ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE
February 7, 2014
3:30 p.m.

MEMBERS PRESENT

Senator Cathy Giessel, Chair
Senator Fred Dyson, Vice Chair
Senator Peter Micciche
Senator Click Bishop
Senator Anna Fairclough
Senator Hollis French

MEMBERS ABSENT

Senator Lesil McGuire

COMMITTEE CALENDAR

SENATE BILL NO. 138
"An Act relating to the purposes of the Alaska Gasline Development Corporation to commissioner of natural resources on the custody and disposition of gas delivered to the advance to develop a large-diameter natural gas pipeline project, including treatment state in kind; relating to the authority of the commissioner of natural resources to and liquefaction facilities; establishing the large-diameter natural gas pipeline project propose modifications to existing state oil and gas leases; making certain information fund; creating a subsidiary related to a large-diameter natural gas pipeline project, provided to the Department of Natural Resources and the Department of Revenue including treatment and liquefaction facilities; relating to the authority of the exempt from inspection as a public record; making certain tax information related to an commissioner of natural resources to negotiate contracts related to North Slope natural election to pay the oil and gas production tax in kind exempt from tax confidentiality gas projects, to enter into confidentiality agreements in support of contract negotiations provisions; relating to establishing under the oil and gas production tax a gross tax rate and implementation, and to take custody of gas delivered to the state under an election for gas after 2021; making the alternate minimum tax on oil and gas produced north of to pay the oil and gas production tax in kind; relating to the sale, exchange, or disposal 68 degrees North latitude after 2021 apply only to oil; relating to apportionment factors of gas delivered

to the state under an election to pay the oil and gas production tax in of the Alaska Net Income Tax Act; authorizing a producer's election to pay the oil and kind; relating to the duties of the commissioner of revenue to direct the disposition of gas production tax in kind for certain gas and relating to the authorization; relating to revenues received from gas delivered to the state in kind and to consult with the monthly installment payments of the oil and gas production tax; relating to interest payments on monthly installment payments of the oil and gas production tax; relating to settlements between producers and royalty owners for oil and gas production tax; relating to annual statements by producers and explorers; relating to annual production tax values; relating to lease expenditures; amending the definition of gross value at the 'point of production' for gas for purposes of the oil and gas production tax; adding definitions related to natural gas terms; clarifying that credit may not be taken against the in-kind levy of the oil and gas production tax for gas for purposes of the exploration incentive credit, the oil or gas producer education credit, and the film production tax credit; making conforming amendments; and providing for an effective date."

- HEARD & HELD

PREVIOUS COMMITTEE ACTION

BILL: SB 138
SHORT TITLE: GAS PIPELINE; AGDC; OIL & GAS PROD. TAX
SPONSOR(s): RULES BY REQUEST OF THE GOVERNOR

01/24/14	(S)	READ THE FIRST TIME - REFERRALS
01/24/14	(S)	RES, FIN
02/07/14	(S)	RES AT 3:30 PM BUTROVICH 205

WITNESS REGISTER

JOE BALASH, Commissioner
Department of Natural Resources (DNR)
Juneau, Alaska
POSITION STATEMENT: Related how SB 138 related to the MOU and the HOA.

MIKE PAWLOWSKI, Deputy Commissioner
Department of Revenue (DOR)
Juneau, Alaska
POSITION STATEMENT: Provided sectional analysis of SB 138.

MARY GRAMLING, Assistant Attorney General
Department of Law (DOL)
Juneau, AK
POSITION STATEMENT: Answered questions on legal issues in SB 138.

ACTION NARRATIVE

3:30:36 PM
CHAIR CATHY GIESSEL called the Senate Resources Standing Committee meeting to order at 3:30 p.m. Present at the call to order were Senators French, Fairclough, Micciche, Bishop, and Chair Giessel.

SB 138-GAS PIPELINE; AGDC; OIL & GAS PROD. TAX

3:31:17 PM
CHAIR GIESSEL announced SB 138 to be up for consideration and that today they would get a sectional analysis of it.

3:31:40 PM
SENATOR FAIRCLOUGH moved to bring SB 138 forward. There were no objections and it was so ordered.

3:32:50 PM
SENATOR DYSON joined the committee.

JOE BALASH, Commissioner, Department of Natural Resources (DNR), said he wanted to revisit a couple of high level concepts in the HOA and the MOU to put the legislation into context.

3:33:17 PM
MIKE PAWLOWSKI, Deputy Commissioner, Department of Revenue (DOR), said the HOA describes the roadmap to advance the project through a phased process, each with stopping points for evaluation and with room for legislative input, and then the decision to move to the next stage.

The MOU describes the agreement to transition from the AGIA license to a more traditional commercial relationship with TransCanada and describes key commercial terms of that relationship. Both documents inform SB 138, which asks for three basic things:
-state participation in the AKLNG project
-that the state set the appropriate percentage through the gas share for the state participation in the AKLNG project

-that the state initiate a process for the development of the project-enabling contracts that will involve legislative oversight and approval of those future contracts

3:35:47 PM
MR. PAWLOWSKI said that the coming together of the parties to work together on an LNG project leverages all the work that has happened in the past to date including:
-the settlement of Pt. Thomson
-the roughly $330 million for qualified expenditures under the Alaska Gasline Inducement Act (AGIA)
-$130 million worth of data collection and work done by TransCanada and ExxonMobil under the Alaska pipeline Project (APP)
-$200 million worth of work performed by BP and ConocoPhillips under the Denali Pipeline Project

SENATOR DYSON said it would be useful to know at some point where the BP/ConocoPhillips and TransCanada/ExxonMobil efforts overlapped.

