ALASKA STATE LEGISLATURE
SENATE JUDICIARY STANDING COMMITTEE
May 7, 2007
1:35 p.m.

MEMBERS PRESENT

Senator Hollis French, Chair
Senator Bill Wielechowski
Senator Lesil McGuire
Senator Gene Therriault

MEMBERS ABSENT

Senator Charlie Huggins, Vice Chair

COMMITTEE CALENDAR

Presentations:
Spencer Hosie: Duty to Produce
Rick Harper and W.H. Sparger: Pipeline Economics
HEARD

PREVIOUS COMMITTEE ACTION

No previous action to record.

WITNESS REGISTER

Spencer Hosie
Hosie McArthur LLP
San Francisco, CA
POSITION STATEMENT: Discussed the duty to produce

Kenneth M. Minesinger, Attorney
Greenberg Traurig
Washington D.C.
POSITION STATEMENT: Discussed gas pipeline economics.

William H. Sparger
Energy Project Consultants, LLC
Colorado Springs, CO
POSITION STATEMENT: Discussed gas pipeline economics.

W.R. Harper, Consultant
Econ One Research, Inc.
Los Angeles, CA

POSITION STATEMENT: Discussed gas pipeline economics.

ACTION NARRATIVE

CHAIR HOLLIS FRENCH called the Senate Judiciary Standing Committee meeting to order at 1:35:30 PM. Present at the call to order were Senator Wielechowski, Senator Therriault, and Chair French. Senator McGuire arrived shortly thereafter.
CHAIR FRENCH announced the committee would hear from Mr. Hosie about the duty to produce.

1:36:04 PM
SPENCER HOSIE, Founding Member of Hosie McArthur LLP, said he was asked to testify on the subject of duty to develop under the Alaska lease form specifically, and oil and gas law generally. He began with an outline of his background in the area and the perspective he brings to the duty to develop question. He's been an oil and gas lawyer for about 25 years and he began his career working for the State of Alaska on what was then known as the Amerada Hess case. His company now runs a national oil and gas practice from San Francisco representing both private and public royalty owners. For about a decade he has served as the lead outside lawyer for the State of Louisiana in its energy matters related to litigation and regulation. The company has represented the State of Hawaii and has also worked with the U.S. Department of Justice in federal royalty matters in the whistleblower context. Over the last several decades he's had the opportunity to see and review millions of pages of oil company documents. Some that were produced in litigation. From that he has a deep and detailed understanding of the processes that oil companies bring to the question of a capital intensive upstream investment. That includes what matters, what doesn't matter, why things get built, and why other things don't get built. "And it's that perspective that I bring to duty to develop," he stated.

1:38:01 PM
MR. HOSIE said that with regard to the substance of the duty to develop, it's necessary to understand the basic nature of the relationship that an oil and gas creates between the royalty owner and the oil producer. That relationship is profoundly unlike a traditional arms-length commercial relationship, he stated. The process begins with a landowner with real estate that may or may not have mineral resources. Because the landowner doesn't have the knowledge or expertise to drill, explore, develop and market the hydrocarbons that might be

found, the landowner needs a partner that has that particular set of skills. Of course, that is a major oil company.

MR. HOSIE explained that the landowner and the oil company execute an oil and gas lease, which is often a short and simple contract to govern a relationship over 50- to 70- years. In that relationship the landowner contributes the real estate and the oil company contributes the promise to use its expertise to explore and develop the property diligently and to market the production for the mutual benefit of the landowner and itself. That's the deal that the oil company strikes to get the initial lease, he stated. As a consequence of making that promise, which includes the promise of diligent development, the oil companies get most of the value of the production. In Alaska, under the Division of Lands 1 Lease Form (DL1), the oil companies get 87.5 percent of the value of the production while the state's royalty share is 12.5 percent. That is low under modern standards, but it was the norm when the DL1 lease form was drafted in the late 1950s.

MR. HOSIE emphasized that the main point is that the producers get the lion's share of the value because of the promises they make to get the initial lease. That includes the promise to explore, to develop, and to market for the mutual benefit of the royalty owner and the oil company.

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MR. HOSIE informed members that for decades the courts have recognized that an oil and gas lease creates a relationship of mutual interdependence and mutual benefit. Importantly, that means that the oil company that is under a lease is no longer able to make decisions based on its unilateral economic best interest. "It can't say 'This is how we make the most money; we want to spend our dollars here and not there.'" Rather, it must make development decisions based on both its interest and the economic best interest of the royalty owner. They're in it together and that covenant to make decisions based on the mutual best interest of both parties is a promise the oil companies make in the initial lease agreement, he stated.

MR. HOSIE said that the economic interests of the royalty owner are often times fully aligned with the economic interest of the oil company. For example, both are interested in high prices; high prices are good for the oil company and the landowner. However, under some circumstances the oil company's economic interest diverges from the royalty owner's economic interest. A key instance where that happens is with development. Almost

invariably the landowner wants their property developed and the hydrocarbons produced and sold, because that activity is what generates the royalty check. “After all, they went to the oil company in the first instance precisely to have the land developed and the property producing and the hydrocarbons sold,” he stated.

MR. HOSIE explained that sometimes an oil company is disinclined to develop and produce--at least right now. For example: the company might be long on a particular resource so it doesn’t value it right now; the company might be capital constrained; the company might have a lot of capital, but for various reasons it might want to spend it elsewhere. “If you’re a major oil company with a development opportunity in Kazakhstan or Qatar, if you don’t spend your dollars there, if you don’t move that project forward there’s likely to be an unhappy consequence for you. You have to go forward in those jurisdictions,” he stated.

MR. HOSIE relayed that another reason for not developing right now is that the company might have high internal hurdle rates or ROI that, as a corporate policy, governs all investment in the company. The internal hurdle rate could be 30 percent, 40 percent, or as high as 45 percent and it won’t invest any money in an upstream project unless it believes it will achieve that return. “That may be its internal hurdle rate and if a project is only 25 percent profitable it’s not going to pass the gating test and won’t get built,” he stated.

