

HOUSE FINANCE COMMITTEE
February 17, 2015
1:32 p.m.

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CALL TO ORDER

Co-Chair Thompson called the House Finance Committee meeting to order at 1:32 p.m.

MEMBERS PRESENT

Representative Mark Neuman, Co-Chair
Representative Steve Thompson, Co-Chair
Representative Dan Saddler, Vice-Chair
Representative Bryce Edgmon
Representative Les Gara
Representative Lynn Gattis
Representative David Guttenberg
Representative Scott Kawasaki
Representative Cathy Munoz
Representative Lance Pruitt
Representative Tammie Wilson

MEMBERS ABSENT

None

ALSO PRESENT

Randall Hoffbeck, Commissioner, Department of Revenue;
George W. Bilicic, Vice Chairman of Investment Banking,
Lazard Freres; Representative Chris Tuck.

SUMMARY

^PRESENTATION: AKLNG PROJECT - LAZARD INTERIM REPORT

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Co-Chair Thompson discussed the agenda for the meeting. He communicated that the Lazard Freres and Co. LLC had been engaged to provide assistance in reviewing and analyzing various financial options for the state's interest in the

AKLNG Project pursuant to SB 138 [gas pipeline legislation passed in 2014].

RANDALL HOFFBECK, COMMISSIONER, DEPARTMENT OF REVENUE, communicated that SB 138 had contracted Lazard to conduct a financial analysis for a pipeline. He detailed that the company would provide an interim report that included a high-level overview of financing options. A follow up report would be presented later in the fall [2015] specific to the AKLNG Project. He noted that the final report would dovetail with various project decisions to be made by that point in time.

GEORGE W. BILICIC, VICE CHAIRMAN OF INVESTMENT BANKING, LAZARD FRERES, introduced his colleagues. He provided a PowerPoint presentation titled "Lazard Interim Report Overview - Discussion Materials" dated February 17, 2015 (copy on file). He shared the team's excitement over working on the project. The goal was to recommend an optimal financing plan or plans for the state pertaining to the AKLNG Project. He pointed to a disclaimer from the company's legal department at the beginning of the report. He highlighted that the presentation would provide an introduction to the company, an overview of Lazard's role on the project, topics covered in the interim report, and steps that would be taken to get to the final report (slide 1).

Mr. Bilicic provided background information about the company that been founded in the mid-1850s (slide 2). The firm had become a public company and its market capitalization was currently listed on the New York Stock Exchange at \$6.5 billion. He discussed the firm's global presence and noted the importance of understanding global dynamics to give sound advice pertaining to the project. The firm was client focused and senior advisors were motivated by client relationships and serving the interest of the clients. He relayed that the company was conflict-free and was only in the advice business. He highlighted that a large part of the firm's business was in the representation of governments. He noted that his biography was included in the back of the presentation.

Co-Chair Thompson noted that Representative Gara and Representative Munoz had joined the committee meeting.

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Mr. Bilicic moved to slide 3 and discussed the company's global presence; it employed 900 investment bankers in all major global business cities. He discussed Lazard's assignment pertaining to the legislature (slide 5). He read from a statement:

Our mandate was issued by Senate Bill 138 and a Department of Revenue request for proposals. Senate Bill 138 calls for the "development of a plan" for Alaska municipalities, regional corporations, and residents to participate in the ownership of a North Slope natural gas pipeline. Pursuant to this legislation the Department of Revenue solicited proposals from qualified firms to serve as a "financial consultant on the state's participation in the continued development of a liquefied natural gas project from Alaska's North Slope." The interim report, which was requested by the legislature, provided a detailed description of the project, an overview of the state's finances, and an introduction in an outcome agnostic way to various financing considerations for the project in advance of the final report.

Mr. Bilicic noted that the interim report outlined all options available to the state to pursue the project from a financing point of view.

Vice-Chair Saddler asked if there were two missions for the interim report: first, to describe methods by which municipalities and residents of the state could participate in ownership of the AKLNG Project; and second, to address the state's financing options.

