

**ALASKA STATE LEGISLATURE**  
**SENATE RESOURCES STANDING COMMITTEE**

March 14, 2007

3:39 p.m.

**MEMBERS PRESENT**

Senator Charlie Huggins, Chair  
Senator Bert Stedman, Vice Chair  
Senator Lyda Green  
Senator Gary Stevens  
Senator Lesil McGuire  
Senator Bill Wielechowski  
Senator Thomas Wagoner

**MEMBERS ABSENT**

All members present

**OTHER LEGISLATORS PRESENT**

Senator Hollis French

**COMMITTEE CALENDAR**

SENATE BILL NO. 104

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

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

**WITNESS REGISTER**

Patrick Galvin, Commissioner  
Department of Revenue

Juneau, AK

**POSITION STATEMENT:** Presented SB 104.

Kurt Gibson, Acting Deputy Director  
Division of Oil and Gas  
Department of Natural Resources  
Juneau AK

**POSITION STATEMENT:** Commented on SB 104.

Dr. Antony Scott, Commercial Analyst  
Division of Oil and Gas  
Department of Natural Resources  
Juneau AK

**POSITION STATEMENT:** Commented on SB 104.

Kevin Banks, Acting Director  
Division of Oil and Gas  
Department of Natural Resources  
Juneau AK

**POSITION STATEMENT:** Commented on SB 104.

#### **ACTION NARRATIVE**

**CHAIR CHARLIE HUGGINS** called the Senate Resources Standing Committee meeting to order at [3:39:27 PM](#). All members were present at the call to order.

#### **SB 104-NATURAL GAS PIPELINE PROJECT**

CHAIR HUGGINS announced SB 104 to be up for consideration.

PATRICK GALVIN, Commissioner, Department of Revenue, explained that he would discuss why the Alaska Gasline Inducement Act (AGIA) is needed, and what the state will get in return for the \$500 million in incentives it offers; he then introduced the presenters who accompanied him to the meeting, and assured Chair Huggins that that an overview of contract criteria would take place later that week.

[3:45:28 PM](#)

He said that the AGIA project needs to be moved along in order to meet the nation's demand for natural gas, and the state needs to maximize its value in the project. One of the primary purposes of AGIA is to move the project forward sooner than would otherwise happen. The North Slope basin needs to be opened to exploration and development, and the pipeline needs to be

designed to emphasize the probability of expansion. The process for a contract needs to be open and competitive; AGIA allows for all project hopefuls to compare their applications fairly through a public process.

[3:48:38 PM](#)

COMMISSIONER GALVIN explained that the state's value of the project will be driven by low tariffs. The value comes from the netback value at the wellhead, in terms of royalties and tax bases; establishing a low tariff is essential. Alaskans need the gas and the jobs created by the pipeline project; a training program will be geared to maximize in-state hiring, and licensees receiving a contract will be required to do so.

[3:50:39 PM](#)

He explained that reducing uncertainties for the producers is essential to the project; the low tariff structure is essential as well, and values for the producers will be tied to the open season.

[3:53:08 PM](#)

CHAIR HUGGINS asked if Commissioner Galvin would be going over the variables important to getting the pipeline built quickly.

COMMISSIONER GALVIN said that he would be talking about that, as well as the application process and the ultimate value of the project.

CHAIR HUGGINS said that the financial wherewithal of a pipeline company could affect the timeline. The timeline will also have an effect on the tariff.

COMMISSIONER GALVIN said that he would explain the \$500 million in incentives provided by the state in exchange for certain actions, and how rolled-in rates will be beneficial to the state.

[3:53:36 PM](#)

KURT GIBSON, Acting Deputy Director, Division of Oil and Gas, Department of Natural Resources (DNR), said that there is an important interest in moving the project forward, and the legislation recognizes this. The oil industry might not have the

same timing in terms of declining oil production and getting the line built.

[3:55:08 PM](#)

COMMISSIONER GALVIN added that the state don't know what the exact parameters of the project will be; there are many necessary assumptions.

[3:55:34 PM](#)

CHAIR HUGGINS asked if Commissioner Galvin anticipated a spur line being part of a proposal.