1:44:09 PM
MR. HOSIE said that for any number of reasons an oil company can decide not to spend money on development right now. Those decisions might be perfectly sensible and from company perspective that may be the right decision. But that’s not the right question with regard to the duty to develop. The right question there is, “Is the project in Alaska, on its own merits, reasonably economic.” If it is reasonably economic, the oil company has an obligation to go forward. That’s how the implied duty to develop solves this conflict between a royalty owner who wants his/her field produced and an oil company that wants to spend its dollars somewhere else. Duty to develop solves that. It says, “If the project is…on its own merits, reasonably economic, you have an obligation to go forward.” He emphasized that goes back to the basic bargain that the royalty owner struck with the oil company to get the first lease signed. “That’s the promise the oil company made then.”
MR. HOSIE stated that in this instance, the oil company went to the state and said it would produce diligently and that is why

it got 87.5 percent. The oil company said it would use its expertise to explore, develop, and market the production. That is why the oil company gets the lion's share. "Those were promises they made to get the leases in the first instance and it is inconsistent--with that bargain long since struck--for an oil company 30-years down the road to say, 'Oh incidentally, this project may be reasonably economic, but we think we can get a bigger bang for our buck in Kazakhstan or Qatar or in Mississippi, or in East Texas.'" That isn't the right question, he emphasized.

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MR. HOSIE said he thinks about it in terms of the following analogy. Toyota is thinking of building a manufacturing facility in one of five or six southern U.S. states. It goes to those states and asks what incentives they can provide Toyota so it builds the facility in one state as opposed to another. That leads to a reverse auction--or race to the bottom--to find which state can put together the most attractive package of economic inducements so that Toyota builds in one state as opposed to another. Say Kentucky wins that race to the bottom and cuts a deal with Toyota, but as part of the deal Kentucky gets Toyota to agree that if the first plant is successful and Toyota decides to build a second plant, it must build it in Kentucky. Toyota made that promise as part of the original deal. "That is exactly what the duty to development is under the Alaska deal on lease form," he emphasized. If an Alaska gas pipeline is reasonably profitable on its own merits, then the oil companies have an obligation to go forward even if more money could be made elsewhere.

MR. HOSIE said he noted yesterday that Exxon has spent $41 billion in the last two years buying back its stock on the open market. It's doing that to drive the Exxon share price up, and Wall Street loves that. It shows fiscal discipline, it reduces outstanding shares, and the value of the remaining shares rise showing that Exxon is a good and promising investment. From Exxon's perspective that may be a rational economic decision. But when you ask whether they have an obligation to commit dollars to a particular development project, it doesn't matter if they believe they might be better off buying back $41 billion of their own stock. He again emphasized that, "If the project is economic on its own merits they have an obligation, under the deal they entered into…to build the project."

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CHAIR FRENCH asked if he's saying that the industry might be in the position that it has to build a pipeline, or is it more accurate to say that they have to be in a position to sell into an economic pipeline.

MR. HOSIE suggested that he is really asking what remedies the royalty owner has if there is a breach of the duty to develop. To begin with, he said, litigation is never the first option and rarely is it a good option. "A company can force you into litigation if it wants to, but that's not really where you want to be." Fortunately though, in the duty to develop context there's a better remedy. If the oil company refuses to go forward with a development project because it says it's not economic, then it must give the resource back. There is a consequence to saying the project isn't economic, he stated. Once an oil company says a project isn't economic, the resource reverts to the royalty owner. Then the resource owner can go to a different oil company that may have a greater need for that production now as opposed to some years later. That's the royalty owners right. He reiterated that the first remedy is if the oil company doesn't want to build a pipeline, then they have to give the resource back so it can be relet through another oil company that is willing to build a pipeline on your schedule. "That is the important remedy here," he stated.

MR. HOSIE explained that if a third party with the means, desire, or ability to build a pipeline goes to the producers and if the producers refuse to commit gas at a reasonable market price, then the producers violate the implied duty. They're in violation because effectively that bottles up the resource indefinitely. The courts call that in-ground warehousing. It is speculative warehousing of a hydrocarbon. "If you're Exxon with a lot of gas on line, maybe that's a good thing for you, but it is not a good thing for the royalty owner that needs the gas to be produced to generate revenue now."

MR. HOSIE said the short answer is that the right remedy is not to spark a complicated litigation. The right remedy is to ask for the resource back. It's really that clear in the law; they can't have it both ways. In this state they have to move it or lose it, he said. If a third party is willing to come forward they can't say they won't build the project and also not sell it to someone that is willing to build it.

1:52:59 PM
SENATOR WIELECHOWSKI said a concern he has relates to the need to reinject the gas to produce the oil.

MR. HOSIE agreed it's an important consideration and if there are conservation and field preservation reasons that make it imprudent to sell gas because it would impede oil production, that is a legitimate reason for a producer to say no. However, in that situation the economic interest of the oil company and the state are aligned. Both parties have an interest in preserving the field and certainly the AOGCC would have something to say about that if someone were of a different perspective. "But that's…not…the problem here. The problem here…is that you don't have a pipeline cuz Exxon doesn't want to build a pipeline—not yet."

SENATOR WIELECHOWSKI noted that recently all the producers came forward and said they would not put a bid in under AGIA. He asked if he believes that is a violation of the leases they have signed with the state. What action would you recommend the state take?

MR. HOSIE replied it may be a violation of their duty to market and it may be a violation of the promises they made to the state a number of years ago. "I think the right action for the state is to avoid complicated, expensive litigation." Instead, tell the producers they can't have it both ways. If they aren't willing to build the pipeline then they must commit to tender it at market price—with AOGCC concerns covered—to a third party consortium. If they aren't willing to do that either then they should be told they forfeit the resource. "Otherwise…they're just bottling it up indefinitely and that is contrary to every tenet of oil and gas law in this country," he stated.

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SENATOR McGUIRE said she thought Senator Wielechowski was going mention the issue of the unit agreement on the North Slope. She asked if he had reviewed aspects of that and if he had an opinion as to whether there would be a violation of that unit agreement if one or two of the three producers made the decision to commit their gas in the form of a firm transportation commitment. If they do she believes there might be antitrust issues there. "You have a unit agreement that…on its face precludes any movement from that basin," she stated.

