

ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE

February 9, 2012

3:32 p.m.

MEMBERS PRESENT

Senator Joe Paskvan, Co-Chair
Senator Thomas Wagoner, Co-Chair
Senator Bill Wielechowski, Vice Chair
Senator Bert Stedman
Senator Lesil McGuire
Senator Hollis French
Senator Gary Stevens

MEMBERS ABSENT

All members present

OTHER LEGISLATORS PRESENT

Senator Cathy Giessel

COMMITTEE CALENDAR

SENATE BILL NO. 153

"An Act relating to a gas storage facility; relating to the tax credit for a gas storage facility; relating to the powers and duties of the Alaska Oil and Gas Conservation Commission; relating to the regulation of natural gas storage as a utility; relating to the powers and duties of the director of the division of lands and to lease fees for a gas storage facility on state land; and providing for an effective date."

- HEARD & HELD

Judge Gleason's Decision: An Alternative Perspective by Bradford Keithley, Perkins Coie, LLP

- HEARD

PREVIOUS COMMITTEE ACTION

BILL: SB 153

SHORT TITLE: NATURAL GAS STORAGE TAX CREDIT/REGULATION

SPONSOR(S): SENATOR(S) THOMAS

01/17/12 (S) PREFILE RELEASED 1/13/12
01/17/12 (S) READ THE FIRST TIME - REFERRALS
01/17/12 (S) RES, FIN
02/09/12 (S) RES AT 3:30 PM BUTROVICH 205

WITNESS REGISTER

SENATOR JOE THOMAS
Alaska State Legislature
Juneau, AK

POSITION STATEMENT: Sponsor of SB 153.

GRIER HOPKINS, Staff
Senator Joe Thomas
Alaska State Legislature
Juneau, AK

POSITION STATEMENT: Explained SB 153, version I, for the sponsor.

LUKE HOPKINS, Mayor
Fairbanks North Star Borough
Fairbanks, AK

POSITION STATEMENT: Supported SB 153.

JIM DODSON
Fairbanks Economic Development Council
Fairbanks, AK

POSITION STATEMENT: Supported SB 153.

BRIAN NEWTON, President and CEO
Golden Valley Electric Association (GVEA)
Fairbanks, AK

POSITION STATEMENT: Supported SB 153.

DOUG ISAACSON, Mayor
City of North Pole, AK

POSITION STATEMENT: Supported SB 153.

DAN BRITTON, President and CEO
Fairbanks Natural Gas
Fairbanks, AK

POSITION STATEMENT: Supported SB 153.

BRADFORD KEITHLEY, Partner and Co-head
Perkins Coie, LLP
Anchorage, Alaska

POSITION STATEMENT: Presented an alternative perspective to the Judge Gleason decision.

ACTION NARRATIVE

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CO-CHAIR JOE PASKVAN called the Senate Resources Standing Committee meeting to order at 3:32 p.m. Present at the call to order were Senators Stedman, Stevens, French, Co-Chair Wagoner and Co-Chair Paskvan.

SB 153-NATURAL GAS STORAGE TAX CREDIT/REGULATION

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CO-CHAIR PASKVAN announced SB 153 to be up for consideration.

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SENATOR JOE THOMAS, sponsor of SB 153, said the cost of energy in much of Alaska is crippling communities' economies. It's still the middle of winter in Alaska, and more specifically Fairbanks pays \$4/gallon for heating oil; they are spending approximately \$666 million annually on energy costs. This averages out to about \$6,667 for every man, woman and child annually. Much of this money leaves the community. Fairbanks is currently paying \$23.35 for 1000 cubic feet of natural gas and \$.23/kilowatt hour. Individual bills run \$1,000 to \$1,500 a month during the heating season (September through April generally). Natural gas is the lowest cost fuel, but it's three times the price of gas in Southcentral and only available to approximately 1,100 customers. No more gas is available for Fairbanks Natural Gas, the local distributor, due to Cook Inlet contracts that provide for Cook Inlet towns being taken care of first.

