

SENATE FINANCE COMMITTEE
April 16, 2010
2:55 p.m.

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CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at 2:55 p.m.

MEMBERS PRESENT

Senator Lyman Hoffman, Co-Chair
Senator Bert Stedman, Co-Chair
Senator Charlie Huggins, Vice-Chair
Senator Johnny Ellis
Senator Dennis Egan
Senator Donny Olson
Senator Joe Thomas

MEMBERS ABSENT

None

ALSO PRESENT

Representative Les Gara; Mide Lesmann, Community Relations Manager, Department of Health and Social Services; Derek Miller, Staff, Representative Mike Kelly; Kevin Brooks, Deputy Commissioner, Department of Administration; Greg Winegar, Director, Alaska Division of Investments, Department of Commerce, Community and Economic Development; Ted Leonard, Executive Director, AIDEA; Tracy LarBerge, Tracy's King Crab Shack; Representative Wes Keller; Kevin Banks, Director, Division of Oil and Gas, Department of Natural Resources; Fred Hagemeyer, Managing Director, Black and Veatch Corps.

PRESENT VIA TELECONFERENCE

Amanda Metivier, Statewide Coordinator, Facing Foster Care in Alaska; Carl Berger, Executive Director, Lower Kuskokwim Economic Council; Mike Borgford, made in Mat-Su, MatSu;

Marty Metiva, President, Alaska Partnership for Economic Development; Yukon Tanner, Talkeetna, Veterans and Family.

SUMMARY

HB 126-EXTEND/RESUME STATE CUSTODY OF CHILDREN

HB 126 was HEARD and HELD in Committee for further consideration.

HB 184-DEBT AUTHORIZATION FOR UNIVERSITY

HB 184 was HEARD and HELD in Committee for further consideration.

HB 421-PUBLIC EMPLOYEE SALARIES

HB 421 was HEARD and HELD in Committee for further consideration.

HB 412-MICROLOAN REVOLVING FUND

HB 412 was HEARD and HELD in Committee for further consideration.

HB 226-NAMING VETERANS' WAY IN MAT-SU

HB 226 was HEARD and HELD in Committee for further consideration.

#hb126

CS FOR HOUSE BILL NO. 126(FIN)

"An Act relating to extensions and resumptions of state custody of children; and providing for an effective date."

[2:55:44 PM](#)

Co-Chair Stedman explained that the bill addresses debt authorization at the university. He mentioned three fiscal notes from the Department of Health and Social Services (DHSS). One fiscal note is designated for children service management for \$103,700 in general funds and \$73,500 in federal match, one fiscal note for foster care special needs for \$38,800 in general funds and \$2,200 in federal match. The final fiscal note is for foster care base rate

in the amount of \$186,800 in general funds and \$37,200 in federal match.

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AMANDA METIVIER, STATEWIDE COORDINATOR, FACING FOSTER CARE IN ALASKA (via teleconference) testified in support of HB 126 which extends foster care to age 21 and allows youths to reenter foster care. She claimed that 40 percent of youth who age out of foster care in Alaska end up homeless and 30 percent incarcerated. She spoke of her successful experience of extending foster care until age 22 because of foster parents allowing her to remain in their care. She appreciated the proposed extension of the foster care age to 21 years.

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MIDE LESMANN, COMMUNITY RELATIONS MANAGER, DEPARTMENT OF HEALTH AND SOCIAL SERVICES, stated that the department recognizes the value of the legislation. He noted that the legislation may be valuable for some youth who are not equipped to exit care before age 21. He added that policy and procedure revisions and updates to the management information system and the office of children's services can implement the legislation.

HB 126 was HEARD and HELD in Committee for further consideration.

#hb184

HOUSE BILL NO. 184

"An Act relating to the debt authorization of the University of Alaska."

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DEREK MILLER, STAFF, REPRESENTATIVE MIKE KELLY explained that the bill raises the current bond debt cap for the University of Alaska to reflect today's construction prices.

Co-Chair Stedman asked if the bill allows the university to increase bonding for the Life Sciences Building. Mr. Miller responded that if the bill passes, the additional notice requirement for the bonding would not be necessary.

Co-Chair Stedman pointed out one zero fiscal note.

HB 184 was HEARD and HELD in Committee for further consideration.

