

HOUSE FINANCE COMMITTEE  
April 15, 2014  
2:15 p.m.

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CALL TO ORDER

Co-Chair Stoltze called the House Finance Committee meeting to order at 2:15 p.m.

MEMBERS PRESENT

Representative Alan Austerman, Co-Chair  
Representative Bill Stoltze, Co-Chair  
Representative Mark Neuman, Vice-Chair  
Representative Mia Costello  
Representative Bryce Edgmon  
Representative Les Gara  
Representative David Guttenberg  
Representative Lindsey Holmes  
Representative Cathy Munoz  
Representative Steve Thompson  
Representative Tammie Wilson

MEMBERS ABSENT

None

ALSO PRESENT

Angela Rodell, Commissioner, Department of Revenue; Michael Pawlowski, Deputy Commissioner, Strategic Finance, Department of Revenue; Joe Balash, Commissioner, Department of Natural Resources.

SUMMARY

HB 385 PERS/TRS STATE CONTRIBUTIONS

HB 385 was REPORTED out of committee with a "do pass" recommendation and with two new fiscal notes from the State Assistance to Retirement Funds for the Office of Management and Budget.

CSSB 138(FIN) am

GAS PIPELINE; AGDC; OIL & GAS PROD. TAX

CSSB 138(FIN) am was HEARD and HELD in committee for further consideration.

#hb385

HOUSE BILL NO. 385

"An Act relating to additional state contributions to the teachers' defined benefit retirement plan and the public employees' defined benefit retirement plan; and providing for an effective date."

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Co-Chair Stoltze asked the commissioner of the Department of Revenue (DOR) to discuss the bill and corresponding fiscal notes.

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ANGELA RODELL, COMMISSIONER, DEPARTMENT OF REVENUE, reported that the bill incorporated the governor's plan to place \$3 billion from the Constitutional Budget Reserve (CBR) into the Public Employees' Retirement System (PERS) and Teachers' Retirement System (TRS) trust funds; approximately \$1.8 billion into PERS and \$1.1 billion into TRS. She indicated that the bill stipulated an ongoing deposit into each of the respective funds every year; \$343 million into TRS and \$157 million into PERS. She commented on the sustainability of the governor's plan and alleged that it could be supported in future operating budgets, paid in full by FY 36. The governor's plan afforded the state to maintain its AAA credit rating. In 1961 Moody's Investors Service issued Alaska its first AA credit rating. At present, the state had a AAA ranking. She opined that the governor's plan placed the state in the needed financial position to address its liabilities and future contracts for major infrastructure projects including the gasline. A large cash infusion payment was required in FY 15. Yearly payments would become part of the operating budget starting in FY 16. She acknowledged that the payment amount may need to be adjusted up or down depending on actuarial and market experience. She urged the committee to support HB 385.

Representative Wilson relayed her concerns about the vague language of the bill referring to a payment of "up to \$500 million" rather than a specific amount. She pointed out that the state should make a yearly payment of \$500 million to ensure meeting the specified timeline.

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Commissioner Rodell responded that she anticipated the request would be \$500 million; \$343 designated in statute for TERS and \$157 for PERS. She stated that in the bill the actuary was required to do performance calculations to ensure the state stayed on target with the timeline. The way the bill was currently written, the state could seek legislative approval for a larger or smaller payment amount depending on the performance of the state's trust funds.

Representative Wilson clarified that the state would be adding \$2.3 billion to the unfunded liability fund due to an anticipated \$700 thousand not being included in the FY 14 operating budget. She also assumed that the state would be looking for \$500 million out of the FY 15 operating budget. Commissioner Rodell responded affirmatively.

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Vice-Chair Neuman reviewed the information from Buck Consultants, page 2 (copy on file). He referenced the funding policy and noted that the projections provided were not predictions but rather expectations supposing all of the actuarial assumptions were exactly realized including an 8 percent investment rate of return in each year from 2014 through 2043. He wondered if, at any time and period, an 8 percent average rate of return had been realized.

Commissioner Rodell responded that the average rate of return for the previous 28 years was just under 8 percent. In analyzing different time periods the state had varying results. For example, the rate of return over the three previous years was 11.09 percent. She reported that historically there were years of both negative and positive earnings. In 2009, the state had negative earnings in excess of almost 20 percent.

Vice-Chair Neuman stated that much depended on the stock market. Commissioner Rodell agreed.

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Representative Costello discussed two fiscal notes for HB 385. The first note provided for a direct appropriation to the PERS account and had a fiscal impact of \$1.8 billion in FY 15 and \$157 million in FY 16 through FY 20. The second note provided for a direct appropriation to the TRS account and had a fiscal impact of \$1.1 billion in FY 15 and \$343 million in FY 16 through FY 20.

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Representative Costello mentioned that of the two plans that had been put forth during the session the current plan before the committee had a higher contribution on an annual basis and would have a substantial effect on state reserves. She wondered about the health of the reserves over the next decade.

Co-Chair Stoltze clarified the reserves of the available funds for state expenditures.