He said that lines that have been built to various parts of the town in Fairbanks, but have not been able to be distributed because gas isn't contemplated being available. SB 153 addresses this problem by incenting the private sector to deliver additional trucked natural gas to Fairbanks in the next two to three years. SB 153 would also extend up to \$15 million of tax credits to an LNG trucking project such as the one proposed by partnerships between Golden Valley Electric Association (GVEA) and Flint Hills Resources. This is the same \$15 million tax credit that is applicable to Cook Inlet's gas storage projects (CINGSA), but in Fairbanks it would be above-ground storage rather than filling depleted wells (because they don't have any). He said GVEA and Flint Hills are the two largest Interior

tenants for gas and it makes sense for them to buy the gas to make use of it, but they may also be willing to accept someone's delivery.

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SENATOR THOMAS said the credits are limited to regulated utilities, so the savings will be passed through to consumers as the RCA looks at their business plans. GVEA and Flints are still narrowing down their cost estimates and once they get to a plus or minus 30 percent estimate, their board will make a decision when to go forward and that is expected this spring or summer. If that doesn't happen, it's possible that an entity such as Fairbanks Natural Gas or Enstar and/or their Canadian parent company, AltaGas, might move on the project. He said negotiations between Foot Hills and GVEA are ongoing and are positive, and that is another reason that the timing of SB 153 is important.

He said this will also ensure that the North Slope producers or LNG export facilities that are not regulated utilities and do not provide for consumption of gas in state will not be able to access these credits. Further, with the gas line still years away, it appears the only project that could bring gas into the Interior in a quick manner is trucking projects such as this one that would be an expansion of an existing trucking project.

CO-CHAIR WAGONER moved CSSB 153(), 27-LS1187\I, for discussion purposes.

CO-CHAIR PASKVAN objected for discussion purposes.

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GRIER HOPKINS, Legislative Aide to Senator Thomas, said there is a fundamental difference between storing natural gas in its gaseous form and storing it in its liquid form; the volumes don't match. He explained that the credits in HB 280 had a floor of 500 mmcf because Cook Inlet has underground reservoirs, but Fairbanks is looking at storing approximately 240 mmcf/gas in two separate tanks. The sponsor found a way to apply the same \$15 million in gas storage tax credits that Cook Inlet has to a Fairbanks project or 50 percent of construction costs for a storage facility, whichever is less. Storage facilities have been estimated to cost about \$30 million.

He said the changes between version M and version I are rather simple. The project is still up in the air, but they want to make sure that any project bringing gas to Fairbanks would

receive those credits. Therefore, language was included allowing for the expansion of an existing facility that was in business before 2011. It removes the date restrictions that a facility must start commercial operations for the same reason.

A new subsection in AS 42.05.990 says only regulated utilities can take advantage of the tax credits so their benefits get passed on to the customers, but it currently doesn't include LNG, and that language is being worked on now.

CO-CHAIR PASKVAN asked him to go through the bill by section.

MR. HOPKINS said section 1 establishes that the AOGCC must certify the 1 million gallon threshold for a project to be eligible to receive the credits. Section 2 addresses the lease exemption and makes it the same as Cook Inlet provisions. It might be applied differently for the North Slope, but GVEA has been in contact with the administration and they understand how it is moving forward.

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Section 3 amends the definition of "natural gas storage facility" and "facility" in AS 42.05.990(3) to assure that tank storage or storage in a depleted or nearly depleted well can apply for this tax credit (as opposed to Cook Inlet Natural Gas Storage Association's project).

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Section 4 amends the existing gas storage facility tax credit by bifurcating it into two separate credits: a nontank storage facility and a tank storage facility. The nontank storage uses a volumetric equation that is necessary for the underground storage, but the tank storage uses \$15 million or 50 percent of the cost of building an LNG storage facility of at least 1 million gallons, whichever is less.

