

**ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE**

February 17, 2014

1:33 p.m.

MEMBERS PRESENT

Representative Eric Feige, Co-Chair
Representative Dan Saddler, Co-Chair
Representative Peggy Wilson, Vice Chair
Representative Mike Hawker
Representative Kurt Olson
Representative Paul Seaton
Representative Scott Kawasaki
Representative Geran Tarr

MEMBERS ABSENT

Representative Craig Johnson

OTHER LEGISLATORS PRESENT

Representative Andrew Josephson

COMMITTEE CALENDAR

OVERVIEW(S): SECTIONAL ANALYSIS - MEMORANDUM OF UNDERSTANDING~
STATE OF ALASKA AND TRANSCANADA

- HEARD

PREVIOUS COMMITTEE ACTION

No previous action to record

WITNESS REGISTER

DONALD BULLOCK JR., Attorney
Legislative Legal Counsel
Legislative Legal and Research Services
Legislative Affairs Agency
Alaska State Legislature
Juneau, Alaska

POSITION STATEMENT: Provided an overview and PowerPoint slides on the Memorandum of Understanding (MOU) between the State of Alaska and TransCanada Alaska Company, LLC.

ACTION NARRATIVE

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CO-CHAIR ERIC FEIGE called the House Resources Standing Committee meeting to order at 1:33 p.m. Representatives Seaton, Kawasaki, Hawker, Olson, P. Wilson, Saddler, and Feige were present at the call to order. Representative Tarr arrived as the meeting was in progress. Representative Josephson was also in attendance.

OVERVIEW(S): SECTIONAL ANALYSIS - MEMORANDUM OF UNDERSTANDING, STATE OF ALASKA AND TRANSCANADA

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CO-CHAIR FEIGE announced that the only order of business is a sectional analysis presentation from the legislature's attorney, Don Bullock, regarding the Memorandum of Understanding (MOU) that the administration and TransCanada Alaska Company, LLC have entered into for the Alaska Liquefied Natural Gas (LNG) Project.

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DONALD BULLOCK JR., Attorney, Legislative Legal and Research Services, Legislative Affairs Agency, Alaska State Legislature, introduced himself, noting he began work as an attorney for the legislature in 2001 and has worked on tax and pipeline issues since 2006. Prior to 2001, he spent 17 years working for the Department of Revenue, including work as a revenue hearing examiner where he figured out what the laws meant and applied them to the factual situations that came up. During his time as legislative legal counsel he has been involved in the petroleum profits tax (PPT), Alaska's Clear and Equitable Share (ACES), the Alaska Gasline Inducement Act (AGIA), and SB 21.

MR. BULLOCK said the focus of his presentation will be how the responsibility of the legislature fits in with the Alaska Gasline Inducement Act (AGIA), which is current law; the January 14, 2014 Heads of Agreement (HOA) between the producers and the state; and the December 12, 2013, MOU with the AGIA licensee. The only thing the legislature will be able to vote on is the enabling legislation [HB 277 and SB 138], he continued, so it is good to have an understanding of the MOU and the HOA. Legislators must figure out what the bounds are for the enabling legislation - the legislature can amend those bills and set up

the boundaries within which the administration can continue toward developing a major gas project in the state.

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MR. BULLOCK outlined the timeline of where the state has been under AGIA: March 5, 2007, bill introduced; June 8, 2007, effective date after bill signed into law by governor; July 2, 2007, request for applications under AGIA issued by the state; November 30, 2007, application from TransCanada Alaska Company, LLC [and co-applicant Foothills Pipe Lines Ltd.] received by the state; January 4, 2008, Commissioners of the Departments of Natural Resources (DNR) and Revenue (DOR) find the application to be the only one received that complied with the requirements; May 27, 2008, issuance of "Written Findings and Determination by the Commissioners of DNR and DOR for Issuance of a License under the Alaska Gasline Inducement Act (AGIA)"; June 3, 2008, HB 3001 and SB 3001 introduced to approve the license recommended by the commissioners; and, August 27, 2008, HB 3001 signed into law by the governor. Mr. Bullock noted that the effective date of HB 3001 failed to pass the legislature, which delayed the issuance of the contract and which is of significance because an effective date could be an issue under the enabling legislation given that there are references to when that enabling legislation will take effect. Mr. Bullock continued outlining the timelines: November 25, 2008, act approving the issuance of the AGIA license took effect; December 5, 2008, AGIA license issued; between April and July 2010, licensee conducted its first binding open season; May 3, 2012, announcement of unsuccessful results of the open season; and July 30, 2012, non-binding solicitation of interest announced for the period of August 8, 2012 through September 9, 2012.

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MR. BULLOCK pointed out that AGIA is the law and is the law that gave the bounds for the administration to determine what the license, which is effectively a contract, should look like. Under this contract the state will reimburse the expenditures in anticipation of receiving the commitments being carried out that are in AS 43.90.130. He explained that during consideration of AGIA, these commitments were called the "must haves" and they were controversial and well discussed. He emphasized that AGIA is not dead yet, it is still in the picture, there are still commitments to pay ongoing expenses under AGIA in the MOU up to a certain point. How AGIA is going to end is one of the biggest issues needing to be considered and addressed.

MR. BULLOCK stressed the importance for members to really understand the MOU - what it says and how the administration wishes to carry it forward. The MOU provides for a transition from the relationship between TransCanada Alaska Company, LLC, and Foothills Pipe Lines Ltd. The TransCanada corporate group will continue to participate in the new Alaska natural gas pipeline project by including another TransCanada affiliate, TransCanada Alaska Development Inc. (TADI), which is also a party to the MOU. Under the MOU, the state must negotiate two transition agreements with TransCanada and the affiliate. The first is the Alaska LNG Project Equity Option Agreement relating to how the state will acquire equity ownership in the pipeline if it so chooses, and which would be through the interest that is actually held by the TransCanada affiliate. The second is the Alaska LNG Midstream Services Agreement.

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MR. BULLOCK pointed out that the first binding open season under AGIA was important. Expected during that open season was that shippers would commit to capacity in that pipeline, enter into Precedent Agreements, and later enter into Firm Transportation Services Agreements in which the shippers use or pay for a certain part of the capacity. The Alaska LNG Midstream Services Agreement is the state committing to put its gas through that part of the pipeline that TransCanada's affiliate continues to own. Thus, it is just like what would happen in an open season as far as commitment goes. However, he said, he is unsure whether in this case it would be subject to the Federal Energy Regulatory Commission (FERC) or whether it would be subject to the Regulatory Commission of Alaska (RCA). The concept is that neither would apply; it would be treated like an industrial pipeline in which a producer gets the gas to the LNG plant and then ships it to water with outlets to the state along the way.

MR. BULLOCK noted that the governor's enabling legislation and the MOU address the state's gas and the issue of taking gas royalty in-kind or in-value. The bill also proposes to allow the state to accept [tax] from the producers in the form of gas; therefore, the state could have a significant amount of gas. Responding to Representative Seaton and Co-Chair Feige, Mr. Bullock confirmed that the enabling legislation would allow the state to take its royalty and its tax in either dollars or gas - royalty in-kind or royalty in-value, tax in-kind or tax in-value. That option will be part of the negotiation between the lease holders and DNR. Under AGIA, there was a similar

incentive for somebody that would commit during the first open season in that it addressed the issue of when the gas would be taken in kind or in value.

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MR. BULLOCK reported that the governor's legislation will change the taxation on gas and oil, such that it would be separate. Under the bill, the taxation of gas would be on the gross value at the point of production at the rate of 10.5 percent. However, the state's [one-eighth] royalty interest is not subject to tax, so only seven-eighths of the gas will be subject to that 10.5 percent. He calculated that 10.5 percent of seven-eighths is roughly 9.2 percent. For purposes of discussion he assumed a royalty of 12.5 percent, then calculated that if the state got all the royalty in gas, assuming one-eighth, and got all the tax as gas, 9.2 percent, that would add together to about 21.7 percent of the production. That percentage is important because it relates to the equity ownership issue that TransCanada will have in the pipeline. If the state has 21.7 percent, it is going to commit to ship 21.7 percent in that pipeline. That will be the interest that the state has; the other interest will be divided by the three major producers.