Commissioner Rodell qualified that Representative Costello was referring to a document dated April 12, 2014 prepared by the Legislative Finance Division, not by DOR. The plan generated a large request on the reserve funds and was not taken lightly. She pointed out that the reserves would be an important part of budget discussions over the next five to ten years. The department looked at the draw on reserves required with something other than the governor's plan and concluded there was more value in maintaining reserves and putting the requests into the trust funds. She reported that in ten years the state reserves would be exhausted. She opined there would be significant discussion about the state's spending priorities over the following 5 to 10 years. She believed that the governor's plan would put the state in a sound financial position from a financial reporting and rating standpoint even if the reserves were at low levels. She indicated that the state would have a much better revenue picture in two or three years. She opined that the document would guide the legislature. She emphasized that the document did not indicate the state would need to tap into the permanent fund.

Co-Chair Stoltze stated that it had been the legislative intent to provide a deposit into the pension fund. He

believed that the efforts of the Legislative Finance Division to come up with a plan had been mischaracterized.

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Representative Holmes stated her appreciation for the deliberative process that had taken place over the previous few weeks. She reiterated that both plans required a cash infusion of at least \$3 billion up front. She clarified that the current plan the committee was evaluating consisted of \$3 billion the first year and \$500 million per year split between PERS and TRS through 2035. A partial payment covering the remaining balance was to be paid in 2036.

Representative Holmes also acknowledged that payments could potentially be adjusted up or down, which would increase or decrease the payment time frame. She mentioned that the state was to meet with its actuaries on a regular basis, adjusting things as needed, in order to avoid an additional unfunded liability.

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Commissioner Rodell concurred with Representative Holmes' review of the bill. She agreed that it was crucial to have the actuary continue to do progress assessments into the future.

Representative Gara defended the plan proposed by David Teal and complimented him on a job well done. He acknowledged that Mr. Teal did the legislature a great service. The department gave the legislature its latest revenue source book indicating that within 10 years there would be a reduction in oil production down to below 300 thousand barrels per day and that excess money would not be available to the state. Mr. Teal's approach allowed some flexibility. The state satisfied its bond raters by paying a lump sum of \$3 billion in 2014 in the current form of the bill. He asked the commissioner if she thought the bond raters cared whether the remaining debt was paid over 19 years, 20 years, or 24 years, for example, as long as the state made a substantial payment upfront to show its commitment to paying off its debt. He asked how the time frame affected the ratings.

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Commissioner Rodell replied that the bond raters cared about the length of time and that a faster payoff was optimal. She stated that the commitment grew larger and more expensive with a longer wait. There was a balance between having budget flexibility without over burdening the state with additional debt.

Representative Gara relayed that up to \$500 million meant that the amount could be less than \$500 million. He asked why "up to" was used versus identifying a specific number.

Commissioner Rodell replied that the recommendation was given because earnings could be such that the funding ratio required a lesser appropriation. She knew from the Buck Consultants' letter, there would be some portion to finish the funding in 2036, potentially less than the \$500 million. She added that another contribution could be solicited.

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Co-Chair Austerman discussed the total liability of \$11.9 billion as the combination of PERS and TRS. He asked what percentage of the total liability went to PERS and what percentage went to TRS.

Commissioner Rodell replied that approximately two-thirds or \$8 billion went to PERS and one-third or \$4 billion went to TRS.

Co-Chair Austerman asked about who was responsible for the \$8 billion PERS unfunded liability. He commented that it was not all the state's responsibility. He went on to say that approximately 42 percent of the liability belonged to the municipalities. He furthered that of the 42 percent paid by the municipalities 22 percent of their payroll went towards PERS where they were carrying. He wanted to make sure that it was placed on record that the extra 20 percent that the municipalities had as a liability, was actually being paid for by the state. The state was not requesting a change.

Commissioner Rodell concurred.

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Representative Munoz MOVED to REPORT HB 385 out of committee with individual recommendations and the accompanying fiscal notes. There being no objection it was so ordered.

HB 385 was REPORTED out of committee with a "do pass" recommendation and with two new fiscal notes from the State Assistance to Retirement Funds for the Office of Management and Budget.

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AT EASE

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RECONVENED

#sb138

CS FOR SENATE BILL NO. 138(FIN) am

"An Act relating to the purposes, powers, and duties of the Alaska Gasline Development Corporation; relating to an in-state natural gas pipeline, an Alaska liquefied natural gas project, and associated funds; requiring state agencies and other entities to expedite reviews and actions related to natural gas pipelines and projects; relating to the authorities and duties of the commissioner of natural resources relating to a North Slope natural gas project, oil and gas and gas only leases, and royalty gas and other gas received by the state including gas received as payment for the production tax on gas; relating to the tax on oil and gas production, on oil production, and on gas production; relating to the duties of the commissioner of revenue relating to a North Slope natural gas project and gas received as payment for tax; relating to confidential information and public record status of information provided to or in the custody of the Department of Revenue (DNR) and DOR; relating to apportionment factors of the Alaska Net Income Tax Act; amending the definition of gross value at the 'point of production' for gas for purposes of the oil and gas production tax; clarifying that the exploration incentive credit, the oil or gas producer education credit, and the film production tax credit may not be taken against the gas production tax paid in gas; relating to the oil or gas producer education credit; requesting the governor to establish an

interim advisory board to advise the governor on municipal involvement in a North Slope natural gas project; relating to the development of a plan by the Alaska Energy Authority for developing infrastructure to deliver affordable energy to areas of the state that will not have direct access to a North Slope natural gas pipeline and a recommendation of a funding source for energy infrastructure development; establishing the Alaska affordable energy fund; requiring the commissioner of revenue to develop a plan and suggest legislation for municipalities, regional corporations, and residents of the state to acquire ownership interests in a North Slope natural gas pipeline project; making conforming amendments; and providing for an effective date."