Section 5 amends the terms of what storage qualifies as a tax credit by adding the 1 million gallon threshold similar to section 1. Sections 6 and 7 added "or payment" to the language as opposed to just a tax refund in order to make it easier and clearer within statute that GVEA, a non-profit that does not pay any taxes to the state, could have access to that credit.

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Section 8 sets forth how a company not subject to tax under this chapter would still be liable to pay back any erroneous payments made by the state. So the state receives some of its money back

if the organization stops commercial operation of the storage facility or if an error was made in calculating the construction cost for the facility as determined by the Alaska Oil and Gas Conservation Commission (AOGCC).

Section 9 amends AS 43.20.046(i) to clarify that a person that receives the payment under this title must also repay interest to the state as the determined under AS 43.05.225 (under calculation of erroneous payment). Sections 10-13 make a number of conforming language changes, especially including the word "payment" going back to the non-profit status of GVEA. Section 14 establishes an effective date.

CO-CHAIR PASKVAN opened public testimony.

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LUKE HOPKINS, Mayor, Fairbanks North Star Borough, said SB 153 is very important for Fairbanks. Increasing storage capacity for the community would allow more people to take advantage of a resulting increased gas supply. He said cars are lined up at the lowest-priced gas pump for home heating oil and people are buying it 5 gallon cans, because they may not have enough money to make to the next delivery. He said this is one of the fastest short term improvements in space heating fixes that can be seen and that GVEA and Flint Hills are already considering expanding an existing trucking project with Fairbanks Natural Gas.

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JIM DODSON, Fairbanks Economic Development Council, Fairbanks, said he supported SB 153. It's a crucial component to Fairbanks' infrastructure in moving from staggering home heating fuel costs (\$4 gallon) to a natural gas system. He said the high costs are devastating families, homes and businesses and making Fairbanks an economically unsuccessful community.

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BRIAN NEWTON, President and CEO, Golden Valley Electric Association (GVEA), said it the largest producer of electric power in Interior Alaska and serves roughly 44,000 residential and industrial customers. Their service territory covers greater Fairbanks and the North Pole area, extending down the Richardson Highway to Delta Junction, and down to the Parks Highway to Cantwell.

He said the cost of electricity is extremely high in Fairbanks and now it is being exacerbated by the high cost of oil. It produces only 36 percent of their power needs, but in 2011, oil

accounted for 60 percent of their fuel bill. Although they secure as much gas fire generation out of the Cook Inlet as possible, and purchase and spin as much power from coal as they can, they still rely on oil for 35-40 percent of their yearly fuel needs.

He said that GVEA is aggressively pursuing ways to replace its oil-fired generation with alternative sources of power. In anticipation that affordable natural gas would someday be available in the Interior they installed an "LM6000," basically a 737 jet engine at their North Pole expansion plant. This 60 megawatt unit is currently run on naphtha (Jet A), but it can easily be converted to natural gas and SB 153 may help determine whether such a conversion is economically feasible.

MR. NEWTON said GVEA watched as the Cook Inlet Recovery Act was debated and passed in 2010; it established an incentive for creation of natural gas storage around the state to satisfy regional energy needs. At the time of its passage, GVEA was investigating trucking LNG to Fairbanks from the North Slope, but the trucking concept for a large volume of gas was not fully developed at the time. Despite this fact, the Interior relied on statewide provisions in the legislation and hoped that would accommodate future Interior energy needs. As GVEA established a partnership with Flint Hills to advance the development of an LNG project, they reviewed the provisions of the gas storage incentive statutes and determined some slight modifications were needed to be applicable to their proposed project.

He explained that at the time HB 280 was passed in 2010, the primary focus was on creating an incentive that would trigger the development of geologic storage in the Cook Inlet to handle seasonal peaks of natural gas demand. The legislation referenced both geologic below ground storage and tank above ground storage. SB 153 clarifies the same level of support for above ground tank storage facilities.

