

ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE

February 12, 2014

3:30 p.m.

MEMBERS PRESENT

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

MEMBERS ABSENT

All members present

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
02/07/14	(S)	Heard & Held
02/07/14	(S)	MINUTE(RES)
02/10/14	(S)	RES AT 3:30 PM BUTROVICH 205
02/10/14	(S)	Heard & Held
02/10/14	(S)	MINUTE(RES)
02/12/14	(S)	RES AT 3:30 PM BUTROVICH 205

WITNESS REGISTER

TONY PALMER, Vice President
Major Projects Development
TransCanada Pipelines Limited

POSITION STATEMENT: Outlined which elements of SB 138 TransCanada supported and more fully explained their involvement with the AKLNG project.

PAT FLOOD, Supervisor
Alaska North Slope Gas
ConocoPhillips Alaska
Anchorage, Alaska

POSITION STATEMENT: Supported SB 138.

BILL MCMAHON
Senior Commercial Advisor
Alaska Gas Development
ExxonMobil Production Company

POSITION STATEMENT: Supported SB 138.

DAVE VAN TUYL, Regional Manager
BP Exploration Alaska, Inc.

POSITION STATEMENT: Supported SB 138.

DAN FAUSKE, President
Alaska Gasline Development Corp. (AGDC)
Anchorage, Alaska

POSITION STATEMENT: Answered AGDC/subsidiary questions relative to SB 138.

JASON DE STIGTER, Senior Consultant
Black & Veatch, Management Consulting Division

POSITION STATEMENT: Was available for questions on the North Slope Royalty Study.

PETER APT, Managing Director
Fuels Practice

Black & Veatch, Management Consulting Division

POSITION STATEMENT: Addressed specifically the LNG markets and supply chain elements of the North Slope Royalty Study.

DEEPA PODUVAL, Principal
Black and Veatch Management Consulting Division

POSITION STATEMENT: Continued presenting the North Slope Royalty Study.

JOE BALASH, Commissioner
Department of Natural Resources (DNR)
Juneau, Alaska

POSITION STATEMENT: Answered questions regarding SB 138.

ACTION NARRATIVE

[3:30:46 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 McGuire, French, Dyson and Chair Giessel. Senators Bishop, Fairclough, and Micciche joined the committee shortly after the meeting started.

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

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CHAIR GIESSEL announced SB 138 to be up for consideration and that they would hear from the companies today.

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TONY PALMER, Vice President, Major Projects Development, TransCanada Pipelines Limited, said they supported SB 138 with regards to the taxation of natural gas, but that is not their primary interest. In their view, the bill is intended to establish a legislative framework to implement the principles set out in the Heads Of Agreement (HOA) and the Memorandum of Understanding (MOU) between TransCanada and the State of Alaska.

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He noted support of the following elements of the bill:

1. It expands the mandate of the Alaska Gasline Development Commission (AGDC) to enable it, through an appropriate subsidiary, to participate as an equity holder in the liquefaction component of the AKLNG project and potentially in the midstream component, if the state elects to exercise its equity option on the TransCanada component of the project.
2. It establishes a large diameter natural gas pipeline project fund and the appropriations would be used to fund the planning, financing, acquisition, maintenance, construction, operations of the project by the state.
3. It also authorizes the Department of Natural Resources (DNR) commissioner to participate in the negotiation of certain contracts relating to the projects and such contracts to be brought back to the legislature for approval.
4. It also authorizes the DNR commissioner to enter into certain short term contracts relating to certain project services contemplated in the project. This provision is intended to cover the precedent agreement (PA) that is referred to in the MOU.

MR. PALMER said it's important to understand that there are lots of stages in this process and that they continue to be

appropriately processed by the legislature and all parties. He said TransCanada will continue to work with the administration to continue alignment on the bill.

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SENATOR BISHOP asked him to summarize the best value TransCanada brings to the project.

