

ALASKA STATE LEGISLATURE
SENATE JUDICIARY STANDING COMMITTEE

April 4, 2007

2:48 p.m.

MEMBERS PRESENT

Senator Hollis French, Chair
Senator Charlie Huggins, Vice Chair
Senator Bill Wielechowski
Senator Gene Therriault

MEMBERS ABSENT

Senator Lesil McGuire

COMMITTEE CALENDAR

SENATE BILL NO. 104

"An Act relating to the Alaska Gas pipeline Inducement Act; establishing the Alaska Gas pipeline Inducement Act matching contribution fund; providing for an Alaska Gas pipeline Inducement Act coordinator; making conforming amendments; and providing for an effective date."

HEARD AND HELD

PREVIOUS COMMITTEE ACTION

BILL: SB 104

SHORT TITLE: NATURAL GAS PIPELINE PROJECT

SPONSOR(S): RULES BY REQUEST OF THE GOVERNOR

03/05/07	(S)	READ THE FIRST TIME - REFERRALS
03/05/07	(S)	RES, JUD, FIN
03/14/07	(S)	RES AT 3:30 PM BUTROVICH 205
03/14/07	(S)	Heard & Held
03/14/07	(S)	MINUTE(RES)
03/16/07	(S)	RES AT 3:30 PM BUTROVICH 205
03/16/07	(S)	Heard & Held
03/16/07	(S)	MINUTE(RES)
03/19/07	(S)	RES AT 3:30 PM BUTROVICH 205
03/19/07	(S)	Heard & Held
03/19/07	(S)	MINUTE(RES)
03/21/07	(S)	RES AT 3:30 PM SENATE FINANCE 532
03/21/07	(S)	Heard & Held
03/21/07	(S)	MINUTE(RES)
03/21/07	(S)	RES AT 5:30 PM SENATE FINANCE 532

03/21/07 (S) Heard & Held
 03/21/07 (S) MINUTE(RES)
 03/22/07 (S) RES AT 4:15 PM FAHRENKAMP 203
 03/22/07 (S) Heard & Held
 03/22/07 (S) MINUTE(RES)
 03/23/07 (S) RES AT 1:30 PM BUTROVICH 205
 03/23/07 (S) Heard & Held
 03/23/07 (S) MINUTE(RES)
 03/24/07 (S) RES AT 1:00 PM SENATE FINANCE 532
 03/24/07 (S) Heard & Held
 03/24/07 (S) MINUTE(RES)
 03/24/07 (S) RES AT 3:00 PM SENATE FINANCE 532
 03/24/07 (S) Heard & Held
 03/24/07 (S) MINUTE(RES)
 03/26/07 (S) RES AT 3:30 PM BUTROVICH 205
 03/26/07 (S) Heard & Held
 03/26/07 (S) MINUTE(RES)
 03/27/07 (S) RES AT 3:00 PM BUTROVICH 205
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 03/30/07 (S) Heard & Held
 03/30/07 (S) MINUTE(RES)
 03/31/07 (S) RES AT 12:00 AM BUTROVICH 205
 03/31/07 (S) Heard & Held
 03/31/07 (S) MINUTE(RES)
 04/01/07 (S) RES AT 11:00 AM BUTROVICH 205
 04/01/07 (S) Moved CSSB 104(RES) Out of Committee
 04/01/07 (S) MINUTE(RES)
 04/02/07 (S) RES RPT CS 6AM SAME TITLE
 04/02/07 (S) AM: HUGGINS, GREEN, STEVENS, STEDMAN,
 WIELECHOWSKI, WAGONER
 04/02/07 (S) RES AT 3:30 PM BUTROVICH 205
 04/02/07 (S) Moved Out of Committee 4/1/07
 04/02/07 (S) MINUTE(RES)
 04/04/07 (S) JUD AT 2:45 PM BELTZ 211

WITNESS REGISTER

Patrick Galvin, Commissioner
Department of Revenue
Juneau, AK

POSITION STATEMENT: Delivered PowerPoint on AGIA, SB 104

Marty Rutherford, Deputy Commissioner
Department of Natural Resources
Juneau, AK

POSITION STATEMENT: Provided information on AGIA, SB 104

Antony Scott, Analyst
Commercial Section
Division of Oil & Gas
Department of Natural Resources
Anchorage, AK

POSITION STATEMENT: Provided information on AGIA, SB 104

Larry Ostrovsky, Chief Assistant Attorney General
Oil, Gas & Mining Section
Department of Law (DOL)
Anchorage, AK

POSITION STATEMENT: Provided an overview of the constitutional issues related to AGIA - SB 104

ACTION NARRATIVE

CHAIR HOLLIS FRENCH called the Senate Judiciary Standing Committee meeting to order at [2:48:56 PM](#). Present at the call to order were Senator Therriault, Senator Huggins, and Chair French. Senator Wielechowski joined the committee shortly thereafter.

SB 104-NATURAL GAS PIPELINE PROJECT

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CHAIR FRENCH announced the consideration of SB 104. He said the administration would deliver an overview with respect to what is in the current committee substitute and if time permits there would also be an overview on the tax freeze issue. In his opinion that is the largest constitutional issue in the bill. The projected timeline is for the committee to take the time to carefully examine the legal issues and give them a thorough vetting while keeping in mind the goal of passing the bill before the end of session.