#hb421

HOUSE BILL NO. 421

"An Act relating to the compensation of certain public officials, officers, and employees not covered by collective bargaining agreements; and providing for an effective date."

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AT EASE

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RECONVENED

KEVIN BROOKS, DEPUTY COMMISSIONER, DEPARTMENT OF ADMINISTRATION explained that the department negotiated with the five largest labor unions resulting in voluntary agreements. The monetary terms were submitted to the legislature. The bill addresses 3000 non-covered employees in the three branches of government.

Co-Chair Stedman pointed out one fiscal note from the executive branch for \$4,182,300 in FY11 with the cost doubling in FY12. The second fiscal note is from the court system for \$1,346,000 in FY11 with the cost doubling in FY12 and one fiscal note from the legislature for \$741,800 in FY 11 also doubling in FY12.

Mr. Brooks explained that the amount doubles because the FY11 amount rolls into the base.

HB 421 was HEARD and HELD in Committee for further consideration.

#hb412

CS FOR HOUSE BILL NO. 412(FIN)

"An Act establishing the Alaska microloan revolving fund; making loans for commercial purposes from the fund; relating to the fund and loans; and providing for an effective date."

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GREG WINEGAR, DIRECTOR, ALASKA DIVISION OF INVESTMENTS, DEPARTMENT OF COMMERCE, COMMUNITY AND ECONOMIC DEVELOPMENT, explained that the bill is modeled after other micro-loan programs offered throughout the United States. A similar program is not yet available in Alaska due to a lack of a qualified intermediary lender as required by the Small Business Association (SBA). He expounded the goal of providing loans for up to \$35 thousand for an individual and \$70 thousand for two or more individuals. The loan proceeds are available for working capital, inventory, lease hold improvements, and other business related matters. The loans must be collateralized. He informed that the fiscal note requests \$81 thousand in operating expenses to hire a loan officer to process loan requests. The fund is established as a revolving fund. The department supports the bill.

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Co-Chair Stedman pointed out one fiscal note from the Department of Commerce, Community and Economic Development (DCCED) for \$3,577,700 in Alaska Industrial Development and Export Authority (AIDEA) dividends to capitalize the fund. He expressed concern with the issue of capitalization as it is abnormal to capitalize a fund with a fiscal note. He cited an over appropriation of the fund. According to Legislative Finance, the AIDEA funds have been expended in the FY11 budget. He asked about the state as a banking institution versus the private sector.

Mr. Winegar responded that he was under the assumption that a new fiscal note had been prepared. He stated that the loan amounts are small and short term with higher risk. He stated that the SBA makes the program available in 46 other states for the same reason.

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TED LEONARD, EXECUTIVE DIRECTOR, AIDEA stated that the proposed loan program is not an AIDEA program. He mentioned that AIDEA's strategic planning process during a spot analysis of the Alaska economy identified a gap in the tools available to help small businesses. He voiced that he was once the Chief Financial Officer (CFO) for a small corporation. He explained that cash flow is the blood of a small business. The business cycles do ebb and flow and occasionally a business requires a loan to allow a business

to continue. He stated that the small economic development supported the need for helping small businesses with capital. While the program is not an AIDEA program, he did support the goal of helping small businesses with working capital.

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CARL BERGER, EXECUTIVE DIRECTOR, LOWER KUSKOKWIM ECONOMIC COUNCIL (via teleconference) testified in support of the legislation. He noted that the support extends to other small communities. The amount provided is exactly what communities require. He stated that Alaska is one of four states without a microloan program.

MIKE BORGFORD, MADE IN MAT-SU, MATSU (via teleconference), testified in support of the legislation. He claimed that HB 412 was the most important small business legislation in the last 30 years.

MARTY METIVA, PRESIDENT, ALASKA PARTNERSHIP FOR ECONOMIC DEVELOPMENT (via teleconference), testified in support of the legislation. He stated that the situation analysis of the state's economy provided a statewide economic strategy implementation plan. He stated that the raw data from the analysis includes that from over 300 business community leaders. He noted that the two key findings addressed include the access to the capitol. He believed that HB 412 compliments the existing financing opportunities.

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TRACY LABARGE, TRACY'S KING CRAB SHACK, testified that she is a small business owner who purchases her inventory from local fisheries. She worked with Juneau Economic Development Council (JEDC) and local banks to establish creative methods of financing. She stated that she requires a loan for inventory. She stressed that the bill allows her business the opportunity for success.