MR. PALMER answered TransCanada brings a number of values to the table:

1. TransCanada's credentials, experience, and expertise. This project contemplates building a \$10 billion pipeline across Alaska in summer and winter conditions and across a significant mountain range. TransCanada has worked on this project now for 40 years; so in addition to its experience and expertise elsewhere in North America they bring tremendous knowledge of this particular project. TransCanada owns 40,000 miles of big-inch natural gas pipeline in North America - 10,000 in the U.S. and 30,000 in Canada. They have been completing projects of this nature for 60 years: the first three gas pipeline across the Andes in South America, a pipeline across the Rockies in Canada, and they are now constructing pipelines in Mexico in similar mountainous terrain.

2. TransCanada brings assets directly to the project that were developed by ExxonMobil and TransCanada under the Alaska Gasline Inducement Act (AGIA). Under the MOU and HOA those assets will be contributed and available to the state with adoption of SB 138. Timing is another advantage in that it has taken a year to negotiate the HOA and the MOU.

3. This is a smooth and amicable transition out of the AGIA structure and into the new contemplated structure that both the state administration and TransCanada are willing to work with.

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SENATOR FAIRCLOUGH said her opinion is that his company is outstanding and that the state paid TransCanada and its shareholders up to \$300 million for AGIA work that took gas to North America, but some Alaskans have questions about TransCanada's involvement in this LNG project and the AGIA work that may not be valuable to it.

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MR. PALMER answered that any of the work completed north of Livengood is clearly applicable and valuable to this project as is the work on the gas treatment plant (GTP) as well as some of

the overall analyses completed on design work - pipeline integrity and strength that are clearly valuable for the entire project, not solely for the mileage south and south east of Livengood. Some say maybe 30 - 50 percent of the work is directly applicable, but it's challenging to give that a direct number. The state has invested in those dollars as have TransCanada and ExxonMobil shareholders, because the reimbursement covered only a portion of the costs that were expended on the entire work.

MR. PALMER said he thought the change in overall gas market primarily caused the AGIA structure to not see a pipeline built. Six years ago shale gas production in North America was in the order of 3-5 bcf/day; today it's 25 bcf/day (about five AKLNG projects) and parties contemplate that will go to 50 or 60 bcf/day, which benefits consumers but not the producers or the producing states.

He explained that North America produces in the order of 80 bcf/day and six years ago gas prices were contemplated being \$6-8, but unfortunately they are more like \$3-4, or in the order of \$4/mcf/day. That's equal to \$300 million/day being transferred from what folks thought would be coming to producers and producing states to what is going to consumers and that is what has made it very challenging to build a pipeline from Alaska down to the Lower 48.

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PAT FLOOD, Supervisor, Alaska North Slope Gas, ConocoPhillips Alaska, Anchorage, Alaska, supported SB 138. He said ConocoPhillips believes there are four key areas where it is important to get legislative input to continue advancing the project as envisioned in the HOA:

1. The state must decide that it wants to participate in the project.
2. The state needs to decide what share of the gas the state would have, which would set the state's participation share.
3. The legislature needs to define a production tax (taken as gas molecules), which, with the existing state royalty (also taken as gas molecules) would provide the state's overall gas share that would support the state participation share. This state gas share needs to be consistent with and support the state's participation share.
4. The legislature needs to give the administration the necessary tools to confidentially work through all the various

arrangements and contracts required to move the project ahead as is outlined in the HOA.

MR. FLOOD said ConocoPhillips thinks overall that the proposed legislation, as general law, effectively addresses these key areas. He said in its sectional analysis this past Friday, the administration broke the proposed legislation into three groups; the first dealt with AGDC's scope, powers and structure. The second group dealt with the DNR commissioner's powers and duties with respect to contract negotiations and oil and gas leases; and the third group dealt with the tax statutes. Today he would address his comments in the same three groups.

The first group of sections address AGDC and its potential role with regards to an LNG project and ConocoPhillips supports AGDC managing the state's participation share in an LNG project and realizes that there are ongoing legislative discussions about the structure being proposed. Ultimately, the details of AGDC's structure and authority are a decision for the state and ConocoPhillips simply supports AGDC as a viable way for the state to participate in an LNG project.