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MR. NEWTON said GVEA didn't consider the establishment of an LNG trucking project from the North Slope as being in competition with a future pipeline. In fact, they believe that bringing a large volume of natural gas to the community via truck will allow a local distribution and customer base to develop thereby underpinning the economics of the future pipeline. He concluded that GVEA is prepared to work with the committee to make sure that natural gas incentives are available to the Interior as well as to other areas of the state.

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DOUG ISAACSON, Mayor, City of North Pole, Alaska, said he supported SB 153 for all the reasons already mentioned, but he wanted to add that natural gas do something else for their communities that no one had mentioned. He said that there is a need for clean air; North Pole has been rated the dirtiest air this winter - largely because they have two refineries and GVEA's 180 megawatts of diesel powered generation along with many wood stoves. He said people are paying on average of \$1,500 each month for fuel, space heating and electricity during the winter. This is not sustainable; there is pain and they are asking for solutions both immediate and long term. This would show people that something credible was going to happen.

MR. ISAACSON said they have been told that the handshake from the municipalities to the legislature looks like a hand out, but this project will mitigate that by allowing them to attract larger stores that presently won't come to North Pole because of the high cost of space heating. Then they would have more of an economy and be able to do more for themselves.

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DAN BRITTON, President and CEO, Fairbanks Natural Gas, said he supported SB 153 for the reasons already stated.

SENATOR STEDMAN said he wasn't sure this wasn't a regular capital appropriation request being coined in a piece of legislation. It sounds similar to conversations with hydros that want help with 50 percent of their costs. He said he would be concerned if they started legislating appropriations and reimbursements on capital projects in legislation in general and that energy issues should be addressed through other processes.

CO-CHAIR PASKVAN thanked him for the comments and indicated that SB 153 would be held in committee.

Judge Gleason's Decision: An Alternative Perspective by Bradford Keithley, Perkins Coie, LLP,

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CO-CHAIR PASKVAN transitioned to Mr. Keithley's presentation of his alternative perspective of the Gleason decision.

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At ease from 4:08 p.m. to 4:10 p.m.

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BRADFORD KEITHLEY, Partner and Co-head, Oil and Gas Practice of Perkins Coie, LLP, said they are a firm of 750 lawyers in offices all over the U.S., Shanghai and Hong Kong. He said he started in the late 1970s with a regional law firm in Tulsa, Oklahoma, and Congress passed the Natural Gas Policy act of 1978 which launched his career. During his six years there, he represented consumers and producers and went on to become senior vice president and general counsel of Arcla, a Fortune 500 integrated utility that was headquartered in Little Rock, Arkansas. He learned many things during that period where he worked for Mack McLarty, Bill Clinton's first chief of staff.

After that he became partner and subsequent co-head of the oil and gas practice law firm called Jones Day, with 2,500 lawyers spread throughout the globe. The oil and gas practice was centered in Dallas and Houston, but they also had lawyers in Washington, New York, London, Moscow, Sydney, Hong Kong, Beijing and L.A. That gave him the opportunity to understand a lot more about the global oil and gas industry. In the early 1990s he started working Alaska issues and over the next several years he went from a point where he was coming to Alaska once a quarter to coming once a week to coming three and a half weeks a month. During the period he has gained a substantial amount of understanding of Alaska issues and finally, four years ago he decided to move up here.

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SENATOR WIELECHOWSKI and SENATOR MCGUIRE joined committee.

MR. KEITHLEY said his opinions are entirely his own and he wasn't speaking on behalf of any client. It's simply because these issues are significantly important to the state and he wants to help get it right. He monitored the case and studied the Gleason decision closely because of its potential impact on Alaska; he was not here to challenge or dispute the logic of the opinion. But he was concerned about the context of the case and wanted to talk about what the decision says and what it doesn't say and those implications.

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He said the case involves a state court dispute over the valuation of TAPS for property tax purposes. While some have said that the judge had no business talking about oil and gas issues, he completely understood why she did and he had the highest respect for Judge Gleason.