MR. HOSIE said the antitrust question is interesting and the state has looked at that in past years in the context of its prior issues with the oil companies in terms of how the production is marketed and how royalties are reported. The question was: Were they acting in concert to report an

artificially depressed price? In terms of the current contract, if the producers act together to not take advantage of a reasonable market activity, that could be a violation of Section 1 of the Sherman Act. It prohibits concerted action for the purpose and with the effect of sustaining or maintaining prices.

MR. HOSIE said the second point is that the fact that there is a unit agreement that requires unitary action is itself not a legal or antitrust issue. Unit agreements are pro-competitive and good for both the oil company and the landowner. "You want there to be a unit with a unit operator that runs the thing sensibly to make sure that there isn't waste in the field." The more sensitive point is whether the oil companies have reached an agreement between and amongst themselves to stand together and say "No." to reasonable market activity or options such as a willing third party. "That is something they would have to be careful about," he stated.

CHAIR FRENCH advised that Mr. Minesinger will talk more about antitrust.

SENATOR WIELECHOWSKI asked if he has an opinion as to whether or not the AGIA process is the appropriate approach. "If the leases are interpreted that way you're saying, it would seem to me that we don't need AGIA—that we don't need the incentives and the inducements."

1:58:29 PM
MR. HOSIE said it is the correct approach; the $500 million is a catalyst to try to get a third party to get past certain regulatory hurdles to make it a reality. "It's in the state's interest to do that to make that happen." And it doesn't undermine the larger legal point, which is that the state does have the benefit of the duty to develop and the producers do have the obligation to move it or lose it. They don't have the option to warehouse the resource in the ground and wait for something to change, he stated.

MR. HOSIE said the legal question asks if this project is economic, so it's essential that the state know what the producers really think about this. It's not just the negotiating posture that should be evaluated here because these are people who negotiate for a living. He said he noted recently that Exxon told the Securities and Exchange Commission in its 2005 K-1 annual report that the Pt. Thomson Unit was economically feasible that year based on 2005 prices and economics. He continued to say:

That is in their 10-K. Why is it there? Because in 2005 Exxon changed its accounting for its capitalized Pt. Thomson costs. And it changed its accounting under FASB—Financial Accounting Standards Board—Standard 19-1, which lets a company undertake a certain type of accounting only if it concludes that the project is economically feasible based on then current prices and conditions—FASB 19.1. Exxon made that conclusion and its auditors—Price Waterhouse Cooper (PwC)—signed off on it and it's footnoted in their 10-K.

That is what Exxon really thinks about Pt. Thomson. Exxon is not misleading the SEC. Exxon is not misleading Wall Street. Exxon's position may have been a little different in its negotiations with the state in years past, but those are negotiation positions. You expect them to be forceful in negotiations. That's what they do for a living.

The point…is that it's essential that the state really know what these companies think about their upstream economics. They have documents, they have upstream investment guidelines that govern where they invest money and what the gating hurdles are and what the return investment has to be for them to green-light a project. These companies are companies with processes that govern these activities. And it's all there in their internal documents.

2:01:36 PM
SENATOR WIELECHOWSKI said that after sitting through about seven weeks of this process he knows that he and others have asked repeatedly what they want and whether this is a profitable project. We haven't gotten a whole lot of straight answers, he said. Do you have any suggestions that this body can do to get the information? In your opinion are we entitled to this information under the leases? Should we be requesting the information in a more formal manner?

MR. HOSIE said you are entitled to the information. That's particularly so if the oil companies have said the project is not economic unless the state changes its royalty percentage or tax regime. "In making those kinds of requests—and I appreciate that was in the prior administration…the industry is essentially trying to recut the deal." He reminded members of the Toyota analogy and said if the oil companies are asking for a change

then it seems that they have an obligation to show their internal economic analyses including their upstream investment hurdle rate documents. Those are the ones that say, "Here's when we invest and here's what we need to invest. Here's what we think we can safely warehouse." The first thing an oil company thinks about is what happens if a project isn't developed. Is there a risk of losing it? "My personal view is that Exxon and the others have not, until very recently, considered the risk of losing the resource real in the state of Alaska.…They thought they could safely warehouse these resources here."

2:03:23 PM
SENATOR McGUIRE, noting that the Chair has the power to ask witnesses to swear under oath and the power to subpoena relevant documents, asked if it might become a political question that the court wouldn't touch, if the oil companies failed to produce the documents that were subpoenaed.

MR. HOSIE said he isn't sure how that would be resolved under Alaska political law. Other avenues would be to formally ask Exxon for the documents through new or current litigation, or ask Exxon to give him permission to show the documents. He said he can't show them without permission because they were produced under protective order, but he does have them. All oil companies have internal investment guidelines; they can't do business without them. Given the fact that you are interdependent, in all fairness I think that you are entitled to see them, he stated.

2:05:00 PM
SENATOR THERRIAULT noted that for 30 some years the price was such that the project was not economic. Is it with the tacit approval of the landowner that you're able to go from year to year, he asked. At what point does the landowner make the determination that somebody else should have the right to go forward?

MR. HOSIE said Pt. Thomson, where a discovery well was drilled in 1977, is a good example. The unit was created 30 years ago and not a drop or oil or gas has been produced from that unit. For a long time the lack of development may have been due to the fact that it wasn't economic. "But certainly for the past many years it has been economic to do a project at Pt. Thomson. And the state has been slowly escalating its insistence that the producers move the project forward." There have been agreements for drilling as well as agreements on expansion and contraction financial penalties, so it's worth looking at ExxonMobil's performance under those agreements. There have been multiple

defaults and they currently owe the state $20 million. That is a penalty ExxonMobil agreed to pay if it didn't do certain development. It didn't do the development and it won't pay its share of the $20 million so there comes a time when the royalty owner is entitled to make the oil company decide. If the project is economic, then move forward and if you truly think it's not economic, then let it go. It's the royalty owner that has to make the call, he stated.