MR. BULLOCK said the state is not coming in independently, and he qualified that he does not completely have his "head around" the option to participate in the equity position of TransCanada. The project is divided into two major parts, he explained. The midstream part goes from the entry to the transmission lines from Prudhoe Bay and Point Thomson to the inlet at the LNG plant, currently expected to be at Nikiski. The LNG plant is the part that will take the gas, chill it, liquefy it, and put it on ships at the marine terminal. The MOU addresses that midstream portion. One option for the LNG plant would be to have the Alaska Gasline Development Corporation (AGDC) expand its powers and invest in state's ownership of that LNG facility, which may possibly be at the same percentage as the state's gas, although, he added, he is not sure exactly where this part is at this point in time. The state is going to have gas and the TransCanada affiliate will be shipping the gas for the state. Signing of the Precedent Agreement and Firm Transportation Services Agreement will mean the state is going to be paying a tariff for a period of 20-25 years, and the state will pay that tariff whether or not it ships gas because that is how tariffs work. The initial contract term is identified in the MOU as 25 years, but the MOU says it could go down to 20. This is nothing new, this is what AGIA or any gas pipeline is looking at because

of the significant costs, particularly in the LNG facility. There has to be assurance of these long-term contracts to support the financing of the pipeline. The state committing to ship its share of the gas in that portion of that pipeline provides some assurance that the owner of that interest will recover its cost and will be able to finance it.

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MR. BULLOCK turned to the topic of alignment, explaining that alignment gets everybody on the same track and moving forward at the same time. The state's "part of the train" will be between 20 and 25 percent of the gas. To that extent, the state is aligned with the producers because the state will have gas and will have to ship it and market it, although the details for how it will be marketed remain to be worked out. One thing, however, makes the state out of alignment, and that is that the state is the caboose on the train. If gas is not produced, the state does not get royalty and there is no production the state can tax under the production tax. So, the state's alignment is there as a gas owner except that the state does not start off with having the right to the gas until it is actually produced or the tax is paid with it.

MR. BULLOCK advised members that the aforementioned is the summary of what he considers the most significant parts of the MOU. He then addressed the enabling legislation, noting that the MOU is in front of committee members, and members have been told that if the enabling legislation is not acceptable to the parties the MOU will go away. If the MOU goes away, there is the issue of AGIA, and AGIA is the same now as it will be if the MOU goes away, and that is where the discussion comes out as, "How does one evolve out of AGIA?" Three statutes describe ending AGIA: AS 43.90.230, AS 43.90.240, and AS 43.90.440. There are no allegations that the licensee has violated the license agreement, so AS 43.90.230 is not much of an issue. TransCanada is a good party that does well in the business it is in and it has stuck to the agreement. Alaska Statute 43.90.240 addresses what will happen if the licensed project is found uneconomic. The MOU contemplates that if certain things listed in the MOU are done, the commissioners will commit to pursue the finding that the project is uneconomic, or they will allege that it is uneconomic, and TransCanada will agree if the conditions are met. However, he counseled, there is some question as to whether that was a statutory way to get out of AGIA because AGIA is the law that protects the state.

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MR. BULLOCK elaborated regarding an uneconomic situation, explaining that the license will end if both the commissioners and the licensee agree that the project is uneconomic. They may use whatever criteria they want, such as the project will not make money or no one wants to use the pipeline. Under AS 43.90.240(e), the state is allowed to get the data and information gathered by the licensee during the preparation of the project by paying the net amount of the licensee's expenses for that data gathering. Drawing attention to page 3 of the handout in the committee packet entitled, "Authority to end the AGIA project in AS 43.90," he read aloud AS 43.90.240(e):

If the commissioners and the licensee agree that the project is uneconomic or an arbitration panel makes a final determination that the project is uneconomic, the licensee shall, upon the state's request, transfer to the state or the state's designee all engineering designs, contracts, permits, and other data related to the project that are acquired by the licensee during the term of the license upon reimbursement by the state of the net amount of expenditures incurred and paid by the licensee that are qualified expenditures for the purposes of AS 43.90.110.

MR. BULLOCK, continuing, pointed out that if the project is uneconomic under the MOU, nothing in the MOU addresses what will happen with the information that is gathered. There is probably a reasonable expectation, he advised, that if the AGIA license faded away under the uneconomic finding and TransCanada's affiliate continued as part of the Alaska LNG Project, that the data would be incorporated, but, he qualified, he does not know.

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MR. BULLOCK said an onerous way for the license to end would be for the state to provide certain types of support to a competing pipeline. A competing pipeline means a project designed to accommodate throughput of more than 500 million cubic feet per day of North Slope gas to market. Last year the legislature passed HB 4, which focused on a smaller pipeline to bring gas to Alaskans soon. It was carefully written to avoid that pipeline becoming a competing pipeline by containing provisions that, so long as somebody is eligible to receive the inducements under AGIA, the smaller pipeline currently proposed by AGDC will not become a competing natural gas pipeline.

MR. BULLOCK noted that if AGIA goes away, there is always the option of looking at somebody else to carry the state's interest forward. Under the MOU, it would be a TransCanada affiliate and the equity interest would be acquired by buying into that limited partner that is going to hold the percentage in the project that is equal to the state's gas that it is going to go through that project. If the legislature wants to continue, there are other options and AGDC is one option; AGDC was part of the discussion in developing the Heads of Agreement.

MR. BULLOCK advised members to look at the 20-25 year period of time that the state will be committing to ship the gas and the interest that the state will have in that pipeline. The state's ability to come up with the money to pay the tariff needs to be looked at because it is a long-term commitment under the Firm Transportation Services Agreement. There will be hefty issues with appropriations, but he guessed that program receipts from the sale of the gas would pay for the tariff. The state's long-term financial obligation is something to really consider.

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REPRESENTATIVE SEATON asked whether the state agreeing to ship gas for 20-25 years is the same condition as the "producer ship or pay." He further queried whether the state could divert an amount of gas if it were willing to pay or would that be a firm commitment that the state is making but [the producers] are not.

MR. BULLOCK replied the state is going to have to pay something because there are certain costs that must be paid regardless of whether gas is flowing through the pipeline. Exhibit C of the MOU incorporates provisions pertaining to the state's relationship with the TransCanada affiliate that is going to operate the pipeline. Drawing attention to Exhibit C, page 2, [item 6.2], he recommended that members find somebody who can tell them about tolls, what goes into tolls, and what the costs will be. It is called a "toll" rather than a "tariff" probably because it is not subject to regulation at this point, but a toll is what a shipper would have to pay to ship the gas. He paraphrased from item 6.2 which states:

Reservation rate, a fixed charge expressed in \$/mmBtu/month, will be designed to capture Depreciation Recovery, Return on Equity ("ROE"), Cost of Debt, Income Taxes, fixed Operations and Maintenance Costs ("O&M"), property taxes and other

non-income related taxes. Reservation rate payments will be made by Shipper regardless of actual GTP and Pipelines utilization by Shipper.

MR. BULLOCK continued his answer, pointing out that item 6.2 includes a usage rate in addition to the reservation rate. The usage rate is a variable charge expressed in dollars per million British Thermal Units and it is designed to capture the variable operation and maintenance costs of the gasline. So, if there is gas, it will be subject to both elements of the toll; if there is not gas going through at any particular time, there will be the reservation rate.

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REPRESENTATIVE SEATON recalled Mr. Bullock's statement that the state would be committing to ship the gas through the midstream. Because ship-or-pay is what was previously being looked at, he said he would like to know whether the state is making a commitment to ship its gas. He posed a scenario in which the state wants one-third of its gas to go to Donlin Creek rather than all the way down and asked whether, in this case, the state could just pay the differential toll charge. Or, he further asked, has the state made a commitment to ship so that the producers would be the only ones that could supply that other use in Alaska.

MR. BULLOCK responded he thinks that will be subject to negotiation between the producers. The limited capacity of the pipeline could be thought about in terms of Alaska Airlines flying from Seattle to Anchorage, with a stop in Southeast Alaska. A seat that is sold to Ketchikan cannot be sold from Seattle to Anchorage. So, to the extent that not all the gas goes all the way to the LNG facility and spares the costs, there might be a disproportionate tariff to the outlet points along the pipeline. The state can sell its gas to who it wants, the consideration will be what it is going to cost; for example, what the tariff is going to be if it comes out at Fairbanks.

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REPRESENTATIVE SEATON clarified he wants to be sure that the state is in exactly the same position as the other parties, that part of the state's gas could go to other places, and that under the MOU the state is not committing its proportion of the gas to go for 20 years through the midstream to the LNG [plant].