MR. KEITHLEY explained that the parties were Alyeska on one side and the North Slope Borough, Fairbanks North Star Borough, Valdez and the Alaska Department of Revenue (DOR) on the other side. He also believed that the life of TAPS is relevant to its economic value and the accumulated depreciation and Judge Gleason had every right to weigh in and value the evidence on these decisions in reaching her decision with respect to TAPS' economic life. He said if TAPS were going to close down tomorrow it would have one value and if it would close down a number of years from now it would have an entirely different value; so she had to take that into account as well as the period over which depreciation would be calculated. This decision is subject to appeal in the Alaska Supreme Court where an appeal of her last decision regarding valuation is being heard.

Judge Gleason's decision says that the value of TAPS for property tax purposes was \$8.94 billion in 2007, \$9.64 billion in 2008 and \$9.24 billion in 2009. In the course of determining those values she concluded that the life of TAPS - based on its proven reserves and incorporating its minimum capacity throughput limitations as of 2007, 2008 and 2009 - is at least until 2065. She also concluded that TAPS could continue to accommodate flows as low as 70,000 barrels a day (bbl/d). He explained that she used 100,000 bbl/d as the mechanical limitation in deciding on 2065, but found that the evidence supported going deeper.

CO-CHAIR PASKVAN said 70,000 bbl/d wasn't solely her conclusion; a BP study also reached that same conclusion.

MR. KEITHLEY replied that the year 2065 was in the BP study that she took as having evidentiary value and he didn't know what the volumes were.

CO-CHAIR PASKVAN asked where the 70,000 bbl/d came from.

MR. KEITHLEY replied that there was evidence in the record relating to 70,000 bbl/d.

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SENATOR FRENCH said the 70,000 bbl/d stood out to him as well and he was on page 150 of the decision, paragraph 438, that said:

For the foregoing reasons and after careful consideration of all the evidence presented at trial, the court finds it more likely than not that TAPS can

effectively transport throughputs at least down to a minimum flow rate of 100,000.

So he didn't know if it was fair to say she concluded that it could accommodate flows as low as 70,000 bbl/d.

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MR. KEITHLEY replied he wouldn't argue the 70,000 bbl/d versus the 100,000 bbl/d, because her decision was that it can go for a long time and he agreed with that. But, he said it's important to keep in mind that there are things the decision doesn't say; it doesn't say anything about current or reasonably foreseeable production levels. The decision simply says "production tail" is the length of time that there will be production. It didn't discuss current production levels or forecasts of future production levels - the level of production as opposed to the length of production. It also doesn't say anything about the effect of declining production on the state's economic wellbeing - and that is an extremely important factor to keep in mind.

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MR. KEITHLEY remarked that Joe Balash has it right when he said that a 300,000 bbl/d throughput scenario would be a disaster. His next bullet was a paraphrase from James Carville when he had to get Bill Clinton's attention during the 1992 presidential campaign by telling him he was stupid. Mr. Keithley said he thinks it's one of those points where we need to wake up and focus on what is really critical here. "In Alaska it's the production rate that's important to our economy....not the reserve life."

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SENATOR STEDMAN said everybody has different views of the world, but this issue is here because of discussions heard in the state that TAPS would be shut down or removed within 10 years or less because of lack of oil. He said:

So to put to rest that we have billions of barrels of proven reserves as we sit here today, and we have billions and billions behind that number into the future in other areas, if it's shale and if it's heavy oil, if it's offshore potential, and that the state would have to take an immediate directional change to prepare the state for the upcoming economic turmoil.

He said the Finance Committee asked the DOR commissioner if they should be turning 90 degrees in addressing that issue and he

answered no. Senator Stedman said there is no imminent demise or stranding of our basin and the public has the perception that there is. So they are spending time going through these documents talking about that to put that issue to rest. He stated that he was not interested in scaring the public. He also said they had spent a lot of time steering the State of Alaska out of the financial ditch and they will continue to do so. The basin will not be shut in and they will continue to put some of these things to rest so they can get to the subject matter at hand, which is the tax structure.