Mr. Bilicic replied in the affirmative. He noted that the missions wound up merging because one could also be a source of financing. He stated that the first clause was really a source of potential financing for the project. He continued on slide 6 that provided a high level process timeline. Lazard had been working on the project for slightly over four months; the interim report had been delivered on schedule. The company was currently undertaking work on the final report and would deliver it by October 1, 2015. He communicated that the advice would be delivered when many of the variables would not yet be determined; therefore, it was necessary to create a report

that identified the variables that would allow people using the report in the future to view the report in a modular way so variables could be inserted into the analysis and changes could be made.

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Mr. Bilicic relayed that the interim report took approximately 13 hours to read. He turned to slide 7 and discussed his intent to provide a brief background of the project including the state's objectives, preliminary financing considerations for the state, and evaluative criteria. He stated that a significant part of the work would be done around financing alternatives and then the company would filter its advice through evaluative criteria that were important to the state. He detailed that there were a number of objectives the state would hope to meet through participation in the project; the objectives were economically, non-economically, qualitatively, and quantitatively motivated. He read state objectives on slide 7:

- Develop Natural Resources for Maximum Benefit to the State
- Realize Investment Returns
- Support State Budget
- Replenish Reserve Accounts
- Stimulate In-State Job Growth
- Provide Investment Opportunity for In-State Individuals and Entities
- Provide Natural Gas to Alaskans
- Support Local Municipalities

Mr. Bilicic expounded that Lazard's ultimate recommendation to the state would be informed by the objectives set forth on slide 7. He addressed the AKLNG Project economic overview on slide 8. He detailed that the state was currently contemplating project ownership up to 25 percent. The project was anticipated to cost between \$45 billion and \$65 billion in 2012 dollars (as time passed dollar amounts would evolve based on overall economic conditions); the state's share would be approximately \$11.3 billion to \$16.3 billion (the total cost divided by 4). He communicated that the vast majority of the cost was expected to be incurred during the engineering, procurement, and construction phase that was estimated to start in 2019. He relayed that

project costs may change over time as a result of many factors including project developments, negotiations, market dynamics, and the passage of time. He remarked that the risk factor was important because costs could evolve.

Co-Chair Thompson asked if TransCanada's involvement was taken into consideration in the economic overview.

Mr. Bilicic replied that the larger report looked at what the state's economic participation would be if TransCanada were participating. He continued to discuss slide 8. He noted that financial numbers used in the interim report were based on a Black and Veatch model. He addressed slide 9 that included an AKLNG Project economic overview chart; the chart illustrated cumulative projected cash flows over time. As an investor in the project the state would need to invest money in the beginning to develop and build the project; as the project became operational it would begin producing cash flows that would start to offset capital spent. The chart showed the crossover point at 2026 (when cash flows to the state would begin). He stated that the actual crossover point would depend on actual costs and revenues. He noted that the crossover point did not account for the passage of time or time value of money. He added that the chart was not atypical from other large infrastructure projects.

Mr. Bilicic turned to slide 10 titled "State of Alaska Financial Overview." The slide depicted the state's current financial situation. The chart illustrated the state's need of a new revenue source because of the way its financial position evolved over time; the AKLNG Project could potentially fill the need. He pointed out that the chart depicted a material weakening of the state's financial position in the coming years, which was the period over which the project would need to be financed. He remarked that the projections were based on an assumed price of oil that was materially higher than the current spot price. The firm's analysis would look at the overall long-term budget position of the state as part of considering the financing alternatives and assessing the project through the different evaluative criteria.

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Mr. Bilicic addressed slide 11 titled "Selected Project Risks and Potential Mitigants." He remarked that the

project had numerous risks, opportunities, and mitigants to risks. For example, there was risk that the project would never make it out of the development phase or that cost overruns during construction would force sponsors to abandon the project. He relayed that under the scenarios it was possible the state could lose all of its investment it had made up to that point. He advised that the specific risk would be difficult to ever eliminate from the project. Mitigants related to the quality of the state's partners, planning, and the analysis. Other potential risks were that relevant commodity prices could change in a way that could negatively impact project viability or that an influx of numerous competing projects could result in a global over supply. He relayed that Lazard was watching projects in Australia, Russia, and other; some of the projects were being canceled and others were being announced. He stressed the importance of the global perspective on the project. The slide listed potential mitigants as:

- ongoing/iterative assessment of project feasibility
- risk transfer provisions/third-party contracts
- partner/sponsor marketing
- political support and strategy
- take-or-pay contracts/hedging strategy
- in-depth market analysis
- delivery flexibility
- other

Mr. Bilicic relayed that the firm would take all of the potential risks into account and would provide advice in the final report.