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SENATOR THERRIAULT asked which companies would be presenting before the full committee.

CHAIR FRENCH said he anticipates communicating the legal issues to the interested parties—the producers, the pipeline companies, and the independents—and giving them the opportunity to weigh in on each of the legal issues including a long-term tax freeze, triple damages, and confidentiality of the material submitted in support of the license application. A point and counterpoint on each issue is not anticipated, but there would be an opportunity for the parties to express their views on the legal issues.

SENATOR THERRIAULT asked if the \$500 million inducement could be discussed even though it is not a specific legal issue.

CHAIR FRENCH said that while the committee will focus on the legal issues, it is each member's opportunity to touch the bill and discuss any aspect. Nothing is out of bounds, but in the interest of efficiency he would prefer the time be weighted in favor of the legal issues since that is the focus of this committee.

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PATRICK GALVIN, Commissioner of the Department of Revenue (DOR), introduced himself and Marty Rutherford, Deputy Commissioner with the Department of Resources (DNR). Describing AGIA as a significant opportunity for the state, he stated that the administration appreciates the opportunity to work with the legislature.

COMMISSIONER GALVIN said the overview will provide a general framework for how the administration is approaching the issue and how AGIA fits that approach. He continued to say that:

- AGIA is a commercial vehicle that creates a competitive playing field. It allows the state to establish an opportunity for the commercial players to make decisions that are in their best interest, but that ultimately lead to Alaska fulfilling its needs.
- AGIA intends to provide a pipeline sooner and on Alaska's terms. The state is seeking very specific things from the pipeline beyond the immediate cash flow from the line itself. The way the terms are structured will be a driver making sure the state's complete interest in the gas pipeline is fulfilled.

- AGIA is a transparent process, with transparent inducements. The issues of transparency and the ultimate cost to the state were significant issues during the previous gas pipeline process and AGIA makes it clear what the incentives are, and in a manner that is as transparent as possible.

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COMMISSIONER GALVIN said it's important to recognize that AGIA is not a negotiation. It's an opportunity for the state to establish the terms in statute and create a commercial opportunity for participants to decide whether they want to participate or not. In a project of this type it is appropriate for government to establish the rules of the road and allow the commercial world to make decisions as to how it wants to participate in the process.

COMMISSIONER GALVIN explained that the state is creating a competitive bidding opportunity and it is offering certain inducements, which will be a significant part of the ultimate success of the project. The inducements must provide for a level playing field to get participants in the game and to create competition that may not otherwise exist. He emphasized that there is a very important linkage between what the state is hoping to get out of AGIA and what it needs to put in to have a reasonable expectation of getting that result.

COMMISSIONER GALVIN said that AGIA has midstream inducements that are geared toward the pipeline construction, and upstream inducements that are tied to the gas itself. The intention is to get the producers to participate in the project through transportation commitments.

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COMMISSIONER GALVIN relayed that AGIA has been structured to provide transparency in the inducements that should be clearly quantified so that there are no hidden surprises such that the state could wake up one day and realize that it is going to cost a great deal more than what it was originally told.

AGIA puts a monetary capital contribution on the table, but it is not in the form of a \$500 million check. Rather, it is an opportunity for a company to take certain actions after which it will be able to get the money. Part of it is a matter of matching; the company will spend its money to have access to the state money. Secondly, the money is on the table and the applicants are going to compete to tell the state how much of

that money will ultimately be needed. He emphasized that the \$500 million is designed to create the opportunity for a competition that gives everybody an opportunity to commit to certain very important things.

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CHAIR FRENCH asked when the \$500 million appropriation would be made—assuming that it remains intact and that AGIA passes.

COMMISSIONER GALVIN said at this point there probably won't be a \$500 million appropriation when AGIA passes because it won't be known whether or not the money will be needed. The expectation is that the demand for the \$500 million will be based upon the measured success of the project moving forward and the amount that the state ultimately needs to put in to get the project to fruition. More than likely an appropriation of a couple hundred million will be needed within the first couple of years. At about that time there will be a juncture on the project and the appropriation would be put before the legislature to clarify progress and determine how much money would be needed to fulfill obligations from that point forward. The administration anticipates knowing more a year from now by which time the actual applications will have been submitted, a licensee will have been selected, and the administration will be coming to the legislature. From that proposal a schedule can be set for when the appropriations are needed. The expectation is that the legislature will basically fill the obligation from there and schedule the appropriations.

COMMISSIONER GALVIN relayed that last year the legislature put \$300 million in Alaska Housing Finance Corporation (AHFC) to be held in the name of an Alaska gas pipeline project. It was sort of a down payment on a previous concept of a state contribution and the idea is to reassign that money to AGIA, he stated.

CHAIR FRENCH recalled that the last contract had some indemnifications that were identified as constitutional problems because they bound future legislatures. He suggested that a better approach might be to identify and set aside the money ahead of time. That way it's there when it's needed and isn't dependant on an appropriation from a future legislature.

COMMISSIONER GALVIN thanked him for the suggestion and said someone would look into that. He continued to say that from the administration's perspective no appropriation is needed this year. After the competitive proposal process and when the legislature is looking at the proposal itself, the potential

expenditures will be more apparent. At that point an appropriation decision can be made that would set everything up through to the end and avoid any sort of legal challenge.

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CHAIR FRENCH highlighted the idea of reassigning the \$300 million that had been set aside and calling it AGIA money from here forward.