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Co-Chair Austerman noted that the department was asked to come before the committee to discuss the concept of transitioning from a tax base to a profit base in taking tax as gas. He wanted information on offtake points and potential plans to meet future demands for anticipated growth.

MICHAEL PAWLOWSKI, DEPUTY COMMISSIONER, STRATEGIC FINANCE, DEPARTMENT OF REVENUE, discussed the Black and Veatch PowerPoint presentation: "State Participation in AKLNG Project Presentation to House Finance Committee" (copy on file). He commented that the slide was put together to help talk about the change from tax in-value to royalty in-kind and taking tax as gas.

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Mr. Pawlowski started with slide 2: "State Revenue From Sale of Royalty and Tax Gas:" He indicated that the illustration detailed the inferred tariffs for each section of the project. He identified some of the acronyms on the slide: PBU/PT referred to Prudhoe Bay/Point Thompson, GTP referred to gas treatment plant, and LNG referred to the liquefaction plant. The slide denoted the general value chain. The way the traditional royalty and tax system worked was that private companies built the infrastructure and were entitled to recover, through deductions, the cost of each one of the components which came in a tariff. In a typical calculation the department would start with the

price of LNG in Asia and subtract the cost of shipping. For example, it would start with an LNG price in Asia of \$16, subtract \$1 for shipping, subtract \$4 to go through the LNG plant, subtract \$2 to go through the pipeline, and subtract \$2 to go through the gas treatment plant. The state would be left with roughly \$7 per one thousand British thermal units (MMBTU) point of production or wellhead value. In the traditional royalty system, the state would take a percentage of the wellhead value, which would equal the royalties. A production tax would be taken after taking the \$7 and subtracting lease expenditures in the production tax equation.

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Mr. Pawlowski discussed the red box on slide 2. He noted that instead of taking the residual value, the state would take a certain amount of value in energy. The department did a rough calculation of the percentage of what was being produced. He referenced the example of 350,000 MMBTU per day for the royalty share and roughly 320,000 MMBTU per day for the tax share. The state would have the gas at the point of production going into the gas treatment plant. The gas would then move through the system and would be sold in Asia for the same price of \$16. The state would have the revenue of \$16 of the sales of the LNG and would use the revenue to pay the same costs, i.e., \$1 in shipping, \$4 in the LNG plant, \$2 in the pipeline tariff, and \$2 in the gas treatment plant tariff. The state would ultimately arrive at the same value at the wellhead. The real difference was that rather than relying on a third party to deduct the costs in the filings with the state, the state would have full control and full vision of the costs because it would own the infrastructure. Slide 3 addressed the reason the state started to focus on the need to invest in the infrastructure and where in-kind offered value to the state. He mentioned that the tariffs in the examples were rounded to the nearest fifty cent.

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Mr. Pawlowski detailed slide 3: "State Revenue From Sale of Royalty and Tax Gas, 25 percent State/TransCanada Ownership of AKLNG Project With Capital Structure Change for LNG Plant." He explained that in the second example the department changed the financing of the LNG plant. In the first example the LNG plant was financed at a 70 percent

debt, 30 percent equity with a 12 percent return on equity. In the second example the LNG was financed at 100 percent equity with a 15 percent return on the equity for the LNG plant. The royalty study, published by DNR, listed several large integrative projects around the world that were financed at 100 percent equity. The LNG plant under FERC section 3 would not be subject to economic regulation. If an investor chose to take profit as 100 percent equity in the LNG plant, the tariff would change in the LNG plant from \$4 to \$8 and the state value would reduce from \$7 to \$3.

Mr. Pawlowski communicated that in the past the state was able, either through disputes in front of FERC or in the state's tax statutes, to fight over the value in the deductibility of returns on tariffs in the midstream. The way LNG projects were structured the state did not see the same opportunity in what was roughly 50 percent of the project, the LNG plant. The decision to co-invest to take the gas and have transparency of what those costs are, would put the state in a similar place as it would be in-value but with greater transparency and greater protection for the state. It would also depend on on achieving the same value in the market through the marketing agreements. Through the value chain the state's co-investment would protect the state. With the change in the royalty, as the price went up, costs would stay the same in the midstream leading to the same value to the state going up, whether in an in-value or in-kind arrangement. He referred back to slide 2 suggesting that if the price in Asia went from \$16 to \$18 and the costs did not change, the value per MMBTU would increase from \$7 to \$9. If the price in Asia went down from \$16 to \$14 it would decrease from \$7 to \$5 - not changing the value in the midstream. Consultants have given presentations to the House Finance Committee that showed the value of in-kind, particularly in co-investment at low price environments. He appreciated a lot of the work that some of the state's consultants had done to illustrate how in-kind actually provided more revenue to the state at lower prices than in-value did along with co-investment.