MR. HOSIE said the duty to develop is the law in Alaska. It is specifically referenced in paragraph 19 of the DL1 lease form. It clearly says that further development will be done with due regard "to the interests of both the royalty owner and the oil company." That matter was litigated in the ANS royalty case where Judge Carpeneti decided that there was a full array of implied duties in Alaska law including the duty to develop. "There's just no question but there's a duty to develop in Alaska," he stated. The real question is will the state say "Move it or lose it." if the oil company says the project is not economic.

2:07:56 PM
SENATOR WIELECHOWSKI asked who would have standing to file a lawsuit ordering the producers to develop the resource.

MR. HOSIE replied a lawsuit posing that question on the Pt. Thomson matter is proceeding right now in the superior court in Anchorage. A decision was made to terminate that unit as of December 2006 because of inadequate plans of development. He noted that there are procedural questions as to which court has jurisdiction and what the proper sequence ought to be. That argument will likely take the next 60 days. But the state will ultimately win the move it or lose it point, he stated.

SENATOR WIELECHOWSKI asked if only the State of Alaska has standing to bring suit, or could the legislature or any citizen do so.

MR. HOSIE said he doesn't know, but DNR certainly has standing. As the responsible agency it has the obligation to police the field and the plans of development. If it believes there has been a default, then it has the obligation to act appropriately and require the oil company to cure the default, put the field in production, or surrender the leases. "Right now DNR is actively…pursuing that with the full support and assistance of the Department of Law. That is underway as I speak--for Pt. Thomson." Asking that question will have a clarifying effect on

the company's willingness to commit. "There's just no question but that Pt. Thomson's economic. They will never let their leases go."

2:10:28 PM
SENATOR WIELECHOWSKI said he has heard from some legislators and from the public that the producers wouldn't say they weren't going to put in a bid unless they really meant it. He noted that Mr. Hosie has an impressive resume, "but I guess from a negotiating standpoint, how credible is a statement from a producer when they say we're not going to put in a bid under AGIA?" Are they bluffing or are we negotiating?

MR. HOSIE said yes, you are in a negotiation. He said it is a mistake to look at the oil companies as one. They are very different companies with different needs and desires. He believes Chevron and ExxonMobil feel very differently about Alaska development. So would Shell, he added. "When they take a unified stance in a negotiation, it is important to remember that they are very good at speaking with one voice to you, but internally they are kicking each other under the table all the time." They like to characterize the state as being litigious, but that is untrue. And they are very quick to sue one another. "It is just part of the business that they are in, and it is a negotiating tactic to back the state up on its heels." It is a negotiation, and "who knows what they individually think and who knows what they will do if you move forward anyway?"

SENATOR THERRIAULT asked if it would be good to know if other companies had to try to buy the acreage, because the company can release it back to the state or sell to another. He noted that other companies have approached ExxonMobil and have been shooed away.

2:13:24 PM
MR. HOSIE said absolutely yes. "If you have another major oil company, or even a smaller oil company that has a foothold in the North Slope and wants more, if they're coming to Exxon and offering to take over the Exxon leases and pay a significant bonus, that's because they think it's an economic project." He has not doubt that the state could generate significant bids if it relet the Pt. Thomson leases today with nine zeros.

SENATOR THERRIAULT said that back when Mr. Hosie made a presentation to the LB&A committee, the committee asked the administration for a formal request for information from the companies holding the lease acreage and suggested using Mr.

Hosie's expertise on what documents needed to be requested. Did they approach you about how to phrase such a request?

MR. HOSIE said no.

CHAIR FRENCH said the lynchpin is if the gas pipeline is economic. He is skeptical that the state can force the oil companies to build a pipeline, but seems that the state can force the industry to sell into an economic pipeline.

MR. HOSIE said the first thing that the state is entitled to is a hard, clear informed answer from ExxonMobil about whether it's economic. "You are entitled to that at a bare minimum." They have equivocated because it's a lose/lose point for them. "If they don't want to build it now, but prefer to negotiate to see how many inducements Toyota can get in Kentucky, they don't want to say equivocally we're not going to build it. It's…we need your cooperation; we need some inducements. On the other hand, if they say it isn't economic, bluntly and flatly, then they have just proven their way out of their leases." So the key thing for the state to do right away is to make them take a definitive position. Ask them to square what they've told the state with what they've told the SEC in terms of Exxon's accounting for Pt. Thomson capital costs.

CHAIR FRENCH said he has gotten himself locked into the mindset that he has to prove this affirmatively and keep marshalling state experts and outside analysts to prove that this is economic, when they have the answer and we just haven't forced it out of them.

2:16:39 PM
MR. HOSIE said, yes and, "you can't, as a royalty owner, prove it is economic." The legislature doesn't have that information. "That's not what you do. That's why you have them. That's why they're getting 87.5 percent of production. That's their expertise, and so the last thing a royalty owner wants is a long drawn out litigation from the oil company about whether a big project is economic or not." It's not the fight you want or one that you need to fight, he said. You have to make them tell you. "Are you going to build it or you going to give it back?" If they give it back, the state can release to a company with specific timetables. That is the right of the royalty owner. What is improper is that the state has been in limbo through these interminable negotiations and sliding down a slippery slope.

2:18:01 PM
SENATOR McGUIRE said when a licensee commits to build the line and there becomes an economic way to transport that gas to market and one of the big three companies won't make a firm transportation commitment, "we get into this morass of litigation that goes on for years and years and years, and we lose opportunity." What about expedited consideration? Is anything like that contained in the lease agreements? Does it already exist in disputes governing the lease itself? Can there be a compelling argument to the superior court that this is the kind of matter that needs to be expedited.

MR. HOSIE said he believes there is nothing DL1 lease form for both the North Slope and Pt. Thomson that compels arbitration or provides for expedited treatment. There is absolutely the ability to ask a superior court judge to expedite a given matter. The state has emphasized the need for prompt treatment in the Pt. Thomson case. He said Judge Gleason is moving it forward very quickly indeed. He said he thinks the parties will be deeply into the substance of the dispute in two months.