COMMISSIONER GALVIN stated agreement with that idea.

SENATOR THERRIAULT asked if the request for access to the \$500 million had been moved into the evaluation criteria.

COMMISSIONER GALVIN said in a way. In the proposal the applicants can establish the matching rate from zero up to 50 percent before the open season and from zero up to 80 percent after the open season. The House and Senate versions diverge with respect to whether the amount of the contribution is part of the evaluation or not. He believes it was removed in the Senate version. It could factor into the net present value analysis and the administration is open to it either way, he stated.

CHAIR FRENCH asked for an educated guess for the universe of likely applicants.

COMMISSIONER GALVIN identified the three major producers, Trans Canada, MidAmerican, and the Port Authority. He noted that Enbridge does not intend to participate in the AGIA process at this level. When AGIA was put together the thought was to set up a competitive environment to meet the needs of the known universe and perhaps attract interest from others that are watching from afar. If the competitive process satisfies the known universe, then more than likely the needs of those that are watching from afar can also be met. Although there is a possibility that everyone will be surprised by an entity or a consortium of entities coming in and participating, at this point there is no knowledge of that, he said.

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COMMISSIONER GALVIN addressed upstream inducements and said the idea is to have them be as transparent and quantifiable as possible. "We're looking at inducements associated with the commitment of gas to the licensed project." They are in the form of royalty provisions, which provide more certainty on the royalty aspects, as well as tax provisions. Those will be

addressed in more detail later, but the idea is to provide some predictability with regard to what the tax rate is going to be for the first ten years of gas flow.

CHAIR FRENCH asked him to explain the mechanics of the royalty inducements.

COMMISSIONER GALVIN reiterated that the purpose of the inducements is to try to get participation in the initial open season. He said that after looking at the discussions with the producers on a gas pipeline we were able to identify a few structural issues with our lease provisions that create some uncertainty for the lessees when they think about making transportation commitments. One has to do with the way the royalty is valued. He explained that for Royalty in Value--when payment is taken in the form of cash--you take the destination price less the transportation to establish the royalty value.

CHAIR FRENCH added that for oil it is a West Coast price less transportation or tariff.

COMMISSIONER GALVIN agreed. Basically it's the price that the other lessees within the same field might get. "When you ship your gas and you sell it for \$7, and you subtract back the \$2 transportation cost, then your net back royalty value is \$5." To ensure that the state gets the best value for its resource when it's sold in the market, you look at all the sales for gas within that field. Then the state gets the highest value in that field. If someone else sold gas from that field for \$7.50 then the state would go back to that original lessee--perhaps a year or two later--and require a royalty based upon a \$5.50 net back instead of \$5. The lessees have expressed concern about that uncertainty, he stated. The state negotiated and put that into its leases as a tradeoff for a relatively lower royalty rate. "But because of the desire to get a gas commitment to the initial shipment, we're willing to give them something that provides a bit more certainty on that value." For the applicants that commit gas in the initial binding open season, the state will establish, through regulation, a price that is based upon a combination of known index values such that everybody can anticipate the price for gas for a particular sale. That would be the price for royalty regardless of what they or somebody else sold it for. The applicants get the opportunity to substitute this language into their lease to have this different valuation methodology so that they can have a bit more predictability on what their royalty value is.

CHAIR FRENCH asked if there is a legal definition of binding open season.

COMMISSIONER GALVIN said he would defer to Mr. Scott.

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ANTONY SCOTT, Commercial Analyst, Division of Oil & Gas, Department of Natural Resources (DNR), said the notion of binding open season is a term of art and some binding seasons are more binding than others. What typically happens in the commercial process is that shippers make shipping commitments that are subject to conditions precedent being subsequently satisfied and the nature of those conditions precedent are a matter of commercial transactions that are sometimes fairly narrow. "So it's my understanding for example that on certain LNG projects, conditions precedent include the ability to secure downstream market to the gas or upstream supply, which is an event that is actually entirely within the control of the shipper making that commitment," he stated.

MR. SCOTT stated that a binding open season need not be wildly binding, which is one reason that it isn't defined in the bill. It's also why the bill contemplates going toward FERC certification and continuing the state match even after what might be termed a disappointing open season. Again, he said, the nature of the success or failure will depend upon the particular open season and it's possible on this project to imagine a very early open season with lots of conditions precedent followed by increasing commitments over time as the conditions are gradually fulfilled.

CHAIR FRENCH asked if he is saying that a binding open season occurs once the conditions in the shipper's offer have been satisfied.

MR. SCOTT said he didn't mean to convey that. The binding open season will be an auction. The rules of the auction, including the conditions precedent that must be satisfied, will be laid out during the auction. The question of whether or not the conditions are satisfied is something that occurs at a later point in time, he stated.

CHAIR FRENCH said so it's an offer and acceptance of those conditions. You nominate your gas with certain conditions and if the pipeline company accepts those terms you have a binding open season. Is that a layman's definition?

MR. SCOTT said that's fair.

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SENATOR WIELECHOWSKI asked if the state has any legal recourse if there is an open season and the project is economically viable, but the leaseholder fails to bid its gas.

