

**ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE**

January 28, 2010

3:45 p.m.

MEMBERS PRESENT

Senator Bill Wielechowski, Co-Chair
Senator Hollis French
Senator Bert Stedman
Senator Gary Stevens

MEMBERS ABSENT

Senator Lesil McGuire, Co-Chair
Senator Charlie Huggins, Vice Chair
Senator Thomas Wagoner

COMMITTEE CALENDAR

Overview: Open Season for Alaska Gasline Project

PREVIOUS COMMITTEE ACTION

No previous action to record

WITNESS REGISTER

SCOTT HOBBS

Consultant for the AGIA Team

POSITION STATEMENT: Gave presentation on open season for the Alaska Gasline Project.

ACTION NARRATIVE

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CO-CHAIR BILL WIELECHOWSKI called the Senate Resources Standing Committee meeting to order at 3:45 p.m. Present at the call to order were Senators French and Wielechowski.

Overview: Open Season for the Alaska Gasline Project

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SCOTT HOBBS, Consultant for the AGIA Team for the administration, said he was here to speak about the open season

process they are about to embark on for the Alaskan Gas Pipeline Project.

Slide 2 - Topics for discussion:

1. Background and progress assessment
2. General discussion of open seasons
3. The Alaskan Gas Pipeline Project open seasons
4. Conclusions

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MR. HOBBS said he's here as adviser to the AGIA Team and his opinions are his own. He has spent the last 33 years in the natural gas business.

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Slide 3 - We've made great progress, but we still have a long way to go - He read a quote from American Gas Association saying that people have been expecting a pipeline for 30 years, and many believe the project is closer to happening than ever before, and that gas could flow by 2020.

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SENATOR WIELECHOWSKI said they've heard from a variety of sources that the gasline and AGIA are dead and this project won't happen because of the explosion of shale gas finds and LNG imports in the Lower 48. Do you share those assessments?

MR. HOBBS said no. "Let's let the facts speak." Right now they have the largest gas pipeline operator in North America and the three North Slope producers all working actively on a gas pipeline project. The shale gas development in the Lower 48 presents a competitive alternative for certain customers, but an increase in demand is also taking place there. LNG imports have not markedly increased and remain at about 1 or 2 bcf/d.

SENATOR WIELECHOWSKI asked if he thought Alaska natural gas from a pipeline can compete economically with shale gas.

MR. HOBBS said that remains to be seen. There are factors that can affect cost of development of the shale gas. For instance, regulations are being considered at the federal level on hydraulic back fracturing. However, at the same time overall demand is increasing and he believed that Alaska gas will play a part in the overall supply mix.

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SENATOR WIELECHOWSKI asked if he has rough figure of what shale gas will cost versus what it is expected that the Alaska natural gas shipped via the pipeline will cost. He has heard that shale gas isn't economic below \$6 or \$7/mcf.

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MR. HOBBS replied that it depends on which shales they are talking about and which part of the shale gas play they are talking about. Clearly some shale gas development will require that kind of price. Others will be more economic. If you have a developed supply at Prudhoe and a developing supply at Pt. Thomson, you have gas that is available; and if you add the transport costs, depending on what the forecast is, it can compete with any sort of supply in the Lower 48.

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MR. HOBBS explained slide 4 - What is an open season and why is it held. He said it is a public process in which the project sponsors propose terms and specific design parameters to potential customers in the effort of soliciting bids for the capacity that they are proposing to build. Open seasons started as a requirement of the FERC in the late 1980s. The purpose is to ensure that all interested parties can bid on that capacity. Then the pipeline sponsors will select those bids that place the highest value on that capacity. This particular project has very specific requirements.

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SENATOR FRENCH asked if oil pipelines go through the open season process or just gas pipelines.

MR. HOBBS replied that it is generally unique to gas pipelines. Oil goes through similar solicitation, but not the same process.

SENATOR FRENCH asked why gas pipelines are different.

MR. HOBBS explained that an oil pipeline is a common carrier; a gas pipeline is a contract carrier. So you contract for capacity that you own and you control on a gas pipeline. No one can come in and pro rate you down to get capacity; you have to bid for new capacity and go through a new open season process where other parties are allowed to come in and the pipeline looks at those bids and decides if it can construct new capacity (expansions). With an oil pipeline, if someone new comes in and wants to move volumes through it, typically they will be brought in and everyone else is reduced somewhat to accommodate those flows.

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MR. HOBBS explained slide 5 - Who will be involved in the open season process. Besides the project sponsors, he said that project regulators (FERC, NEB, NPA, and the state as AGIA licensor), shippers (producer, marketing company, or local distribution company), and other parties (land owners, competitors) may decide to get involved in the process. For this particular open season they will have to file all of their procedures (21 different items) with the commission and those also provide avenues for other parties to intervene.