MR. BULLOCK answered that the initial contract term is going to be the term that is required to pay for the facility. There will be cost estimates and that is how the toll charge will be figured out. Whatever the tolls are for short shipping will have to be factored in and considered to pay for the project as a whole. He brought attention to Exhibit C, page 5, item 6.17, which sets a minimum of five in-state offtake points for non-LNG consumption and sets three tariff zones, one zone from the North Slope to Nenana, one for deliveries to Big Lake, and one for deliveries to the LNG plant for LNG exports. Calculations will be made for what it will cost to ship to those three points. Once the gas is flowing, the state has gas and the producers have gas. Mr. Bullock said he thinks the state is equal from the standpoint that the state has a quantity of gas to sell. He recalled that both the August 2013 gas symposium in Anchorage and the [November 2013] Black & Veatch [report] talked about the various risks that are involved with the state participation. The state will have gas and will have to sell the gas. The Heads of Agreement mentions that the producers will negotiate with the state to sell the gas on the state's behalf. There is a risk that the state does not have the flexibility that another producer might in that the state has to pay some part of the toll if it does not have gas to ship. If the state has a contract for that gas, the state may be scrambling, or even having to buy gas, to make its commitments. The Black & Veatch report cautions about that when it talks about the various risks that are involved. Thus, the optimism has to be tempered a little bit. In all projects, the risks must be identified and then the extent must be identified to which these risks can be mitigated and get the rewards.

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CO-CHAIR SADDLER inquired whether the context of Mr. Bullock's points is to provide discussion in a general sense, or to highlight problem areas, or to provide a walk-through.

MR. BULLOCK replied he is doing both; for example, just now he was specifically referring to the documents. However, he continued, he is mostly concentrating on the issues that these agreements raise because members do not have the opportunity to amend these agreements. Members will have the opportunity to look at the enabling legislation and decide whether that legislation is giving a framework with it in which the state can negotiate for this pipeline to go forward. For particular issues that committee members are concerned about after this overview, members need to talk to the administration about what

the language is, where it is, and how the administration intends to use it.

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MR. BULLOCK, responding to Co-Chair Feige, confirmed he is talking about additional boundaries that legislators may want in the future to add to the enabling legislation. For example, right now the MOU has an affiliate of TransCanada owning the interest that the state will buy into. This has not gone to a competitive process and the competitive process might be delay, but he advised that members should still consider whether this is the best deal that the state is going to get. If the enabling legislation is amended to say it is not the affiliate, which is what the MOU is based on, this would probably go away. Members need to consider what effect that is going to have on AGIA and the length of delays in trying to figure out who else might be interested. Regarding who else might be interested, Mr. Bullock noted that some things are not known. There was a failed open season. TransCanada has talked with the producers all along, but it is not known how the producers and TransCanada necessarily get along and "whether they are, for example, the partner that they would choose."

MR. BULLOCK said that the producers are going to have at least three-quarters interest in the pipeline, and they have their own pipelines and their own energy experience. Another consideration is TransCanada's interest in the pipeline project in British Columbia to Prince Rupert and whether Alaska will get TransCanada's full attention and how TransCanada will protect itself when it is involved in a competing project. British Columbia is pretty much in the same position as Alaska as far as the timing of each project and what it will take to grab part of the market. TransCanada is following an aggressive timeline in development of its Prince Rupert gas transmission project; the company vice president has said that time is certainly of the essence because growing demand in Asia, and particularly in China, means huge new volumes of LNG will be needed. "TransCanada is a pipeline company, this is what they do, it is not a problem here, but it is something you might wish to consider," Mr. Bullock advised. When looking at competing gasline projects, he continued, Alaska has an advantage over British Columbia because Alaska's North Slope fields are pretty much ready to produce gas whereas British Columbia's gas fields are not developed. A disadvantage is that British Columbia's pipeline will be 460 miles long while Alaska's will be 800.

When looking at the competition, the cost of getting the gas from the field to the LNG tanker must be considered.

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REPRESENTATIVE KAWASAKI inquired whether amending HB 277 is at all a possibility.

MR. BULLOCK said that the legislature writes the laws, but there are repercussions from an amendment. For example, an amendment to the legislation to require similar terms in the contract that overlapped with the commitments in AGIA might be considered by the participants to be too much of a change. However, that type of amendment is not as harmful as precluding a participant in the MOU from participating.

REPRESENTATIVE KAWASAKI said he sees the MOU, HOA, and HB 277 as a "take it or leave it" scenario. He asked whether Mr. Bullock also sees it this way. He observed that Article 4 of the MOU provides that any of the parties can say the enabling legislation is not acceptable and void the MOU.

MR. BULLOCK confirmed that any party can say no; if the enabling legislation is different than introduced, the parties have the option of deciding whether they can still work with it and continue. It is important, he advised, that members somehow get guidance from the parties to the agreement as to what is open to change and what is not. One big thing, he counseled, is how the state's interest is going to be handled, who is going to handle it, and whether the state should get involved directly or through somebody else as is currently in the MOU.

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REPRESENTATIVE SEATON requested Mr. Bullock to elaborate further regarding the state being the caboose on the train and what the state will remain committed to if there is nothing.

MR. BULLOCK replied the agreement has certain cost recovery provisions for TransCanada, but that he does not completely understand how they go. Regarding being the caboose, he pointed out that while a lot is heard about it being Alaska's gas, only part of it is Alaska's gas. As the sovereign, the state is in an interesting position. The state owns the resource when it is in the ground. The state issues leases for somebody else to take the gas out of the ground. The state is not in the gas business, just like the farmer with mineral rights in the Lower

48 who does not want to develop the gas under his or her own land. Therefore, the state needs somebody else to produce the gas and turn it into money. The producers enter into lease agreements and the state's compensation for entering into the lease agreements is that the state gets its share of the gas, which is the royalty gas and which is constitutionally required to be paid to the state.

MR. BULLOCK said that as sovereign, the state also needs money to run government, and production taxes pay for the cost of government. It is similar to an occupation tax; if an entity is producing oil and gas, then the entity pays the tax on producing oil and gas. However, the state does not get anything unless there is production. Even though the state may have 21.7 percent interest in the gas, the state does not get that until the gas is coming out of the ground. That is why the three engines of the train are the three major producers and they have to all agree for this project to go forward, he explained. The fourth partner is the limited liability company; it would be the only interest that does not directly own gas because it will be shipping the state's gas, not TransCanada's own gas. In that respect, the state is separated from the producers; that is where the state's interest diverges. The producers can decide to sell gas and their decision determines whether the state is going to get gas or money for the gas. So, the state is aligned in ownership percentages once the gas is produced, but until it is produced the gas in the ground is like money in the bank.

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CO-CHAIR SADDLER requested an explanation of the structure and how the structure would work given that TransCanada's subsidiary would be the general partner in a limited partnership in which the state would own all the structure and leasing.

MR. BULLOCK responded that a limited liability company has characteristics that are similar to a corporation in that the limited liability partners are like shareholders and are not actively involved in operation of the business. Under the MOU, the general partner will be an affiliate of TransCanada and the affiliate will have a minimum interest in the entire project, which is about 1 percent or less. The percentages of ownership of this limited partnership are a critical element of the MOU because there is a limit in how much of this partnership the state can buy. Under the MOU, TransCanada wants to keep a minimum of 14 percent interest in the project as a whole. Available to the state, then, is the difference between that

floor amount of 14 percent and the percentage of the ownership that reflects the percentage of state gas that is going to go through this pipeline. If it is 21.7 percent, the maximum state interest under this agreement would be the difference between the state's share and the 14 percent, which is [7.7 percent]. Mr. Bullock qualified that he does not know whether the 1 percent attributed to the general partner is part of the 14 percent or whether it reduces the margin that the state will get above 14 or 15 percent.

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MR. BULLOCK, responding further to Co-Chair Saddler, said the 14 percent interest that TransCanada wants to keep is 14 percent of the Alaska LNG Project as a whole.

CO-CHAIR SADDLER asked what percentage of the entire project would represent Alaska's quarter.

MR. BULLOCK answered that it could go to the same percentage of 14 percent. To better provide an answer he noted that under the Pipeline Leasing Act the general requirement is that pipelines built across state lines must be common carriers. In this case, if a shipper is Exxon, some of Exxon's gas will go through Conoco's part and some will go through BP's part - there are no assigned seats on the airplane. Last year the possibility of a contract carrier was introduced in the Alaska Gasline Development Corporation (AGDC) changes in HB 4, which would allow parties to break out of the common carrier and by entering into contract would be guaranteed a certain part of the transportation capacity without being at risk of getting bumped by some new gas producers. A disadvantage of the common carrier is that it is open to all shippers. This is a third approach in that this pipeline is just like a pipeline from a field to the dock and in this case the dock is 800 miles away. It is being characterized as an industrial pipeline; it is just part of this whole structure for a producer to get its own gas to market, the producer has a definite percentage. The ideal situation for a producer is to have the same percentage of ownership in a pipeline as it has in the resource so that the producer has some comfort in knowing that if it produces its share it is going to have a way to ship the gas to market and turn it into money.