MARTY RUTHERFORD, Deputy Commissioner, Department of Natural Resources (DNR), said that is one reason the state chose to promulgate regulations. It is to clarify the process by which a lessee could take advantage of this change to its lease structure in exchange for making an FT commitment. We anticipate triggering it through some determination that the project is going forward under the conditions of the open season, she said. It wouldn't be left open as to whether or not there was a potential failed open season or a shipper decided not to take advantage of the commitments that they made. The shipper might have some flexibility in getting away from those commitments so it is going to be a rather complicated process to determine how to protect the state's interest.

SENATOR WIELECHOWSKI asked if there is language in the leases to require a leaseholder to produce its gas when it is economically viable.

COMMISSIONER GALVIN said one of the issues on your list is the duty to market/the duty to develop, but generally yes. The lessee has an obligation under the lease to market its gas when it has an opportunity to do so. "What we're trying to establish here is a number of opportunities and reasons for them to participate and try to avoid a situation where we have to exercise our rights to enforce such a duty." It is clear that the duty exists and it is clear that the state recognizes that the duty is there. But we don't want to end up in a situation where we are forced through the courts to enforce it, he said. We would rather it is a commercial decision that is in our mutual interest, he stated.

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SENATOR WIELECHOWSKI asked why the state would want to provide incentives for something that the leaseholders are already required to do.

COMMISSIONER GALVIN explained that when AGIA was put together there was discussion about what level of upstream inducements would be appropriate. As part of those discussions the state was balancing that issue. In the end, he said, we recognize that

reasonable minds can differ. Also, there is the need to get the project going as quickly as possible and litigation to enforce that lease prerogative is not the most timely way to resolve this issue.

CHAIR FRENCH asked Senator Wielechowski to set his question aside to continue the overview because that issue would be discussed at length.

SENATOR THERRIAULT asked for clarification that the inducements aren't diminishing that particular lease requirement. In fact, he said, the committee might change elements to increase the chance of success in the event that that language needs to be exercised at some point in the future.

COMMISSIONER GALVIN replied nothing that's included in AGIA diminishes the state's option to enforce those sorts of terms. Ultimately providing these opportunities increases the state's claims in that regard, he stated.

SENATOR THERRIAULT summarized that the commissioner talked about reviewing the state's existing system, about determining what inducements to offer upstream, and about the provision for taxing at the "higher-of" selling price. He asked him to address switching between RIK and RIV.

CHAIR FRENCH asked the commissioner to continue the discussion of royalty inducements.

COMMISSIONER GALVIN said before continuing he wanted to clarify something with respect to a binding open season and the lack of a definition. "You indicated that it might be something that people might dispute." He suggested it's important to recognize that in the proposal the licensee will identify the binding open season that fulfills the obligation to hold a binding open season. That is the one that will be identified in the license and that is the one to which the upstream inducements will attach.

CHAIR FRENCH asked if the successful pipeline licensee will conduct the open season.

COMMISSIONER GALVIN said yes, but it's important to understand that pipelines generally have a series of open seasons and some are more binding than others. "People end up focusing on the idea that there's a single magical open season—that everything

kind of comes together. I think we need to recognize that that's not necessarily always the case."

MR SCOTT added that on this project the initial binding open season will be clearly identified by not only the applicant but also by the new FERC regulations governing the terms of a binding open season. Basically there are no regulations governing the conduct of a binding open season in the Lower 48, but the Alaska Natural Gas Pipeline Act (ANGPA) in 2004 said that FERC should promulgate such regulations. For the first time for this project FERC has issued regulations governing the terms of a binding open season.

Touching on the commissioner's point about multiple open seasons, he said when projects are trying to get off the ground it is not uncommon to have a binding open season where the initial participation is not sufficient to construct the project. When that happens there may be another binding open season several years later. For instance in Cheyenne Plains he recalled it was the third binding open season before there were sufficient commitments to construct the project.

CHAIR FRENCH noted that AGIA ties the upstream inducements to the initial binding open season. "There may be three binding open seasons, but only if you nominated gas at the first one do you get the royalty inducements and the production tax inducements."

MR. SCOTT agreed that the upstream inducements will be tied to the first binding open season.

SENATOR THERRIAULT added that generally the open season process conveys to FERC the need for the transportation system. But this project passed that hurdle when Congress passed the act and dictated the need to FERC.

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COMMISSIONER GALVIN continued to explain that the royalty has two aspects. The first is the "higher-of" aspect that refers to the valuation, and the second has to do with the state's ability to switch between royalty in value and royalty in kind. Royalty in value means they ship the gas they sell the gas and they give the state the money. Royalty in kind means that the state takes possession of the gas at the wellhead and takes responsibility for shipping and ultimately selling the gas.

For gas, capacity in the pipeline is reserved and then there is some contract to sell it in spot or through a longer term contract. Because of the obligations associated with the transportation and sale, the state's ability to switch between taking the gas in value and in kind—in as short a time as 90 days—puts the lessee in a vulnerable position. They must react quickly to either find and buy gas somewhere else at a less favorable price, or scramble to get capacity, or displace their own gas. Because switching could be commercially disadvantageous, the state recognizes the value in providing the lessees with an alternative. By committing gas at the first open season the lessee could take some regulation generated alternate language and switch it into their lease to basically protect their interests through a combination of having a longer notice provision and also the state taking some of that capacity responsibility.

CHAIR FRENCH noted that AGIA speaks to establishing terms under which the state will exercise its authority to switch. He asked if the terms are set by regulation.