Co-Chair Austerman expressed concerns about knowing how to proceed with conversations with the general public. He stated that the two-year time frame would allow the legislature to make a commitment. His objective was to allow the public to have a voice.

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Mr. Pawlowski stated that DNR would manage the sale of the energy value. There would be a daily value of energy for royalty and for gas. The commissioner of DNR would manage the revenues of the sale of gas, of which a portion would be deposited into the Permanent Fund. The enabling legislation set up the relationship between DNR and DOR where the DNR commissioner would take the \$320 MMBTU per day times the value as tax revenue. The tax revenue would then be directed to the general fund by the commissioner of DNR. The tax share would become public information in order for people to see the value the state received from taxed gas. He made one final point that there were other taxes that the state would receive from the project apart from the ones that have been discussed. The additional taxes included the corporate income tax of 9.4 percent statutory rate and the property tax, a very substantial piece of the \$45 billion to \$65 billion the state would be investing. He summarized that the state would receive corporate income tax, property tax, and taxed gas in royalty from the advancement of the Alaska Liquefied Natural Gas (AKLNG) project.

Vice-Chair Neuman discussed the value to the state of \$7 per MMBTU. He noted that the value did not account for the costs for the lease expenditures for standard allowable deductions. He referred to the Point Thomson unit and used a \$5 billion investment as an example. He asked if \$1.75 billion was the correct lease amount that would have to be paid.

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JOE BALASH, COMMISSIONER, DEPARTMENT OF NATURAL RESOURCES, replied that the deductions were realized in the year that the expenditure was made. It would depend on how much of the \$5 billion was spent over which years.

Vice-Chair Neuman clarified that the Point Thomson example had been used because the related lease expenditure was a cost the state was currently incurring. He reiterated that the lease expenditures and standard allowable deductions were not taken from the value as seen in the example provided (in the Black and Veatch presentation). He opined that the number in front of the committee was a gross value. He wanted to see a netback value for the state.

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Mr. Pawlowski offered to supply Representative Newman with additional information from work done by Black and Veatch to answer his question. He indicated that the intent was to illustrate the value chain. He conveyed that in the larger project there were other costs associated upstream that were deducted as well as additional oil production that counted as an additional value. He mentioned that when the department ran the equations, the internal rate of return for the state investment metric exceeded 20 percent. He noted that there were additional tens of thousands of barrels of oil that came with the build out of Point Thomson as well as the gas production that came with it. He stated that some work by Black and Veatch was done and could be circulated to committee members. The consultation information was not provided by DNR.

Co-Chair Austerman asked if there was a price per MMBTU associated with Point Thomson to the gas treatment plant (GTP) that the state would pay. Mr. Pawlowski responded that it was rolled into the GTP tariff. He reported a small cost for the pipe moving the gas from Point Thomson to the GTP just as there was a cost already incorporated into the tariff for the pipe moving from Prudhoe Bay to the GTP in the Prudhoe Bay unit geographically. He restated that the numbers used in the presentation were rounded.

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Representative Gara requested that the department return with the answers. He mentioned the corporate tax of 9 percent. He clarified that it was not 9 percent of the oil industry's profits in Alaska, it was 9 percent of their world-wide profits which has been 5 percent in some years.

Mr. Pawlowski pointed out that the March 10, 2014 presentation to the Senate Finance Committee contained the answers to Representative Gara's inquiries. Mr. Pawlowski confirmed that the department modeled a lower number than 9.4 percent, which was a statutory number.

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Representative Gara specified a change made in the House Resources Committee that included the qualifier "best

interest finding" when considering royalty in-kind or royalty in-value. He suggested that, based on everything presented by DOR, it was in the state's best interest to receive its royalty in-kind. He asked for the department's position.

Commissioner Balash replied that the assumptions used in the state's materials supposed that the state was getting the same price as the producers. Either the state made a satisfactory arrangement with the producers to dispose of the state's gas on the same terms or they would receive in-value. He noted that, for purposes of doing the analysis, the department relied on a reasonable set of assumptions. The state's agreement with the other parties, the Heads of Agreement, stipulated that the state reached satisfactory resolution on the sale or disposition of the state's gas in order to take payment in-kind. However, he mentioned the challenge of satisfying the state. He emphasized that the purpose of publishing the royalty study in November 2013 was to let all parties (the public, the companies, and the legislature) know that there were real risks associated with the state opting for royalties in-kind. The parties in the best position to help mitigate risks for the state were the other producers. He felt the notion that the state would have to bargain hard was misplaced. He opined that, in essence, the parties had already agreed. He indicated the difficult task would be fashioning the necessary agreements with each company individually and also keeping everything fair relative to the federal and international anti-trust statutes. The state would need to protect itself and the interest of Alaskans while protecting the information of competitors from other competitors at the same time.

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Representative Gara stated that Ms. Poduval of Black and Veatch testified about a concern he had raised that the state would be paying for full capacity without receiving full capacity. Her response was that more than 90 percent of capacity was usually filled. He asked if the state would owe TransCanada for any unused capacity with in-kind value.