MR. KEITHLEY said he appreciated that and agreed with him on the point that the discussion around TAPS shutting down was a diversion. On the other hand, based on information that is out there, there is a need to move in the very near term to increase investment and production because of the consequences of the lack thereof. The correct motivation for acting is not that TAPS is going to shut down, but that doesn't mean there isn't cause for concern.

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SENATOR FRENCH repeated that some of the pressure they have felt in the public arena is that the threat of a pipeline shutdown is being used to extract a tax concession. He pointed to a headline on the "Make Alaska Competitive" website that says, "Producers tell Alaska to become competitive or pipeline will be in jeopardy." This leads the public to believe that taxes have to be lowered or the pipeline will be shut down. That is something these hearings were designed to break.

MR. KEITHLEY said it is also fair to recognize that substantial additional investments are going to be required to keep the pipeline operational.

SENATOR STEDMAN said it's not a "substantial amount of investment" to keep the pipeline operating relative to the amount of revenue that in one fiscal year is \$14 billion. The capital expenditures are for enhanced oil recovery and additional volume, not the operation of the line.

MR. KEITHLEY said it's not cheap either to make the investments necessary to put heaters in and adjust the operations of the line to accommodate lower flow along the way.

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SENATOR STEDMAN said he didn't want to draw to fine a line without numerics in front of them, but they are talking about

billions of profit in oil. If they are talking about \$3 billion in capital costs and \$2.5 billion in operating costs, and you're gross stock is \$20 billion, he said, "I think you've got enough room to buy a couple of heaters if they are several hundred million dollars."

MR. KEITHLEY responded that Judge Gleason found that the economics would justify doing that, but the decision to make that investment still has to be made.

CO-CHAIR PASKVAN asked if he agreed that the value of just the proven reserves alone is probably the greatest it's been in the history of oil relative to the ANS price at \$110 to \$120.

MR. KEITHLEY replied that he had not looked at that analysis.

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SENATOR WIELECHOWSKI said a couple of things came out of the Brenna testimony that were important: one was a BP document written in 2004 entitled "Alaska's Role in BP's Portfolio is to Provide a Stable Production Base and Cash Flow to Fuel Growth Elsewhere in the Business." He said that BP hasn't explored in years in Alaska; Exxon hasn't explored here either (although they might be doing something at Pt. Thomson now); ConocoPhillips hasn't explored either, and the testimony from a number of the majors has been that even if they pass HB 110 they still don't plan to explore. Producers have been saying for years that they are not exploring in Alaska. So, why would the legislature give them a tax break now to promote something which they have been saying for years they're not going to do? And even now they are saying they won't do? He was curious to hear Mr. Keithley response to that.

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MR. KEITHLEY replied in 2006 BP testified to that particular point and it was basically that they have more potential opportunity sitting in Prudhoe Bay, Milne and Kuparuk than you can reasonably find by going out and exploring "ram acreage" outside of the existing basins. If you look at 2006 numbers, the estimates of what is left in existing units is substantial and the focus of the companies has been to develop the technology to get to the production in the existing units.

SENATOR WIELECHOWSKI then showed him a USDOE chart that was produced during the trial of the decline curve on the North Slope; it flattened out for 8 or so years and then spiked up

significantly. He remarked that even without tax breaks it showed production levels of 1 million bbl/d within a decade.

MR. KEITHLEY asked if he read the DOE report that came from.

SENATOR WIELECHOWSKI said he had read prior reports; this was presented by Robyn Brenna and he hadn't read this specific one.

MR. KEITHLEY said this particular report came from a 2009 report entitled "Alaska North Slope Oil and Gas, a Promising Future or an Area of Decline." This comes from a portion of that report that is entitled "Undiscovered ANS Oil and Gas Forecasts." It's composed of adding the estimated but undiscovered gas reserves that some people have estimated exist on the North Slope to the undiscovered oil reserves that some people have estimated exist on the North Slope and coming up with what the report says is "an ideal scenario if all of the assumptions in the report were fulfilled." That kind of projection is not what the State of Alaska ought to be predicating its policies on.