MR. PAWLOWSKI said he would work with the partners on how they view that work for him and also get a recent report on the AGIA reimbursements that have a geographic breakdown of that spending.

Following passage of SB 138, he continued that the project will step into the pre-FEED (front end engineering and design) stage which is the point at which all the AGIA and Denali work will be contributed to AKLNG. The state and TransCanada will agree mutually to abandon the AGIA license and that there will be no more reimbursement.

3:38:44 PM
In lieu of taking that step and moving forward, under the AGIA license the state has an option to buy that $130 million worth of data. AGDC, at this stage, is also progressing towards their open season in 2015 sharing the work they are doing with AKLNG, working together cooperatively as their statute says.

3:39:33 PM
The pre-FEED stage, expected to last a number of months, is estimated to cost around $435 million, which does not include any of the costs upstream in Prudhoe Bay or Pt. Thomson. He said the HOA contemplates a range of 20-25 percent for the state's share of the project; the producers' share of costs in the pre-FEED stage would be roughly $348-$327 million. The state/AGDC

subsidiary share would be roughly $35-$43 million. This does not include some of the agency costs to hire experts and to do a lot of the work that a will come along with the development of the contracts, nor some of the contingency for exercising the equity option, or potential overruns at this stage of the project.

MR. PAWLOWSKI said part of what TransCanada brings to the table is the commitment of their cash resources to move the project forward, because in pre-FEED TransCanada is spending $53-67 million. After the pre-FEED period progresses there will be a point in time where the contracts contemplated in the HOA and enabled through SB 138 come back to the legislature for approval and are put through the public and deliberative process. At that point is another gate where everyone will decide if the project is ready to move forward. In a go scenario, the state has an opportunity, per the MOU, to step back in and take a share of the equity that TransCanada is carrying on its behalf in pre-FEED. Again, if the project decides to stop, there is an opportunity to pay TransCanada development costs plus the 7.1 percent AFUDC (allowance for funds used during construction).

3:42:23 PM
SENATOR FRENCH asked what TransCanada is risking if the off ramp is for the state to pay back all of its costs.

MR. BALASH answered that the nature of this relationship is differentiated from the AGIA license in that it is much more like a traditional transporter/shipper arrangement where the pipeline company takes on certain development costs in order to provide service to the shipper, in this case the state agencies. If the agreement is terminated, we pay back their development costs, and in this case the state receives all of the equity rights associated with work that was done during the pre-FEED phase.

He contrasted this with the AGIA process where for the last six years the state has been reimbursing TransCanada at either 50 or 90 percent of their qualified expenditures and not gaining any equity rights associated with what could be described as ownership. The state now has a right to an option to exercise for all of that information, a much more direct approach where there is no question of who owns the data at the end of the day if things don't go forward.

3:44:32 PM
SENATOR FRENCH asked what risk TransCanada bears.

MR. BALASH answered the use of their equity to pay pre-FEED and FEED costs, which they are accustomed to earning a higher return on, and the AFUDC at 7.1 percent reflects that debt to equity capital. So, there is a certain opportunity cost associated with their equity at this point, as well as the use of their expertise.

3:47:49 PM
SENATOR BISHOP asked if the equity is the documents, engineering data, and everything that is tangible.

MR. BALASH answered yes.

SENATOR BISHOP asked if the state would have to pay $130 million for that data if the project would be a no go.

MR. BALASH said that was correct, if we wanted to get that information from them.

SENATOR BISHOP said that information could be plowed into AGDC advancing to its 2015 open season.

MR. BALASH said that could be done, but they weren't recommending it. However, they are recommending to take this step forward with SB 138 and then would see that legacy information contributed to the joint venture.

SENATOR MICCICHE remarked that besides risk equity opportunity, TransCanada is also risking $63-77 million in development costs that would not be reimbursed, and simply by executing this contract, the state absorbs $130 million worth of previous work, not mentioning the work done by the other companies. And the state's cost at the first off ramp if we decide to back out is only $53-67 million.

MR. PAWLOWSKI said that was correct. He said there are a lot of quantifiable risks which the legislature's consultants would review on Monday and just as TransCanada has an equity opportunity cost, so does the State of Alaska (SOA). Money that remains in our treasury and is invested through the Constitutional Reserve Subaccount and other funds returns 6 percent to the state long term. So, the evaluation looks at the spread between what the state is not spending in cash versus the 7.1 percent we would be repaying TransCanada in a development cost situation outside of that $130 million for the expertise, the data, and the momentum.

He said they would develop how that plays across time on Monday, but today he wanted to bring it back to just the near term and what is going on in the first two or three stages with off ramps and legislative approval, so that when they get into the contracts, members can orient the raw costs with the raw step.

3:49:58 PM
SENATOR FRENCH asked if he saw this potential repayment avenue as having been capitalized on the front end or subject to appropriation.

MR. BALASH replied there are a couple of ways to do that.

SENATOR FRENCH said that nothing in the fiscal note sets out some set-aside for covering the cost of the off ramps.