COMMISSIONER GALVIN replied that no such project has come forward yet; the state is offering incentives that will make everyone realize that gas off-takes are economical, but a spur line isn't necessarily included.

He said that the economics of AGIA were built around a prototype project similar to the Stranded Gas Act. Today, the project would cost \$20.5 billion; the number is built on a 70/30 debt equity ratio, and assumes the current PPT tax rate would apply to gas.

[3:58:48 PM](#)

CHAIR HUGGINS asked if he is assuming that the current tax rate is accurate.

COMMISSIONER GALVIN replied yes.

SENATOR STEDMAN commented that the PPT has a progressivity feature.

[3:59:48 PM](#)

CHAIR HUGGINS asked to know the assumptions about the rates.

DR. ANTONY SCOTT, Commercial Analyst, Division of Oil and Gas, Department of Natural Resources (DNR), replied he would get that information for the committee; the oil to gas ratio would not be six to one as previously stated.

[4:01:07 PM](#)

SENATOR STEDMAN stated that a 22.5 percent tax would be embedded in the PPT.

DR. SCOTT concurred, and said that the rate is based on a 30-year project.

SENATOR STEDMAN asked if the first gas will be produced in 10 years.

DR. SCOTT answered that first gas production could occur as early as 2016.

[4:02:57 PM](#)

MR. GIBSON clarified that in today's market pricing, the ratio for oil and gas contracts is nine to one. He added that the assumptions in the modeling don't assume what is an appropriate project, or that the proper tax is today's PPT; they are just assumptions their model is based on.

[4:04:08 PM](#)

He presented a graph showing the cost of delay and the value of accelerating the project. In terms of the \$500 million contribution, a single year of acceleration could earn the state \$1.8 billion at present value. Three years acceleration would earn \$5 billion.

CHAIR HUGGINS asked if a delay would mean completion in 2019.

COMMISSIONER GALVIN replied yes.

[4:05:32 PM](#)

SENATOR WAGONER asked how conservative the \$3.50 gas rate estimate is.

MR. GIBSON replied that it is very conservative, and explained that the timing of the project affects the rate very much.

[4:06:46 PM](#)

SENATOR WIELECHOWSKI asked if Commissioner Galvin is assuming that the incentives will speed up the pipeline process.

COMMISSIONER GALVIN replied that the idea of the incentives is to garner the state money that would be lost by a delay.

SENATOR WIELECHOWSKI asked if there's any proof that the incentives will help speed up the project.

COMMISSIONER GALVIN replied that the proof will be in a company accepting the money and committing to a timeline.

CHAIR HUGGINS asked him to share a couple of other techniques of how to use the \$500 million.

COMMISSIONER GALVIN replied that the figure is based on statements that getting the FERC certificate would cost \$1 billion. There isn't yet a model showing where money will be spent once it's awarded, and there aren't any project ideas being debated.

[4:11:34 PM](#)

CHAIR HUGGINS asked what weight the \$500 million incentive carries.

COMMISSIONER GALVIN replied that the extent to which a company doesn't need the money will put it at an advantage.

SENATOR WIELECHOWSKI opined that rigorous analysis as to why the \$500 million will work is needed; he is skeptical of its efficacy.

COMMISSIONER GALVIN replied that there are numbers available today on how the \$500 million will affect the tariff; the state needs to get people in the door to participate in the process. He spoke about the negative appearance of the state as wanting without giving; it needs to put money into the project to make it happen and inspire confidence.

[4:15:33 PM](#)

SENATOR STEDMAN said that if gas is valued at \$6.50, a one-year delay could cost \$2.3 billion.

COMMISSIONER GALVIN said that the figure would represent the net present value, discounted by five percent.

SENATOR STEDMAN asked what a delay would cost the industry.

COMMISSIONER GALVIN replied that the dynamic changes; the industry can find income somewhere else.

SENATOR STEDMAN repeated that there is clearly a cost in delaying.

COMMISSIONER GALVIN said that there's no loss to the industry if they have projects elsewhere; it's not the same dynamic the state of Alaska faces.

[4:18:31 PM](#)

MR. GIBSON said that if the state was perfectly aligned with the producers, the cost of delay would effectively be the same.