CO-CHAIR PASKVAN said that may be going a little too far. Don't all basins around the world have a limited definition of proven reserves - some under development, some undiscovered - it's pretty standard terminology. He asked Mr. Keithley if he had performed an economic analysis of the present value of the economic stream that will be coming down from the Central North Slope.

MR. KEITHLEY answered no.

CO-CHAIR PASKVAN said he just wanted to know the support for his position.

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MR. KEITHLEY replied his position is that the production rates are what are critical to Alaska's future. The support for that comes straight out of the Alaska government reports, and in particular, the Office of Management and Budget's (OMB) 10-year plan that was recently published. In it, scenario 3, the Governor's FY2013 budget, assumed a 4 percent annual general fund growth and oil prices in the report, and showed that at current production rates revenues are below expenses in FY 2016, and we stay in that position from 2016 onward through 2022.

SENATOR MCGUIRE asked the chairman to allow Mr. Keithley to get through his presentation before questioning him.

CO-CHAIR PASKVAN responded that he was presenting.

SENATOR STEDMAN said he had questions on Mr. Keithley's presentation plus he didn't want to leave the public with the impression that the Finance Committee is not aware of this stuff and is now early in the process of taking action to deal with some of the forthcoming issues.

MR. KEITHLEY said his central point is that Judge Gleason's decision doesn't reach those issues. It talks about how long the production life is going to be, but not production levels. Scenario 3 in the OMB report shows us hitting those issues already in 2015 even with good oil prices (\$108 in FY2012 up to \$120 in FY 2022), and yet even with these prices the red begins in FY 2016. He said OMB also did a report that relied on \$90 oil using the same analysis. It showed the state hitting a deficit as early as 2013. When that happens, we will start drawing down on Constitutional Budget Reserve (CBR) and the statutory budget reserve as our backups to funding state expenditures. But he remarked that this report shows that at \$90/barrel not only does the state go into the red in 2013, but the two budget reserves are both drawn down to zero by 2021.

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SENATOR STEDMAN said it's nice to have these types of projections, but he was concerned that they don't ring fire alarms just to ring them. When he first started serving in the Senate he received a chart every year showing how the CBR was going to run out and getting into the Permanent fund within a handful of years. Every year that gets changed and pushed out and manipulated, and as time has passed, they have the same chart delivered to them every year, but now that point is substantially in the future.

With that, Senator Stedman said, the CBR isn't going to run out of money. It's been fully paid back and the reserves are increasing. When you have a budget shortfall you don't continue to allow your operating account to grow at 4 or 6 percent and you don't drive the car off the road until you run out of cash. "It's just not going to happen." He said that two years ago, when the state had a sharp decline in oil, the Finance Committee immediately cut a half billion dollars out of the capital budget. After a spike up in revenue in the following year, those expenditures were picked up. They continually look at these trends; and, in fact, the legislature required the governor's office to do a 10-year plan so everything would be on the table

and they could deviate around some of the outlooks, one of which is the unfunded pension liability of \$11 billion.

CO-CHAIR WAGONER raised a point of order saying they were going way off the point of the presentation. They could listen about the budget all year, but that wasn't why Mr. Keithley was here.

CO-CHAIR PASKVAN said he believed the slide raised that issue.

SENATOR STEDMAN summed up for the public that:

These numbers aren't going to happen! We're not going to be that derelict in our duty to allow the state to fall off a financial cliff immediately in a few years with our eyes closed! It's just ridiculous! We don't operate like that!

SENATOR STEDMAN stated that they work every year to ensure that the state moves forward financially.