Commissioner Balash replied that the state would assume some risks regardless of the in-kind acceptance. He continued that underutilized capacity, the state's or the producers', would impact revenues. The revenues generated

would be based on the throughput. If the project was not at 100 percent every day, the underutilized capacity would still have to be paid for upfront. It would be reflected in the deductions through the value chain and impacting the total revenue, whether in-kind or in-value.

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Mr. Pawlowski offered to reach out to Ms. Poduval.

Representative Gara was interested to know if DNR's model was satisfied whether it reflected 100 percent capacity or less. Mr. Pawlowski responded that he would follow up with Ms. Poduval and get back to Representative Gara.

Co-Chair Stoltze appreciated the detailed questions asked by committee members in spite of the limited time schedule. He added that the amendments were due by 4:00pm the following day. He wanted to make sure committee members had the opportunity to ask questions and make suggestions. He hoped that the vetting process would help committee members.

Representative Gara asked if 4:00 pm was the deadline for submitting amendments or debating them in committee.

Co-Chair Stoltze replied that 4:00 pm the following day was the deadline for submitting amendments to his office.

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Representative Gara suggested that if the state was shipping gas at 95 percent capacity, the cost would be much greater taking royalty in-kind versus royalty in-value. He surmised that not only would the state receive less than full capacity, it would owe TransCanada shipping charges, which were never owed when taking royalty in-value. In the instance of taking royalty in-value, the lower the amount of gas shipped, the higher a company's tariff would be and the less taxes the state would receive. In other words, the cost of paying for empty shipping charges would be higher to the state than if the state only filled it 95 percent and took its royalty in-value. He asked whether they were the same amount of money.

Commissioner Balash explained that throughput utilization was one of the associated risks of the project, whether the

state received its royalty in-value or in-kind. He clarified Representative Gara's concern about the state either receiving less gas than it planned or choosing to drop off gas in-state, thus, not taking it to the liquefaction plant or to market. He affirmed that in such cases there were greater risks to the state. He asserted that the state would need to mitigate such risks by making sure the state received the amount of gas it needed to fill its capacity outlining terms in the offtake and balancing agreements. He indicated he was unwilling to take out capacity on any infrastructure without knowing that the state would receive gas to put into the capacity. The lending institutions that would be setting up the financing for the project would not let the state engage without sufficient security to ensure that gas would flow through the infrastructure.

Commissioner Balash brought up his second point. If the state's demand suddenly and drastically increased, the state would be faced with deciding whether to divert its gas and underutilizing the pipeline and liquefaction plant. He added that the scenario was unlikely.

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Commissioner Balash continued that in the terms of the MOU with TransCanada, the state had assumed 100 percent utilization of the capacity in order to establish rates and tariffs. However, the state knew it would not be at full capacity all of the time. Maintenance turnarounds and unforeseeable circumstances would influence utilization. In the event that TransCanada was able to find customers willing to take interruptible service, they would be able to move more gas per day resulting in revenue credits for the state. The department planned for mitigation in all of the state's agreements. He claimed that there would be additional steps to mitigate against risks to protect the state's interest.

Representative Wilson asked about current royalty in-kind contracts. Commissioner Balash replied that there were currently two contracts; the first with Flint Hills Resources which would expire by the end of the year, and the second with Tesoro.

Representative Wilson asked if there were any royalty in-value contracts at present. Commissioner Balash answered

that the state had settlement agreements with all three of the major North Slope producers to value the state's oil produced under the DL1 lease form.

Representative Wilson asked about rectifying the difference between the prices at which the producers sell their gas versus the prices at which the state sells its in-kind gas in the same Asian market.

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Mr. Pawlowski replied that the state would receive royalties in tax gas as gas was produced prior to going to market. The gas would be sold at the same price, in the same day, and in the same way. It was not a calculation that came back and then created a volume of gas. Rather, 13 to 14 percent of the gas produced would belong to the state through royalty. Another 13 percent of the gas produced would be the state's tax share. In other words, the state's share was 25 percent of what came out of the unit.

Representative Wilson asked if the tax would be paid in gas at 13 percent no matter what the value. She also asked if the transparency that Mr. Pawlowski referred to was the price of the day at the wellhead.

Mr. Pawlowski responded that the state would receive 13 percent in gas for its tax share, the same way the state received royalty in-kind. Once the state took delivery of its gas it would be sold at a price determined in a contract. In terms of transparency, the state would be deducting or paying the state or an agent like TransCanada. In the in-value situation the producer elected how, where, and when the state's gas was sold, which was the misalignment discussed in the royalty study. He continued that (in the example on slide 3) the producer had the incentive because its tax would earn money in the liquefaction plant and drop the dollar amount that taxes and royalties were based off of from \$7 to \$3. The state would be getting 25 percent of \$3 rather than 25 percent of \$7.

Representative asked if it was good for the state. Mr. Pawlowski avowed that it was bad for the state. He stated that the transparency was important in order for the state to have control of what was being deducted. All the parties

would earn what they earned based on their share of the project.

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Representative Wilson concluded that the companies wanted assurance that the state would not consistently alter the tax regime. If the state wanted the project to move forward the tax regime would have to be based on a percentage in order to guarantee a level of certainty for the other three parties. Mr. Pawlowski concurred that certainty was imperative for the other parties. He added that it was also about placing the state in a position to control the state's destiny and to protect the state's interest. He furthered that whether the state partnered with TransCanada was a separate question.