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Senator Olson asked if \$35 thousand was enough to capitalize a small business. Mr. Winegar responded that the amount of \$35 thousand is patterned after the SBA program. The private sector is a better place to obtain larger

amounts of capital. He specified that HB 412 targets smaller loans.

HB 412 was HEARD and HELD in Committee for further consideration.

#hb226

CS FOR HOUSE BILL NO. 226(TRA)

"An Act renaming Seldon Road and that portion of Bogard Road that extends between Palmer and Meadow Lakes as Veterans' Way."

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REPRESENTATIVE WES KELLER discussed the legislation as an opportunity to honor veterans. He described the need for the signage as the current situation proves confusing to drivers.

Co-Chair Stedman mentioned the fiscal note from Department of Transportation and Public Facilities for \$8,500 in general funds to install signs.

Senator Huggins supported the legislation and spoke to the popularity of the bill.

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YUKON TANNER, TALKEETNA, VETERANS AND FAMILY (via teleconference) stated that the opportunity to rename the signs on the street was supported by the community. He noted further support from the veterans.

Representative Keller affirmed the positive support for the legislation expressed to him during his travels between Palmer and Meadow Lakes.

HB 226 was HEARD and HELD in Committee for further consideration.

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AT EASE

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RECONVENED

^Presentation by DNR on AGIA regulations

KEVIN BANKS, DIRECTOR, DIVISION OF OIL AND GAS, DEPARTMENT OF NATURAL RESOURCES, explained that the presentation includes regulations regarding oil and gas and the Alaska Gas Inducement Act (AGIA) as a potential inducement for the calculation for the royalties for oil and gas. The presentation includes regulations designed to establish value for natural gas and other royalty issues. He stated that he had colleagues available to answer questions. He spoke to the challenges in statute and regulations.

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Mr. Banks began with the "Proposed AGIA Royalty Regulations" (copy on file). He presented the overview beginning with Slide 3, "Overview of the AGIA Royalty Regulation."

- Purpose of the regulation is to make offer to modify state lease contracts, consistent with requirements of the Alaska Gas Inducement Act (AGIA)
 - Establish method to determine "fair market value" (FMV) of the state's royalty share of gas production that increases clarity and predictability of royalty value
 - Establish terms under which the state will modify its ability to exercise current rights to switch between taking royalty in value (as money) or in kind (as gas), that reduces lessees exposure to stranded or insufficient transportation
 - Lessee who qualifies for royalty inducements can elect either (or both) Valuation or Royalty Switching provisions

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Mr. Banks continued with Slide 4: "Requirements in AGIA"

- Valuation regulations must:
 - Minimize retroactive adjustments in royalty value
 - Establish FMV based on reliable trade publications
 - Allow reasonable and actual deductions for transportation and processing
 - Allow for reasonable share of unused capacity
 - Allow deductions under the 1980 settlement agreement

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Mr. Banks addressed Slide 5: "Dynamic North America Natural Gas Market" He explained that oil travels down a pipeline and is evaluated at "pump station one," Valdez, or refineries on the west coast. The oil values are reported effectively. He noted that the North Slope adds complexity with the assumption that the gas will flow into Alberta. He noted that the gas might bypass Alberta to go into the West Coast. He pointed out that other areas exist within the pipeline system to capture value for the purposes of calculating royalty and to provide relevant and correct transportation tax deduction. Thirty years ago, gas in the United States was under strict regulation by the federal government. He spoke of a current liquid market for gas throughout the country. He observed that the market of the changes include the development of a royalty system that captures enough flexibility and allows for understanding of the expectations.

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Mr. Banks described Slide 6: "Overarching Principles"

1. Reduce lessee uncertainty
2. Maintain state's full royalty value
3. Incorporate natural gas industry practices to the extent doing so is consistent with (1) and (2)

He stated that the lessees account for royalties using the same accounting systems and marketing tools already established. He explained that a prediction of the royalties is not possible.

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Mr. Banks discussed "Overarching Principle: Reduce Uncertainty" on Slide 7.