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CO-CHAIR SADDLER asked whether the 14 percent is 14 percent of the entire pipe or 14 percent of the one-quarter of the pipe.

MR. BULLOCK replied it is 14 percent of the whole Alaska LNG Project. He said that if all the gas is produced on the North Slope and the state gets, for example, a 12.5 percent royalty and 9.2 percent of the seven-eighths that the producers have as gas, the state will have 21.7 percent. That 21.7 is the interest of the total project and the state can buy that fraction of the 21.7 percent that is above 14 percent. Using rounded numbers, he explained that if the state's share is 22 percent of total gas production, the state's pipeline share would be 22 percent; if TransCanada keeps 14 percent, then the state can buy in at 8 percent of the total project. Thinking aloud, he recalled that Alaska has seen scenarios where the wellhead value of gas was very small or nothing. For example, in 1986 oil prices were rock bottom. While he was working at the Department of Revenue, the department was speculating as to whether an integrated company could continue to produce oil at below wellhead value. In some cases an [integrated] company probably could because that is not the company's only source of revenue - under the pipeline tariffs, a company is entitled to a certain rate of return and the tariff is going to provide for that. If a company is refining, there is some profit to be made there; the same for if a company is retailing or wholesaling. Thus, there are different points in which an entity can recover its cost.

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REPRESENTATIVE HAWKER stated he is still trying to get his head around whether this is the right thing to do. Observing that TransCanada's 14 percent minimum ownership provision and the 1 percent general partner provision are part of the Alaska LNG Project Equity Option Term Sheet [MOU, Exhibit B, page 1, items 2 and 3], he concluded that this means those are right up front in priority. He pointed out that the 14 percent is equity participation interest in the midstream component and does not include below the midstream.

MR. BULLOCK agreed the aforementioned is correct and said the midstream component is from transmission lines from Prudhoe Bay and Point Thomson down to the LNG plant inlet. Additionally, there is a possibility that, under a different mechanism, the state would acquire ownership interest in the LNG plant. The Heads of Agreement (HOA) contemplates that AGDC or some other party might have a representation for the state in that project.

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REPRESENTATIVE HAWKER stressed that one must be cognizant of the necessity of preserving the occurrence of that percentage throughout the value chain. He asked whether Mr. Bullock has identified anything magic about that 14 percent number.

MR. BULLOCK answered he is unaware of any particular reason for 14 percent. TransCanada is a pipeline company, he continued, and that 14 percent will be a factor if the gas is flowing. It is probably the interest that will keep TransCanada interested and as long as the pipeline is operating TransCanada will get a share of any money that it might generate.

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REPRESENTATIVE HAWKER observed the language in [Exhibit B of the MOU, Alaska LNG Project Equity Option Term Sheet, item 2] definitively states "must not" be less than 14 percent. He said he would like to identify the reason why this is so definitive.

MR. BULLOCK offered his belief that those points which are put forth so strongly in the MOU are red flags for the enabling legislation. For example, AGIA required commitments in certain things. One thing that would be related to a commitment is the state would be able to buy all of its interest of this partnership. If the state were to consider other people who may participate or represent the state in the Alaska LNG Project - that would be a negotiating factor depending on what the interest of the state was to acquire a percentage of ownership, it would be a variable. The way it is presented in [Exhibit B] is "kind of a flag" that says do not do anything in the enabling legislation that would reduce that particular point. For example, if the enabling legislation says the state would work toward 20 percent ownership, it would cut out the 14 percent.

REPRESENTATIVE HAWKER remarked it is a bit more than a flag.

MR. BULLOCK quipped there are flags and then there are "almost guns to the head."

[2:28:51 PM](#)

REPRESENTATIVE HAWKER surmised the 1 percent general partner provision in Exhibit B, item 3, is a management provision to allow one partner that will have preferential voting rights in the management and affairs of the entity that ends up owning this piece of the project. The general partner for that 1

percent will make all decisions on behalf of the limited partnership, with a couple of caveats. The only thing profound about that is that even though the state may own 40 percent equity in that portion of the project, all the control and decision making is being handed to a general partner that is owned 100 percent by TransCanada.

MR. BULLOCK confirmed the aforementioned is correct and stated the general partner will have responsibility for actually doing the work of the limited liability company.

MR. BULLOCK then advised that there is another red flag and that this flag arises partly because of the delay between when the AGIA license was issued and when it was known that the open season had failed. He read Exhibit B, page 3, item 8:

The Parties acknowledge the confidentiality provisions of the Alaska LNG Project agreements to which the Limited Partnership may become a party may prohibit or restrict disclosure of Project information to the State. The parties agree to use reasonable efforts to allow for disclosure to the State (including on a restricted basis) as required under applicable Alaska law.

MR. BULLOCK continued, saying that because the state does not have a direct interest in the ownership, as the state is effectively buying into this limited liability company, there is certain information that the state would not have access to. He qualified he does not really understand this option for the state to enter in. At some point, he said, the state will say it wants to have the option to buy into the partnership, but he is unclear as to when the state would actually exercise the option. It seems to be a two-step process: the first step is the state gets an option, and the second step is when the option is actually exercised and the state actually becomes part owner of that partnership.

[2:32:17 PM](#)

CO-CHAIR SADDLER inquired who the partners would be in the limited liability partnership.

MR. BULLOCK replied he is unsure. He added he is unsure that by buying into the limited liability partner, the TransCanada affiliate, whether the state is just combining interest with the affiliate or the state is becoming a separate limited partner.

While it is possible the MOU may say that, he said he is unsure whether there would be "limited partner Alaska, limited partner TransCanada affiliate, general partner TransCanada affiliate." Responding further, Mr. Bullock clarified he does not know whether it would be two limited partners and one general partner or one limited partner and one general partner, of which Alaska is part of the limited partner.

CO-CHAIR SADDLER asked whether a general partner normally has the authority to speak for the other partners or whether it is just specifically this agreement language that gives this power.

MR. BULLOCK responded that limited partners are like investors, and general partners are like the executive officer who is going to run the business. "The risks in that type of business structure are different," he continued, "depending whether you are general or limited partner."

[2:34:10 PM](#)

MR. BULLOCK began a PowerPoint presentation, stating he will be mentioning things for members to think about as they move forward. Drawing attention to slide 2, he noted that not in the MOU is Exxon, the party that was working with TransCanada as the licensee on the Alaska Pipeline Project, and that Exxon may not be there because it is more directly involved with the Heads of Agreement. The new party in the MOU is [TransCanada Alaska] Development Inc. (TADI) which is participating in the Heads of Agreement with the producers but was not previously part of the AGIA project. Moving to slide 4, Mr. Bullock addressed the question, "Given the MOU, what changes could be made to the enabling legislation [HB 277, SB 138] without causing the MOU to fail?" He said red flags that members might see are the specific 14 percent interest or the specific partner and that there may be others. He urged members to look at any provision that raises a red flag [slide 6] and to consider whether amending the bill to change the criteria under which the administration negotiates will cause the MOU to go away. Mr. Bullock emphasized that it is important for the separation of powers to distinguish what the legislature does from what the executive does - the legislature legislates, executive executes [slide 5].

[2:36:06 PM](#)

REPRESENTATIVE HAWKER, addressing slide 5, stated that the legislature gets one vote on the enabling legislation, which

then "shoots this whole thing off into the administration" to complete it, exercise the option agreement, and go forward. He queried whether this is truly an option agreement. Nowhere in the legislation or elsewhere is money being provided to exercise the option agreement. He understood the administration would need to come back to the legislature for an appropriations vote in order to successfully exercise that option agreement, of which the provisions are the earlier of December 31, 2015 or the date of the commercial agreements from commencement of Front-End Engineering and Design (FEED). From a practical standpoint, that seems to throw a level of risk, doubt, and uncertainty into giving the administration the commitment to proceed, he opined.