Representative Wilson expressed her concerns that the state would be giving up revenue because the terms were defined in percentages rather than dollar amounts. In the past, fall and spring revenues were distinct dollar values. Her main concern was that the project would bring affordable energy to her district. She expressed her doubts.

Co-Chair Austerman discussed the offtake points and the amount of gas that would be available for in-state use. He wanted to know how the state would determine current and future demand, which he suspected would play a role in determining pipe size specifications.

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Mr. Pawlowski referenced Page 3, Recital I of the HOA. The HOA described the progression of thought that the parties of the HOA went through in laying out the project. He noted that the governor and the administration recognized a synergy between the in-state project under Alaska Gasline Development Corporation (AGDC) and the larger AKLNG project. The work that AGDC was doing, moving towards an open season in FY 14 into the first quarter of FY 15, was looking for gas in the field and the demand for gas from Alaskans along the right-of-way. Sub I recognized that the administration would work with AGDC. In turn, AGDC would participate in and cooperate with the AKLNG project.

Mr. Pawlowski continued with page 12 of the HOA, Article 6.5. He noted that AGDC was tasked with the small in-state

line and getting gas to Alaskans, a core mission. In the current legislation some of AGDC's missions were defined. In the near-term, the project would include five offtake points between the North Slope and Nikiski. The offtake locations would be determined in consultation with AGDC who would assist in addressing in-state gas demand. He noted that DNR would assess the work of AGDC.

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Co-Chair Austerman asked for clarification about the role of AGDC. He asked if AGDC would do the work to determine the state's potential use of in-state gas. Mr. Pawlowski responded that AGDC was currently doing the work as part of advancing the smaller project. By building cooperation between the large and small projects information was being shared back and forth. The state would transfer AGDC's work to the larger project should it progress.

Co-Chair Austerman asked about the price value of offtake gas prior to LNG. He assumed that the price value would be appraised at less than gas processed at the LNG facility.

Mr. Pawlowski agreed with Co-Chair Austerman's assumption. He elaborated that the terms of the MOU with TransCanada stated the gas entering the LNG plant going north was less expensive because the transportation costs were less. He reported that there was a mileage sensitive tariff and that the tariff of transporting gas from the North Slope to Fairbanks would be lower than the tariff imposed on transporting gas to Southcentral Alaska. He noted that the gas going north was worth less. The tariff to get to Fairbanks would be lower than to Southcentral.

Co-Chair Austerman supposed that if the state sold its 25 percent of gas in-state it should be priced at the same end value as in the Asian market.

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Commissioner Balash responded that there was a point at which the state would be indifferent to whether it sold its gas in-state or in Asia. He remarked that it was an interesting economic analysis because the state had to also consider the costs associated with the risks of the liquefaction plant and the counter party risks with the state's buyers. He referred to slide 3 and the \$3 netback,

the value of the gas at the slope after deducting all costs. He suggested that the first two \$2 figures for the GTP and pipeline tariffs plus the \$3 netback price equaled \$7/MMBTU. Arguably, a sale of the gas of \$7 MMBTU in-state would bring just as much revenue to Alaska as would a sale of LNG overseas. Exactly whose gas would satisfy in-state demand was undetermined at present.

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Mr. Pawlowski stated:

This goes to a term in the MOU that Commissioner Designee Balash talked about yesterday is you can look at the gas in Fairbanks as a coming from the North Slope then coming south. Or looking at the backhaul provision in the MOU, look at a Cook Inlet price going north for free. and so that was put into the MOU to provide that sort of benefit to the Interior and being able to look at which is the better price compared to what is going on in the Cook Inlet Region.

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Co-Chair Austerman asked about the anticipated length of contract for gas sold in the Asian market.

Mr. Pawlowski reported that the initial contracts would be 20 years or more in duration. The contracts would have to reflect a long-term commitment that allowed the state and the other parties to obtain financing and to make a final investment decision in the project. Also, there would be other interim agreements that would provide other opportunities in additional capacity. However, the state would need to look for the long term agreement to be able to make a final investment decision with any confidence.

Co-Chair Austerman pointed out that the state should make sure to determine the in-state demand correctly up front to avoid selling off any of the state's supply. Otherwise, it could experience some in-state problems as well.

Commissioner Balash believed it was important to have a midstream partner like TransCanada who knew how to make money moving additional gas. He felt the state agencies lacked the needed expertise to expand the pipeline to meet the in-state demands. The incentive to make an extra buck

moving an extra metric of gas is something that would be in TransCanada's interest and ultimately serve the people of Alaska very well.

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Vice-Chair Neuman discussed reducing the state's risk. He noted that he looked at the LNG facility and shipping gas to the market in Asia. He concluded that depending on foreign-flagged vessels for shipping could be a huge risk for the State of Alaska. His concerns regarding shipping began after reading an article in the Alaska Journal of Commerce or Business Monthly Magazine that discussed the topic. Apparently, there were currently 375 LNG tankers world-wide. In 2008, there were 300 LNG tankers. In comparison there were 5,700 oil tankers. At a cost of \$150 million to \$200 million each, the most expensive tanker built was about \$300 million. He wondered if the state had looked into purchasing 1 or 2 tankers to ensure flow and reduce the state's risk. Since there were no other LNG vessels the state could potentially make a share in the profits. He further suggested that, with an LNG vessel, the state could ship to other places in America. He wanted to know how to reduce risk and get the best value for the state. He wondered about the opportunity to purchase tankers to allow for a share in the profits.