- Eliminate "higher-of" lease valuation terms
- Establish value based on published prices
- Minimize or eliminate retroactive adjustments
- Allocate volumes Pro rata to increase clarity of gas value and costs of transportation and processing

Mr. Banks elaborated on the various slides. The published prices will be a mechanism to capture full fair market

value. He commented on the need for regulations to allow updates of the price publications, destination markets, and location differentials as the market evolves.

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Mr. Banks elaborated on Slide 8: " Overarching Principle: Full Value Under Lease"

- "Full Value" without gross proceeds
 - Gas components are valued for residue gas, gas plant products, unprocessed gas, LNG
 - Published prices in destination markets establish value
 - Ability to update price publications, destination markets, location differentials
 - Valuation backstop "basket" ensures unrepresentative destination market published price doesn't distort reasonable value
 - No negative royalty
- *Pro rata* allocation of value and costs back to the lease establishes fair distribution and ensures full value

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Mr. Banks Slide 9: "Overarching Principle: Incorporate Gas Industry Practices"

- Use well established regulatory structure and methodology where practical to determine transportation costs (i.e. FERC)
- Incorporate use of published indices based on commercial practices
- Used elements of MMS regulations
 - Used as baseline; modified where necessary to reflect differences in circumstances of Alaska project
 - North Slope producers have extensive experience in complying with MMS gas regulations in Lower 48

FRED HAGEMEYER, MANAGING DIRECTOR, BLACK AND VEATCH CORPS, discussed Slide 10: "Key Valuation Concepts and Approaches"

1. Destination where gas is valued
2. Publishing value at destination
3. Backstop measure of FMV for residue gas
4. "Actual and reasonable" transportation and processing deductions
5. Appropriate deductions for unused capacity

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Mr. Hagemeyer commented on Slide 11: "How to Determine Destination"

- A lessee's gas is valued for royalty at "Destination"
- A lessee's qualified gas is generally considered to be at "Destination" when it first:
 1. Enters a first destination market;
 2. Has been sold in an arm's length transaction; or
 3. Has been processed to extract residue gas and gas plant product
- "Destination values" are determined with reference to "first destination markets"
- First destination market is the first liquid market where ANS gas is physically transported to and bought, sold, processed, or regasified that has a reliable and widely available published price

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Mr. Hagemeyer discussed Slide 12: "Department to Publish Information Necessary to Determine Destination Value"

- The department will publish on its website prior to the royalty reporting period:
 - The location of all First Destination Markets
 - The name of the source of the published price for residue gas, gas plant products at the First Destination Market
 - Appropriate location or quality differentials to establish FMV with reference to First Destination Market
 - Reasonable gas treatment, processing, or re-gasification cost allowances

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Mr. Hagemeyer discussed Slide 13: "Alternative Destination Value for Residue Gas"

- Basket of published indices used to calculate a "backstop" fair market value to published index prices at destination markets
- Basket is relied upon only when the published price at a destination market is less than 95% of the basket price; i.e. a safety valve
- The alternative destination value protects the State from being locked in to a valuation rule that fails to reflect fair market value
- Pricing elements making up the basket determined by market liquidity criteria
- Basket reflects the volume weighted average of value received by the market.

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Mr. Hagemeyer discussed Slide 14: "Actual and Reasonable Cost of Transportation and Processing- Non Arms Length Transactions"

- Non-arm's length transportation cost allowance for Alaska and Canadian mainline is based on the terms proposed in the Open Season offer
 - If affiliated lessee negotiates a lower rate, then the transportation cost allowance will be based on this negotiated lower rate
- Other pipelines - Cost deductions calculated using FERC based cost of service methodology
- Generally follow MMS methodology to establish non-arm's length processing deductions

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Mr. Hagemeyer discussed Slide 15: "Deductions for Unused Transportation Capacity"

- Unused capacity deductions were designed to balance the need to mitigate producers risk, but not expose the State to bearing unintended costs
- Deductions are allowed for Unused Capacity on Alaska and Canadian mainlines
- Unused Capacity = Allocated Capacity - Allocated Shipments

- Allocated Capacity - Portion of firm transportation capacity acquired by lessee in first binding open season to transport production from state leases; measured with reference to actual state lease production
- Allocated Shipments - greater of shipments of production from state leases or a pro-rata allocation of total shipments from all sources

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Mr. Hagemeyer acknowledged Slide 16: "RIK/RIV Switching Issue"