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MR. FLOOD said the second group of sections in Title 38 relates to the DNR commissioner's flexibility in negotiating changes to the oil and gas leases from which gas could be committed to a larger project and for the myriad other agreements that would be required in order to manage the state's role in such a project. He explained that the LNG business requires numerous contracts covering nearly all the aspects of the value chain and for the state to effectively participate in a large natural gas project, such as the AKLNG project, with other private co-venturers the commissioners of both DNR and Department of Revenue (DOR) need to be able to negotiate, confidentially, the details of these many agreements in a way that doesn't compromise the commercial positions. The commissioners need this authority in order for the state to effectively participate in a project with other parties.

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The final set of sections deals with the tax statutes in Title 43. These provisions set a fixed gross value production tax at 10.5 percent with the ability of the state to accept payment of this tax in gas molecules. Effectively, the choice of the tax rate when combined with the existing royalty percentage would set the state's gas share for participation in a natural gas project such as the LNG project contemplated in the HOA. He said

that ConocoPhillips does support the provisions that allow for a fixed gross production tax, payable in gas. The 10.5 percent rate the administration has proposed yields a combined royalty plus production tax in the range of the 20-25 percent that is in the HOA.

Overall, he said, ConocoPhillips supports the legislation, recognizing that it contains some significant policy decisions the legislature needs to make when contemplating the state's role in a large natural gas project, including the LNG project contemplated in the HOA. He offered to help by providing information or perspectives on those issues.

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SENATOR BISHOP asked how many other agreements he meant when he said "myriad agreements."

MR. FLOOD answered that he couldn't give him a head count; the types of agreements he could think of are an LNG marketing agreement between any one of the producers and administration, and any of the project agreements that will be required.

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SENATOR FRENCH asked if a fiscal stability contract was one of those.

MR. FLOOD replied that ConocoPhillips has said for many years that durability of fiscal terms is a very important and vital part of this project and that is something they contemplate requiring, although terms had not been discussed yet. Those terms would have to come back to the legislature for ratification.

SENATOR MCGUIRE asked if the following were important to ConocoPhillips:

1. A subsidiary of AGDC manages the state's share rather than the corporation itself.
2. Sections 1-7 have specific requirements as to how that subsidiary will be managed with the idea that it will be only a portion of the board and that the finances will be kept separate.
3. Share a broader view of how the producers might view working on this project through AGDC, which was empowered through HB 4 with fairly specific direction to keep working on a Plan B, which at some point could possibly compete with the AKLNG project.

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MR. FLOOD answered the key thing from ConocoPhillips' perspective is that the state participate in the project. It needs to participate in a way that is consistent with a very large project of this magnitude. How and with whom is a state matter. As to the AGDC structure, ConocoPhillips didn't have any objections to what is in the current legislation.

In regards to AGDC's role in HB 4, he said ConocoPhillips has no comment as to whether that is an issue or not. They support AGDC and recognize it has an obligation to also advance the ASAP project.

SENATOR FAIRCLOUGH said section 5.3 on page 10 of the HOA says "The state would participate in an AKLNG project at a participating interest share in the Alaska LNG project components consistent with the state's gas share in these components," and asked if that was accurate.

MR. FLOOD answered yes.

SENATOR FAIRCLOUGH said she wanted to know now if anyone had a problem with any of the three individual pieces that were being reviewed. The HOA talks about protecting and maximizing the value of the state's mineral interests. It tries to improve alignment between the state and the producers and tries to create transparency for the administration, so that the state can act in a proprietary manner. It makes sure that access and pro-expansion principles are available to those that want to produce LNG, and creates an opportunity to deliver gas to Alaskans as well as an opportunity for the state to get additional revenues. She thought the HOA was solid, but it "sort of rocks" on the issue of if the state should have an equity interest equal to what it is investing and she wanted to hear from any Alaskan if they had questions about it.