COMMISSIONER GALVIN said they are set in regulation and then if the lessee makes a commitment, it could opt to have those terms set in the lease thereby becoming a contractual right.

CHAIR FRENCH summarized it's first by regulation and then they become contractual through the lease.

COMMISSIONER GALVIN agreed; the royalty provisions are contractual so through this mechanism the state makes an offer to change through the regulation and then the lessee would have the option to accept that and amend its lease accordingly. That would then become the lease provisions that it could rely upon until it agreed to make a subsequent change. He noted there is language in AGIA that allows the commissioner to potentially readjust those regulations every couple of years. "We want to make it clear that the changing of the regulations doesn't change the lease. It just provides the lessee another opportunity to accept the changed regulations as part of their lease." Certainty is provided by the fact that once they opt in, that language becomes their contractual right. If the regulations change, the lessee may have the opportunity to change again if it might be more advantageous. "We're trying to...balance those interests of making sure that the state has a responsible...public process to develop those rules, but that it's ultimately the lessee's decision as to whether or not to incorporate those into their leases."

SENATOR THERRIAULT asked if there's nothing that times that out in the alternative language for RIK, RIV and higher-of. "That's for the rest of the life of production of gas for that particular field. It's locked in unless the commissioner makes a modification and then it's optional whether the producer accepts the new language."

COMMISSIONER GALVIN said yes, but not for all the gas from that lease. It's only for the gas that's committed to value.

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MR. SCOTT added a technical amendment to Senator Therriault's comment. He explained that the royalty provisions will attach to capacity that is subscribed for the initial open season. All gas that flows through that capacity will enjoy those benefits so it is not particular leases that are dedicated. It's gas that the lessee has that flows through the capacity that the lessee obtained in the initial open season. Those rights would actually expire with those contracts, he stated.

COMMISSIONER GALVIN commented that gets down into the minutia, but it is a volume calculation of gas.

CHAIR FRENCH asked if the part that ensures that the state will stick with the licensed partner is the triple damages.

COMMISSIONER GALVIN said that is part of it. Basically it is a linkage between the fact that we've got upstream inducements tied to the licensed project. Although they are identified as upstream inducements, it must be recognized that because they are tied strictly to the open season of the licensed project, they are also very valuable to the licensee. That's a particular value that the state is also providing the licensee, he stated. Within AGIA there is a state obligation not to provide monetary value to a competing project so from the prospective bidder or licensee view this ensures certainty that the terms aren't going to change. "So there is a tie between both the upstream and the midstream that create what we consider to be an opportunity for driving this project ahead from the get-go," he stated

COMMISSIONER GALVIN emphasized that this is geared toward getting that initial open season to be a success. In the end getting gas committed in the initial open season is what keeps us on the best timeline for this project and provides the maximum value to the state.

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COMMISSIONER GALVIN continued to say that the state needs to maintain the option of proceeding past an open season if it does not get those commitments. It is not in the state's interest to have an all or nothing open season. If the producers choose not to participate or if the potential commitments do not come in, the state does not want to be where it is now. A vital part of the AGIA model is that when the licensee accepts the inducements "they are going to commit to not only get to an open season, but if it is unsuccessful they are committed to continue to move that project ahead so that the focus stays on the project, stays on the economics of that project and people are talking about how do we get the gas in the context of the project that is moving toward a FERC certificate."

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COMMISSIONER GALVIN explained that the state's "must haves" are intended to be a big part of the tradeoff in return for the inducements. They are geared towards a vision the state has of the future of the North Slope, "which is a vibrant competitive market where there is oil and gas exploration that is being done with the confidence that if they have a discovery they know that they will be able to get that to market in a reasonable period of time at a reasonable price." The jobs that are discussed will come not only from construction of the gas pipeline, but also from the vibrant competitive oil and gas fields on the North Slope. "That's the vision that our must haves are geared to trying to fulfill," he stated. Finally, he said, the state wants to ensure that as the line comes in and the gas begins to move south, that there is an opportunity to use that gas for Alaska's needs as well.

SENATOR THERRIAULT thanked him for clarifying the issue of the royalty modifications applying to the capacity. "That's to prevent someone from coming in and nominating gas in the first open season for only a five-year period. "You want them in order to get that incentive to nominate capacity for a longer period of time because that is critical for the economic underpinning of that investment decision."

MR. SCOTT said the mechanism he is referring to is a beneficial consequence of how AGIA is designed. In truth, the reason the incentives are tied to capacity is because capacity is what is subscribed for and reserves are not typically coupled with capacity. "The design was a function of the practical realities that the state faced, but you are correct that it does have the salutary economic incentive."

SENATOR THERRIAULT added that is because the FT is basically a contract for capacity, the way this will work is that it will incent them for a long time.

COMMISSIONER GALVIN said it's a form of durability. The way it is linked to the lease provides the expectation that it will be there for the length of the project.

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CHAIR FRENCH asked him to flesh out gas for Alaskans and whether he was referring to the deliver points.

COMMISSIONER GALVIN explained that gas for Alaskans has three components. The first is the off-take points and it's important that the lessee recognizes that it has an obligation to provide off-take points. The second part is what AGIA calls distance sensitive tariffs. Using a toll road analogy he said that someone who gets off at the first exit shouldn't be expected to pay the same amount as someone who drives the entire length of the road. The applicant would need to accept the idea that the tariff for an off-take point within Alaska will reflect that distance and not the entire line. The third component is the expansion provisions. There needs to be an expansion expectation on the line such that Alaskans can take advantage of that gas in a manner that fulfills their needs.