2:20:03 PM
SENATOR WIELECHOWSKI asked the definition of "reasonably profitable." He has asked that question repeatedly and he expects the answer to be that they don't know because they don't know what the pipeline deal is going to look like. Is it fair because of the unknowns?

MR. HOSIE said reasonable profitability means that they can build the project out, get the gas market-ready, with an expectation of making a reasonable return on their investment. It may be six percent or ten percent. It isn't 30 percent, he stated. If there is an internal hurdle rate of about 20 percent, it can still be profitable at half of that. Bond rates and investment debt are what a court looks at. There are uncertainties. But there are always uncertainties in any upstream oil and gas project. That is the deal they took when they got the lease. "It's theirs to develop diligently." They can't tell the state to make it risk free for us, because that is a renegotiation the basic deal by which they got the North Slope leases, under which they've taken hundreds of billions of dollars of profit. Yes, there may be contingencies and risk. Maybe gas will drop by 90 percent in three years. "I don't think so." But no one can guarantee that. "It's not their right to insist that the state compromise its economic position to make their business riskless. They're getting the lion's share because they agreed to take the risk."

2:22:42 PM
SENATOR THERRIAULT said under the Stranded Gas Act, AS 43.80.300, if the administration is negotiating a package under that act, if the application is approved the respective commissioners shall require the successful applicant to provide financial, technical and market information. "So the commissioner gets to determine what information he wants." If the information is not provided, then the application can't go forward under the act. "Since you were part of the previous administration, you had done some work for them, are you aware, was such a request ever put into the producers to see whether, in fact, the economics of this project were acquired, the things that were being offered up?"

MR. HOSIE said he is not aware of any such requests.

SENATOR THERRIAULT said in a conversation with the previous chief of staff specifically on the work that you had done, he warned me that there was a hole in your argument. "He called it a circular non-sequitur that you get into some little loop." He asked what flaw he referenced.

MR. HOSIE said no one in the prior administration commented any such thing to him. If they had thought that, he would have appreciating knowing. "I do not think that there is." For an oil and gas lawyer, these are not abstract shades of gray concepts. There is a duty to develop and it is in the DL1 lease form. They do have the obligation to go forward and if they don't there is price to pay: they have to turn the resource back to the state. "Those are black letter rules of law."

MR. HOSIE said his final point is that the producers are all very different with fundamentally different views and willingness to go forward with a project in spite of speaking to the state with one voice.

2:25:49 PM
KENNETH M. MINESINGER, Attorney, Greenberg Traurig, said he has practiced before the FERC for 15 years representing several major gas pipelines and other clients. He has tried some of the major FERC market power cases, including cases around the recent so-called "California energy crisis." He has served as chair of the Energy Bar Association antitrust committee and has significant experience on energy-related antitrust matters. He said he will cover three issues today: 1) antitrust and

competitive problems associated with a producer-owned pipeline, 2) how AGIA would largely fix or ameliorate those problems, and 3) the question of what if the producers fail to bid in an open season.

2:28:10 PM
MR. MINESINGER said in 1977 the U.S. Attorney General found that a producer-owned pipeline would present serious vertical market power issues and recommended a complete ban on producer ownership. The issue is that there would be a disincentive to expand the line to serve third party competing gas supplies, he said. He addressed this in a December 21, 2006 memorandum that is on the Legislative Budget and Audit website. The 1977 opinion is consistent with subsequent precedent of the Department of Justice and FERC dealing with vertical market power issues. It is like three trains owned by three companies and one company buys the one bridge they all need to go over. That company will have an incentive to favor its train and discriminate against its rivals. That is what the attorney general was talking about in 1977. It boils down to expansion, delay, and access, he said.

MR. MINESINGER said a producer-owned pipeline would have a disincentive to expand. AGIA, however, fixes that because it has a requirement that if it's economic to do so, the pipeline must expand. If there are customers willing to pay, the pipeline must expand. AGIA also requires that the pipeline hold open seasons every two years. AGIA addresses the issue of delay by requiring the winning applicant to hold an open season within 36 months and requiring the applicant to propose specific dates by which it will file for a FERC certificate and initiate the prefiling process. So AGIA goes a long way in addressing the delay problem with a producer-owned line. AGIA addresses the access issue in the area of rates. If there's a producer-owned pipeline, the producers (Exxon, BP, and Conoco) would be indifferent to a high tariff rate, because it is money from one pocket into another.

2:32:35 PM
MR. MINESINGER said AGIA requires the pipeline to have lower rates. A 70/30 debt to equity ratio, for example, drives the rate lower than if there were a higher debt to equity ratio. AGIA requires rolled-in rates. That's related to the expansion issue where the pipeline would be required to roll in up to 15 percent above the initial rate. Lower rates improve access for third parties, like BG or Anadarko. AGIA establishes an open, competitive process for all parties, unlike the 1977 attorney general opinion, which advocated a total ban on producer ownership. AGIA invites the producers into the process. It

establishes a middle ground between not banning them and negotiating with them exclusively. His opinion on the failure to bid is similar to Mr. Hosie's. If the failure to bid by the producers were the result of an agreement amongst the producers, "you could have a very serious issue under Section 1 of the Sherman Act." It's premature to go beyond that regarding antitrust issues. "We need to wait and see what happens." We all hope it will be a successful open season no matter who conducts it, he stated. The documents Mr. Hosie spoke of would be interesting from the duty-to-produce perspective and they might be interesting from an antitrust perspective. But we need to wait and see.

2:35:28 PM
SENATOR THERRIAULT said he met with him in Washington D.C. prior to writing the memo for LB&A. "If there is a waiver of the earlier language that said that the producers should not own a part of this particular transportation system, there was some concern that that would not necessarily satisfy the Department of Justice…and that there are some turf battles that always goes on between the…federal agencies. Just because one has signed off doesn't mean the other wouldn't be putting a proposal through all these hurdles. And so if I take your testimony correct…if we did have a producer participating, or the three producers participating together, in a proposal under AGIA to be the owner of the transportation system, the requirements of AGIA would go a long way to satisfy that Department of Justice process?"

