

ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE

February 20, 2014

8:03 a.m.

MEMBERS PRESENT

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

MEMBERS ABSENT

All members were 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 WAIVED PUBLIC HEARING NOTICE, RULE 23
02/12/14	(S)	RES AT 3:30 PM BUTROVICH 205
02/12/14	(S)	Heard & Held
02/12/14	(S)	MINUTE(RES)
02/13/14	(S)	RES AT 8:00 AM BUTROVICH 205
02/13/14	(S)	Heard & Held
02/13/14	(S)	MINUTE(RES)

02/14/14 (S) RES AT 3:30 PM BUTROVICH 205
02/14/14 (S) Heard & Held
02/14/14 (S) MINUTE(RES)
02/19/14 (S) RES AT 3:30 PM BUTROVICH 205
02/19/14 (S) Heard & Held
02/19/14 (S) MINUTE(RES)
02/20/14 (S) RES AT 8:00 AM BUTROVICH 205

WITNESS REGISTER

JANAK MAYER, Partner
Enalytica
Anchorage, Alaska

POSITION STATEMENT: Presented information on "Competitiveness, Project Structure & Cash Exposure."

NIKOS TSAFOS, Partner
Enalytica
Anchorage, Alaska

POSITION STATEMENT: Presented information on "Competitiveness, Project Structure, & Cash Exposure."

ACTION NARRATIVE

8:03:49 AM

CHAIR CATHY GIESSEL called the Senate Resources Standing Committee meeting to order at 8:03 a.m. Present at the call to order were Senators Bishop, Fairclough, French, and Chair Giessel. Senator Micciche arrived shortly thereafter.

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

8:04:47 AM

CHAIR GIESSEL announced that the only order of business would be SB 138 and the presentation from Enalytica.

JANAK MAYER, Partner, Enalytica, Anchorage, Alaska, presented information on "Competitiveness, Project Structure & Cash Exposure." said it was his third year working with the legislature on energy issues.

NIKOS TSAFOS, Partner, Enalytica, Anchorage, Alaska, presented information on "Competitiveness, Project Structure, & Cash Exposure" and said his background is in natural gas and consulting.

8:06:05 AM

MR. TSAFOS said he would address the question of whether Alaska will be in the money or out of the money and how that related to "in kind" or "in value," the mid-stream options in the MOU and address the state's cash exposure. He showed a chart of places around the world that have LNG noting that Alaska is competing in a world with many choices. However, many of those resources have considerable risks. The key element in looking at this chart was to reassure Alaska and to draw a key distinction between an expensive project, a project that is out of the money, and a project that doesn't get built.

8:08:31 AM

MR. TSAFOS showed a similar map of LNG sites in the mid to late 2000's and began with Trinidad that had just brought on a train in 2005 and were proposing another. At some point Venezuela laid out plans for three separate LNG facilities, Nigeria had just brought train six on line and it had a number of other proposed projects. (But if Nigeria built everything it said it was going to build it would overtake Qatar.) Equatorial Guinea in 2007 had just brought on a project and in 2008 and 2009 people were working on a second train. North Africa was "really opening up" and Algeria was very aggressive. Libya had just opened up the deal with Kaddafi that brought in ENI, Shell, and BP that all had proposed projects there. Egypt had just started up, Norway was bringing on line a project, Russia had a just finalized a project with partners, Qatar had placed a moratorium on new projects, but Iran was still going. Myanmar at some point was thinking about exporting gas by pipeline or LNG, but Australia was moving very slowly and Russia obviously had a lot of gas, but at huge costs.

The reason he showed them this chart with all the projects on it was because none of them ever happened - none! Algeria finally built some projects, but they basically offset some old facilities they had but were shut down. Everything happened in Australia and the reason was because everything else had failed. So, when companies were looking for supplies, when you start crossing everything off the list, whatever remains is the place you go. The key element he wanted to point out is that Australia was "by no means" the low-cost choice. All the cheap stuff never materialized. The reason he says that is because it is important to distinguish between an expensive project, a project that is out of the money, and a project that does not get built. Just because there are a lot of other projects out there that may be cheaper than Alaska doesn't mean that all are going to happen or that Alaska can't compete in that market. At the end of the day

what really matters is whether Alaska can sign contracts for a price that make the buyers and the sellers happy.

[8:12:09 AM](#)

SENATOR FRENCH asked about the Snofit expansion in 2005, because their Black & Veatch Royalty study says it went on line in October 2007.

MR. TSAFOS agreed that the first train went on line in 2007, but an expansion was proposed. The reason he said this is because yes, Alaska is an expensive project, but it doesn't mean that it's an impossible project. Alaska, in particular, has a number of attractions; folks in Japan are getting excited about Alaska's potential. Compared to the shale gas revolution in the Lower 48, the route from Alaska to Japan is not only closer, but it does not cross any "choke points:" territorial waters of any country that Japan is concerned about. A lot more than price determines what Japan gets built, because they worry about the Strait of Malacca, the South China Sea and other problem areas.