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MR. KEITHLEY said he greatly appreciated that, and one of the things the state needs to do in that regard is to address the production levels. One of the things that drive the need to cut expenses out of the budget is a fall in production levels; so the best way to address that is to get production levels up. But Judge Gleason's decision doesn't say anything about current production levels and to assume that we're in okay shape because she said we may go to 2065 is the wrong assumption.

SENATOR WIELECHOWSKI said they all agree they want more production, but have different philosophies on how to do it and he asked Mr. Keithley if he felt comfortable sharing his ideas on how to increase production with them.

MR. KEITHLEY said that would take him completely out of the presentation, but he would be happy to come back and talk about Norway.

CO-CHAIR PASKVAN asked him to continue.

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MR. KEITHLEY said with oil hovering around \$90 barrel, things will have to be done to address the significant revenue drops beginning as early as next year and if we didn't do that, the CBR and the statutory reserve would run out as early as 2021. His hands went cold over the weekend as he caught up on his

current reading and saw that Shell is seeing lows of \$70 a barrel in 2012. The presentation said they are looking at \$50 to \$90 a barrel over the course of the year (with \$70 being the mid-range).

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MR. KEITHLEY said another perspective from last year, in addition to OMB's, was probably one of the most important papers on fiscal policy that has been done in this state in a long time by Scott Goldsmith of UAA's Institute of Social and Economic Research (ISER) called "Web Note No. 9." In it, Mr. Goldsmith took the 10 year budget forecast from last year and extrapolated it out for another 10 years. His point was that by only looking at a 10-year cycle we were masking the effect on ourselves and not looking out for the longer term. It showed a 6 percent expenditure growth and drawing on the CBR and the statutory budget reserve by 2018. After 2028 it didn't show any revenues to match expenditures. Another extrapolation looked a lot like the OMB's \$90 bbl/d case; it showed revenues dropping below expenditures as early as next year and drawing down on the statutory reserve and CBR beginning next year. Neither budget reserve got contributions, because deficits were happening next year with and they would run out by 2022 and go into the twilight zone from there into the future.

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Other consequences of Judge Gleason's decision are worth mentioning Mr. Keithley said, because it's sort of the law of unintended consequences. They need to factor through what this is going to do. First, if they are concerned about the level of TAPS rates, this decision actually increases those rates, because roughly 25 percent of current TAPS rates are to recover ad valorem taxes.

Secondly, the decision disproportionately benefits three boroughs - the North Slope Borough, Fairbanks and Valdez - and hurts the state. Increased TAPS rates reduce royalty and production taxes, because TAPS rates are deducted from the calculation of net back, and royalty and production taxes are based on net back. So, the state as a whole will have lower production tax and royalty revenues as a result of the decision.

Finally, it's a significant tax hike on industry and reinforces the perception of an unpredictable and litigious Alaska business environment.

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In conclusion, Mr. Keithley said, Judge Gleason's decision looks well-reasoned and he didn't argue with it, but says nothing about the decline curve Alaska is on, and that is the most important factor that has to be taken into account. It is what drives state revenue levels and economic well-being. At most the decision merely says that the tail end of the decline curve may be extended longer than some have previously forecast. He didn't dispute that, but that is not the important point. It means the person at the end gets to stay a few years longer before the lights get turned off on the Alaska economy, but the remainder will have long since left.

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SENATOR STEDMAN cautioned that people should take some of this presentation on finances with a grain of salt and that the rating agencies have triple-A-rated the State of Alaska in an economic time when most of the other states are going backwards financially. He would be very surprised if the state was on the edge of a financial abyss, because the Finance Committee had just spent several years working to get the state's rating upgraded. And while there will continue to be challenges, Alaska is one of the most solvent states in the union.

SENATOR FRENCH invited Mr. Keithley to come by his office if he had time to discuss some of his questions.

CO-CHAIR WAGONER said they appreciated Mr. Keithley meeting with the committee and missing a basketball game.

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CO-CHAIR PASKVAN also thanked Mr. Keithley on behalf of the committee and adjourned the Senate Resources meeting at 5:02 p.m.