4:00:07 PM

BILL MCMAHON, Senior Commercial Advisor, Alaska Gas Development, ExxonMobil Production Company, said ExxonMobil supported SB 138 and is committed to pursuing commercialization of Alaska natural gas and being a part of the AKLNG project. The HOA and SB 138 are critical steps towards successfully bringing the natural gas resources of Alaska's North Slope to market through this project. It makes a significant step towards allowing the state, the producers, AGDC and TransCanada to work together to progress the project and to establish a process to develop the fiscal and

project framework that is essential for advancing this project to completion.

If SB 138 passed the legislature, he said that ExxonMobil will be ready to move forward with pre-FEED work activities, a necessary step that has never been taken before. Three things contemplated by SB 138 are state participation, state percentage of the gas, and a process to negotiate project enabling agreements and they are encouraged that the legislature is looking at it so early in the session.

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SENATOR MCGUIRE asked if all the statutory references needed for enactment of the HOA and the MOU are in SB 138.

MR. MCMAHON replied yes for the HOA, but he couldn't speak directly about the MOU, because that was between the state and TransCanada.

SENATOR MCGUIRE stated that it would be helpful now to hear if there someone might want to amend SB 138, because that might affect the HOA and might in turn would affect the MOU.

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SENATOR FRENCH asked if he thought would be possible to agree to exclude any linkage to oil taxes from the future contracts with respect to the HOA and the MOU. Would it be possible to build a pipeline together as partners without having embedded oil taxes in that contract and do it just through the royalty in kind (RIK) on our gas and tax as gas with respect to our production taxes?

MR. MCMAHON answered that they all face a tremendous challenge with this project and they are faced with putting together project enabling contracts that are going to be sufficient to allow investors to put up the capital for it: to allow investors to have the assurance that they will get the returns expected, and lenders will the assurances they need that they will get repaid, and most importantly that the buyers of LNG will be able to sign long term contracts that they can count on so that Alaska resources can fuel their economy for decades to come. He couldn't answer how stability of oil taxes would play into it and that is why he liked SB 138; it sets out a process to find the solutions to move the project forward.

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SENATOR BISHOP said when they write the history books, everyone wants to make sure they are on the right side of history. From a poker player's perspective, he thought of the producers as three excellent professional poker players and himself as a novice, and he didn't want to be left owing them a bunch of IOUs at the end of the day. He urged them to help build trust with the people of Alaska going forward.

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DAVE VAN TUYL, Regional Manager, BP Exploration Alaska, Inc., supported SB 138. He said BP believes that the HOA, AGDC, DOR and DNR - all seven parties - are critical to successfully advancing the AKLNG project. Therefore, the key question for examining SB 138 is simple: is SB 138 faithful to the HOA? And for BP the answer is yes. SB 138 moves all the parties together as envisioned in the HOA.

The first of the three Ps is participation and SB 138 provides for state participation through AGDC and authorizes the state to negotiate contracts consistent with the terms of the HOA. The second P is percentage and the bill provides a percentage for tax as gas that when added to the state's RIK share puts the state at the table with 20-25 percent again consistent with the terms of the HOA. Third is process and the bill lays out a process for negotiations to occur and provides transparency to the legislature as outlined in SB 138, and BP believes that is the winning way. This really needs to be done together.

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An area of particular interest to BP was ensuring that the newly formed AGDC subsidiary is established by tax and finance professionals in an efficient and timely and using due diligence so that pre-FEED can start ramping up once the bill is enacted. That efficiency includes the appropriate sharing of staff between the new subsidiary and the AGDC parent.

MR. VAN TUYL said the language requiring various administrative determinations should be clearer and consistent with the HOA and that would reduce uncertainty for all the parties, avoid unintended consequences, and enable a timely and efficient ramp up with pre-FEED activities. Other technical corrections may be inevitable, but he didn't see the need for any substantive changes to the bill.

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SENATOR FAIRCLOUGH asked if anything in the bill was structurally inconsistent with the determinations in the HOA versus the subsidiary being created.

MR. VAN TUYL said the HOA is fairly broad in terms of the state's involvement through AGDC and he hadn't noted any inconsistencies, but the devil is in the details and that is why he recommended the necessary due diligence. It is an opportunity for AGDC's skilled staff to work where those skills are best used and that can be done through subsidiaries.