MR. BULLOCK answered by directing attention to the terms defined in the MOU on page 5. Enabling legislation, he pointed out, is defined to include the giving of authority to the commissioners to negotiate and enter into the transition agreements that are described in the MOU. The transitions agreements are the option agreement to require equity interest and then to the Precedent Agreement and Firm Transportation Services Agreement. The definition of enabling legislation also includes authorizing the commissioners to negotiate and enter into commercial arrangements with the Alaska North Slope (ANS) producers for the Alaska LNG Project. The third part of the definition for enabling legislation is the appropriation provision referred to by Representative Hawker. He said he does not know, however, what the approach will be, whether this part is in [HB 277 and SB 138], or in a fiscal note to the bills, or some other approach. Regardless, he continued, there must be a bill that will fund the state's contingent and direct payment obligations of the costs under the Precedent Agreement.

[2:39:02 PM](#)

REPRESENTATIVE HAWKER remarked it seems like a gap in the documentation that the committee currently has, including the bill and the MOU.

MR. BULLOCK replied this relates to another part of the MOU that is confusing - page 7, Article 4.1, Term and Termination, which states that the "MOU shall commence on the effective date hereof and shall terminate upon the earliest of" the seven actions listed below it. Action (a) is execution and delivery of all of the transition agreements, in which case, he said, everything just goes along. However, he continued, if it terminates for actions (b) through (g), money will be changing hands from the state to TransCanada as guided under Article 4.2. Currently,

AGIA is still in effect, there is an agreement that the state will continue to pay reimbursement costs after December 31, 2013. So, he advised, this ongoing potential cost liability is a red flag to think about - not only from the standpoint as to whether the MOU is going to go because the enabling legislation passes or not, but also from the standpoint that if the MOU fails, what happens to AGIA because AGIA has not been terminated. The Alaska Gasline Inducement Act will only be terminated under the terms of the MOU if the MOU is in effect and this liability for development cost reimbursement survives the MOU specifically [Article 4.3].

[2:41:07 PM](#)

REPRESENTATIVE HAWKER recalled that in a previous conversation between the committee and Mr. Pawlowski [Deputy Commissioner, DOR], it was determined that there is nothing truly definitive about the state exiting AGIA, that it is a soft provision the committee was invited to keep in mind as it goes forward in developing the enabling legislation. [The MOU, page 3, recitals 11-12] state that the commissioners will initiate the process of making a determination, but it does not talk at all about concluding that process or in fact making it happen. This causes him trouble, he said, because it seems to be very open-ended, there is no mandatory exit from AGIA.

MR. BULLOCK explained that AS 43.90.240 is the agreement that says AGIA will end if the project is found to be uneconomic. That statute is set up such that if TransCanada, as the licensee, and the state agree that it is uneconomic, both parties will walk away. There is no specific guidance for the state or for TransCanada to decide it is uneconomic. It is a business decision for TransCanada, and reasons that would probably be good enough could include that there is just not enough money, or it is not going happen, or it is going down the wrong path. But, if the state and TransCanada disagree in this regard, it goes to an arbitration panel. Certain facts must be found for the panel to conclude that it is uneconomic. Those are more black and white, and clearer, because in that case it is a third party making the call as to whether the project is uneconomic. In the MOU, these provisions partly do what the uneconomic/abandonment provision does. They say that the commissioners make a decision after the enabling legislation becomes effective and the commercial agreements are executed committing the ANS producers to initiate the pre-FEED phase of the Alaska LNG Project. The commissioners will initiate the process of making a determination for purposes of AS

43.90.240(a), which is the allegation that the project is uneconomic. There are always different ways to write things, he noted. Not counting the licensee not living up to its terms, the recitals do not refer to the other way of getting out and that is competing pipeline, which is not mentioned in this agreement. "There is no agreement that if the MOU fails that TransCanada would not seek to recover treble damages by alleging that the Alaska support for the LNG project is support for a competing pipeline," Mr. Bullock said. "That is an issue that will continue." It could be that this is a very amenable and friendly agreement that says "rather than litigate we will welcome you to a part of this next project," but he does not know. While TransCanada has worked in this state probably since before AGIA, it is an issue as to why TransCanada's involvement is characterized in the terms of these recitals.

[2:46:09 PM](#)

REPRESENTATIVE P. WILSON understood Mr. Bullock to be saying there is nothing in the MOU that says what will happen if the state walks away.

MR. BULLOCK posed a scenario in which there is no MOU and it is the AGIA project that is being looked at right now. First, he said, it is unclear what the AGIA project is, which is something that he discussed in his [February 15, 2013, memorandum to Representative Hawker] during the consideration of HB 4. The project pitched to the legislature in the AGIA application and approved by the legislature - so it is the AGIA license project - would have gone to the Alaska/British Columbia border and on through Canada. Is that still a good business option? Without finding that that project is uneconomic, the findings and the project plan amendments have said it does not look like that project is going anywhere, but this other project is going to be done. Doing this other project and forgetting about the uneconomic part of the original one is fine in some ways. But AGIA is a law and the AGIA law delineates specific ways to end the AGIA license. Sometimes a contract can be entered into where both parties find that the contract is not working for them and ask if the other party would be open to changing it. In a general contract environment those kinds of changes can be made. However, in the case of a government agency in procurement there are certain changes the agency cannot make; for example, can a change be made after entering into a contract that would have been more favorable, that if at the time the procurement was done there would have been five other people that were interested? At some point the change is too great.

Continuing, Mr. Bullock explained that in the concept of AGIA, particular bounds for the AGIA licensee were set - the commitments in AS 43.90.130 - the safety of the state to say that it is not going to continue to fund a project that is not showing value. Regardless of the contract the legislature can always review the appropriations and evaluate the project. The responsibility for defining the project as uneconomic is placed with the commissioners. Under AGIA, the duty of the commissioners is to consider the economics of the project along the way. Recital 11 is consistent with AGIA because it says to keep looking at it and if at some point it is seen as uneconomic, not going to go, it raises the issue. Then, after that, it is an issue of how it will be handled. In this case, it says that the licensee is committed and that if all the things that have to happen before the commissioners can commit to allege the project is uneconomic are in place, that TransCanada will agree that it is uneconomic as well. It is kind of based on the AGIA provision, but it is silent on whether the state will buy the information paid for by TransCanada by paying TransCanada its net cost. However, it probably covers most of the spirit of the abandonment provision.

[2:50:41 PM](#)

REPRESENTATIVE P. WILSON surmised the state would have to pay a lot of money and it is unknown whether the state would get the data.

MR. BULLOCK replied, "Right - that is another whole game." Continuing, he reminded members that the state is only paying for those qualified expenditures that were pinned down in the inducement provisions of AS 43.90.110. Up to open season, the licensee can get up to 50 percent reimbursement of those qualified expenditures. After open season, TransCanada can get 90 percent reimbursement of the qualified expenditures, but now TransCanada is going to have other costs that are not qualified expenditures. Thus, "it is not all the qualified expenditures; it is just the money that TransCanada has put out."

CO-CHAIR SADDLER understood that TransCanada's unreimbursed qualified expenditures are at about \$130 million.

MR. BULLOCK answered he has heard that figure but offered his belief there has not been a report on the status of the project since January 2013.

CO-CHAIR SADDLER requested that a firm number be provided to the committee.

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CO-CHAIR SADDLER inquired whether Mr. Bullock's legal opinion is that the Alaska LNG Project is not a proper legal descendant of the AGIA process and does not extinguish AGIA.

MR. BULLOCK responded he is saying that because of the way AGIA is written, and because AGIA is still active since there is still a licensee that the state is still reimbursing for qualified expenditures, the issue is raised of the extent to which the state is promoting this parallel pipeline. A certain amount of protection is probably there because an affiliate of the licensee is part of this new project. When everybody is in agreement, he continued, things go along fine, but not so when something breaks.

CO-CHAIR SADDLER understood that the MOU provides a way for both the State of Alaska and TransCanada to slide on past AGIA and not let go of the trapeze handle that is AGIA until a firm grasp is had on the next trapeze handle that is the enabling agreement and so forth.

MR. BULLOCK agreed the aforementioned metaphor is a reasonable reading of the situation. He said TransCanada as the licensee continues to have an interest in the pipeline project. He reminded members that AGIA was not to build a pipeline, but to work toward a pipeline. So, the issue of who would actually own part of that project would continue. This MOU, in a way, covers that because it allows TransCanada to continue to be involved and it actually clarifies more than did AGIA as to what ownership interest TransCanada would have in the ultimate project.

2:54:38 PM

CO-CHAIR SADDLER asked whether Mr. Bullock, as the committee's attorney, is advising the committee to clarify the extinguishment of AGIA, or to proceed with the MOU and get past the whole AGIA question, or to be cautious and cognizant of all the elements at play as the committee makes a decision.