[4:19:20 PM](#)

CHAIR HUGGINS said that it's important to understand the junctures where delays are expected, and what those delays will mean for initial production.

COMMISSIONER GALVIN said that the state recognizes that once the project gets a FERC certificate...

CHAIR HUGGINS interrupted to ask Mr. Galvin to talk about open season because that might be the first point of delay.

MR. GIBSON responded that the state had a timeline that it would present to the committee later, and there may be other sources of delay. The state wants an obligation for someone to take action.

CHAIR HUGGINS said that the Stranded Gas Act is in the past, and AGIA is the vehicle for success.

[4:22:01 PM](#)

SENATOR MCGUIRE mentioned the strict confidentiality provisions in the Stranded Gas Act, and said that while transparency and openness should be practiced by the committee, the state's negotiating position shouldn't be given away.

MR. GIBSON said that he appreciated that sensitivity. He pointed out a timeline for the AGIA bill, with the award of a license as year zero, and corrected a mislabeling. The timeline shows the country what it can expect from gas development in the US, and accounts for alternative energy sources in case the pipeline is delayed substantially.

[4:24:09 PM](#)

COMMISSIONER GALVIN said the state doesn't want the project to stall; the aggressiveness of the schedule will carry weight in value to the state. The more work that's done before open season, the less will have to be done in order to get the FERC application. Some companies want at least two field seasons before holding an open season in order to prepare better; the timeline accommodates that but doesn't allow for ultimate delay. Aggressiveness of schedule is an important factor to the state.

[4:26:45 PM](#)

CHAIR HUGGINS asked what unfulfilled expectations for an open season would do to the timeline.

COMMISSIONER GALVIN replied that AGIA would move forward anyhow and a plan could still be submitted to the FERC. The underlying premise is that even a project with a failed open season provides a greater level of certainty.

[4:28:10 PM](#)

CHAIR HUGGINS asked what an unsuccessful season would do to the risk profile of AGIA.

COMMISSIONER GALVIN replied that after the open season, the applicants will have to provide their proposals to the state before getting FERC certification. The object is to ensure the certainty of getting the FERC certificate. He said that he would be happy to continue answering questions but would prefer to do more presentation.

[4:29:57 PM](#)

SENATOR STEDMAN asked what involvement or influence the FERC would have if there were a failed open season.

MR. GIBSON replied that first it's important to understand what a failed open season is. Some people imagine that means that a pipeline ends up being only 50 percent or 75 percent subscribed; he envisions less than 100 percent subscribed as a possibility.

SENATOR STEDMAN gave two scenarios for a failed open season, including a no-show of producers or missing the target of gas transported each day.

COMMISSIONER GALVIN said that AGIA is letting the market provide different paths of development for the line. It's unknown what the FERC's commercial reaction will be, but under federal law it doesn't require FT commitments in order for there to be a need for the project.

[4:33:11 PM](#)

MR. GIBSON showed a slide of declining North Slope oil production and projected demand, and said that by encouraging gas exploration additional crude oil will be discovered and revenues will go up. He showed another slide of the supply profile for the United States, which is just an educated guess from 2006 forward. Liquefied natural gas (LNG) is becoming an increasingly important part of American energy, but the market won't wait for more production.

[4:36:43 PM](#)

COMMISSIONER GALVIN said that the presenters would talk about the lower tariff values built in to the AGIA process.

MR. GIBSON showed a slide to illustrate the difference in market prices and netback values. The importance of Alaska's contribution is a grant, not an equity position, so it has a positive impact on transportation to market. By contributing \$500 million outside the rate base of a project, the tariff is reduced by up to six cents.

CHAIR HUGGINS asked what would change if a company didn't accept the \$500 million.

MR. GIBSON replied that not accepting the \$500 million wouldn't necessarily give an advantage; there is real value to the state and producers in making a capital contribution. Not accepting the incentives might not be appropriate.

[4:41:35 PM](#)

COMMISSIONER GALVIN said that whoever refused the incentives wouldn't have a reduction in the tariff; it's a trade-off.

[4:42:23 PM](#)

CHAIR HUGGINS said that another technique could be to put the \$500 million in an escrow account as a later reward for meeting performance criteria.

SENATOR WAGONER said the exact opposite would happen if the money was put into their rate base.