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SENATOR MICCICHE said everyone is consistent in feeling that state participation is key and no one seems to care who it goes through for that participation or if it has a partner, and asked him the most important reasons for BP that the state participates.

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MR. VAN TUYL replied that it's not that uncommon for the host government to have a role in big LNG projects around the world just because of the magnitude of a project and the nature of that roll varies with the regime. He said BP does care who the state chooses to partner with. The HOA sets out the state participation and the manner of participation is what is dealt with in the MOU. They want to make sure that whoever comes into their joint venture has the requisite financial strength and technical capabilities, which TransCanada does, but it is the state's choice.

The reason state participation is so critical is because "Nothing aligns like equity," Mr. Van Tuyl said. Having the same equity investment in a project means they all have the same commercial interest in seeing problems get solved in the right way and partners will tend to agree more and when investing \$65 billion, agreeing is pretty important because they want the project to run efficiently. State participation provides for that sort of alignment like no other lever they can think of.

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SENATOR FRENCH said Article 8 of the HOA talks about royalty and gas taxes, but doesn't mention oil taxes as being part of the negotiations of a contract that would spring to life if this legislation passed and asked if he saw oil taxes as being art of that conversation.

MR. VAN TUYL answered with passage of SB 21 last year BP and others have had new activities on the North Slope and that kind of healthy oil business is important to have for building a gas project on top of, because it will disperse some of the costs it takes to operate the North Slope. This is a multi-decade project that has to be robust and it's important that the contract works for everybody.

SENATOR BISHOP asked if anything precludes more equity from coming into this project.

MR. VAN TUYL answered that it's not unusual for another party to come into a big project like this one and typically a framework provision for transfers makes sure the party is credit worthy and technically capable. Nothing precludes that from happening now.

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SENATOR BISHOP asked if he could partner up with his \$10 billion.

MR. VAN TUYL replied that the bill envisions a process that would result in an actual agreement.

SENATOR FAIRCLOUGH asked if that process would be developed at the next step of the game, because if someone brings \$10 billion to the table, they have to be able to buy someone else's interest.

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MR. VAN TUYL answered that those sorts of terms will be included in the actual joint venture agreements that will be worked on with the state at the able through the pre-FEED and the FEED processes.

SENATOR FAIRCLOUGH asked if the legislature could add intent language or make recommendations.

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MR. VAN TUYL said he thought they could add a letter of intent providing direction in the manner in which the state should be exercising its equity participation in the project.

SENATOR FAIRCLOUGH said she was trying to find a way for the legislature to guide the process in future agreements that are going to be negotiated in confidentiality and without having 60 people in the room. They might think about what is valuable

within a joint venture and articulate that, so when it came up for review again they could tell if it was accomplished.

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SENATOR DYSON said he thought at some point they should state their intent and clear understanding that nothing in these agreements lock in oil taxes.

SENATOR MICCICHE said he valued all that industry has created in terms of jobs and wealth in Alaska, but because folks in Alaska fear having the top corporations in the world in front of them now walk away from this agreement all rubbing their hands together feeling good about "what you pulled over on the people of Alaska," and asked what the value of SB 138 is for the state in their eyes.

MR. VAN TUYL answered that SB 138 enables a number of very important elements of value for the state:

1. This is the best opportunity to commercialize North Slope gas. This is a shared interest that will bring in new long term revenues to the state.
2. Getting gas to Alaskans is a critical element for a successful project, and AGDC participation ensures that will happen.
3. Opportunities for massive creation of jobs during construction and operation of facilities for decades to come.

He said it's not BP's intent to enter an agreement where one of the parties disagrees or feels like it isn't a square deal; that is not the bedrock of a long term commercial agreement, which is what they want. They want an agreement that will be robust for decades and that is what the HOA and SB 138 are based upon.

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SENATOR MICCICHE commented that in his experience the best negotiation is when both sides walk out of the room equally unhappy and asked what he thought would be a pitfall the legislature should watch for.