- Under lease the State has the option of taking its royalty share of production either in kind (RIK) or in value (RIV). This option creates a risk for shippers.
 - If the State switches from RIV to RIK, shippers may have stranded capacity corresponding to the royalty volumes
 - If the State switches from RIK to RIV, shippers may not have sufficient capacity on a timely basis
 - Additionally, shippers' marketing arrangements need to be reconciled with the State's RIK/RIV election
- Given the substantial tariffs on the Alaska project, the potential exposure associated with the State's RIV/RIK option is significant

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Mr. Hagemeyer noted Slide 17: "RIK/RIV Solution: "Capacity Follows the Gas"

- Switching from RIV to RIK:
 - State obligated to seek capacity corresponding to the State's RIK share ("*RIK Capacity*") from the Producers via a pre-arranged deal
 - Released capacity will be acquired at original contract rates (state forgoes opportunity to get a better deal)
- Switching from RIK to RIV:
 - Capacity corresponding to the State's RIK share ("*RIK Capacity*") reverts back from the State to the Producers at contract rates

- State requested and FERC approved a waiver to allow pre-arranged deals for FT capacity at contract rates, consistent with these terms
- Increase notice period for RIK/RIV switching
 - 120 days when between 100,000 & 200,000 MMbtu/d
 - 180 days when quantity is greater than 200,000 MMbtu/d

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Mr. Hagemeyer detailed Slide 18: "Value of Royalty Inducement to Producers"

- The AGIA regulations provide value to producers while protecting State interests
- Some of the key provisions that provide value to producers include:
 - Valuation - moving away from "higher-of" provision
 - Transportation -
 - Adopting FERC-like approach for transportation deductions, rather than MMS-like approach
 - Allowing deductions for unused capacity
 - RIK/RIV switching - FERC waiver allows capacity transfer deal at contract rates

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Mr. Banks discussed Slide 19: "Aggressive Assumptions were made to Establish Upper Bound of Value to Producers"

- Recognize that the value of and need for these provisions may be lower depending on the facts of the project going forward:
 - Methane valuation - Assumed impact of moving away from "higher-of" provision is not offset by market basket concept
 - Transportation deduction for non-arm's length transactions - Assumed that alternative was MMS methodology
 - Unused capacity deduction - Assumed that no YTF gas is found
 - RIK-RIV switching - Assumed that entire royalty volume is switched from in-value to in-kind

- Very approximate estimates of the value to producers from provisions in the 1980 Royalty Settlement Agreement have also been shown here to provide a more complete picture of royalty value to producers

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Co-Chair Stedman wished to communicate the amount of money discussed and the potential liability exposure.

Mr. Hagemeyer noted that the assumption shown on Slide 20: "Estimated Value or Range of Value to Producers from Key Provisions in AGIA Regulations and 1980 RSA." The assumption is that the state takes the RIK for the entire 25 year period without a waiver or regulatory element. The exposure exemplified in the graph is to the producer with RIK RIV switching.

Mr. Hagemeyer noted that the exposure to the producer could equal either zero or \$17 billion. He spoke to the agreement that fuel cost allowances, gas treatment plant allowances, and the central compressor plant allowances combined over twenty five years equal \$6 billion. He highlighted that the calculation encompasses 25 years. He pointed out that the assumptions are aggressive.

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Mr. Banks clarified that "higher up" is a retroactive calculation involving auditing to capture the "higher up" value. Transportation deduction is a comparison of a methodology. He estimated that approximately 127 trillion cubic feet of undiscovered economically recoverable reserves exist on the North Slope, which means that if any gas is found the number for unutilized capacity is altered.

Co-Chair Stedman clarified that the RIK-RIV switching is on the industry side of the ledger with a \$7 billion exposure to the state. Mr. Hagemeyer agreed, in a worst case scenario.

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Co-Chair Stedman asked about the mid-range expected. He referenced Slide 16 and asked about the comment regarding significance to switching. He asked if the industry's liability was \$17 billion. Mr. Hagemeyer clarified that the

reference on Slide 16 exhibits the exposure to the producer.

Mr. Banks pointed out that it is as if one eighth of the pipeline is empty regarding the industry's exposure. He explained that the state's royalty share equals one eighth of total production.

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Co-Chair Stedman asked for an estimation of current gas consumption with five hundred as the royalty share. He estimated that the current natural gas consumption in Cook Inlet is 250 million cubic feet per day. He advocated for in-state development of our gas resources.