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Commissioner Balash replied that the department had not looked at his question specifically. What the department had considered was the relationship of ownership of the vessels to the nature of the sales contract. There were two significant categories of contracts; those that sold product free-onboard and those that sold decimation ex-vessel. The first category meant that title was changing hands at the outlet of the LNG plant. The other was changing title at the dockside destination in Asia. The way in which the department examined the question, the shipping costs would be approximately \$1. However, the sales price was a dollar higher or lower, depending on whether the state owned or chartered the vessel or whether the buyer owned or chartered the vessel.

Vice-Chair Neuman suggested placing a provision concerning reducing risk in the HOA. He noted that the biggest risk he anticipated would be an interruption in flow.

Representative Wilson asked why the state was building an LNG plant on the North Slope when it knew it could get gas in Cook Inlet and would build an LNG plant in the same location. She inquired why the state was building two LNG plants.

Mr. Pawlowski replied that he was the designee for DOR on the AIDEA board. He indicated he spent a lot of time on his favorite immediate LNG project compared to the other big LNG project that would take longer. It really had to do with the timing. The small LNG plant slated to be built on the North Slope for the Interior energy project was a near-term project that would provide the ability to build out the infrastructure to take advantage of the larger LNG project. The large LNG project was not slated to come online prior to the early 2020s because of the scale of permitting and the amount of work that needed to be done. The Interior energy project had a very near-term start-up. He elaborated that loans were already being authorized for build-out in the region at present.

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Representative Wilson recalled a smaller LNG plant that was currently not at capacity and taking gas from Cook Inlet. She wondered if it would be smarter for the state to reshape the plant currently in Cook Inlet as a temporary solution rather than investing in another LNG plant on the North Slope.

Mr. Pawlowski replied that the direction to advance the Interior energy project belonged to the legislature. He expressed his confidence in the work in progress, especially since MWH [Global] was recently selected as the preferred party. The opportunity to use the facility long-term was there. He stressed to the committee to think about what level of state resource would get stranded in the smaller project if the larger project moved forward. The opportunity to bring gas to Fairbanks was not limited to supplying residents but also to possibly supplying Golden Valley Electric Cooperative, that had expressed interest in the LNG trucking project. The project was moving rapidly forward; however, a final approval of the project has not been issued. He opined that the small project should continue to advance in order to keep the larger project advancing as well. He highlighted the importance of getting

gas to the Interior as soon as possible and helping to lay the ground work for the demand for the AKLNG project.

Representative Wilson agreed that she and Mr. Pawlowski had the same goal in mind. She just wanted to make sure the state was not passing up a more expeditious and more affordable opportunity to bring gas to the Fairbanks area.

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Representative Guttenberg discussed the state's relationship with TransCanada. He relayed that TransCanada would have a 25 percent interest in the project. The state wanted the ability to expand to whatever capacity possible at the beginning without filling the line up with compression. He suggested that the other three investors may want to minimize the cost up front developing a different design strategy that had the line at capacity with compression. He asked how the state would direct the remaining 75 percent interest in the line when the state was in conflict with the other investors.

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Commissioner Balash talked about the unique challenges of the project. He indicated that because of the size of the project and the length of the financing terms all of the gas at Point Thomson and Prudhoe Bay would need to be developed. He surmised that every party at the table had a veto. The likelihood that the project would succeed or move forward without every party's interests being satisfied was slim. He pointed out that the state needed to be very thoughtful about the agreements coming together for review and approval. Inside the equity arrangements and governance structure the final design would be very important. The expansion principles that were found in appendix A of the HOA laid out the circumstances under which an expansion could not move forward. One of the circumstances listed was when one of the other parties could be harmed. He explained that once the pre-FEED phase was completed a final design would be taken to FERC to file for National Environmental Policy Act (NEPA) purposes. The state would need to be satisfied with the design providing a sufficient increment of capacity available through compression. The state would seek certifications from the other parties making sure the design was expandable to meet the state's need. He mentioned having discussions about building the pipe

slightly larger. Forty-two inches was estimated as the correct number. However, the state had not agreed to it, at present.

Commissioner Balash suggested there were scenarios where it would make sense to pre-pay for a larger pipe. He reported that the department had looked at the difference in cost between a 48-inch pipe and a 42-inch pipe. The pipe would cost more but the compression and associated facilities would cost less; the difference of about \$600 million. Much like Representative Neuman's idea of putting another vessel in the water, the idea that the state pre-pay for additional pipe capacity upfront was something DNR investigated. He also pointed out that, in Appendix A, when there was a reallocation of capital among the parties, if the state pre-paid money for an expansion and did not end up wanting it the state would have the opportunity to get some of its capital back. Such a provision was already incorporated into Appendix A in the expansion principles.

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Representative Guttenberg inquired about the state's liability to use the increased capacity if it contributed \$600 million for a larger pipe.