MR. VAN TUYL said he was involved in the HOA but not development of SB 138. One thing springs to mind in terms of pitfalls and that is to not foreclose options. A near term decision could change over time and become a hasty decision in retrospect. One of the bits of genius about the HOA is it has high level principles that everyone can stand behind allowing the details to be developed over time.

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DAN FAUSKE, President, Alaska Gasline Development Corp. (AGDC), said he didn't have testimony but was available for questions.

SENATOR FAIRCLOUGH asked about the nature of creating the subsidiary within AGDC and if it would work to the benefit or to the detriment of AGDC as a corporation and why.

MR. FAUSKE answered that this subsidiary is unique in that it's a separate entity with a new board and structure and the current management of AGDC would not be involved with it. He had created other subsidiaries - the Alaska Housing Finance Corporation (AHFC), the Northern Tobacco Securitization, the Alaska Capital Corporation, and the Corporation for Affordable Housing - that have all been successful; so, there is a precedent that if done properly subsidiaries bring an extreme benefit. They can take on a specific piece of business, build a border around it that is structured towards that type of activity and service and help the parent corporation in widening its business scope in the work that it needs to do.

CHAIR GIESSEL, finding no further questions, thanked everyone for their participation.

Alaska North Slope Royalty Study

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CHAIR GIESSEL announced that they would next hear the rest of Black & Veatch presentation that had concluded on slide 34, fiscal framework.

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JASON DE STIGTER, Senior Consultant, Black & Veatch, Management Consulting Division, said he had been working on some version of marketing natural gas for the State of Alaska for the past six years. He was one of the main modelers for the royalty study and had performed a big part of the analysis. His background is in financial and economic analysis and he specializes in risk analysis for Black & Veatch.

PETER APT, Managing Director, Fuels Practice, Black & Veatch, Management Consulting Division, said he would be addressing specifically the LNG markets and supply chain elements of the royalty study.

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DEEPA PODUVAL, Principal, Black and Veatch Management Consulting Division, said is an economist and engineer by training and had been involved with Alaska natural gas since before AGIA. The analysis they did looked at how the AKLNG project compares to fiscal structures of other successful projects and ways the state could incentivize the AKLNG project.

Slide 36 showed projects worldwide that are either in operation or have achieved FID and are under construction. The government take from these projects ranged from 40 to 85 percent, but most of the large capital projects were on the lower end of the government take ratio.

Slide 37 showed government take for the AKLNG project under SB 21 without any changes to the fiscal structure and an assumed capital cost of \$45 billion, at 70-80 percent, depending on whether one is looking at undiscounted cash flows or from an MPV perspective. Ms. Poduval said this would be considered a fairly aggressive government take for a project that is as large and as complex as this one is. And unlike a lot of the other projects there is an almost-fixed element that is hard to move, the federal government IRS take of 35 percent.

She said slide 38 tries to demonstrate straightforward ways of incentivizing the AKLNG project and first they took away royalty and production tax completely to see how much the project's attractiveness could be improved. The producers' return is a little less than 15 percent under base case assumptions and taking away the royalty moved their return up by 1 percent; taking away the production tax moved it up by 1.5 percent.

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They found that any transfer of value designed in this way from the state towards the producers is constrained by the fact that 35 percent is transferred to the federal government in the form of corporate income tax.

They next looked at the state's choices with respect to its royalty share, mainly trying to understand what the value would be of going RIK instead of royalty in value (RIV). Slide 39 laid out some advantages and disadvantages relative to the two alternatives. RIK can be attractive to the producers, because it reduces valuation disputes and commercial uncertainty for the project. It creates some disadvantages for the state because it requires marketing expertise, especially in the LNG case, that the state doesn't have.

The state is familiar with RIV having administered it on much greater volumes than RIK, but disadvantages would be a lack of transparency and not having access for third parties into the project.