COMMISSIONER GALVEN said taken together those three components make up the package that will provide the opportunity for economic gas to Alaskans.

CHAIR FRENCH said his constituents are most interested in the Y or spur line.

COMMISSIONER GALVIN said ANGDA (Alaska Natural Gas Development Authority) did an instate gas demand study and it provides a look at what Alaska's future could be in terms of energy use within the state and how a gas pipeline could fill a number of different uses. There could be an off-take at the Yukon River for propane that would lead to a facility that barges it on the river to communities that would be able to substitute the currently barged-in heating fuel for the lower cost fuel. There could be lines into Southcentral, the Fairbanks area, and to tidewater. The latter could be for export out of Alaska and for coastal communities. There are a number of different opportunities for Alaska once a gas pipeline is being pursued. The administration believes that AGIA has the needed tools to

ensure maximum opportunity for Alaska to pursue those options, he stated.

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COMMISSIONER GALVIN said some of the state "must haves" are accomplished structurally. One is through low tariffs. The primary driver for that is the debt to equity ratio that the tariffs are based on. It's the cost of the project and how it will be financed, but it isn't how it is actually financed so much as the proposal to FERC to get your money out. That will be based upon a weighted average of the cost of debt, which is basically at that cost. It's going to be lower than what you expect to get as the return on equity. "Depending on how much you slide your weights between the low cost debt return and the higher cost equity return is going to be the amount of money that you expect to get...out of this project." In looking at any model for any pipeline you'll find that the line between debt and equity is going to be a primary driver of the tariff. A 70/30 debt/equity ratio was selected because it seems to be a reasonably commercial term that many pipelines meet. The administration believes that 70 provides an assurance to the state that it will have a commercially reasonable tariff structure, but the applicant will be allowed to compete to provide a potentially higher level.

COMMISSIONER GALVIN said that the netback value to the state and the tariff that's used will be a very significant portion of the evaluation criteria. "If they propose a 75 percent debt level or an 80 percent debt level it is going to have a very large impact on their tariff and a very large impact on the net value of that to the state." Establishing 70 as a minimum is a reasonable term and it would allow them to compete at a level higher than that, he stated.

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COMMISSIONER GALVIN said expansion requirements, which were mentioned previously, are a critical component of the vision for a vibrant North Slope gas field. "We fulfill this through a number of requirements in the AGIA application process to be soliciting demand, be fulfilling that through an expansion if the demand comes in at an appropriate level, and to provide rolled-in rates." He explained that describes how the cost of the expansion is going to be shared among the shippers. Under a rolled-in rate scenario the cost is spread across all the shippers after the expansion, including the ones that were shipping prior to the expansion. The alternative is referred to

as incremental and under that system only the expansion shippers carry the cost of the expansion.

COMMISSIONER GALVIN said we strongly believe that it's in Alaska's interest to provide for maximum economic potential for explorers at reasonable terms. Rolled-in rates do that. They have been used in Canada and various other areas and have led to a great deal more expansion and exploration. "Ultimately it serves Alaska's interest to see that fit into our gasline and so when we put this inducement in there we're expecting to get in return a gasline that meets our interests." Rolled-in rates are a critical part of that interest, but the administration does recognize that there is some concern. Initial shippers that are not expansion shippers may, in their view, be economically impacted under rolled-in rate treatment.

CHAIR FRENCH added that their view is they are suddenly paying for a new shipper to bring gas to market.

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COMMISSIONER GALVIN said yes; they had the expectation that they would pay a certain amount when they came in. Once the expansion takes place they can opt out of their contract, but they wouldn't be able to ship. If they want to continue to ship, then under rolled-in rate treatment they would have to pay the price that everybody else is paying, which is potentially higher.

COMMISSIONER GALVIN said there are a couple of different things to point out with respect to rolled-in rates. First there is the cap. That obligates the pipeline company to use rolled-in rates until it gets to 15 percent above the initial shipping rate.

CHAIR FRENCH asked if that is the initial tariff or the initial volume.

COMMISSIONER GALVIN said it's the initial tariff. Pipeline expansions usually takes place through compression initially. With rolled-in rates that reduces the cost for everyone and you end up with a J curve. "Through the first one or two expansions the tariffs go down for everybody. Then as you go into... looping where you add actual pipe. You end up with the cost starting to move up." AGIA provides the obligation to use rolled-in rates. "You follow that J curve down and you'd continue to follow it as you move up, but once you reach a point where you...have returned back up and gone past your initial tariff level - up to 15 percent above that--then the obligation to use rolled-in rates no longer applies."

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COMMISSIONER GALVIN emphasized that this can't be a mandate. The tariff treatment is either 70/30 or under the rolled-in rate treatment it's a decision that will be made by FERC for an interstate line, or by the Regulatory Commission of Alaska (RCA) for an instate line. They will ultimately decide what the tariff should be and whether the rolled-in rate should be used at a particular level. But the state is requiring that anybody that takes the inducement has to commit that they are going to apply for a rolled-in rate treatment up to the 15 percent cap.