[8:14:32 AM](#)

His graph was a simplified version of what the four options - by no means exhaustive options - and would look at how the MOU changes that structure when going through the numbers for each option.

[8:16:16 AM](#)

MR. MAYER explained the by going to the status quo - taking royalty and production tax in value - that far from insulating the state from price exposure actually increases it in many ways. The reason for that is that by solely looking at the wellhead for value you have this enormous fixed cost component (the \$66-odd dollars of tariff) that would apply to all of the different midstream elements combined that would actually amplify the effect of movement in price.

He asked them to think (abstractly) about the impact, for instance, of another fixed claim: the mortgage that is a fixed claim on the portion of the value of one's house. For instance, if you buy a \$100,000 house, put down \$10,000 and have a \$90,000 mortgage, and then the value of the house appreciates by \$10,000, the fixed claim remains that same, but your investment has doubled. If the value of the house depreciates by \$10,000 the fixed claim remains the same, but your entire investment is gone. So the 10 percent change in value of the house can give one 100 percent change either way in the value of his

investment. So, leverage in that sense increases exposure to price risk.

The idea that any form of fixed claim, whether it's a loan from the bank or having another party build some piece of infrastructure and pay them a tariff for that - those are all fixed claims that are a form of leverage - would increase the state's exposure to price. So, taking value by solely taxing the wellhead even though the state isn't directly paying a tariff itself, by calculating the wellhead value on the basis of that implied tariff is essentially economic leverage, and that increases the state's exposure to price and price risk.

8:19:00 AM

SENATOR DYSON asked him to explain the tariff piece on the graph.

MR. MAYER explained that in comparison to the world of oil where the tariff combined for TAPS, marine transport and everything else is maybe \$10, here the tariff is as much as \$66/BOE. This means if you take the approach of simply taxing the well head value that is the same as saying this part of the stream - regardless of what the price is - is always going to get its return first. The state would take what's left over after that in the same way as the bank is always going to get its money first.

8:20:22 AM

MR. MAYER said they ran their model looking at the world of royalty and production tax in kind as 25 percent gas share with a corresponding equity share with the idea that it's counterintuitively reducing the state' price exposure rather than increasing it (precisely because they are removing a substantial part of that element of leverage from the equation).

8:21:09 AM

SENATOR FRENCH went to the Black & Veatch study and asked if their model took into account the B&V warning that the state could lose up to 70 percent of the value of the royalty gas by taking it in kind. Is there any reduction in the value of the in kind gas because of the marketing issues and the other factors that the study pointed out?

MR. MAYER answered that was an excellent question and they had assumed parity. And if one were to say there is a specific impact on the state that it receives a poorer price than others,

it wouldn't change the slope of the line, but it would bring it down.

SENATOR FRENCH requested a slide of the state losing 25 percent in the translation from value to in kind to get a better idea of what might be our first or second years' experience.

MR. MAYER agreed.

CHAIR GIESSEL noted the arrival of Senator McGuire.

8:22:59 AM

MR. MAYER continued to explain that the slope of the line depends on a range of other factors: one is the tariff through taxing at the wellhead or the physical tariff one has by having other parties build the infrastructure and paying them for it. It is a fixed claim that increases the exposure he stated. There will be other forms of leverage as the project develops. These assumptions from Black & Veatch assume a 70 percent equity capital structure behind the project. That means that the state, if it's a 25 percent participant, is only on the hook for direct cash for 30 percent of its total capital call for its share of the project and the bank has first claim on the cash flows from the project, increasing the price exposure.

This represents the pure in kind world that the actuary sets out before getting into the detail of the MOU and the question of what goes to TransCanada. If there is a third party participant in some portion of the midstream you are again bringing back in some element of a fixed claim and the question then becomes what is the ideal way of juggling that. Because by going with that world you are reducing the state's initial upfront cash outlay exposure (which is important to manage), but that also gives someone else first cash call. There is a balancing act between what you are doing in that participation versus the decisions one is making further down the track on things like overall level of debt and equity in the project. These could balance each other out. For example, a bigger share for TransCanada could mean the state needs to take a little less debt in doing this to even out the risk reward that goes with the price exposure. It's a question of thinking about all fixed claims as a form of leverage that can be balanced against each other to achieve a degree of price exposure that the state is comfortable with.

8:25:38 AM

MR. MAYER noted that they had corrected the slide they presented last time that had an error and also updated the model to reflect a few additional things: factoring in the fact that under SB 138 costs from production tax purposes remain claimable against oil taxes regardless of whether they come from oil or gas expenses. To that extent, they talked about the state having a 25 percent share in the entire midstream from gas processing down to the LNG facility but not having to front other cash for upstream development. In fact, effectively by having those costs be deductible against oil taxes there is an after-tax state contribution towards upstream expenses and those numbers are reflected in this slide.