Vice-Chair Saddler believed take-or-pay contracts represented potential liabilities. He wondered how the state would hedge against the commitment to make a take-or-pay contract from transportation commitment.

Mr. Bilicic replied that take-or-pay contracts referred to entering into long-term contracts with people who would want the LNG. The contract would provide cash flow stability, which could be used to enhance the financeability of the project.

Representative Gara discussed that when the state had been making a large amount of oil revenue the legislature had

passed a law specifying that companies that became involved in a gasline could deduct certain upstream costs from their oil taxes. He observed that financial circumstances had changed and the state was currently bringing in negligible revenue. He wondered if the firm had advice on how to move forward with a law that would allow the "big three" oil companies to deduct the significant portion of their gasline expenses from their oil tax payments.

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Mr. Bilicic replied that the company had not considered the scenario. He elaborated that the firm would focus on that the state's consideration of risk had to be different than that of the other partners that operated as for-profit entities. Lazard would look at ways to mitigate risk and to structure the investment in a way that would minimize Alaska's exposure. He relayed that the company was open to ideas.

Mr. Bilicic moved on to discuss preliminary financing considerations on slide 12. The slide provided an overview of the framework Lazard believed the state should use to think about its investment in the project (i.e. how much money the state would need, where the money would come from, and how to structure its investment). The slide illustrated three key points including: 1) the state must identify sources of funds (internal and/or external) to provide the capital required to invest in the project; 2) the state can structure its economic interest in the project via a mix of debt and equity financing structures; and 3) construction of the project is expected to require \$13.7 billion of capital in the scenario in which the state invests in the project on its own. He noted that the list was not meant to be all encompassing. He relayed that Lazard would provide advice on the mix of debt and equity that would make sense; debt was cheaper than equity, but too much debt would not make sense. He added that there would be a period of time when the project would not well-support significant debt. He listed the three large components of the project including the gas treatment plant, the pipeline, and the LNG plant [all related to point 3 above].

Representative Edgmon pointed to the Sources of Funds category on slide 12. He asked about the inclusion of the Power Cost Equalization Endowment Fund.

Mr. Bilicic responded that the firm did not have anything in mind related to the item; the point was to note that there were funds at the state level that could potentially support the project. He continued to address potential funding sources on slide 13. As part of the final report Lazard would offer its point of view on the various funding sources because each source had different return requirements and had a different investment appetite for the project at different stages. The firm would also comment on availability of capital, marketability, financeability, and precedence for making investments in items like the project. He noted that the back of the interim report included case studies of similar projects. The firm would also look at how use of the funding sources would impact the state's borrowing capacity and/or future borrowing costs.

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Vice-Chair Saddler pointed to examples of third-party investors on the lower left hand portion of slide 13. He wondered if the firm envisioned looking for potential overseas equity investors (e.g. from Asia).

Mr. Bilicic replied that there were at least four potential "buckets" of investors that were non-U.S. The first was the emerging class of infrastructure investors. He detailed that portions of the project looked like infrastructure (i.e. roads, bridges, utilities, tunnels, and other), which was currently a "hot" area for investment. He expounded that the party raising capital could receive an attractive return profile in exchange for offering investments; some of the investors were in the form of sovereign wealth funds or pension funds in other countries (e.g. Canada, Asia, and other). The second category included people who want the gas and may find it interesting to take an equity investment in the project directly or indirectly including as part of entering into long-term projects. The third category included bank lenders that happened to be organized overseas. The fourth category included other investors who were active in the LNG area. He detailed that there were a significant number of trading firms that may be interested in entering into arrangements to take the LNG to resell to utilities or others in different parts of the world.

Vice-Chair Saddler had heard that it was possible for the state to offload its risk in exchange for equity. Mr. Bilicic replied that the company had the idea in mind.

Mr. Bilicic advanced to slide 14 that included a description of structuring alternatives for debt and equity. The slide indicated that the least expensive financing came from recourse debt; the party that purchased the debt would have recourse against the state. Taking traditional common equity at the lowest level of subordination in the capital structure would tend to have the highest cost. He noted that the factors that went into choosing a financing structure were not limited to the lowest or highest cost. Other factors included the efficiency of capital raising, market capacity, and whether the state wanted to be an obligor. The firm would look at all of the alternatives in its analysis.