COMMISSIONER GALVIN said that FERC has a rebuttable presumption of rolled-in rates and hopefully that will stay in place. Ultimately that will help support what is being proposed by our applicant, but it isn't appropriate to rely on that. "We want to have a contractual obligation on the part of those who are getting our inducement to fulfill it."

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SENATOR WIELECHOWSKI asked what the remedy is if there are rolled-in rates, but the explorer or producer doesn't comply with the contract and actually requests incremental rates before FERC.

COMMISSIONER GALVIN said under AGIA the license would still be in place and they would be found in violation. The commissioners would give notice of that violation and the opportunity to cure. If they didn't cure, the state would be able to seek damages associated with that violation.

COMMISSIONER GALVIN said the corollary to the rolled-in rate discussion as it relates to the pipeline company is the obligation that the state is placing on those who take advantage of the upstream inducements. "If they commit their gas to the line, in order to get those royalty and tax provisions that were discussed, they would have to commit to not oppose the rolled-in rate treatment proposed by the licensed project, up to that 15 percent maximum.

COMMISSIONER GALVIN noted that the language in the current committee substitute says that the obligation not to oppose the rolled-in rates only applies if the FERC rebuttable presumption goes away. "We'd like to talk to you about that," he said.

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CHAIR FRENCH acknowledged that is an item of concern and said it would be addressed at length at a later time.

SENATOR THERRIAULT asked if the presumption is only on voluntary expansions.

COMMISSIONER GALVIN said yes; the FERC presumption is only for a voluntary expansion. That means the pipeline company is requesting from FERC an expansion at a particular rate. The alternative is a FERC imposed expansion that would occur when someone wants the pipeline company to expand and it is unwilling to do so. He said he views expansion requirements as going hand-in-hand with the rolled-in rates. "We shouldn't reach the rebuttable presumption because our expansion provisions are probably going to result in it being extremely unlikely that there would be an involuntary expansion imposed by FERC. We believe they would have a contractual obligation to us to expand before we would reach that point," he stated.

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COMMISSIONER GALVIN explained that transparency associated with the level of inducements is to make sure that everyone knows what the state is offering and what it will cost. In addition the state is trying to ensure that the process to advance the project and select the licensee is equally transparent. He emphasized that AGIA sets up a very public competitive process. "It is not a negotiation; it is not an individual discussion with any particular entity." Everyone is given a chance to compete. The public provides comment to the commissioners, the commissioners make a decision and provide an explanation to the legislature, and the legislature decides whether or not it was the right decision. Although everything associated with the project that the state backs will be available for public review, he said that "we do make some recognition of commercial reasons and competitive reasons why certain aspects of the proposals may have to be held confidential during the competitive portion of the process."

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SENATOR THERRIAULT asked if all information, including the confidential information, will be available to the legislature immediately when the bids are opened. "We should start our independent process as soon as you open up the envelopes on all of them," he stated.

COMMISSIONER GALVIN stated agreement. "We crafted an amendment on the House side just yesterday to ensure that the bill

reflects the opportunity for legislators to access even the confidential information." With respect to the timing, he said there will be some give and take between the departments and the applicants during the initial process to make sure that all the information clear. "So we see the start of the opportunity for the legislature to see even the confidential information being at the notice that there is public comment." He estimated it might take a week or two to ensure that the applications are in order and that there is a fully competitive process. "Once we have the completed applications, they become public and the legislature will be able to see everything," he stated.

SENATOR THERRIAULT asked what the estimated timeline is between opening up the envelopes and the executive reaching a final decision.

COMMISSIONER GALVIN said the applications are due October 1 and they become public October 14 so it's a fairly quick turn around. "Everything becomes public, absent the confidential information, and at that moment in time the legislature would...have the opportunity to sign the confidentiality agreements and see the confidential information."

SENATOR THERRIAULT asked how quickly he expects to get to the final selection of a proposal.

COMMISSIONER GALVIN said there is a 60 day public comment period from October 14 to December 14. Then we anticipate up to six weeks for the commissioners to make a decision and give the notice to the legislature with the finding and other things. Of course if there's just one application or if the applications are so disparate that one clearly stands above the others, then the decision-making timeframe from the close of the public comment period could be shorter, he stated.

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SENATOR THERRIAULT recapped that "at the very least there will be 90 days that the legislature could be running numbers, questioning or maybe even making comment in the public comment, but it's not like...we don't do anything until you make your decision."

COMMISSIONER GALVIN said correct. "Regardless of what the timeframe is, the legislature will have probably 30 more days than the commissioners would to make the evaluation." The review time will be basically the same, but the legislature will have the extra time on the end.

CHAIR FRENCH stated that Senator Therriault raises a good point because nothing in AGIA says that all the information that the commissioners have is forwarded to the legislature for consideration. "We wait until you issue the preliminary notice that you want to issue a license."

COMMISSIONER GALVIN restated that language was crafted and put into the House version to clarify that point. The Senate could consider and add similar language providing the legislature with access to all the information from the beginning of the public review process.

CHAIR FRENCH said it seems like a simple clarification.

COMMISSIONER GALVIN agreed.

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SENATOR HUGGINS said there isn't parity because the commissioners are working full time and the legislature isn't in session fulltime. The earlier the legislature starts its evaluation process the better, but there is reason for restraint until it's clear that an application is complete.

CHAIR FRENCH agreed "you don't want to waste time."