COMMISSIONER GALVIN responded that the comparison is based on the state not making the contribution and using it for debt equity.

SENATOR WAGONER clarified his comment.

[4:43:59 PM](#)

MR. GIBSON referenced a slide on the time value of money, and explained how the \$500 million would turn into \$900 million in reduction of the rate base. He said that the capital contribution will take the form of a \$900 million reduction in the rate base by the time first gas flows, because of an allowance for funds used during construction.

COMMISSIONER GALVIN said that, in reference to Chair Huggins' question, there could be an effect on the tariff.

CHAIR HUGGINS said it would to the state's advantage if there was a stipulation that there couldn't be rolled-in loan rates if the \$500 million wasn't accepted.

MR. GIBSON replied that the issue is related to FERC rate-making, and he would find an answer for the committee.

COMMISSIONER GALVIN said the presenters would talk about the effect of the tariff on the 70/30 debt equity ratio.

[4:47:48 PM](#)

DR. SCOTT said the 70/30 structure ensures that the tariff will be low. It's a reasonable requirement that provides protection for the state's interests. Eight of fifteen recent major pipeline projects had a 70/30 structure, and three projects had much higher equity percentages. The pipeline will be financed with both debt and equity and debt is much less expensive. If the payments are lower, the tariff is ultimately lower.

He then showed a table listing the effects of different capital structures on tariffs of a hypothetical project; he said that the FERC wouldn't consider a 50/50 structure unreasonable.

[4:52:31 PM](#)

CHAIR HUGGINS asked about the size of the project.

DR. SCOTT replied they had prepared a number of project parameters, and emphasized that while there are no Lower 48 pipelines of this scope the project is still viable. The federal loan guarantees up to 80 percent debt but they didn't want to use the full amount because the project is so risky.

[4:54:47 PM](#)

CHAIR HUGGINS asked for detail on the two or three larger projects not on the list.

SENATOR WIELECHOWSKI remarked that if someone were to want to spend \$20 billion on the project, under current terms they would be rejected.

COMMISSIONER GALVIN explained that that would be a non-conforming bid.

SENATOR WIELECHOWSKI asked if there's a risk in having such a high debt ratio.

COMMISSIONER GALVIN clarified that the 70/30 rate is the capital recovery rate. It doesn't mandate that a company has to take on that amount of debt; they can choose how to finance it, but in order to recover the investment it has to be based upon the 70/30 ratio rate of return.

MR. GIBSON said that even if an entity declares 100 percent equity, the equity would be recovered in tariffs over a multi-decade period. If an entity told the FERC it wanted tariffs determined on a 100 percent equity basis, the FERC would deem it unreasonable and assign a structure.

He explained that a lower tariff benefits the state and any shipper, and it certainly benefits future explorers.

CHAIR HUGGINS asked if there would be a more in-depth discussion of tariffs at a later point.

COMMISSIONER GALVIN said that there would be discussion on rolled-in rate tariffs.

[4:59:23 PM](#)

KEVIN BANKS, Acting Director for the Division of Oil and Gas, Department of Natural Resources (DNR), said that expansion is the future of the North Slope and will be threatened without the provisions in AGIA. He cited statistics on the size of gas deposits, and said that initial open season will occur in three years. At that point, few explorers will be able to nominate pipeline capacity. AGIA proposes assessing the market demand for additional capacity every two years.

[5:01:58 PM](#)

He showed a slide about the problems and costs associated with delays. The FERC assumes a sufficient market for pipeline capacity, and the typical pipeline owner has the incentive to grow by tendering for new gas capacity on a regular basis. The pipeline act treats the Alaskan situation as unique, and requires mandatory expansion. Conditions include shippers being required to have gas reserves and takeaway capacity before requesting expansion. In each situation, the applicant bears the burden for new capacity. The pipeline act has not been through a judicial review and is therefore untested; the first orders related to the pipeline act are already under litigation before the FERC. Even with the expedition required by the pipeline act, the litigation has already reached two years' length. The investment in seismic programs is fairly serious; ensuring getting expansion at the end of it would cost the explorer a lot of money, and the threat of delay could kill a project.