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SENATOR STEVENS joined the meeting.

CO-CHAIR WIELECHOWSKI asked what other parties they could expect to see in this process.

MR. HOBBS answered maybe no one. But for instance the state, as a royalty owner needing to protect its interest, may decide it has to comment on some provisions in the open season filing. It all depends on whether this avenue is the right place to do it. But he assured there may be just the traditional regulators and shippers that participate in this process.

Slide 6 - What takes place in the negotiation process. Mr. Hobbs explained that in a typical open season a pipeline sponsor will identify a project (often in a press release), and then initial discussions with potential customers (shippers) will begin. They will generally come up with a package of rough terms and then the negotiation process begins. The project gets defined, scoped and developed during the negotiations and once they get that "feedback," the open season is announced.

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SENATOR STEDMAN joined the meeting.

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SENATOR WIELECHOWSKI asked if only the producers bid for capacity and not someone - like China.

MR. HOBBS said he is really trying to describe a general project, but that is probably correct.

SENATOR WIELECHOWSKI said that TransCanada is making a filing tomorrow and asked if they are at Box 2 - the Open Season Package on slide 6.

MR. HOBBS said yes. He said once the open season begins, more negotiations happen and bids for capacity are submitted; generally a draft precedent agreement is included in the package. The projects sponsors would ask the parties who they would like to participate to submit that agreement. More often than not, that agreement is submitted with changes and things the shipper wants (terms). Then there are more negotiations; then there is a precedent agreement. This has a lot of conditions and things that have to be accomplished before a firm transportation service agreement is achieved - the real goal for a project sponsor. Then you get a firm commitment and those conditions are removed.

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Slide 7 - The Precedent Agreement. Mr. Hobbs said the precedent agreement lays out the project scope, the services that are going to be provided, the key commercial terms and conditions that the pipeline sponsor's are looking for; it lays out obligations on the parts of the shipper and the pipeline sponsor, representations, and warranties, conditions precedent (for example, an acceptable certificate from the FERC), and termination rights for both parties.

In transforming these into a firm transportation agreement, Mr. Hobbs said, a lot of the terms and conditions will be carried forward. This gets them to the final commercial terms and conditions, but most importantly those conditions precedent are resolved. Then there really is a firm commitment.

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SENATOR WIELECHOWSKI said it has been speculated that maybe all bids will be precedent upon fiscal certainty, for instance. Do you expect that in this case? Is it common?

MR. HOBBS responded that he would answer those questions a few slides from now.

Slide 8 - Typical Outcomes for an open season. In some cases there may be minimal interest and no meaningful commitments, Mr. Hobbs said. In that case for the project sponsor it's back to the drawing board. They may decide to defer the project or abandon it. While this has happened, most savvy pipeline operators won't have an open season if they don't think they will get some kind of meaningful feedback from the shippers.

A second potential outcome is shipper interest, but insufficient commitments to fill the pipe. This type of outcome is fairly common and maybe they go back and negotiate some favorable terms or change the scope.

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MR. HOBBS said a third potential outcome is that there are sufficient commitments volumetrically, but they have a lot of conditions. This is a highly probable outcome for most open seasons. In this case, negotiations are continued and mutually agreeable conditions are established. Another potential outcome is that you get commitments that commit to exactly what the sponsor was looking for, but that is highly unlikely. The likely outcome for any real commercial project easily comes in between two and three.

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Slide 9 - Timeline for a project in the Lower 48. Mr. Hobbs explained that the typical project takes from three to five years. It can be compressed if the pipeline sponsor is willing to spend a lot of money on the front end to remove some of the "time takers," like environmental or field work or filing for the FERC certificate early.

MR. HOBBS said that right now both the Denali and AGIA projects are trying to get terms worked out before initiating a formal open season. A typical open season period in the Lower 48 is about 30 days or less. In this case FERC Order 2005 is requiring 90 days.

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Once the bid is made, you're back to negotiations, which could take another six months before getting to firm pressing agreements. Then work can be done to get a FERC certificate filed. Assuming you receive a certificate, over a 12-month period you would look at the project sanction decision, which is "where the rubber meets the road" - when the pipeline sponsors are ready to commit to the project.

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Slide 10 - Mr. Hobbs said that they will really know that a project will be constructed at the project sanction point, when the sponsors commit to construct the project. This is generally well after an open season and after front-end engineering and design work, environmental impact studies, major regulatory and permit approvals (including approvals from the FERC and NEB), critical rights-of-way acquired, detailed cost estimates, and

all conditions precedent in the precedent agreements are resolved. Once that is done, firm transportation service agreements are executed and then the project financing needs to be assured.