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Risks to the state from going to RIK would be that some elements get included in RIV that may or may not be included in RIK - whether GTP costs would be considered as a deduction and whether upstream field cost allowances would change going between RIK and RIV - and some of that is just not clear yet. But she highlighted the biggest risk is the state's inexperience in marketing LNG if it went to RIK. In that case it would be competing with the producers who are some of the best marketers in the world and it would run the real risk of being disadvantaged in negotiating deals that could result in a discounted price relative to the value it would receive just by taking a percentage of the price that the producers are able to negotiate. The state could lose as much as 75 percent of the value relative to RIV.

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SENATOR FRENCH asked how GTP costs would be treated differently under RIV versus RIK.

MS. PODUVAL said some of this is still uncharted and that now only Prudhoe Bay is allowed to deduct GTP costs for royalty calculations.

SENATOR FRENCH asked if that is captured in the tax code.

MS. PODUVAL replied that she thought it was captured in the royalty settlement agreements.

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JOE BALASH, Commissioner, Department of Natural Resources (DNR), Juneau, Alaska, said she was correct; only Prudhoe Bay has a settlement agreement pertaining to gas.

MS. PODUVAL said slide 41 highlighted the additional risks the state would face going to RIK. First, it would have to build its own marketing organization and she had just talked about how complex global LNG markets are, and they are not transparent. It would have to face competition from producers with well-established LNG marketing expertise as well as global portfolios. And being counterparty to the various agreements would open the state to default by any of the counterparties.

Taking RIK would cause the state to make firm capacity commitments along the LNG supply chain and entering into sales commitments without controlling the upstream is risky, because the state might not be able to meet its sales obligations. It would have to lean on the producers or a third party that has experience in dealing with these market uncertainties as well as the global LNG markets to help address these risks.

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SENATOR FRENCH asked why the counterparty risk and would fall on the state.

MR. ABT explained that the counterparty is the party the state would enter into the long term sales and purchase agreements with: for example, an Asian buyer or a Japanese utility. The counterparty risk is the credit risk or the performance risk of that party to honor the terms and conditions of the long term sales and purchase agreement. "Counterparty risk" refers specifically to an ability to perform under the terms of a contract. For example, if LNG was delivered as per the contract and for whatever reason the buyers are not able to pay for it - due to bankruptcy or some other credit issue - that would be a risk the state would assume. If the buyer couldn't physically take the gas for whatever reason (perhaps they didn't have capacity in the regasification terminal to receive the LNG), they would still have an obligation to pay us, and it's possible that they wouldn't. The state would then need the ability to go sell that volume in the open market to another buyer.

SENATOR FAIRCLOUGH asked if that scenario could be reversed if the state marketed its own gas and was not able to deliver.

MR. ABT answered yes.

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SENATOR FRENCH asked where the LNG price would be that the state would be experiencing negative royalties.

MS. PODUVAL answered if the midstream tariff is \$10 and if the global LNG price falls below \$10 - because we've moved to a Henry Hub-type price - the state could find itself facing negative royalties.

SENATOR FRENCH stated that could be put more simply by saying "the state could lose money if the LNG price is too low."

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MS. PODUVAL said slide 42 summarized the key findings from examination of the fiscal framework:

1. Government take at 70-85 percent is high for a project of this complexity and an estimated IRR of approximately 15 percent may be insufficient for producer investment relative to their alternatives.

2. Well-designed incentives to lower project costs (especially reducing leakage to the federal government) and modifying fiscal structure can help make the AKLNG project competitive in the market place.

3. The state taking RIK could result in a substantial increase in risk and potential loss of value if it is not managed prudently. The producers have more experience managing associated risks.

SENATOR FAIRCLOUGH asked if the state could really lose money, or just get a subpar return on an investment, or a combination of both.

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MS. PODUVAL replied that it could be a combination of both. If global prices truly fall below capacity commitments, in an RIK world without equity participation, the state could see negative cash flows. With equity participation it would appear as subpar return on investment.

CHAIR GIESSEL, finding no further questions, said they would break until tomorrow at 8:00 a.m. [SB 138 was held in committee.]

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CHAIR GIESSEL adjourned the Senate Resources Committee meeting at 5:06 p.m.