MR. BULLOCK replied he is advising to be cautious. He urged the committee to remember executive power versus legislative power. The legislature cannot find that the project was uneconomic, the

legislature cannot find that the licensed assurances have been violated; those are executive branch functions. Recital 11 is consistent with the executive branch function because it requires the commissioners to move forward on the uneconomic aspect after all these other conditions have been met.

CO-CHAIR SADDLER inquired whether, during Mr. Bullock's time with the legislature, a more complicated deal has ever been presented to the legislature.

MR. BULLOCK responded no, usually it would not for the reason that laws can be complicated, but within the laws the legislature has set boundaries within which the executive operates. For example, the state has a procurement code that tells state agencies what they must do. What makes this a big deal is that the legislative branch has overlapping functions with the executive branch. The approval of the AGIA license passed without a two-thirds vote to have an immediate effective date, so there was not universal acceptance of the AGIA approach. The issue came up then as to whether the governor could have done it anyway. There is a possibility that that could have happened because the legislature, by saying what all the rules are, and the administration, by operating within all the rules, had carried out its executive function. It is contemplated that the contracts will come back to the legislature for approval, plus the legislature has to appropriate money anyway and therefore the legislature always has that hook on a project.

[2:57:45 PM](#)

CO-CHAIR SADDLER asked whether Mr. Bullock has been involved before with agreements that are this complicated, cascading, and contingent.

MR. BULLOCK answered he has not been involved in agreements like this, but he has helped clarify some of the laws as they have gone through the legislative process.

CO-CHAIR SADDLER noted that the flow chart the committee has requested will show all the different contingencies, moving pieces, decision flows, and implications of those decisions. The chart will help members as well as the public to understand such a complicated transaction.

MR. BULLOCK pointed out that there also needs to be "a seat belt and airbag analysis" [slide 10]. Everything may look great

right now if the enabling legislation passes and the MOU and the option agreement just click along, but [there should be analysis of] how the state is covered should they not. This uneconomic issue under AS 43.90.240 is going to continue, so there must be a plan for that.

2:59:12 PM

REPRESENTATIVE SEATON expressed his concern about giving permission to the executive to negotiate terms, including terms outside those that were specified. Noting that the enabling legislation, as written, would separate the oil and gas tax formats, he inquired whether the bill would give legislative approval to the executive to negotiate terms of the oil tax.

MR. BULLOCK replied there are two aspects of that issue. There have been many discussions about setting tax rates by contract so that the state cannot change them over a period of time. However, the law is pretty clear that [the legislature] cannot do that, not only in the state's constitution, but the state's own experience between floods and earthquakes. The state has had to have the flexibility to impose the \$10 disaster tax when the state needed the money. Agreements are going to be discussions in quiet rooms behind locked doors. There may be factors that affect what the tax rate is going to be, but the administration or the executive branch cannot set tax rates; that is the legislative branch. The administration has flexibility to establish how royalty is going to be established and collected because that is a contract and those contracts must be within AS 38.05.180, the oil and gas leasing statute. It depends on how the legislature gives the authority to the administration. Under AGIA there were the must-haves in AS 43.90.130 that required an applicant to commit to those things. If the applicant did not commit to those things the administration did not have the power to say the applicant did most of the things so the state would go with it. The tax rates are going to be just like they are under the governor's legislation, which is proposing a new tax rate and different method of tax on gas. Members do not know how it got there - it may be that 10.5 percent was a compromise between the state getting that percentage of the gas production on the North Slope, or maybe at 11 percent the project might not have been able to go forward, or maybe 9 percent was giving too much away. It is hard to say because what goes into the governor's bill is negotiation and thought from [the executive's] standpoint as to what is in the best interest of the state. But, particularly in tax, it is the legislature that decides which rate, what method

of taxation, and what is taxed, that is in the best interest of the state. So, tax rates are not negotiated, but the legislature may get a bill that proposes a change in tax rates. For example, in SB 21 last year the proposed rates and proposed change in structure were based on the information that was presented to the legislature; that [information] was the administration's basis for selecting that method and those tax rates.

[3:03:18 PM](#)

REPRESENTATIVE SEATON clarified he is asking for Mr. Bullock's legal opinion as to whether the legislature, under the enabling legislation, would be giving the authority to the executive to negotiate additional terms and would those additional terms, by giving that authority, be to set in contract a tax for oil.

MR. BULLOCK answered the contract cannot set the tax rate or the tax system. But, the way it can be done is by calling it enabling legislation and setting up that this is agreement that requires certain changes to be made. The enabling legislation includes more than just giving the commissioners the authority to negotiate these commercial agreements. It addresses re-defining the point of production for gas and provides for taxing gas on the gross value at the point of production rather than the production tax value. When considering this bill that states a tax rate, legislators must determine whether that is the appropriate tax rate and look at why it is being offered. Last year, legislators were shown that the tax rate was to make Alaska more competitive. This year, legislators are going to be shown that the MOU and Heads of Agreement require a different method of taxation and the opportunity to pay the tax with gas.

[3:05:12 PM](#)

CO-CHAIR FEIGE understood Mr. Bullock to be saying that, in the enabling legislation, legislators can either give the authority [to the executive] to renegotiate oil royalties or not, and that that authority should probably be just for gas royalties.

MR. BULLOCK said the proposed enabling legislation only addresses gas, but noted there is an overlap between gas and oil that would continue in the governor's legislation and which will be seen when the legislation is before the committee. He said his first thought was about lease expenditures when he heard the proposal that the gas would be taxed on gross value, because lease expenditure reduces the gross value at the point of

production down to the level that the state would be taxing, so that would be the deduction. Because the state would be taxing on gross, the lease expenditures would go somewhere and he believes they would be taken against the gross value at the point of production for oil to determine the production tax value. The cost for processing gas is generally not as great as oil; however, at the LNG facility those costs are very high.

[3:06:43 PM](#)

REPRESENTATIVE SEATON concluded, then, that all production costs on gas would get accounted for in oil, reducing value for oil taxation, that that is the interchange between gas and oil.

MR. BULLOCK agreed, saying the whole theory of the petroleum profits tax (PPT), Alaska's Clear and Equitable Share (ACES), and SB 21 is that there are so many common facilities and common costs in a field that it is very difficult to divide them between gas and oil. Legislators looked at the combination of gas and oil in the progressive part of ACES and how the more gas produced dilutes that average and brings the tax down, which is known as the decoupling issue. However, it is not anywhere near the impact of mixing oil and gas values when just taking some of the lease expenditures and using them against the oil tax. It is an incentive for producers with oil and gas deposits to produce gas, which would help this project along.

[3:08:10 PM](#)

MR. BULLOCK, responding to Representative Olson, noted the date of [July 31, 2014] is a trigger date. If the enabling legislation is not actually in effect as of that date, i.e. if the effective date fails, the legislation must be signed 90 days before that date, otherwise the parties will look at it and decide whether it has triggered the abandonment of the MOU.

MR. BULLOCK, responding to Representative Hawker, agreed the date has a provision that allows it to be extended with the joint approval of the parties. That date is one of the flexibilities, he said, and there is also flexibility on the parties' interpretation of whether the enabling legislation is satisfactory.

REPRESENTATIVE TARR posed a scenario in which enabling legislation goes through, but sometime later the process is disrupted and does not continue. She asked whether there is a grey area in those transition agreements for getting out of the

AGIA license and whether the legislature could be given a financial liability because of actions by the executive branch.

MR. BULLOCK responded there are liabilities in this agreement if things do not happen as expected. Drawing attention to the seven contingencies in Article 4.1 of the MOU, he said only one [4.1(a)] does not put the state at risk of having to make payments. Article 4.2(a) recognizes that certain things are continuing to happen under AGIA as it mentions "net of AGIA reimbursement...." Enabling legislation gives the authority to the administration to make it work, but it will have to be within the bounds of the legislation passed by the legislature.

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CO-CHAIR SADDLER understood that TransCanada would receive a 7.1 percent return on its development expense [Article 4.2(a)]. He inquired how much development expenses are likely to be and whether 7.1 percent is reasonable.

MR. BULLOCK deferred to the administration for an answer, saying he is not sure about the 7.1 percent but that it probably is a negotiated percentage based on cost plus. He noted that "AFUDC" stands for Allowance for Funds Used During Construction.