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Slide 11 - Recent Open Season workshop conducted by FERC on January 12 in Anchorage. Mr. Hobbs said that FERC detailed all the requirements of FERC Order 2005 and found 21 separate things that have to be addressed. The Ruby Pipeline Project was used as an example of a major project progressing over the years.

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Slides 12 & 13 - The Alaskan Gas Pipeline Project. Mr. Hobbs said a few more pieces have to come together to make it work. Probably the most important piece is the project timeline. This project will probably take a minimum of 10 years. When that kind of timeframe is added to a project, uncertainty and risk is injected, especially with respect to cost of construction. This project will cost over \$30 billion and it will have corresponding development costs that go along with it. No other project in the Lower 48 has even exceeded \$7 billion.

The Allowance for Funds Used During Construction (AFUDC), in other words the cost of money for this project, is part of the overall construction costs, Mr. Hobbs explained. For this project, it exceeds the cost of any other pipeline project that has been attempted in the Lower 48.

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SENATOR FRENCH asked Mr. Hobbs to remind him where the state stands in relation to throughput. Do other pipelines in the Lower 48 deliver 4.5 bcf/d of gas?

MR. HOBBS replied that some pipelines deliver that volume, but they have been built over years with multiple expansions and additional loops. No other project has attempted to take on that initial volume with the opportunity to go up.

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SENATOR STEDMAN asked him to expand on the impacts of AFUDC.

MR. HOBBS explained that the AFUDC is considered a capital cost. For years FERC has allowed it to be capitalized and included in the rate base and ultimately charged.

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SENATOR WIELECHOWSKI followed up by asking if the tariff is based on the present value of that money.

MR. HOBBS answered that is where the AFUDC comes into play. If you spend \$500 million in the first year, the rates are actually based on the accumulated cost in year-10. So that \$500 million might be \$700 million by the tenth year with the cost of money applied to it. That is what goes into the rates.

He pointed out that the gas quality and treatment is another complex issue. The largest gas treatment plant in the world will have to be built on the North Slope to process this gas. Its construction and logistical requirements over 1700 miles - arctic and subarctic terrain, mountain ranges, and earthquake zones - are not insurmountable problems, but they are a challenge. The regulatory requirements and oversight are in at least two countries and aboriginal peoples will be involved. No other project has had to deal with this level of regulatory and right-of-way complexity.

Slide 14 - What will be negotiated as part of this open season process? Mr. Hobbs said the obvious answer is the mutually agreeable precedent agreement. He explained because the timeframe is short for building a pipeline in the Lower 48, the pipeline sponsor will ask for a specific figure for building it. Here, because of the timeframe and uncertainty associated with the cost, rather than agreeing on a rate, parties will have to agree on rate principles - like return on equity, capital structure, and defined components of the cost of service that will ultimately yield the rate once the project costs are established.

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MR. HOBBS suggested that, because this pipeline is a non-operating pipe they will probably try to adopt an existing tariff (all the terms and conditions that establish what a pipeline company has to do when they operate a pipeline - hundreds of pages long). Typically sponsors adopt the existing tariff and maybe modify it for the shippers. Hopefully that gets negotiated out during the open season process. All of the major producers on the North Slope want to own part of the pipeline and he thinks that may be one of the terms that will be negotiated between the parties. They may also want to participate in the project management.

Slide 15 - What sort of conditions will be included in negotiated precedent agreements? - Mr. Hobbs gave examples based

on his experience - maybe key commercial terms or tariff provisions that haven't been worked out yet. Shippers may say if adverse changes to their economics occur - like a change in gas price or project costs exceed a certain amount - they want the right to get out of the agreement - a term that is in most precedent agreements.

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MR. HOBBS said shippers may condition their bids on project milestones not being achieved, on reaching acceptable fiscal terms with the state or on a minimum level of equity participation in the project. Using certain board approvals is a standard in any precedent agreement, but those are generally limited to a certain time period. Finally, the termination rights; it's very important to understand the basis for a termination and who is exercising it and what the consequences are. Who pays for the incurred costs up to that point if a shipper pulls out or if the project dies?

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SENATOR FRENCH asked Mr. Hobbs if he has seen fiscal terms negotiated in open season commitments.

MR. HOBBS answered that fiscal terms are generally not raised in open season commitments, but because Alaska's resources are so much more vast than, say, the State of Texas, a foreign country that has a known huge resource would be a better comparison.