MR. MINESINGER said, "Correct, and we discussed that in the memo." He said he is glad he mentioned the waiver. It is a detail that is covered in his handout. The Reagan Administration came along and said that producers can perhaps own the pipeline so long as they satisfy the FERC that there is no antitrust problem. He said in 2005 the FERC Chair said the antitrust issues were still valid and will be addressed in any FERC certificate proceeding.

SENATOR THERRIAULT said, "So that would be part of a FERC proceeding that would invite input from the Department of Justice."

MR. MINESINGER said it would be a FERC certificate proceeding if the producers win the AGIA license or otherwise submit an application to FERC for a certificate to build the line. At that time parties could raise antitrust issues. There are multiple agencies and the Department of Justice or the Federal Trade

Commission could show interest, particularly if there was evidence of joint agreement to not bid or other reasons.

2:38:57 PM
SENATOR THERRIAULT asked if there is a potential antitrust issue that AGIA doesn't speak to.

MR. MINESINGER said he thinks AGIA speaks to the issues. He said it is a middle ground, particularly with access issues. It significantly improves the situation, short of banning producer ownership.

2:40:05 PM
WILLIAM H. SPARGER, Principal, Energy Project Consultants, LLC, Colorado Springs, Colorado, said he has 35 years experience in natural gas pipelines and has worked in project management, cost control, engineering, and construction management. He has worked for two major pipeline companies in the United States. He said terminology changes with whoever is speaking, so he gave the following definitions:

- Project: An assumed natural gas pipeline along the southern route through Alaska into Canada
- Producers: The three existing North Slope oil producers
- North America: United States and Canada only

MR. SPARGER noted the following unfounded “concerns” advanced by primarily the producers:

- Shippers bear all of the financial risks of the project cost overruns.
- Producers must have economic certainty.
- Producers are the only ones qualified to construct the project.
- Schedules with milestone dates drive up the project cost, so firm dates are bad.

MR. SPARGER said it is simply not true that the shippers bear all the financial risks of cost overruns. Most new projects have negotiated rates. The rates are negotiated between the shipper and the pipeline company. Those rates may be some form of firm transportation and may take some form of risk sharing, whereby the pipeline company may take some risk of an overrun and the shipper may take some. “I think that’s what’s going to happen with this project,” he stated. He said he doesn’t know how that

risk sharing will take place, but it is a certainty that the shippers will not bear 100 percent of the risk of cost overruns.

2:43:27 PM
CHAIR FRENCH said, "What you're saying is that should the initial pipeline tariff be estimated at $2.00 and should cost overruns drive the tariff up to $4.00…that full $4.00 tariff isn't just automatically passed on to the shipper." It is possible that a shipper could negotiate a $1.75 tariff in the first place, and then have some protections from assuming that cost overrun tariff.

MR. SPARGER said that is true. A multi-billion dollar project in the Lower 48 (Rockies Express) has negotiated rates. "And those rates are, in fact, firm, whereby the pipeline bears all of the risk of cost overruns."

CHAIR FRENCH asked, "100 percent of the overrun risk put on the pipeline builder?"

2:44:47 PM
MR. SPARGER said yes. He referred to the idea of producers needing economic certainty. That certainty breaks down into three areas, and one is supply or upstream, and for this project the supply side is as certain as it gets. "The gas is there; they know it's there; they know what the reservoir looks like; they know within reason how it behaves; and the producers have much more economic certainty on the supply side than most any other producers on normal projects." A good example is Rockies Express where the producers signed FTs without having 500 million per day to turn on—they only think they will by the time the pipeline is in place. In Alaska's case, about "twice the volumes that are being talked about is being recirculated as we speak," he explained. People are talking about a billion cubic feet a day pipeline and over eight is being recirculated today.

MR. SPARGER said that the negotiated rates will mitigate midstream cost overrun issues. The market and the downstream is a normal business risk faced every day. If you look in the producer's annual reports or their 10-Ks, it is listed as a business risk. It is a risk assumed all over the world every day.

2:46:44 PM
SENATOR WIELECHOWSKI asked if he agrees with the producers repeated statement that the size of this project takes it to a new level of risk.

MR. SPARGER said no. Pipeline projects are not rocket science; they are relatively simple from an execution and engineering standpoint in North America where there are rules that don't change. He said he won't minimize the magnitude of the project; however, pipelines are constructed one mile at a time, and the length makes little difference to the execution. It just needs more surveys, rights-of-way, contractors and other resources. The Rockies Express is 1,400 miles long and on an execution-basis it is not being treated any different than any other pipeline, he noted. "I would not agree with those statements."

SENATOR THERRIAULT referred to the Rockies Express and the FT commitments for more gas then is known about, and asked about paying for unused pipeline capacity and the market for that capacity.

MR. SPARGER said these companies think they will have that gas, but they also can sell that reserve space to someone who has the gas. The FT is a commodity. If they don't use it and there is a market for it, then someone will take that space.

2:49:22 PM
MR. SPARGER said he has heard testimony saying that schedules with milestone dates drive up the project cost. AGIA has only one firm date and that is to go to an open season 36 months after the license is awarded. All other dates that are asked for are dates that will develop in proposals. They are not prescriptive dates. Without a schedule, projects tend to go on forever. "No project is ever, to my knowledge, started or executed without a schedule for not just through the FERC certificate, but from beginning to end." If things drive up costs, then the schedule is revaluated under a total project economic analysis. It happens on every large project that at certain points one must revisit the schedule and adjust it depending on the economic decisions at the time.

2:51:40 PM
SENATOR THERRIAULT asked if Mr. Sparger has looked at information that consultants supplied to the previous administration about large project scheduling. There was some caution that if a timeline is too rigid "you force things along…you move from one step to the next step…before you have everything lined up and you're ready to take that step."