MR. BALASH replied that what is reflected in the AGDC fiscal note is a capitalization that would assume success in the pre-FEED stage and cover the state share of costs for liquefaction as well as the cost to exercise the option to acquire the 40 percent interest in the midstream - but nothing for the off ramps.

3:52:07 PM
MR. PAWLOWSKI said slide 5 shows the FEED stage that comes after pre-FEED and costs that were developed by the consultants. The numbers are very rough estimates recognizing that FEED is something where you get a better idea both as sponsors of the project with the legislature of what the costs will be going forward. Black & Veatch estimated 4 percent of the cost of the project or roughly $1.8 billion would go into the FEED stage.

3:53:01 PM
Without exercising the equity option the state's share of the FEED period would be $145-180 million; exercising the equity option that would increase to $310-390 million, whereas TransCanada carrying the interest alone would spend $215-270 million; but with the option $130-160 million. So, the state realizes some significant synergies and benefits from the partnership with TransCanada. And again, after the FEED is another point where all of the parties involved will decide if the project is ready for financing and advancing. That is the final investment decision (FID).

MR. PAWLOWSKI said the core mission of AGDC, regardless of ASAP, was thoughtfully described as getting gas to Alaskans and that mission does not go away if the AKLNG project advances. A lot of

work will continue being needed, which is not captured in any of the estimates.

3:54:31 PM
SENATOR MICCICHE asked if it was safe to say that prior to the FID if the state would buy out TransCanada's interest at either of those two gates [on slide 5] and the project were to go forward anyway that none of the work including the AGIA-related work would have gone to waste.

MR. PAWLOWSKI said he thought that argument could be made; having that information keeps the project on track. The work done north of Livengood up to Prudhoe Bay is valuable in any instance. The big challenges from the state perspective really start to grow in the FID stage with the cash commitments coupled with financing. A lot needs to be understood that will become much clearer during pre-FEED stage and that's where the partnership will really pay dividends. He sees it using the past to move forward as expeditiously and successfully as they can.

3:57:03 PM
At each stage in the project there are off ramps and decision points for legislative and public review, he summarized, and the state's commitments will be commensurate with the project's progress.

Sectional Analysis of SB 138

3:58:13 PM
CHAIR GIESSEL announced taking up the sectional analysis of SB 138.

3:58:31 PM
MR. PAWLOWSKI started with a presentation prepared by the Department of Law (DOL). Sections 1-9, on pages 2-10, deal with expanding the general purposes of the AGDC to add a subsidiary corporation of the state to pursue an equity option in the midstream portion of a gas pipeline and in the associated treatment and liquefaction.

Sections 10-22, on pages 11-18, amend Department of Natural Resources (DNR statutes), empowering the commissioner to negotiate the agreements both under confidentiality and with the ability to work with legislative committees and legislators in executive session relating to the authority of the commissioner to work with lessees to amend certain oil and gas leases, provide royalty in kind for the project, and to manage the tax

as gas (TAG). This is where the authority is found to develop the project-enabling contracts that would be subject to subsequent legislative oversight in certain circumstances; for example, the firm transportation services agreement with TransCanada, that final agreement to enter into the true commercial partnership.

Sections 23-27, amend tax statutes and related authorities of the commissioner of DOR allowing him to participate with the DNR; it affects confidentiality for the commissioner and makes adjustments to the corporate income tax and the oil and gas production tax, which are the most significant changes in the tax sections. The current production tax is amended to a gross tax levied on gas after 2022 and allows for certain leases to pay that production tax in kind, which is one of the key sections in the project enabling concepts in the HOA. Those are the broad three section of the legislation as they related to the 3-Ps.

4:03:05 PM
Key terms in the legislation:
-definition of a "large diameter natural gas pipeline project" inserted to provide a distinction versus the Alaska Stand Alone Pipeline Project (ASAP) that AGDC is currently pursuing
-"statutory subsidiary," in section 7, calls out the bright distinction the draft contemplates for that AGDC subsidiary which would be participating in the AKLNG project
-"tax as gas" (TAG), in section 29, is a term not actually used in the bill, but refers to the concept of production tax being paid for in gas rather than in payments under taxes to the DOR.

4:04:14 PM
SENATOR DYSON asked if paying tax with gas is common in the industry.

MR. PAWLOWSKI answered not to his knowledge on this continent.

4:05:01 PM
SENATOR FAIRCLOUGH asked if there were any federal tax consequences to the state for taking gas in kind versus dollars.

MR. PAWLOWSKI replied none that he was aware of. He added that issues were raised surrounding infrastructure rather than the actual receipt of revenue through the tax.

SENATOR FAIRCLOUGH asked if the state taking gas in kind would provide an advantage to the state's other partners.

MR. PAWLOWSKI responded that the advantage to the other partners is really in the economics of the project and the alignment of interests in the project. As they get into the specific sections related to state corporate income tax and the tax as gas sections there are some important points they would want to be conscious of in the legislative process about how that gas gets claimed for the purposes of the state's corporate income tax, and yet doesn't inadvertently impact the producers on their claims at the federal level, because their payments to the state for production tax are deductible against federal income tax. It is a key point and the valuation needs to be transparent in order for them to make that claim. That's why they should be cautious with the language here.