SENATOR FRENCH said the subsurface mineral rights always belong to Alaska - period, but that is not entirely common, and he asked if that plays a role in setting the fiscal terms in the Lower 48.

MR. HOBBS answered that he has not seen it as an issue in the Lower 48.

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SENATOR WIELECHOWSKI said one of the terms in AGIA said companies that bid their gas in the initial open season get a locked-in rate for 10 years and asked if a company makes a bid in open season and conditions it on acceptable fiscal terms with the state, would they qualify for that AGIA benefit.

MR. HOBBS said he did not want to speculate; it would be a legal question.

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Slide 16 - what value will conditional open season commitments provide to project? Mr. Hobbs answered that the open season process has to be gone through to get the commitments that start defining how they are going forward. The pipeline sponsors need the technical information contained in those bids - volume, term, maximum and minimum operating pressures - and under AGIA they have to provide an option to go both Valdez and Alberta. The shippers need to commit where that gas will go; it's very important to establish the route and allow all comers to make commitments so they know how to go forward with the project. He said it will provide the commercial terms and conditions that are needed for shipper commitments.

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MR. HOBBS said the open season will define the allocation of risk sharing for moving the project forward and the termination rights. Under any scenario, the project sponsor's understanding of the commercial requirements will be substantially improved by going through the open season process.

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Slide 17 - Timeline of what may be seen for the AGIA licensee's proposed open season. Mr. Hobbs explained that with this timeline, the FERC has about 60 days to act on the filing by TransCanada. Once the FERC issues an order on the filing for the open season, Mr. Hobbs said he plugged in 30 days for TransCanada to actually put together and formally initiate the open season - sometime around the end of April of this year. AGIA requires a 90-day open season and at the end of that time, hopefully draft precedent agreements will come in from people participating in it. He estimated five months for negotiations after the open season; however, he cautioned it could take a lot longer.

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He said hopefully after the end of the year they would have signed precedent agreements. At that point the front-end engineering and design - a tremendous amount of work - has to continue based on what was learned from the precedent agreements a certificate filing will be put together and made to FERC around the end of October 2012. If that is the case, he plugged in about an 18-month period for FERC to act on it - maybe by June 2014. He provided an additional four months for the parties to review the filing, convert the precedent agreements into firm transportation agreements, and actually make a project sanction decision at the end of October.

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Slides 18 & 19 - Conclusions. Mr. Hobbs concluded that the project has made significant progress, but it faces future risks and uncertainties. Numerous issues have to be negotiated throughout the development phase - all the way up to project sanction. The successful completion of precedent agreements will not insure that this project will go forward. That won't occur until the project sanction date, which he estimates will be late 2014. The state may need to participate in negotiations with all of the parties to complete precedent agreements, but it is very likely that it will have to engage in negotiations to reach project sanction. He thought the upcoming open season will likely result in conditioned bids, but that will frame the issues for what needs to be negotiated to get binding precedent agreements to advance the project forward. Under any scenario, he thought the project sponsors will be a lot better informed and better equipped to move the project forward through the certificate process regardless of the outcome of the open season.

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SENATOR WIELECHOWSKI asked who decides what is acceptable if there is a contingent bid, let's say, based on fiscal certainty or tax structure.

MR. HOBBS answered that both the licensee and the state will have to agree that fiscal certainty is provided on the condition that an absolute commitment is made to the project.

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SENATOR FRENCH said because the state has granted fiscal certainty by statute, he expected that would be confronted during the opening of the bids.

MR. HOBBS agreed, but said he would suggest any negotiation or request for fiscal certainty be spelled out in very specific terms, and the administration would agree, and then obviously submit it to the legislature for its approval.

SENATOR FRENCH asked when the negotiations stop.

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MR. HOBBS replied there is always an opportunity for parties to negotiate. A lot depends on what is negotiated between the shippers, the pipeline sponsors and the representatives of the state that are participating in that negotiation. He thought the state would lay that out in a form that would be subject to

legislative approval, and if that doesn't occur, it's back to the drawing board.

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SENATOR FRENCH asked if there is any external deadline to negotiate.

MR. HOBBS said it may be that the shippers will lay down a timeline or they will want to terminate their commitments.

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SENATOR WIELECHOWSKI asked when the TransCanada package comes out tomorrow, does the public have an opportunity to comment.

MR. HOBBS replied that is to be determined. TransCanada will file with the FERC; the FERC will notice the filing and stipulate how many days for parties have to comment. He speculated that it wouldn't be more than 30 days because they have a 60-day window in which to act. They also have the right to extend the whole process.

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SENATOR WIELECHOWSKI thanked everyone for their comments and adjourned the meeting at 4:41.