Mr. Bilicic turned to slide 15 titled "Illustrative Financing Cost - Project Lifecycle." He discussed that as a project began and the work continued the cost of financing was the highest due to the most risk and uncertainty. He detailed that as the project became more certain the cost of financing would decrease; when the project was completed a large portion would be viewed as a set of reasonably risk-free cash flows. He added that the related financing would be extremely efficient. The firm had spent significant time on the consideration because the global capital markets demonstrated that there was not significant capital available that was efficient for greenfield development. However, there was an overwhelming amount of capital for operating brownfield infrastructure projects. He elaborated that there was a value arbitrage between the greenfield and brownfield pools of capital that was able to be captured by the successful party constructing an infrastructure project. He reiterated that the cost of financing was the highest at the beginning of a project.

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Mr. Bilicic turned to slide 16 that included other considerations reflected in the interim report. Other considerations included ways to get credit support for the project from third-parties; looking at whether there were insurance products that would allow certain risk mitigation; and ways for investments by the state or others to be syndicated to other investors over time (perhaps

capturing some of the value dynamics covered on the previous slide).

Representative Gara wondered if Lazard would look at the state's law that allowed the big three oil companies to deduct a certain portion of their gasline costs from their oil taxes. He wondered about the net present value the state would receive under the current terms of the project given upfront costs paid by the state.

Mr. Bilicic replied that Lazard would inform the state of the value proposition when it provided the final report; explicit and implicit in that would be a point of view based on the assumptions about project viability well in advance of when project construction took place. The firm would also look further at Representative Gara's question related to tax.

Co-Chair Thompson asked for the information to be channeled through his office for dissemination.

Mr. Bilicic turned to slide 17 related to preliminary selected evaluative criteria. The criteria was the method the firm would use to analyze and filter through the myriad financing alternatives. Lazard's goal in identifying an optimal financing plan for the state would be to optimize how the financing plan or plans compared to other plans when taking into account the evaluative criteria. The first criteria was the potential impact on debt capacity/opportunity cost for the state. He explained that the criteria examined how to account for lost opportunity if the state invested money in one project and was not able to invest it elsewhere. The firm would factor in the potential impact of its recommendations on Alaska's credit rating; it would also look at the potential cost of borrowing or issuing equity. Additionally, Lazard would consider whether an option under discussion was feasible and practical. Lastly, the firm would look at how the relevant financing plan did or did not align interests among key parties; the state's view of risk could be different than one of its partners, which may affect the financing structure.

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Mr. Bilicic moved to slide 18 titled "Recommended Next Steps." He relayed that the firm would focus on the global

LNG market dynamics and project developments in the coming months in relation to advice the firm would give to Alaska. Other recommendations would include further analysis of potential sources of funds, capital structure alternatives, further refinement of preliminary evaluative criteria, formation of potential financing alternatives, analysis of the plans, and a drafting of the final report. The final report would include advice on the optimal financing plan or plans including how the plans may be affected by changed circumstances. He turned to slide 19 titled "Illustrative Process Review." Lazard's process would begin with potential fund sources, different capital structures, and the state financing need including as affected by potential partner arrangements. The firm would develop financing plans (there would be more than three alternatives); it would also look at various financing approaches that could be pursued to be folded into an overall plan. Plans would be analyzed based on the evaluative criteria and advice would be provided to the state.

Representative Guttenberg asked about international risk factors and market volatility. He observed that the price swing had been phenomenal. He wondered how volatility played into the firm's analysis. He recalled use of the expression "we're always one car bomb away from \$100 oil" during a past legislative oil tax debate. He stated that the price of oil had actually reached \$100. He used the statements in context of the current volatility of the world.

Mr. Bilicic answered that the firm anticipated that a large portion of the project would be contracted with long-term contracts. He explained that the contracts would provide a stability of cash flows and the state's risk would be credit risk of the counterparty. He detailed that most of the potential long-term contract counterparties had good credit (i.e. utilities, trading firms, or other). He suspected that another portion of the project would not be contracted and would be subject to the whims of the market; therefore, the value at any given point would be greatly impacted by LNG prices. He communicated that the LNG market had historically been an oil indexed market. However, one of the Gulf [of Mexico] projects in the Lower 48 had entered into contracts with a price index that was different than the traditional index; Lazard believed there may be flexibility for the state to structure its contracts

differently. He stated that there was a "whiteboard" dynamic that was an opportunity for the state.