He said that if an a explorer can anticipate putting gas in the line whenever they want to, they can make a profit, but even a one-year delay would send the value of their project below zero.

[5:07:16 PM](#)

COMMISSIONER GALVIN said that after the break they would change the focus of the economic models before the committee, and look at investment opportunities from explorers' perspectives.

[5:08:10 PM](#)

CHAIR HUGGINS called a recess.

[5:20:30 PM](#)

CHAIR HUGGINS called the meeting back to order.

COMMISSIONER GALVIN said that rolled-in rates are part of the expansion provisions in AGIA. One of the requirements is that explorers use a rolled-in rate base for establishing the tariff on the line expansion.

DR. SCOTT explained that AGIA requires rolled-in rate treatment on expansions so long as the resulting rates do not exceed 15 percent of the initial in-service tariffs. He then gave an example of how rolled-in rate treatment would work.

CHAIR HUGGINS asked if rolled-in rates are a special provision for the Alaska pipeline.

DR. SCOTT replied that the rates are a provision of AGIA. In the Lower 48, the rate treatment on expansions is handled on a rolled-in basis if doing so lowers the tariffs for everybody, and on an incremental basis if it would cause rates for existing shippers to rise. The rationale is that in the Lower 48 there are frequently multiple pipelines serving the same production basin and rolled-in rates are a safeguard to prevent less-efficient pipeline expansion. The Alaska pipeline is different; it's a natural monopoly, so the FERC adopted a rebuttable presumption in favor of rolled-in rate treatment for expansions.

He added that when addressing the presumption, the FERC will look to the initial government subsidies provided, and consider them in making the determination as to whether the presumption should be rebutted or not. Rolled-in rates foster exploration and development because shippers pay lower rates and decrease cost factors. They also ensure that all shippers pay the same rate, which is the norm in the economy as a whole. Incremental rate treatment results in uneven payments from shippers.

[5:29:08 PM](#)

He then showed a slide to demonstrate how rolled-in rates work in case of expansion, and how incremental rates give uneven tariffs to initial and expansion shippers. Rolled-in rates make prospects economically feasible, and increase the scope of gas that can be recovered. He clarified that a prospective site is a land position where there may be hydrocarbons; however there is a considerable likelihood that the drilling site won't be profitable. A positive prospect value means a company will want to drill, whereas a negative prospect value site won't be drilled and expansion won't occur. Rolled-in rate treatment encourages expansion because expansion capacity is cheaper, and it means more prospects are of positive value. Looping expansion

is an expensive way to add capacity, but on a rolled-in basis will still result in positive prospects; with incremental rates, the prospect value is negative.

He then referenced another slide showing fuel demand consequences for different rate scenarios.

[5:36:04 PM](#)

COMMISSIONER GALVIN said the last two slides further explained the value of expansion to the state.

MR. BANKS explained that the final slides illustrated different scenarios for expansion, and how the state will earn more revenue by doing so. If the tariff goes up for all shippers, including the existing ones, the royalty netback will decrease. He then explained how taxes would increase in the case of a looping expansion.

[5:38:31 PM](#)

COMMISSIONER GALVIN said that the next presentation would explain in-state use and upstream inducements.

[5:39:04 PM](#)

CHAIR HUGGINS asked the committee members for questions, and asked the presenters if there will not being any PPT adjustments before FERC certification.

COMMISSIONER GALVIN said the economic numbers used in the presentation were based on the current PPT rate.

CHAIR HUGGINS asked when the presenters would address adjusting tax rates.

COMMISSIONER GALVIN replied that it's not an issue for AGIA. However, freezing the production tax rate at the right time is important. The intent of the bill is to keep the tax rate at the open-season level.

CHAIR HUGGINS asked Commissioner Galvin if he anticipated the legislature adjusting the tax rate during the project, or making any amendments.

COMMISSIONER GALVIN replied that he didn't.

CHAIR HUGGINS said he would like to hear insight on financing timing in AGIA, and said that there should be further conversation about the timeline and its risks.

He thanked the presenters and said that the committee has high hopes for the bill.

COMMISSIONER GALVIN said that the presenters feel the same.

There being no further business to come before the committee, Chair Huggins adjourned the meeting at [5:43:33 PM](#).