CO-CHAIR SADDLER understood Mr. Bullock to have earlier said that the enabling legislation would allow qualified lease expenditures for gas production to be deducted from oil income for tax purposes.

MR. BULLOCK confirmed that is the way lease expenditures are handled in the enabling legislation, but it could change. It comes back to the issue of whether those costs can really be separated.

CO-CHAIR SADDLER understood that would be after the initial contract period.

MR. BULLOCK replied that the current tax provisions in the governor's enabling legislation have an effective date of January 1, 2015. In the bill the present tax rate is referred to as the tax in effect on and after January 1, 2014 and before January 1, 2022. The bill adds a section that will tax oil at 35 percent of the production tax value and will tax the gross at 10.5 percent. A new provision in the bill, AS 43.55.014, would allow a taxpayer to elect to pay its tax in the form of gas instead of dollars. To be able to make that election the

taxpayer has to be a taxpayer that had its leases renegotiated under the authority of the bill. If the legislation passes with those changes, then starting January 1, 2015, negotiations with the producers who want to pay their tax with gas will commence and the state will learn how much gas percentage it is going to get from the total production on the North Slope, as well as what gas it will get as royalty in kind rather than value. Once this gas percentage is known, the ownership options discussed in the MOU can be considered and the state will have a better idea about the actual percentage of the project that the limited liability company would own that the state could buy into. It is a chain of events. One thing leads to another and they all have to happen in a certain order.

[3:15:50 PM](#)

MR. BULLOCK turned to his presentation to address state ownership in the midstream part of the Alaska LNG Project [slide 17]. He said there seems to be two options - an option to pick up the option to buy in and then a point at which the state actually requires the equity interest. However, he said, he is unsure how that works and what the timing is. Regarding state ownership, he paraphrased from slide 18 which states:

Under the MOU an affiliate of TransCanada would hold that portion of the midstream project equal to the percentage of North Slope gas the state may receive as royalty in kind and production tax on gas paid as gas. May be 20-25 percent depending on amount of royalty gas in kind and production tax paid as gas.

MR. BULLOCK, addressing slides 19-21, urged committee members to be aware of the economic impacts of an agreement to pay for the gas transportation cost over [the 20-25 year] period of time.

[3:16:44 PM](#)

REPRESENTATIVE HAWKER offered his understanding that a sole-risk expansion would be another way that the state could acquire ownership in the project.

MR. BULLOCK responded the expansion comes up once the state has this percentage of ownership. The state can open its interest to other producers in the state and if that requires expansion of the pipeline, then how it will be paid and how it will be done is another subject.

REPRESENTATIVE HAWKER said he is looking for affirmation that instead of acquiring a greater interest in the partnership with the TransCanada entity, the State of Alaska could actually own a direct equity interest in the midstream part of the project by taking a sole-risk expansion.

MR. BULLOCK confirmed this is addressed in Exhibit C of the MOU, [Alaska LNG Midstream Services Term Sheet], page 7, item 7. In further response, he said he is unsure how it works and that the people who wrote the agreement would be able to give a definitive answer.

[3:19:12 PM](#)

REPRESENTATIVE P. WILSON surmised a sole-risk expansion would cost the state more because there would need to be compression, resulting in [the state] not getting as much for its gas.

MR. BULLOCK answered that expansion by adding compression capabilities can actually reduce the cost. However, expansion by looping, which is the building of another pipeline next to the current pipeline, can have costs that get quite high. Under AGIA, a person is required to commit to rolled-in rates in which the existing shippers help pay for the cost of expansion within certain bounds; however, that commitment is not really enforceable because it is up to the regulatory agencies. Generally, he continued, any cost of adding capacity is passed on to whoever will be shipping their gas through.

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CO-CHAIR FEIGE pointed out that a main feature of the Heads of Agreement is that the cost of any expansion will be borne by the party doing the expansion and the original equity owners will not see an increase in their cost unless they elect to buy into the expansion. Thus, the future expenses of the equity owners are protected.

MR. BULLOCK replied that is a good observation and said the common situation between HB 4, which allowed for contract carriers, and this situation, which is an industrial approach to getting gas, is that the people with gas know they will be able to ship it. A North Slope producer is not precluded from buying gas from a new producer and shipping that gas, which would be another way that new gas could get into the project. The state would have the option of adjusting its capacity to accept new gas in the part of the midstream project that it owns. Also,

AGDC could participate in the LNG plant [slide 21] as another way of state ownership. Gas not sold instate would go through the LNG plant, so the state would become part of all of it.

[3:22:34 PM](#)

REPRESENTATIVE SEATON posed a scenario in which the state, to promote economic development, sells gas to various development projects around the state, thereby reducing the throughput to the LNG plant. He asked whether this scenario would require a subtraction or addition of tariff to the price of the gas for the state's capacity on the pipeline.

MR. BULLOCK responded that would all be part of it. For example, the proposed terms in the MOU allow for three different tariffs depending on where the gas is going to be delivered, which would affect the cost.

REPRESENTATIVE SEATON surmised that if the state did not have the additional 25 percent of the gas to go down the pipeline because the Alaska Oil and Gas Conservation Commission (AOGCC) did not increase the available gas off the North Slope, the state would have to decide whether it wants to stimulate that economic development and tack on the additional capacity that would then not be used going down to the LNG plant.

MR. BULLOCK replied this is where the state is the caboose. Whether the state gets anything at all depends on whether the three producers are producing. He recalled there was discussion in the terms of Point Thomson as to whether the state would take its royalty of the gas at the time it came out of Point Thomson and went to pressurize Prudhoe Bay and that the tax would not be due until it came off the cap in Prudhoe Bay, but added that he does not think anything came of the discussion. Generally, the state does not get gas and does not get tax unless there is oil or gas produced. This is why the state is the caboose, not the engine. The state cannot say to start producing the one-eighth of the gas because it wants its royalty now.

[3:26:16 PM](#)

MR. BULLOCK returned to his presentation, saying that the state does not know why the first open season failed [slides 26-29]. For example, did the producers think TransCanada's project was a good one but the taxes were not worth it, or that the market was not pretty enough, or that the producers, being the ones with the gas, wanted to pick who to go into business with? The

producers may not know the details of building a gasline through permafrost like TransCanada does, he continued, but they are not part of the process of who is going to represent the state in this project.

CO-CHAIR FEIGE inquired whether there were specific statutory requirements in AGIA mandating that that open season information remain confidential.

MR. BULLOCK answered AGIA had a number of confidentiality provisions that were necessary because an entity does not want to publish why the open season failed and possibly jeopardize the next open season. Communication would be helpful. The license was issued in 2008, open season ended on July 30, 2010, and appropriations were being made for reimbursement expenditures for that period without [the legislature] being able to know whether the state was getting the bang it expected for the buck. A reason HB 4 was attractive is that there is more open communication and more open reporting requirements along the way. He advised that information is going to be a problem - these are billion dollar business decisions that people want to hold close to their vests, which is understandable. But at some point legislators need to know enough information when trying to determine how much money to appropriate, what the state's money is going for, and what can be expected from it.

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MR. BULLOCK, turning back to his presentation, said the licensed AGIA project was, in his opinion, the Alberta project [slides 26-29]. But, he said, TransCanada always said that it would solicit information to Valdez at the same time, Valdez being the focus for the LNG facility. So, there was discussion about LNG facilities. While it was a different format than the Alaska LNG Project, the pros and cons must have come up in conversation and those would be good things to know. Also important is the big difference between the AGIA project and the Alaska LNG Project - the AGIA project was mostly a pipeline. In the past, the producers have been reluctant to participate in a project that they could not own a part of; that, plus other terms like common carriage, made a stand-alone pipeline project less attractive. The negatives of the AGIA project go away with the Alaska LNG Project where the producers are part owners. He pointed out that he is talking about the producers because they are the ones that are going to decide whether or not gas comes out of the ground, although the AOGCC will say when and how much. The

producers will have the Alaska LNG Project all the way to the LNG facility and into the tanker.

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CO-CHAIR SADDLER brought attention to slide 28 and queried whether the question regarding what happened is about whether interest was or was not expressed.

MR. BULLOCK answered yes. A question is whether changes were identified that would have made the AGIA project viable; for example, maybe the project was too small. Responding further, he noted there was a formal open season in 2010 and a solicitation of interest in 2012. The state does not know, for example, whether conditional commitments were made, such as the agreements would be signed if the tax rates on gas were reduced. Or perhaps it was a dislike of the way the project was formed. The information required for an LNG project was as complete as for an overland project, but there was never full information for an LNG project like there was for the overland project.