Mr. Bilicic discussed a third consideration related to the global power generation market. He elaborated that the power generation market was very different globally. The firm believed the coal market would continue to come under significant pressure in every country; new coal plants would continue to be constructed in places like India and China, but it was almost impossible to build a new coal plant in the U.S. and Europe. Nuclear power continued to grow, but not as rapidly as the overall global power needs. Additionally, nuclear power was expensive and complicated; sometimes the risk was not fully taken into account. Renewable energy was improving and wind and solar power were cheaper, but did not work in many places. He added that a good full-time energy storage solution had not been developed. He stated that for a while the answer was gas. He elaborated that many parts of the world that were growing and in need of power did not have access to gas or their nuclear programs were under stress, which was a positive for the Alaska project. However, there was associated technology risk because someone would figure out a storage solution in the future. Additionally, where other gas sources would be discovered was not known. For example, it had been clear in 2007 that the U.S. would need to import LNG, which was no longer the case. He added that the general front-page-of-the-newspaper risk would continue to be a part of everything done in the [LNG] business for a long time. All of the items would be taken into account in the firm's analysis; the information would flow through as a technical matter on the returns the state and others should demand for investing in the projects. However, the project would never be a safe, perfectly easy investment to contemplate.

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Vice-Chair Saddler wondered how Lazard gauged its success. He asked if success was defined by a good outcome for the state or a good process leading to a decision. He asked if the firm's goal was a well-crafted "yes" or a well-informed "yes or no."

Mr. Bilicic responded that the firm needed to create a work product and process where all options were evaluated and the client could understand the pros and cons of the

different options and how the firm reached its particular advice. The firm had undertaken the engagement because it believed the project made sense for the state and could be successful in different commodity price environments. He opined that the project could act as a great "gap filler" for the state and could set a nice foundation going forward. The firm believed the project could be successful, but did not diminish the complexity and large size of the project that was subject to many variables. The goal was to provide a financing plan or road map to a financing plan that could make the project successful. He asked members to keep in mind that the report would be issued in 2015, but significant time would pass prior to the completion of a project.

Vice-Chair Saddler wondered if the duration of the firm's contract would last up to the FEED [Front End Engineering and Design] decision or longer. Mr. Bilicic replied that the firm had a three-year contract. He elaborated that Lazard would like to work on the project for a long time and liked to see things through to completion. The firm anticipated that questions may arise after the delivery of the final report and that a supplemental analysis may be needed. He added that the firm could answer questions after the completion of its contract.

Vice-Chair Saddler asked if the contract included a flat fee or other. Mr. Bilicic replied that the contract included a flat work fee and was "outcome agnostic." He stated that the request for proposal had been designed with the flat fee, which he believed was the appropriate structure.

Representative Kawasaki spoke to the Black and Veatch slide that was shown as an example on the economic overview. He believed committee members saw the example as a great way to stem off the state's revenue decline. He remarked that the information was predicated on fiscal terms that the committee had yet to discuss. He wondered if the information [on slide 9] would be factored into Lazard's analysis. He observed that similar cash flow charts were provided for most projects. He spoke to the importance of timing for the project. He noted that there would be a time the state would not have any cash; the legislature was working to ensure that the state would make money at some point. He wondered whether Lazard was factoring timing into its analysis.

Mr. Bilicic answered that the firm would try to create a report that identified the sensitivities and was modular in nature in order to identify what would change if revenues were different. For example, what would happen to revenue if 68.2 percent of the project was contracted compared to 43 percent of the project. He noted that in the example there would be higher exposure to the market. He believed the timing of the report was important, but it would be provided before information was known (including an updated estimate of construction costs).

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Representative Guttenberg asked what advantage a sovereign or government had in a negotiation on a project like the one at hand. He wondered about advantages that other parties did not have. He asked if the state was acting in its best interest thus far.