MR. SPARGER said he has seen it and believes it is IPA's paper presented last year in Centennial Hall. He's seen a course they

put on regarding the same topic. “I think it’s being quoted out of context.” He said he thinks the intent was not to say there shouldn’t be a schedule, but that one shouldn’t set unrealistic or arbitrary dates. The dates should be realistic, he stated, and that is what the cost estimate is based on. The dates should be open to change as circumstances change, and then an economic decision is made based on the entire economics of the project.

MR. SPARGER noted other unfounded issues and concerns. It is false to say that leading-edge technology is required to reduce project costs. Also, the statement that AGIA requirements for a detailed project description are premature and costly is not correct. “I believe, although I can’t put any specificity to this, that the currently proposed schedule may be able to be shortened.” He thinks it is somewhat pessimistic. The proposed schedule is built on end-to-end dates whereby one step is finished before the other begins. However, that is not the way pipeline projects are built—they are overlapped. Procurement overlaps with the FERC process, for example.

2:54:49 PM
CHAIR FRENCH said the committee would next hear from Mr. Harper who would talk about FT commitments and their affect on a company’s balance sheet as well as other economic issues.

RICK HARPER, Independent Advisor to the Legislature, said he is working in collaboration with Econ One Research, Inc. He has been involved in this capacity for two years.

CHAIR FRENCH pointed out that Mr. Harper is not a consultant for the administration, but for the legislature.

2:55:38 PM
SENATOR THERRIAULT asked Mr. Harper to disclose his relationship with the Murkowski Administration prior to working for the legislature.

MR. HARPER said in addition to assisting the legislature over the better part of the last two years, “during that time I also, on occasion, advised the Murkowski Administration on matters related to the proposed gas line contract, specifically with regard to issues related to capacity release, capacity brokering, and those types of issues.”

MR. HARPER spoke of being involved in the oil and gas industry for over 34 years and with Alaska gas since 1977. He worked for

Atlantic Richfield for 15 years running its North American natural gas business operations. He served as president of Arco Gas and he was retained as an advisor for 10 years after that. Also he has served as president and chief executive officer of a Canadian oil and gas exploration and production company. And he was the senior vice president and officer of a natural gas pipeline distribution and storage company. He said he has been involved in his own international oil and gas consulting business activities for over six years.

2:57:13 PM
MR. HARPER said he has been asked to look at the testimony on AGIA. His observations will focus on the overall risk of a pipeline from a commercial transactional standpoint, the nature of FTs, and how a company evaluates projects. He will put the term "internal rate of return" (IRR) in perspective. He said he agrees with Mr. Sparger, substantially, that the Alaska gas pipeline, unlike many other pipelines, will serve a developed market with adequate existing downstream infrastructure and will access known supplies. "The risk of this pipeline from that perspective is certainly not very substantial." This pipeline will stimulate unprecedented gas exploration in Alaska. He believes that many of the estimates have been understated. Producers have the obligation to develop, market and account to the lessors. It presumes a reasonable expectation of profit, not a reasonable certainty. The IRR is always an indicator that is looked at along with cash flow, return on capital employed, and net present value. The primary determinate on the producing and pipeline sides is net present value. He said he and Econ One Research have reviewed Antony Scott's recent work, and the methodology is accurate. "With the current world that we live in, in terms of interstate natural gas pipelines, no commitment of supplies is required. No commitment of supplies is called for." In order to support a project, transportation commitments—generally firm ones—are required. The obligation to make payments under those commitments, which are called demand charges, begins when a pipeline is placed in service—normally when gas flows. Demand charges and FTs are not take-or-pay commitments and aren't even related, he said. There have been suggestions and confusion about that. As Mr. Sparger said, natural gas pipelines are not generally considered high risk propositions, and traditionally producers have not been involved in the construction, with some minor exceptions. Producers or their marketing affiliates, however, do routinely subscribe to FTs. Producers are not generally the primary FT holder on a given pipeline. It varies, he said. For a pipeline such as this, one would expect to see a large participation on the part of the

producers, both to maximize and to protect their interests. He would expect to see others as well. There might be some speculative taking of FT capacity here.

3:02:39 PM
MR. HARPER said pipeline transportation costs, whether firm or interruptible, are generally treated as expenses and not as debt. It is not only producers, but gas pipelines, distribution companies, and others that take on these obligations. They are obligations he said, but they are not treated in that fashion, at least from an SEC [Securities and Exchange Commission] earnings perspective. Occasionally consideration is given and perhaps implemented as a way of amortizing the cost from a tax standpoint, but that is much different from looking at SEC-type rate of return calculations. The duty to develop and the duty to market are essential duties, he said. He has seen pervasively this pipeline and the taking of FT referred to as risk, and that is not consistent with his experience. It is an expense that has to be managed. "But what you're really dealing with is the opportunity to monetize substantial resources." One would never contemplate that unless there was a prospect for a reasonable expectation of profit.

MR. HARPER said the pipeline transportation side is not generally considered to be a material risk, but it's considered to be a part of the real opportunity of monetizing resources. He agrees that FT subscribers do not bear all the risk of project overruns. They can be shared and mitigated contractually through negotiated rates. There are also processes through FERC should the overruns result from a lack of diligence in the project. He said he has been involved in situations where FERC was asked to require the pipeline company to absorb the overruns. There are different ways, "but it is absolutely not a given that FT subscribers will bear all the risk of project cost overruns."

3:05:49 PM
SENATOR THERRIAULT asked what his duties entailed as president of Arco Gas.

MR. HARPER said, "We were generally responsible for everything that happened to the corporation's natural gas once it got to the wellhead. That included marketing, trading, pipelines, processing, and you name it." He was also responsible for the operation of the company's intrastate pipeline company.

SENATOR THERRIAULT said he is trying to figure out if he knows what he is talking about. He said FTs not being take-or-pay, is

“sort of something that I think we’ve fallen into here, and it is my understanding…that the take-or-pay comes from the old pipeline model where the pipeline took the molecules of gas or had to pay for them.” But this is more use-or-pay, whereby you either use your capacity or you pay for it. If take-or-pay really is not the correct terminology, I want to be clear, he said.