CO-CHAIR SADDLER, regarding the question asked on slide 28 about whether changes were identified that would make the AGIA project viable, inquired which route is specifically being referred to as the AGIA project.

MR. BULLOCK replied both. He noted the interest is that the overlap was solicitations to Valdez and the Alaska LNG Project.

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CO-CHAIR SADDLER suggested that the question could be better expressed by asking whether changes were identified that would make "an" AGIA project viable.

MR. BULLOCK agreed, but added that because the open seasons and the solicitation of interest were related to the AGIA project the discussion would have been to the AGIA project. But, at that same time, the Valdez LNG option would have been discussed. Why the AGIA project was not viable would have been because the LNG was a better option. In further response, he clarified that 2010-2012 is the timeline being referred to in his question about whether any changes were identified. Regarding what changes were identified, he said he is meaning what would have to change for someone to sign up to ship gas.

CO-CHAIR SADDLER surmised Mr. Bullock is saying that he is unsure whether a viable deal was presented and negotiated but not committed to.

MR. BULLOCK replied that if it was not committed to, then it was not a deal. He said he thinks it was more of the terms and conditions during that discussion of what it takes to make a gas project in Alaska work. Because there were not commitments during the open season, something was missing and it would be nice to know what that was.

MR. BULLOCK urged committee members to remember that the most control they have over this process is being members of the legislature that will write the laws and appropriate money to make anything happen.

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REPRESENTATIVE P. WILSON requested Mr. Bullock's opinion on whether the HOA and the MOU provide the state with assurances that any other pipeline the state is doing does not kick in the clause that would make the state pay triple damages.

MR. BULLOCK responded he thinks the state has to be careful as specific things under AS 43.90.440 are the trigger. The AGIA inducements were to provide the services of an AGIA coordinator to help move things along. The royalty and tax incentives in AGIA were to induce producers to make a commitment during the first binding open season, and the benefits of when and how to take gas as royalty in kind or royalty in value. The tax incentive to a producer committing during the first open season was that the producer would be exempt from increases in the tax rate. That was one of the ways the constitution allows for exemptions; it does not allow for contracting it away. Another inducement was the grant of state money, the reimbursement of costs. A further assurance to the licensee was that the state would not also give to a competing natural gas project, a project of more than 500 million cubic feet a day. A concept behind the 500 million cubic feet was that it was the amount of gas identified that the state would need, but that amount was also related to the amount of gas that the AGIA project would need to be viable. Regarding the Alaska LNG Project, he said there are many good lawyers in the Department of Law, the governor's bill is well written, and he trusts those lawyers to make sure the state is not approaching that point, particularly since the MOU does not address the risk of providing incentives to a competing pipeline. He qualified that the statute must be

looked at and he does not know everything that is going on in the background. The agreements can be looked at, the products of discussions can be seen, he said, but he does not know "what is behind these or how they got there."

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REPRESENTATIVE P. WILSON commented that the pages of information provided by Mr. Bullock do not state exactly what she wants to hear.

MR. BULLOCK stressed he is not going to say the state's likelihood of success in any litigation. The legislature and its lawyers will defend legislative contracts, but it is the Department of Law that represents the state's interest. He pointed out that the information he provided the committee refers members to, [and includes], his [February 15, 2013] memorandum to Representative Hawker that is part of the HB 4 record, which discusses the assurances in AS 43.90.440 and what has to be in place. For example, TransCanada would not be eligible for treble damages if it is out of compliance with the terms of the AGIA license or if it is not in compliance with applicable state and federal law. Another set of conditions that would have to be met is that the state has provided benefits to a particular competing project. But it also has exclusions - lowering the tax for everybody would not be a benefit to a competing pipeline and renegotiating a lease agreement under existing law would be okay. The state would only have exposure if it has provided particular incentives to somebody that would threaten the project that was contemplated under AGIA.

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CO-CHAIR SADDLER inquired whether TransCanada is in compliance with AGIA.

MR. BULLOCK replied he thinks it is safe to say TransCanada is in compliance with AGIA. Through TransCanada's partnership or working arrangement with Exxon, it still files quarterly status reports with the Federal Energy Regulatory Commission (FERC). The Alberta project is still alive and in the background and in the future that may be the more economical option because things change. For example, in 2008, shale gas was not an issue and it looked like Alaska's market was going to be in the Midwest. Within a couple of years, the Midwest is where most of the shale gas became available and gas prices went up enough that it was

worthwhile. Hydraulic fracturing (fracking) of shale is more expensive than producing from Alaska's fields which have sufficient pressure to not need fracking. Alaska's advantage in the LNG market is that its cost of production could be more competitive against a fracking operation.

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CO-CHAIR SADDLER inquired about Mr. Bullock's earlier statement that the enabling legislation would change the location of the point of production.

MR. BULLOCK confirmed that is one of the amendments in the bill. There are additional costs with taking custody of the state's gas, he explained. For example, if the state takes its gas where it enters into the transmission lines from Prudhoe Bay or Point Thomson, that gas will then need to go to what may be a combined gas processing and gas treatment facility. Gas processing takes the liquids out, so the gas generally going into the pipeline is methane, a single carbon and four hydrogens. Gas treatment has to make the gas of pipeline quality. There will be other things besides hydrocarbons in the gas, such as sulfur or carbon dioxide. The farther up the line the state gets its gas, the more costs associated with actually transporting that gas. The point of production is important for tax purposes, because that is going to be the point where the gross value is determined.

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CO-CHAIR SADDLER understood the state currently takes possession at the point of production at the wellhead. He asked what location is proposed in the enabling legislation.

MR. BULLOCK addressed page 48 of HB 277, noting current law states that for gas that is not subjected to or recovered by mechanical separation or run through a gas processing plant, "the first point where the gas is accurately metered". So, traditionally, he explained, the gas is measured as it comes off the lease. The bill changes that language to:

the furthest upstream of the first point where the gas is accurately metered, the inlet of any pipeline transporting the gas to a gas treatment plant, or the inlet of any gas pipeline system transporting gas to a market.

Thus, he elaborated, instead of one particular point, the enabling legislation would establish a new point of production relative to the gas treatment plant. The bill also redefines gas treatment plant and gas processing plant. This provision does not apply to the state's royalty, he pointed out, or to where the state takes possession of the gas, which is something else to look at. This provision addresses for tax purposes where the value is going to be determined at the point of production.

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REPRESENTATIVE SEATON, [referring to the enabling legislation], understood that in the future these terms would apply not just to the North Slope but to all of Alaska, including the Cook Inlet sedimentary basin.

MR. BULLOCK replied that the bill as currently written provides that, on and after January 1, 2022, oil will be taxed at the rate it is now; the rate applicable to oil and gas will only apply to oil. Gas tax will be on gross value and will be 10.5 percent. People not having a lease modified, or people with a lease modified but not electing to pay the tax as gas, will continue to pay the tax in dollars and it will be at 10.5 percent of the gross value at the point of production. While this may be changed after the first version of the bill, it is something to look at.

REPRESENTATIVE SEATON concurred it is something the committee needs to look at because it is quite a change from current treatment of gas in Cook Inlet.

MR. BULLOCK, in regard to the amount of gas the state could receive, pointed out that the state only gets royalty off of state land. So, those are the only leases that can be renegotiated and the only leases that could pay the production tax as gas. Production off of land claims, oil and gas reserves, and federal oil and gas reserves is subject to tax but not to royalty.

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CO-CHAIR SADDLER inquired whether the MOU provides enough information to able to calculate whether there is going to be residual value. He said he is concerned that legislators know before making commitments in legislation whether there is going

to be residual value for the state and that it will not all be eaten up in transportation, processing, and other costs.

MR. BULLOCK answered that the February 14, 2014 presentation by the legislature's consultants is probably the most significant of what has been heard. He said it all comes down to what the gas can be sold for, who is going to buy it, and what has to be done to get it to the buyer. For example, the state's barley project created a great product without a market. The state must be careful to do everything it can, as soon as it can, to identify its markets and try to get itself in a position to deliver. These are long-term contracts. Gas prices are in flux. As seen by the graphs [on February 14, 2014], the older contracts were tied to oil value, the newer contracts, especially from some of the LNG exporters in the Gulf of Mexico, will be tied to the Henry Hub. It is a competitive market. Each of the many LNG suppliers have different costs and a buyer's approach may be to look at the cost of production and base what the buyer is willing to pay on that rather than tying it to oil.

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ADJOURNMENT

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 3:51 p.m.