[8:26:45 AM](#)

SENATOR FRENCH asked about the overall government take of the project. Black & Veatch says it's from 70-85 percent and it seems like they are splitting the net present value 50/50 between the state, the feds and producers.

MR. MAYER said they would like to discuss that with Black & Veatch in a little more detail to understand their modeling, because it looks like there is a slight discrepancy.

SENATOR FRENCH quipped that they might have different ideas about the word "slight," because they're talking about \$20 or \$30 billion.

[8:27:48 AM](#)

MR. MAYER said the MOU starts off with the overall 25 percent share across the midstream that the HOA entails and then has a number of possibilities; option 1 would be that the state exercises its right to purchase a share of the TransCanada vehicle that is responsible for the state's 25 percent of the gas processing plant and the pipeline. If that were exercised to the full 40 percent envisioned in the MOU, the state would end up with a 10 percent stake in that portion of the midstream, but still 25 percent share in the liquefaction project.

The alternative is if the state has no stake in the upstream or in the pipeline and only retains the 25 percent stake in the liquefaction project. The next slide would show what that would mean to the state in terms of overall project cash flows and what the state is on the hook for, particularly in the years of construction.

[8:29:24 AM](#)

MR. MAYER showed a graph of the pure world of the SOA 25 percent stake in gas treatment and processing, pipeline and LNG and the effect on total cash flows of TransCanada having 100 percent of gas treatment and pipeline on one line (red) and if the state exercises its equity option and TransCanada only has 60 percent of that 25 percent share the effect on the cash flow is another line (yellow). Obviously having an additional partner in this decreases the cash exposure in the early years and correspondingly means that one takes less of the cash in later years. He said it was easier to compare cash flows to what one might get from another investment.

8:31:19 AM

SENATOR MCGUIRE asked if he had a position on the 7.1 percent that TransCanada wants to assess the state (because it's an equity loan). Is that fair market value?

MR. MAYER said that was an excellent and relevant question. It's a fixed claim on the cash flows of the project. Under the MOU there is a 12 percent cost of equity and a 5 percent cost of debt; a 70/30 percent split between those two in weighted average cost of capital is 7.1 percent during construction, and for any subsequent expansions once the pipeline is in service is a 75/25 percent split.

The MOU also has the rate tracker differential that gets set at the time of final investment decision, so they know what the actual rate is depending on how the 30 year treasury has moved between now and the time of final investment decision. There is risk in both directions, but he suggested primarily upward risk in where that may move over the next several years, but that decision can also be made based on conditions at that time.

MR. MAYER said there are a number of questions: one what limitations there are on the state's total ability to carry debt for such a project and the difference in that sense between TransCanada doing this versus the state doing it through debt and all the other issues they have talked through in previous sessions in terms of having a professional pipeline operator that makes its money by moving molecules, not by selling them. However, he said, you can't look at this only in cash terms have a stake in the project. TransCanada brings a premium to the table that one needs to weigh.

8:34:41 AM

SENATOR BISHOP said you can't lose sight of the leverage (having a lower tariff rate for instate use of gas to Alaskans) by

having TransCanada able to negotiate it. Alaskans want to see something else out of this project besides cash to the treasury as direct cash back in their pocket at the burner tip. That value is here and it's not showing up. But if that was modeled over 40 years it would equal a real number.

MR. MAYER said that was true, but the counterpoint is whether the state could take that 25 percent stake itself and (arguably charge a very low tariff) and also be a good pipeline manager, particularly when it comes to expansions. If it is a sole partner in an expansion, does it really want to get into a business like that in the future by itself?

[8:36:36 AM](#)

MR. MAYER addressed what the state is potentially "on the hook for" saying they looked solely at net cash flow out in the first years of a project's lifespan in a number of different scenarios. The first thing they noticed was that even in the in-value/no equity world there is negative cash out. That comes back to the question he mentioned previously: because costs are deductible against oil production tax as well as both state and federal corporate income tax, simply from their being investment (in this case) in the upstream there is effectively a negative cash impact of that to the state. Investment, particularly at this level by itself creates an implicit liability to the state.

The state could have close to \$3.5 to \$5 billion in total cash call for the capital outlay in a 25 percent equity across the value chain. The path of the MOU reduces that by up to \$1-1.5 billion by having another partner to share some of that capital burden with.

He said this shouldn't be taken as gospel in terms of how cash is actually spent through the project; those plans are a long way off and it's hard to know how they will look. Enalytica is trying to be conservative as possible by saying that maybe 30 percent of the cash could be spent in one year, which is how you get to the negative \$1.5 billion in 2023.