4:07:22 PM
-"modifications of leases," which is not used in the legislation, but actually refers to sections 13-14 and the power of the DNR commissioner to adjust the lease terms
-"North Slope natural gas project," which is in section 19 and covers a generic trigger that is a gate for qualification for entering into these processes with the DNR and ultimately the DOR

4:08:12 PM
Section 1 on page 3, lines 20-27, amends AS 31.25.005 and is intended to clarify and expand the authority of AGDC to advance a large diameter natural gas pipeline project other than the instate pipeline project described in one other section and provides that important parallel path for the state. The addition on lines 24-27 is the power for liquefaction and treatment in connection with that large diameter natural gas pipeline project; it's a separate authority but connected to advancement of the large scale project as drafted. Section 2 is largely conforming.

4:09:36 PM
SENATOR BISHOP asked him to explain section 3 that removes the description of a large diameter natural gas pipeline and asked if that is taking the large diameter pipeline out of HB 4.

MR. BALASH answered that this section, in particular, distinguishes between the two projects that AGDC will now have an interest in in going forward In an effort to make that clear, the specific language referring to the two projects and the use of funds for the projects is changed - in part to conform with the establishment of a separate fund to capitalize the expenses

associated with AKLNG. Previously, HB 4 was talking about cooperating with some other project that it didn't have anything to do with, and in this case, they will basically have a foot in each camp.

SENATOR FRENCH said they just created AGDC last year and gave them the function of building a small pipe and told them not to even compete with the other pipeline, and now they are sort of shoehorning this much bigger project into the same corporation.

MR. PAWLOWSKI responded that is an extremely important part of the discussion around SB 138. The A version is drafted with very bright lines between the AGDC subsidiary participating in the AKLNG project and AGDC participating in the ASAP project. The idea is to start from a very bright line and leave open to the legislative process some discussion about how to wrestle how the state's participates in terms of that corporation.

SENATOR FRENCH said he agreed with that but was struck that money to the large diameter pipeline subsidiary can never be used in advancing the ASAP line (page 4, lines 20-24), which seems to be almost the exact opposite of efficiency.

4:14:50 PM
MR. PAWLOWSKI said he could see how it would appear that way, but the intent of the administration in developing this version was to provide the protection and support for that distinct vision.

As deputy commissioner of DOR, Mr. Pawlowski said, he serves on the Alaska Industrial Development and Export Authority (AIDEA) Board and he thinks about it potentially in this way: AIDEA and the Alaska Energy Authority (AEA) are separate corporations with separate budgets and separate missions that co-locate and share resources. So, there are examples, in state, where those concerns for inefficiency are dealt with, even when there are separate budgets and distinct protections.

The statutory subsidiary developed in this language is slightly different in that in AIDEA he wears the same board hat whether he is on the AIDEA Board or the AEA Board. The legislature can then clearly follow what money is devoted to what project.

SENATOR FRENCH asked if he foresaw any possibility that one state bureaucrat would be forbidden from seeing what another state bureaucrat was working on in these two subsidiaries or should they be able to share information freely.

MR. BALASH answered there may be certain circumstances where employees of the subsidiary and employees of the ASAP effort don't see information or share information, particularly in the context of marketing.

4:18:15 PM
SENATOR FAIRCLOUGH asked what a large diameter pipe size is exactly.

COMMISSIONER BALASH answered that the current plan and configuration for the ASAP project is a 36-inch low pressure pipeline; the AKLNG project currently being evaluating is 42-48 inches operating at the significantly higher pressure of 2200 psi.

SENATOR FAIRCLOUGH said the tariff for the larger diameter pipe in theory should be lower and she thought that was why they were going after a larger project.

COMMISSIONER BALASH said that was correct initially. The more efficient the pipeline, the lower the cost will be to recover the cost of constructing it. So, as an initial matter, the ASAP project may experience a higher tariff, but over time, that would change.

4:21:31 PM
SENATOR FAIRCLOUGH asked if one could report fixed fees to establish those tariffs or could different costs be blended across boundaries in a subaccount (referencing Senator French's comment about efficiencies to be had by merging money together).

COMMISSIONER BALASH said she was really "striking at" the tension between efficiency and transparency and that they were erring on the side of transparency.

4:22:14 PM
SENATOR DYSON mused that he was a late and reluctant supporter of the ASAP, because he couldn't see how it could deliver energy anywhere in Alaska at an attractive price, but then realized for lots of places, a price north of $15/mcf would still be quite attractive and that with all the uncertainties - geopolitical stuff and world gas supplies - and significant pushback on lots of unconventional gas development plus extraordinary decline rates in those fields, plus reservoir dynamics, and the fact that this project is out at least 10 years, and his sense was that this governor has known that there will never be two

pipelines built. But with the ASAP line going forward if everything else went in the ditch, Alaskans would be working forward to a project that could supply gas for Alaskans, although expensive. It also provides a bargaining point for the state in talking to the producers. He was also a believer that the rocks were there in the reservoir in Cook Inlet and two or three years ago that was very much in question.

MR. PAWLOWSKI said he thought that line of reasoning was sound and encouraged all Alaskans to be very cautious about assuming something is expensive or not, and the AGDC should be commended on all the work it had done to drive those costs down.

4:27:16 PM
SENATOR FRENCH said they were careful last year not to make the small diameter a competing project of the big diameter pipe and asked if that restriction is gone now. Can they actually set them up as real alternatives?