COMMISSIONER GALVIN said evaluating the proposals for completeness will take place before the clock starts running on the public review process. That isn't specified in the bill, it simply allows the commissioners the time it takes to get complete information. Once notice is given of the complete applications then the 60 day clock starts running.

He clarified that the original bill allowed 30 days for legislative review and the current committee substitute [CSSB 104(RES)] has a 60-day period for legislative approval.

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COMMISSIONER GALVIN summarized AGIA's purpose is to create a competitive opportunity for commercial entities to participate in a process that has a level playing field. The inducements are geared towards getting as much participation as possible and getting the participants to meet the state's "must haves" with regard to expansions and tariff, and the expectation of committing to get to an open season and a FERC application within a certain timeframe. The intention is to get a pipeline as soon as possible, to provide for a pipeline that meets the

state's long term interests, and to have it all in as transparent a process as possible. In the end this is all geared toward improving the state's position with regard to getting a pipeline under our terms, he said. "It's a matter of providing the state with better leverage as it relates to our options for getting a pipeline."

COMMISSIONER GALVIN acknowledged that right now there isn't movement from any participants but, he said, we have experienced what it may cost if we ask the producers what it'll take to move this project ahead. The previous contract provided a clear example of the price, but it didn't get a commitment to do more than just continue to study. "We believe that the state needs more than that and we believe that through AGIA we will establish a process that will provide the leverage necessary to get this project moving and to ultimately result in a project that meets the state's interest," he concluded.

CHAIR FRENCH thanked Commissioner Galvin for the overview and asked Mr. Ostrovsky to preview the constitutional issues that he would talk about next week.

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LARRY OSTROVSKY, Chief Assistant Attorney General, Civil Division, Oil, Gas & Mining Section, Department of Law, said he would briefly discuss the context of the issue of fiscal certainty with respect to AGIA and how the Department of Law analyzed it.

He referenced Article 3 on page 19, which says essentially that an entity that commits gas in the first binding open season is entitled to an exemption from the state's gas production tax that holds it harmless from increases in that tax. The exemption is good for 10 years from the commencement of commercial operations and it applies only to tax levied on North Slope gas that is committed to the pipeline during the first binding open season. Also, the exemption constitutes a "contract" between the entity and the state.

CHAIR FRENCH asked what legal issue that raises.

MR. OSTROVSKY said although it does raise a legal issue, AGIA has been carefully crafted and the belief is that the approach is consistent with the state constitution and with past practices of the state as well as other legislation. To reach that conclusion the first place we looked was Article 9, Section 1 of the state constitution.

Article 9 - Finance and Taxation

§ 1. Taxing Power

The power of taxation shall never be surrendered.
This power shall not be suspended or contracted
away, except as provided in this article.

MR. OSTROVSKY said he provided the under lining in the last clause because that is where the entire debate rests. If it wasn't there I wouldn't be here, he said. If the sentence ended after the word "away" everyone would agree that there could not be a contract. It's interesting that when the Constitutional Convention originally considered this section for inclusion in the constitution, that last clause was not included. The National Municipal League provided the first model of this article and it ended with the statement that "This power shall not be suspended or contracted away." The final clause was added during the convention.

What does the clause mean? He explained that a basic tenet of statutory construction is that "every word sentence or provision in the statute was intended to have some useful purpose, have some force and effect." Not only can that clause not be ignored, he said, it must be given some meaning. "Unfortunately Article 9 doesn't go on to describe specific circumstances where that clause takes effect. But I think that pretty much...every lawyer who's looked at this provision believes that it probably takes effect, if at all, in Section 4 under exemptions." That's the only place that's relevant to it, he stated.

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Article 9 - §4. Exemptions

The real and personal property of the State or its political subdivisions shall be exempt from taxation ... [P]roperty used exclusively for non-profit religious, charitable, cemetery, or educational purposes, ... shall be exempt from taxation. Other exemptions of like or different kind may be granted by general law. All valid existing exemptions shall be retained until otherwise provided by law.

MR. OSTROVSKY said he underlined the sentence "Other exemptions of like or different kind may be granted by general law." to emphasize that general law is law that has general applicability as opposed to a special law that applies to a particular person or class of people. We believe that AGIA is a general law, he

said, because it is open to any participant that can come in and apply for the inducements. We believe that to give effect to the clause "except as provided in this article" in Section 1, you must read Sections 1 and 4 together and the power of taxation may be contracted away or suspended through other exemptions of like or different kind in general law.

MR. OSTROVSKY said this is also supported by another tenet in statutory construction. That is that statutes should be construed so that effect is given to all the provisions and no part is inoperative, superfluous, void, or insignificant. Under Section 1, if you had no circumstance where the power of taxation could be suspended or contracted away, the portion following the comma - "except as provided in this article." - would have no meaning. "So we find meaning in the other exemptions by general law," he stated.

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CHAIR FRENCH summarized that we are operating in the exception to the rule. The issue is, "Can we drive a gas pipeline through that exception?"

MR. OSTROVSKY commented that that is a provocative note on which to leave the committee.

CHAIR FRENCH recognized the excellent work that his staff, Cindy Smith and Andy Moderow, had done in putting together the very complete compendium of all the legal opinions rendered with respect to the constitutionality of a long-term tax freeze. He noted that copies are available to the public.

Chair French announced that the committee would take up SB 104 after the long weekend. He adjourned the meeting at [4:21:23 PM](#).