Mr. Bilicic responded that the state's presence added credibility and conviction to the idea that the project could move forward. He referred to a global map of projects that were under contemplation and offered that the Alaska project should stand out because of the state's involvement. He relayed that some counter parties would like the idea of the state's presence for purposes of entering into contracts rather than dealing with pure industrial players.

Representative Guttenberg referred to the Alyeska Trans-Alaska Pipeline System (TAPS) in which the state was an owner but not a partner. He noted that tariffs were approached differently; there were also royalties and other. He wondered if the state would lose anything if it entered the project with a partner.

Mr. Bilicic replied that the state's interests and the way it evaluated risk may be different than the other parties. The state may need to structure its ownership differently. He believed the state would gain more than it would lose.

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Representative Guttenberg noted that the partners had different fiscal needs such as showing profits. The state

may be more interested in long-term gains. He wondered how to use the relationships to the state's advantage.

Mr. Bilicic responded that the project was distinct relative to other governmental situations. He detailed that in the private sector Lazard had worked on partnerships where one party wanted stable cash flows and one party did not care about the stability of cash flows and believed they could manage the commodity price risk. Lazard had structured the party concerned about price risk in a long-term security situation that provided more stability (some of the upside was given away with lower risk); the other party assumed the variability of cash flows. He noted that the structure could be considered for the project.

Representative Guttenberg asked if the options would be provided in the final report. Mr. Bilicic replied in the affirmative.

Vice-Chair Saddler noted that two directives would be addressed including local/municipal participation and the state's financing. He asked how frequently the municipal/individual participation was a common feature in large infrastructure projects. He cited Australia and Indonesia prospects as an example.

Mr. Bilicic answered that many of the projects done in the U.S. were done at the municipal level (e.g. municipal water systems). He stated that the combination of oil companies, a pipeline company, state government, and individuals would be an unusual mix of investors. He was not aware of a situation in which individuals invested in an infrastructure project like the AKLNG Project except in cases where the project became a public company. For example, the Charles De Gaul airport in Paris, France was a publicly traded company.

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Vice-Chair Saddler envisioned individual participation along the lines of a person investing their Permanent Fund Dividend in a big "good deal" project, which he believed was unusual. He wondered if there were other projects that included individual ownership (such as a class B stock). Mr. Bilicic replied that in Australia there had been circumstances where the provincial governments had sold infrastructure to the provincial pension fund (investors

were all individuals in the region) to provide a long-term financial return for a young population in the country. He would look into the question further and surmised that there was probably a situation that included an attempt to bring in individual investors. Except to the extent individuals would have been investing as part of a public offering, there had been examples where labor unions had been brought in as investors. He referred to the nuclear Bruce Power Plant in Canada where British Energy had leased the plant from the Ontario government in the late 1990s; the lease had included TransCanada, labor unions, and Borealis (a Canadian pension fund in Toronto) as investors. He reiterated that he had seen bringing in labor unions or workers as investors, but nothing quite like the scenario under discussion.

Vice-Chair Saddler discussed that it had originally been debated whether the Alaska Permanent Fund should be an investment return or a development bank for in-state projects. He stated that many Alaskans would be fascinated to see Lazard's recommendations for or against the involvement of the Permanent Fund in the project financing. Mr. Bilicic hoped the report was not disappointing.

Representative Pruitt was looking forward to the report. He was concerned about the current state of Alaska's finances. He was concerned whether the state would have the necessary equity for the project. He asked how Lazard saw the current state of Alaska's finances playing into the picture.

Mr. Bilicic responded that if the project was viable the state would be able to find the money. He stated that it may be necessary to cobble it together with different partners.

Representative Pruitt asked for verification that the project would sell itself despite some of the challenges the state faced internally. Mr. Bilicic responded that if the project made sense, the state would be able to find the money. However, if the project did not make sense or it was borderline and the state took into account many factors in pushing the project forward that the capital markets did not take into account, it would be harder to find the money. He believed the state's borrowing capacity would be focused on in the debt/equity split (e.g. what the internal source of funds looked like, how the partnership with TransCanada worked, and other potential partners). He

reiterated that if the project made sense, Lazard believed the state would find the money.

Co-Chair Thompson noted Representative Chris Tuck's presence in the committee room.

Co-Chair Thompson thanked the presenters. He discussed the schedule for the following day.

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ADJOURNMENT

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The meeting was adjourned at 2:35 p.m.