4:27:57 PM
MR. PAWLOWSKI went to page 4, section 3, and said the references have changed and now includes a "cooperation standard." The concept of competition really is rooted in an AGIA concept and with the cessation of AGIA that concept of competition doesn't have the same issue related to it. However, the question of the level of competition going forward that anyone would want to see is a fair point that needs to have some discussion, but the intent for cooperation - not competition - is retained in the language.

SENATOR FRENCH said it's still not clear whether the state is in AGIA or not.

COMMISSIONER BALASH said the question around competing projects are rooted in the commitment in the MOU to the state's licensee to not otherwise compete with them by providing inducements - cash or fiscal terms. In the MOU the state pre-agreed with TransCanada to abandon that license and move forward. He explained that this particular clause about ensuring that the AGDC project does not become a competing project had put some handcuffs on AGDC in their approach to things, and when AGDC holds its open season in early 2015, they might have already gotten to a point where they know AKLNG is not moving forward for one reason or another: the market or some fatal flaw affected cost estimates or design.

If, however, AGDC's open season meets with success and they have bids in excess of 500/mmcf/day, by having the license behind them, AGDC will be able to respond to those bidders and hopefully develop firm transportation arrangements with them.

4:32:11 PM
MR. PAWLOWSKI went to section 7, on page 6, line 17, that establishes a statutorily-created subsidiary as an instrumentality of the state to hold the state's equity interest in the large diameter LNG pipeline and associated facilities. The subsidiary would also act as an investment entity during the LNG project and return revenues to the state. The subsidiary is in the AGDC chapter for administrative purposes, but has a separate legal existence (the bright line).

Some advantages to the statutory subsidiary are that the powers flow directly from the legislature over which the state maintains control, including state revenues. They believe in maintaining state revenues' exemption from federal income taxes related to gas and the infrastructure, itself. Taking a step away from traditional instate gas pipelines to a liquefaction facility requires a higher level of diligence.

4:33:55 PM
The subsidiary is created as an instrumentality as an integral part of the state and the state has the authority to terminate it. Some key attributes are:
-the state directs its revenues
-its employees are state employees
-the state retains control over its operation
-it's subject to general laws that apply to other governmental entities
-the governor retains board members' appointment and termination powers

MR. PAWLOWSKI went back to section 4, because having created that statutory subsidiary he wanted to focus on separation of the money between the two projects. As Senator Bishop pointed out, Section 3 creates clarity around the instate fund that was established last year and amends it to be clear that it cannot "cross purpose" with the fund created for the new statutory subsidiary in section 5, on page 5, lines 11-25.

4:35:38 PM
SENATOR FRENCH said language through the top of page 10 goes to great lengths to keep the different lines distinct, but then it says "instate natural gas pipeline shall refer to a large

diameter natural gas pipeline project described upstream." That caused him to scratch his head and ask why they are suddenly conflating the two. They are bootstrapping the instate natural gas pipeline and the large diameter gas pipeline into a bunch of provisions in HB 4 from last year. Is the large diameter pipeline exempt from procurement, confidentiality and so forth?

4:38:29 PM
MARY GRAMLING, Assistant Attorney General, Department of Law (DOL), said Senator French was correct in his interpretation: where the AGDC corporation provisions say "instate" those powers need to apply also to the large diameter natural gas pipeline project that would be transferred over to the subsidiary.

SENATOR FRENCH asked if all the provisions, like the instate natural gas pipeline exemption from the Procurement Code, apply to both the large diameter pipeline as well or just the large diameter one, since it seems like one definition was substituted for another.

MS. GRAMLING replied that the intent in the current version is that the ASAP powers stay the same and the subsidiary would have all the powers that it needs that are currently in "Sec 4 31.25.080."

SENATOR FRENCH said that section seems confusing.

MS. GRAMLING said the intent was to do minimal edits to the ASAP line since they are so close to going to an open season.

4:40:42 PM
MR. PAWLOWSKI said Sections 10-11, starting on page 10, line 24, amend the powers of the commissioner of Department of Natural Resources (DNR) to enter into short term commercial agreements for project services, the precedent agreement (PA) in the MOU prior to the firm transportation services agreement, to negotiate terms for inclusion in proposed contracts related the North Slope natural gas pipeline, to enter into confidentiality agreements related to the negotiations and contracts - recognizing that a proposed contract subsequently presented to the legislature for purposes of obtaining authorization is not confidential, the development of the contract is, but the return to the legislature is not. The changes are on page 11, lines 27-31, to page 12, line 14.

4:41:54 PM

SENATOR DYSON asked him to explain why at several points confidentiality is necessary in building these relationships. People want to know why everything can't be in the open.

MR. PAWLOWSKI responded that the DOR thinks, for one, that under the construct, the DNR would be managing the taxed gas on behalf of the DOR; they would be consulting and following along because of their fiduciary duty to that tax revenue to return to the general fund. He envisioned, for instance, that the DNR through the HOA is entering into one of those individual negotiations with one of the producers for disposition or sale of a share of the LNG - ExxonMobil, for instance - so the state is benefiting from their expertise (their global supply chain). The ability at the same time of another party - say ConocoPhillips - who is also negotiating with the state in that marketing arrangement, to file a freedom of information act and get the terms of the negotiations with DNR would inhibit DNR's ability to get the best deal for the state of Alaska. There is constantly a tension in all of these discussions between the need for transparency and protecting a very real business interest.