MR. HARPER said take-or-pay is a vestige in the natural gas industry of a bygone era when pipeline companies purchased all of the gas from producers in or near the field. Today pipeline companies are precluded from purchasing natural gas in interstate commerce and must function solely as transporters. “Take-or-pay was a concept whereby the pipelines would agree to take a certain amount of production or pay for it in lieu there of--not as a penalty but as a cash flow device and had the opportunity later on to make it up.” From the “deregulation” of the natural gas industry, where interstate pipeline companies became contract carriers, the ability to ship required a company to enter into an agreement to acquire space, either on a firm basis or on a non-firm basis. On a firm basis there are two components: “you pay a demand charge, which is a charge you pay whether you move gas or not…it generally covers the fixed cost portion of the pipeline, and then there’s a commodity charge, which generally covers the variable components of rates.” The payment is made whether the gas is moved or not. But that has become a commodity in and of itself in the industry. “It’s not something that you are necessarily saddled with.” It can have more or less value than you pay for. The value can oscillate over time, and people make good livings doing nothing but managing that activity. It doesn’t relate to take-or-pay; it’s just a marketing function and expense that occurs within the industry and that is how it is generally treated.

3:09:17 PM
SENATOR THERRIAULT asked what happens if he commits to a certain capacity and then can’t fill it, but he doesn’t want to sell it on the open market. “I haven’t filled my own capacity…I have to pay for it even if I’m not utilizing it, but then the pipeline company is operating a pipe that’s not up to its full potential.” How is that addressed?

MR. HARPER said, “As a part of addressing competitive concerns at the time that the industry went through its transition, mechanisms were put into place; just like lessees, as Mr. Hosie said, cannot warehouse oil and gas reserves at the lease level, you can’t warehouse capacity through paying demand charges. If

you're not using your capacity on a given day, the pipeline has an obligation to make that capacity available to others on an interruptible basis. You can step back in and exercise your rights under certain guidelines that are established, but no, that capacity would not sit idle if there is a need for it or a demand for it."

SENATOR THERRIAULT asked if the capacity is made available on an interruptible basis, is the person with the FT commitment relieved of the obligation to pay for it. "They don't get double billed?"

MR. HARPER said there are mechanisms for crediting a portion of what is received by the pipeline.

SENATOR THERRIAULT said he has heard the suggestions that if one pipeline company had a portion of the pipeline and another had another portion then they can participate in each other's open seasons, and "end up with a virtual straw from a to b even though they don't own it all."

MR. HARPER said that is correct. "Owning the pipeline and controlling space in the pipeline and another pipeline are really two distinct issues. And in a situation where you've got two pipelines which own interlocking segments, I would expect that each of those pipelines might take positions in the other vis-à-vis FT. In fact, in the industry, [that] has happened before."

3:12:09 PM
CHAIR FRENCH said he used to be an oil production operator, and he didn't know about the legalities of oil production, "but we did a lot of arithmetic. We were always counting how much money the industry was making and even though we were getting pretty well paid, we thought, well, they're making a lot of money too." If the proposed gas line moves 4.5 bcf/day and gas prices are at $5.00, would that be $22.5 million a day in revenue?

MR. HARPER said he believes that is correct.

CHAIR FRENCH said if the tariff was $2.00, it would be subtracted from that revenue, and there would be $13.5 million per day in revenue.

MR. HARPER said that is correct, and that is referred to as a net-back calculation.

CHAIR FRENCH said that every 73 days—after paying the tariff—there would be $1 billion in revenue. “So every couple of months you’re putting $1 billion into the cash register.”

MR. HARPER said, “Your math and your concepts appear to be true to form.”

SENATOR THERRIAULT asked if he can speak to the blessings from the Econ One team regarding the work Antony Scott has done.

MR. HARPER said he is ill-equipped, but he has had contact with his colleagues at Econ One who did review the methodology that was used in his calculations. They support the methodology and the treatment of FT, acknowledging that FT is an important consideration and not one taken lightly by producers or anyone else. The fact that it might be treated as an expense doesn’t minimize the obligation itself, “but we think the overall methodology that was utilized is correct.”

SENATOR THERRIAULT asked, “But is it your understanding in the calculations done by Dr. Finizza or Mr. Scott, that the obligation to pay for those FTs was calculated; a netback calculation was done so that’s all accounted for in the calculations?”

MR. HARPER said yes; last year, at the request of the legislature, Econ One made an attempt to simulate the upstream and midstream returns on the producer project, and there was no scenario, including the downside, that was not profitable. He said BP’s presentation had numbers “quite a bit higher than what has been seen before, but there has been no supporting documentation provided that would allow a critical review of any update of those numbers at this time. But as of last year, based upon Econ One’s analysis, there was no scenario that…didn't suggest that there was a reasonable expectation of profitability from North Slope natural gas.”

3:16:26 PM
SENATOR THERRIAULT said one of the companies told him that it has been careful to not call FT debt, but it said it was debt-like. It appears that the FT commitment gives the pipeline company something to go to the financiers with to get financing, so it must have value. The company seemed to be pitching that even though the FT is an obligation to pay in the future as a monetized resource, “that it was almost as if they had transferred value—actually paid cash across, and so they want to be compensated for that.” He said it doesn’t seem like that can

be done. “Other than taking it into consideration for what the netback--the profitability of monetizing the resource—is, that there’s any way that they should expect to be compensated or that it should be calculated in, to drag down the overall profitability.”

MR. HARPER said it shouldn't drag down overall profitability aside from being a marketing expense. It certainly is an important decision that has to be made, but one generally does that when one has substantial opportunity to monetize assets or to gain market share, and it is usually regarded as a very positive thing. “Usually there’s quite a bit of celebration associated with acquiring it and the business proposition that is implied that goes along with it.” Chair French’s calculation is exactly the way one takes a look at it when one is talking to one’s board of directors.

SENATOR THERRIAULT expressed disappointment that the TV camera wasn’t present so the testimony could be replayed. He asked for a transcript to be posted.

3:19:13 PM
CHAIR FRENCH said he too regrets the lack of cameras, and that is a good idea. He recessed the meeting until 6:00 pm.