Mr. Pawlowski indicated that the state would recover the extra costs in the tariffs. With the reallocation of capital, should a party use the capacity, the state's rates would go down essentially reimbursing the state for its initial outlay.

Representative Guttenberg clarified that he was not asking about when the pipe reached capacity for expansion. He was referring to the larger pipe when the gas initially started to flow. He wondered if the state would have to compensate TransCanada for unused gas.

Mr. Pawlowski replied that the extra incremental cost would be rolled into the capital costs that then would be spread across the tariff. Less gas would be moved through a larger pipe. The extra cost would be borne by the state because the state would be buying the opportunity for the expansion.

Representative Guttenberg expressed his approval of the idea.

Co-Chair Austerman commented that additional hearings on the bill. He mentioned that government take had not been discussed.

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Representative Thompson discussed the expansion of capacity. He mentioned the provision in the HOA which provided for at least 5 Offtake points. He asked if there had been any provisions for an in-take point if a large amount of gas was found.

Commissioner Balash replied that of the five offtake points, at least two of them would potentially be in-take points as well. He believed one of the points would be at Nenana.

Vice-Chair Neuman asked if there were any further questions regarding slide 3.

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Mr. Pawlowski reminded members about the analysis regarding the state's expenditure with slide 4: "SOA Investment for a 25 Percent Ownership with TransCanada is Expected to be \$1.3-\$4B Lower than for a 20 Percent Ownership Going Alone." He explained that the slide depicted three different cost curves corresponding to the state's level of investment options for FY 18 through FY 23. Twenty percent state ownership would require an investment of approximately \$11 billion. If the state chose not to exercise its equity option with a 25 percent TransCanada ownership the state's investment requirement would drop to approximately \$7 billion.

Mr. Pawlowski referred to slide 5: "SOA Revenues for a 25 percent ownership with TransCanada are Expected to be \$0.4-\$0.5 billion per year higher than for a 20 Percent Ownership Going Alone." He explained that the slide was a comparison of potential revenues depending on the state's level of ownership. The slide showed how much more revenue the state would receive with a 25 percent ownership in partnership with TransCanada compared to a 20 percent stand-alone ownership. The state's revenues would go from \$3.6 billion per year to \$4.1 billion or about a \$400 billion benefit to the state as an owner with TransCanada

versus going it alone at 20 percent. He remarked that there was a balancing of upfront investment versus long-term return.

Representative Wilson asked about the option to proceed without a partner and about a preferred time frame.

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Commissioner Balash replied that ending Alaska Gasline Inducement Act (AGIA) was not difficult. However, DNR's main concern was maintaining project momentum with all of the partners the state had worked with over the previous three years. He noted partnerships were planning on TransCanada's involvement. Summer fieldwork was scheduled, as was the remaining pre-FEED activity for the project. The activities would be populated with TransCanada employees with certain skill sets and expertise. If TransCanada were suddenly not involved, there would be a scramble to fill the void left behind. His prediction was that the other three investors would debate over what company would fill the void, possibly causing delays in the project.

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Representative Wilson asked if there was a list of items that should be included in order to remain in alignment with the HOA when considering amendments. Mr. Pawlowski encouraged members to review sections 60 and beyond; directions for financing information, a range of options, and expansion policies.

Representative Wilson commented on avoiding another DNR.

Vice-Chair Neuman asked if the 13 percent production tax rate was locked in.

Commissioner Balash replied in the negative. He stated that SB 138 set a production tax, but the bill did not allow the administration to execute long-term agreements. The bill gave the administration the authority to negotiate and execute agreements of less than two years in duration. Any agreement longer than two years had to be approved by the legislature prior to execution.

Vice-Chair Neuman clarified that, as an example, the state legislature could add an additional 2 percent in-value production tax after the passage of the bill.

Mr. Pawlowski stated that the power to set taxes belonged to the legislature. The administration was confident in the tax rates established in the bill. He was not implying that the administration supported any changes to the rates.

Vice-Chair Neuman clarified that his question aimed at dispelling the fears of other members about being locked into a percentage with the bill. He was glad to know the agreements would be brought before the legislature again for final approval.

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Representative Edgmon referred to the difference between express and implied agreements. He mentioned that as the project continued to move forward legislators would potentially feel additional pressure to maintain project momentum. He stressed that he was not making any accusations. He emphasized that with the different permutations he wanted to better understand to what extent the state was making implied agreements because the decisions were being made at present that would likely add to the pressure of keeping the project going.

Mr. Pawlowski appreciated Representative Edgmon's comments. He remarked that it was essential to the project that the administration and the legislature work together and were engaged as the agreements were crafted. He opined that the bigger decisions should not be rushed.

Representative Edgmon asked the administration's team about Co-Chair Austerman's point regarding the offtake lines. He wanted to see an informal analysis of what the debt service would potentially be for an offtake point. He wanted to know, of the 20 percent royalty amount of up \$180 million per year, how many offtake points could be serviced. He requested greater detail than high-level concepts.

Vice-Chair Neuman discussed the schedule for the evening meeting.

CSSB 138(FIN) am was HEARD and HELD in committee for further consideration.

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ADJOURNMENT

4:11:59 PM

The meeting was adjourned at 4:11 p.m.