SENATOR DYSON added that these individual companies certainly don't want any of their partner/competitors to know much about their financial situation.

MR. PAWLOWSKI said that was a good point and that Section 10 has that balance and confidentiality that is critical in moving a project forward in a way that protects the project from competitors and protects the state interest within that project. Language on page 12, lines 11-13, provides the ability for the legislature (as the state's board of directors) to get a window into these discussions by extending confidential information into executive sessions. The next step will demand a different level of engagement between the administration and the legislature that they were looking forward to having.

4:46:16 PM
SENATOR FRENCH said three sections - section 10, subsection 13 on page 12, line 14, and section 11 that modifies subsection 13 and adds a 14 - seem to modify the same existing law and asked why that was done.

MS. GRAMLING explained that when sections appear to repeat each other it's often because they have different effective dates. Section 10 would be effective immediately; section 11 would be effective January 1, 2015. In this bill the reason for the occasional delay in the effective dates is that the tax

provisions would take effect January 1, 2015. So, any section of the bill that refers to the tax provisions has the similar delayed effective date.

4:47:43 PM
SENATOR FRENCH said page 12, lines 3-13, talk about the legislature authorizing the contracts and there is no procedure set out for how that happens: how much time they might have for what sort vote or whether or not the contracts are negotiable at that point, and asked what the minimum time would be for the legislature to consider this proposal.

4:48:27 PM
COMMISSIONER BALASH answered that the administration envisioned leveraging the state's royalty disposition process that they rely on for purposes of selling royalty oil to Tesoro, for instance. In those cases they provide a public notice - opportunity for comment and review by the public - and subsequent review by the Royalty Advisory Board, and then that process finally culminates in the introduction of legislation approving said contract. In this case the public notice opportunity is a minimum of 30 days, the notice and meeting schedule for the Royalty Board is also required to be publicized on line and in numerous publications; the opportunity then for the legislature is a function of the legislative process and how long it will take to do the work.

SENATOR FRENCH asked if he would object to them making some of those provisions explicit to this decision.

COMMISSIONER BALASH answered that they would be open to consider those things, but they don't want to set out conflicting processes.

4:50:55 PM
MR. PAWLOWSKI said the addition in section 11 is where in consultation with the commissioner of DOR, the commissioner of DNR takes possession of that tax as gas, works it through the same process that the DNR and policies use for disposal of the tax as gas with the royalty gas. Here they are leveraging DNR's expertise, and the reason for the repeat of the section is the effective date of that tax provision is January 1, 2015, happening after the powers granted to DNR are effective in the legislation with that immediate effective date.

4:51:51 PM

MR. PAWLOWSKI went to Section 23, on page 20, lines 23, to page 21, line 30, where the commissioner of DOR's directions and powers reside. He explained in the previous sections the legislation amends the powers of the commissioner of DNR and some key elements need to be expanded in the powers of the commissioner of DOR. The authorization for the commissioner of DOR to consult with the commissioner of DNR on the development of those contracts is on page 21, lines 28-30. A similar situation exists in section 24 on page 21, line 31, to page 23, line 11, where DOR needs the ability to work with DNR immediately on the beginning of the development of contracts, recognizing that the tax provisions don't come into effect until January 1, 2015. So, then the powers to direct the disposition of revenues received from that tax as gas need to be authorized.

4:53:51 PM
The purpose of sections 10 & 11 and 23 & 24 are really to describe the relationship between DNR and DOR. He said the DNR today has people who work through the contracts and manage the resources and the DOR does not do that; it has auditors, accountants, and economists. So, they are leveraging DNR's expertise in managing the resource by creating these sections where they cooperate together.

Sections 13-14 that begin on page 14, line 26, give additional powers to the commissioner's powers to make modifications to leases. There are specific instances in the HOA where the particular impacts to things like switching between in value and in kind where the department needs to really have upgraded powers to deal with gas. He asked Commissioner Balash to describe the real impacts of this section.

4:55:26 PM
COMMISSIONER BALASH said over time considering the impacts of certain lease terms on the operation, commercial and otherwise, of large diameter natural gas pipelines they have seen a need to make changes driven by the contractual needs of the players in the project. When they considered an overland project to North America, the ability of the state to switch from in value to in kind on relatively short notice could create a real challenge in managing capacity on the pipeline. So, the solution in that particular instance was to seek from the Federal Energy Regulatory Commission (RCA) a limited waiver of the rules on capacity or lease, so that in effect, capacity for royalty could move from the shipper to the state.

4:56:58 PM

In an LNG context, Commissioner Balash said they have a different challenge stemming from the nature of the sales and purchase agreements that the gas holder is likely to enter into with LNG buyers and how much of their reserves are being committed in the sales contract. Prudhoe Bay, as an example, has 24 tcf of proven resource that will hopefully be sold under long term contracts to buyers in the Pacific Rim. If all, 24 tcf of that gas is sold under SPAs and the state is taking in value, that is fine; but if in some other year the state suddenly decides to switch and take our gas in kind, the producer will be short of proven gas resource. That means a couple of things: the seller of the gas and potentially the buyer may take that right to switch into account by striking a lower price for the gas. That is not necessarily in our interest and would put the state in the position of having to accept the terms of that SPA in order to facilitate the switch. So, then what's the point of switching back and forth from in value to in kind? Realistically, there may need to be some limitation on the state's right to switch, and in certain cases it may be an elimination of that right, but only if talking about the commitment of all of the reserves.

