shippers, thereby, making a shipping commitment. A lot of the value from the project has been moved from the producers to the State because of the effective tax rate, indicating downward movement.

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Slide 21 illustrates 50 different up-stream investment opportunities & projects the producers currently have. The Alaska project is near the "top" including the anticipated rates of return. Rolled in rates should not be a burden to producers. Presently, producers believe shouldering a risk of net-back value is unattractive and that there are realistic risks not changing the economics of rolled-in rate projects. If there were no expansions, the producers would receive roughly two-thirds with likelihood that the project would generate at least \$8 billion dollars. He discussed how the internal rate of return could affect a project from the profitability ratio perspective.

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Slide 25 highlights facts indicating that a rolled-in rate provision would not present reasons to not commit to the project.

Mr. Scott summarized:

- AGIA's rolled-in rate provisions promote competition, exploration and development.
- Given the uncertainties, AGIA's rolled in rates are clearly in the State's monetary interest.
- Protests notwithstanding, the objective evidence indicates that AGIA's rolled-in provisions costs are modest to the producer and that they are unlikely to affect the initial investment decisions.

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Representative Kelly asked about the percentage of an increase to the producers, generating new gas and requiring expansions for the State. Mr. Scott responded that the Administration had not investigated the query enough to make a determination.

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Representative Kelly thought that the approach should include the producer also. Mr. Scott acknowledged that would be a reasonable assumption.

Mr. Scott assumed ConocoPhillips intended to own the project.

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Representative Gara asked if building a pipeline to Alberta with a spur-line to Valdez, would require an expansion. Mr. Scott said yes.

Representative Gara inquired if there was a significant difference between the rolled-in rates for a spur-line. Mr. Scott thought there could be but was not presently, aware of any structured modeling done by the Administration.

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Co-Chair Chenault requested that Mr. Scott be present during the "round-table discussion" with producers and the Administration.

HB 177 was HELD in Committee for further consideration.

#

ADJOURNMENT

The meeting was adjourned at 3:49 P.M.