Co-Chair Stedman stated that 500 is a large amount of gas for the state. Mr. Banks agreed.

Mr. Banks pointed out that RIK oil is not sold in spot sales as long term contracts are preferred allowing for the development of local refineries.

Co-Chair Stedman asked if the regulations lock the state down under AGIA. Mr. Banks responded that the transportation deduction might provide an entitlement in terms of an interpretation of actual and reasonable.

Co-Chair Stedman asked about a deadline of May first regarding regulations. Mr. Banks responded that the comment period is over and the regulations will be published by the end of the open season. Co-Chair Stedman asked if the AGIA lock down date was May first. Mr. Banks did not agree. He explained that regulations must be promulgated during the open season.

Co-Chair Stedman asked if the tax structure is locked down in statute instead of the regulations. Co-Chair Stedman asked how confident Mr. Banks was about his answer. Mr. Banks responded that he would return to the committee with a confident answer.

Co-Chair Stedman understood that regulations allow the ability to expose the state to billions of dollars and lock the state down.

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Mr. Banks responded that commitments are defined in the regulations. The access to the regulations is made in the open season commitments. The lessee is required to provide an open bid in the open season to have a precedent agreement within 120 days. The lock down occurs in the acceptance of the state's offer. The qualification for the offer is defined in the regulations. The transportation services agreements allow for the open season and the regulations accepted in the offer. The qualification for the offer depends on the commitment to the pipeline.

Co-Chair Stedman clarified that the lock down is a contractual bind beginning on May first, but there may be ability for the state to change the regulations in September. He expressed concern about the ability to expose the state to up to \$7 billion without much input from the legislature. When low gas and high oil prices occur, a substantial offset to our revenue stream exists. He claimed that he asked to have a cash flow analysis run regarding expected outcomes for the state. He requested a net cash flow analysis for a worst case scenario. He stressed that the policy calls were sizeable.

Mr. Banks stated that there is an approximate indication of the cash flow analysis in the graph shown on Slide 20.

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Mr. Banks noted the consequences of making decisions during the development of regulations designed to strike middle ground. He cited fiction in the valuation number because of the assumption that the state will acquire greater than fair market value.

Co-Chair Stedman stated his concern involving \$7 billion of exposure without any state input. He discussed the idea of a cash flow analysis for the state. He asked about the net cash flow in the worst case scenario. He expressed great concern that \$7 billion is a sizable policy call.

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Co-Chair Stedman voiced that the legislature was not privy to the full exposure of the treasury. He observed that the presentation included only small snapshots of the analysis

run. He stressed that his comfort level with the information provided is low.

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Co-Chair Stedman alleged that the legislature receives only bits and pieces of information from the administration. He asserted that the state might face a fully subscribed gasline while the ability to maneuver under AGIA remains restricted.

Mr. Banks responded that if the department was attempting to obscure the downside risk assumed by the state, he would not have offered the presentation. He noted the regulations mitigate for a balance and resolve the exposure problem for the companies. He did not believe that the presented assumptions would be the outcome. Co-Chair Stedman responded that worst case scenarios occasionally materialize. He wished to see a worst case scenario run on the proposal.

Mr. Banks commented on past proposals. Co-Chair Stedman added that the past proposals were thoroughly discussed with the legislature. Mr. Banks clarified that the current proposal was to build a pipeline as opposed to merely planning one.

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Senator Thomas asked about the mitigating factors on Slide 17. He asked about the assumptions regarding the reasons for switching that led to the chart on Slide 20. Mr. Hagemeyer explained that Slide 17 explains the actions to mitigate the risk perceived by the producers. He continued that Slide 20 suggests the potential of a lack of mitigation of risk.

Senator Thomas asked about the concerns regarding the reasons for switching and its frequency. Mr. Banks responded that concerns raised include unused capacity. Another concern was that a producer may have midterm or long term contract commitments and gas taken in the form of RIK would compromise those commitments.

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Co-Chair Stedman appreciated the presentation. He maintained that the magnitude of the state's exposure must be discussed. He stressed the hope for a gasline and a successful open season. He hoped for the success of AGIA, but wanted to ensure ample revenue.

#

ADJOURNMENT

The meeting was adjourned at 5:25 PM.