He contrasted that with a different sales scenario and using the same 24 tcf/gas. If only half of it is committed to SPAs, then the state switching from in value to in kind won't necessarily create the same challenge in terms of total reserves available. There will be an impact on production and how quickly the field could potentially ramp up production and produce one-eighth more on a daily basis for the state's taking, but in that particular circumstance there might need to be some reasonable limitation on the duration of the notice the state must provide before switching, but not necessarily an elimination of that right to switch. So, here they ask for some flexibility in how those prerogatives the state currently has under the lease might be limited to fit the commercial needs of the circumstance in question and the volumes under consideration.

5:00:25 PM
SENATOR MICCICHE said he wanted to know what the calculation in number 3 providing revenue to the Permanent Fund is.

5:01:18 PM
COMMISSIONER BALASH responded that all of the leases provide revenue (25 percent of the leases) to the Permanent Fund.

5:01:26 PM

SENATOR MICCICHE said section 13 (page 14) starts by saying the commissioner may propose modifications to existing leases that relate to: (3) establishing fixed royalty rates and modifying net profit shares under leases subject to this subsection (page 15, lines 12&13) and it seems to him that it should also state "not to go below 12.5 percent royalty rate."

COMMISSIONER BALASH said he understood what he was asking, but in this item they have a desire to seek a fixed number in instances where the state has leases that pay a net profit share or that has a sliding scale royalty. As they talk about establishing a fixed position equity-wise in the project, if the state winds up in a situation where our royalty payment of gas is going up or down, that is something that is going to affect the producer as well as the state. So, they want to establish a fixed number somewhere between the base royalty rate and whatever the high end is. The counterparty would want the minimum and the state would want the maximum, so they would find something reasonable in the middle. He would entertain language that provides more comfort.

SENATOR MICCICHE asked if he would feel comfortable at least matching this code to the base royalty, so that people realize the Permanent Fund is protected.

COMMISSIONER BALASH replied he would be happy to provide waders in addition to the belt and suspenders.

SENATOR FAIRCLOUGH said she thought that was a good idea and likened it to a floor for the boots to walk on.

5:04:16 PM
MR. PAWLOWSKI said preserving the state's royalty share is very important and this is an appropriate place to put a floor for the boots to walk on. He said tax provisions come in on January 1, 2015, and a conforming amendment (to the commissioner's authority) was made in AS 43.55.014(b), which is the "taxed as gas" where the department gets a share of the molecules instead of a tax payment.

5:05:17 PM
SENATOR DYSON said he was worried about the scenario where the capacity of the pipe is not fully committed and the state is receiving both royalty and tax in molecules and it has elected to get its gas in value, so our gas is being marketed for us, but there is more supply than we have long term contracts for. So, then there is the opportunity for gas to be sold on the spot

market. If our gas is being marketed in long term contracts, he was worried about losing the opportunity to sell it in the spot market at two or three times the fixed price, because of choosing to sell our gas in value.

MR. PAWLOWSKI said that was a good question that is solved in the contracts related to the LNG sales themselves. The state could decide to subscribe only 90 or 95 percent of its gas in a long term fixed contract and keep some for the spot market. DNR might be a little more comfortable with that concept today and DOR would be a little cautious - part of the tension that will continue. That issue will be developed in the pre-FEED stage with more expert advice and work with people on the appropriate level of what the spot market in LNG might evolve to.

SENATOR DYSON asked if it was possible for the state to say we'll take ours in value and we want you to market ours just the way you do.

COMMISSIONER BALASH said that was something he would expect to achieve in an arrangement with any one or all three of the producers for marketing purposes. Ultimately, the state will want to get to a place where it has a portfolio of contracts; then the question will be how many of them will similar and which ones will differ and why. The issue is if the state will be putting all of its eggs in one marketing basket and taking our tax as gas puts a lot of it there. The state hopes to continue receiving corporate income tax payments and property tax payments in cash and those are not insubstantial revenue streams.

5:10:14 PM
SENATOR FAIRCLOUGH said Asian markets do not have spot pricing and Alaska has not been a partner before. So, they must proceed very cautiously in marketing on behalf of Alaskans so that they can provide sustainable energy across the state. There are both risks and rewards.

MR. PAWLOWSKI agreed that this is a major step for the state; with it comes risks and the opportunity for more substantial revenues than we would see in playing it safe and trying to make a project competitive. That is why they envision a very phased approach where these issues continue to be worked with the legislature and come back to it for approval; the state's commitment grows as its understanding grows, but it's not a decision to unilaterally take today. That is why there are requests in the fiscal notes for additional experts and very

good staff to work on these things. The opportunities are substantial, but they are not something that should be entered into lightly.

5:12:49 PM
MR. PAWLOWSKI said a key point in the modification slide [12] is the step that needs to be taken before the processes are initiated: the commissioner of DOR needs to make a written determination that the North Slope natural gas project really has sufficient financial commitment for a work plan, sufficient commitment of gas by lessees, and the concurrence of lessees to the proposed modifications. It's a trigger to start a process so that not just any idea draws staff time and resources. The royalty study the DNR did this summer cost several hundred thousand dollars' worth of detail work plus staff time.