[8:39:24 AM](#)

SENATOR FRENCH said he liked the slide, but he imagined David Teal, a legislative financial analyst, sitting in the audience and developing a big stomach ache as he envisioned the State of Alaska spending \$1.2 billion in 2023 on a project in a year when they will be looking at deficits and worrying about how long our savings will last. The public should be thinking about where the money will come from in these long out years.

[8:40:21 AM](#)

SENATOR MICCICHE said what the slide covers is the variation in the potential cash outlay depending on what deal gets entered into and he asked Mr. Mayer to talk a little bit about the sliding scale of the lowest to the highest potential outlay in those years on this slide.

MR. MAYER explained that there is always some outlay even in a case of not participating in kind at all. So, in a peak year that could be half a billion or just over that in a peak year of construction versus \$1.5 billion in the case of equity at a 25 percent level throughout the value chain. By having another partner, TransCanada as proposed in the MOU, that \$1.5 billion peak spending annual exposure could then be clawed back to \$1.1 to \$1.2 billion.

[8:41:41 AM](#)

SENATOR MICCICHE said with all due respect to Senator French it sounded like a scary statement; the reality of it is that Alaskans would like gas available so that their futures could look a little brighter and they could have some potential industrial activity. But there is a cost all the way across the value chain no matter how the state chooses to participate. This discussion is about if we want to share on some of the upside or sit back and have it all sort of be outside of our control.

CHAIR GIESSEL said the other implication is if the state doesn't participate if the project would even go forward at all.

[8:42:33 AM](#)

MR. TSAFOS added that the other part they have talked about in previous presentations is there is nothing that prevents the state from offloading part of that 25 percent along the way if it gives heartache to too many people. The state could think a little more strategically; it may make sense to have 25 percent share today and for the first one, two, three years before the project has momentum, but the state could also decide at that point that it's a lot of money to invest. He opined that there would be a lot of companies that would be happy to take some of that share off our hands and that there are multiple ways to mitigate the state's cash exposure.

[8:43:53 AM](#)

SENATOR MICCICHE said he assumed that in most of the analyses the state's cost of capital is 6 percent and the cost of capital from TransCanada at 7.1 percent.

MR. MAYER asked him what he meant by the state's cost of capital.

SENATOR MICCICHE said he meant our Triple A rating where the cost of our capital is lower than TransCanada's.

MR. MAYER answered the cost of debt entailed in the MOU for TransCanada will cost the state 5 percent and come up to 7 percent when blended with the 12 percent cost of equity. The modeling in their recent slides looked at the returns rather than the cash outlays in the early years. For simplicity's sake they went with a 5 percent cost of debt for their analyses, but they could use other numbers.

[8:45:49 AM](#)

SENATOR MICCICHE asked what he would call a realistic scale for the cost of capital over the next 30 years.

MR. MAYER said 6 percent could be called the state's opportunity cost of capital, but it can borrow capital at substantially less than that.

SENATOR MICCICHE said it is important to really understand that in comprehending the full value of TransCanada's relationship.

MR. TSAFOS agreed. The way they look at it, the state has two numbers: what it can borrow (cost of debt) and its opportunity cost (alternative uses for funds). They will definitely work through that analysis. That is why chart 11 shows bigger variations. They are not assuming that it's just a 1.1 percent difference. He underscored the difference between opportunity cost and borrowing cost.

[8:48:02 AM](#)

MR. MAYER concluded with a slide showing that 70/30 percent debt/equity ratio would be 30 percent of the corresponding capital call. This is simply to say what the maximum in a base cost scenario would look like what if the state decided that it wanted to reduce price risk and do this all through equity.

[8:49:12 AM](#)

SENATOR FRENCH said he appreciated the "base case," because if there are 20 percent cost overruns, everything gets multiplied by 20 percent. He asked if that would be from the \$60 billion figure.

MR. MAYER replied \$45-65 billion cost of the midstream including \$3-4 billion in upstream costs above that (GTP, Pipeline, and LNG plant).

[8:49:47 AM](#)

SENATOR MICCICHE asked if the initial outlay is higher going in-kind if the state would gain more downside protection.

MR. MAYER said that was correct. There are many ways to change that red line.

SENATOR MICCICHE asked if slide 11 cash flows for the state between the two cases of in value and in kind were fairly substantial for the long term.

MR. MAYER responded particularly if one is looking solely at the undiscounted cash flows. If one looks at the net present value of what the state is giving up, they could present some analysis on that, but it is a relatively small piece of the total value of the project. It is a significant reduction in the upfront capital required, but it's a significant reduction in the total cash flows for the project (it's giving a piece of the midstream to a third party in the in kind world).

CHAIR GIESSEL held SB 138 in committee.

[8:52:13 AM](#)

There being no further business to come before the committee, Chair Giessel adjourned the Senate Resources Standing Committee at 8:52 a.m.