5:15:02 PM
MR. PAWLOWSKI said the heart of the tax section is in section 29 on page 26, line 17, to page 27, line 13, and the opportunity for a producer to elect to pay production tax with molecules. So, the state gets a larger share of the gas than the regular tax payments. The trigger is on page 26, lines 18-20. The oil and gas that is eligible to be paid in molecules comes from a lease that has been modified by the commissioner of DNR, to recognize that these are production tax payments.

But the DOR doesn't have the same interaction in the civil arrangement with the lessees. The in kind sections of the HOA recognize there are still a few major issues that need to be worked out: marketing (the downstream) and what happens to the LNG sales, what happens on the upstream (around the off take and balancing agreements) that provide the gas custody transfer from the producer to the DNR. The option to pay tax as gas is limited to production from those leases where the DNR has entered into a modification agreement. The DOR saw that as a gate to limit the scope of where this ability to elect by a producer to pay their tax as gas provides some protection to the DOR.

5:17:27 PM
SENATOR FRENCH asked how many leases have the opportunity of changing rates referred to in sections 13 & 14.

MR. PAWLOWSKI answered the ones they contemplate in looking at this project have been Prudhoe Bay and Pt. Thomson, particularly the Pt. Thomson leases, because that's the gas that is committed to the AKLNG project.

COMMISSIONER BALASH agreed and added that this is a general law, which may be useful again further down the line by other companies or for other lessees at other fields. That is why they tried to make it a fairly flexible tool to use depending upon the circumstances that come through the door.

SENATOR FRENCH asked if there is any oil and gas lease on the North Slope to which that could not be made to apply.

MR. PAWLOWSKI answered that the payment of tax as gas wouldn't be possible on a federal lease, because the DNR doesn't have any relationship to modify.

5:19:32 PM
SENATOR FRENCH said it could apply to any lease where the state is the primary land owner. Mr. Pawlowski nodded yes.

MR. PAWLOWSKI said the first instance of a gross tax rate of 10.5 percent (not the variable net tax rate) was on page 26, lines 24-27. The HOA envisioned a tax rate somewhere between 7 and 13 percent and on Monday he would discuss why the administration introduced the legislation at 10.5 percent. Language on page 27, lines 2-7 (slide 16) says if there is somehow a tax deficiency related to the TAG that the tax including interest and penalties would be paid in value.

Also, he said it's important to know that TAG will be reported in annual filings where the producer will be required to note the gross amount of gas produced from each lease or property subject to the election of payment (in section 37). He mentioned it now because members and the DOR hadn't worked with this concept before. While DNR is fairly used to accounting for barrels in kind, the DOR has to adjust its system to account for how much gas was produced that was taken in kind because a producer might actually have another lease where they are not producing production tax as gas. That is why their fiscal note has an addition of money to reprogram the tax revenue management system. The bill has some conforming section to detail how that will be reported.

Often members are concerned about Section 25 (page 23, lines 12-16) that states the amount of gas produced from each lease, and the name of the person - in tax law a producer is a person - will be public information. This is important for the Revenue Sources Book.

5:23:16 PM

MR. PAWLOWSKI said Sections 27-47 are about the implementation of this tax for North Slope gas. He explained that two taxes are happening: one is the ability for tax as gas and the other is setting a basic fixed tax of 10.5 percent on gas recognizing that there may be opportunities for in value production to be contributed. It does not amend the 35 percent production tax value on oil but rather separates out the tax on gas throughout the sections of the bill.

The additional conforming amendments are in places where, for example, in the minimum tax section it makes no sense to have a minimum tax of 4 percent on the gross when the tax is 10.5 percent on the gross. So, a conforming amend is in the minimum tax sections. Also, recognizing that the Middle Earth oil and gas production may be subject to the tax ceiling and credits, there is conforming language to adjust to what really is a simple settling of the gross tax rate for the production tax.

5:24:50 PM
When they get into the modeling next week, Mr. Pawlowski said, he would talk about the impact of some of the sections - section 43 (AS 43.55.165(e) - on page 44, line 21, which discusses how the calculation of lease expenditures is done and the fact that the production tax as gas is not included in as a deductible lease expenditure. Mr. Pawlowski said the dilemma for the department and the policy call is that lease expenditures do not apply in a gross world, but yet they are still lease expenditures related to the production and development of gas. So, they looked at the impacts of lease expenditures on the overall production tax system and next week they would walk through how that push and pull around lease expenditures affect the gross tax rate on gas. He pointed out that this section looks conforming but in economic terms it's actually not. It has some substantial issues to understand from a tax perspective. For instance, SB 138 does not change several pieces of statute like the Alaska Gasline Development Corporation's (AGDC) core mission, the property tax for oil and gas exploration production pipelines, what happens with royalty for Permanent Fund (PF) or tax revenues for general fund (GF), or some of the oil and gas production tax limitations. There are sections that have an important impact on revenues that they would also highlight for the members.

CHAIR GIESSEL thanked the presenters and held SB 138 in committee.

5:28:28 PM

CHAIR GIESSEL found no further business to come before the Senate Resources Standing Committee and adjourned the meeting at 5:28 p.m.