

ALASKA STATE LEGISLATURE
JOINT MEETING
SENATE RESOURCES STANDING COMMITTEE
HOUSE RESOURCES STANDING COMMITTEE
Anchorage LIO
August 25, 2016
1:00 p.m.

MEMBERS PRESENT

SENATE RESOURCES

Senator Cathy Giessel, Chair
Senator Peter Micciche - via teleconference
Senator Bill Wielechowski - via teleconference

HOUSE RESOURCES

Representative Benjamin Nageak, Co-Chair
Representative David Talerico, Co-Chair
Representative Mike Hawker, Vice Chair - via teleconference
Representative Bob Herron
Representative Andy Josephson
Representative Paul Seaton
Representative Geran Tarr

MEMBERS ABSENT

SENATE RESOURCES

Senator Mia Costello, Vice Chair
Senator John Coghill
Senator Bert Stedman
Senator Bill Stoltze

HOUSE RESOURCES

Representative Craig Johnson
Representative Kurt Olson
Representative Mike Chenault

OTHER LEGISLATORS PRESENT

Senator Mike Dunleavy
Senator Anna MacKinnon

Representative Dan Saddler
Representative Liz Vasquez

COMMITTEE CALENDAR

NEW CONCEPT PLAN FOR STATE-LED ALASKA LNG PIPELINE:
Legal Discussion of State Tax-Exempt Status
Producer Partner Comments on Transition
Comments from enalytica, Legislative Consultant

- HEARD

PREVIOUS COMMITTEE ACTION

See Resource Committee minutes from August 24, 2016.

WITNESS REGISTER

CHARLES SCHUETZE, Attorney
Manley & Brautigam
Anchorage, Alaska

POSITION STATEMENT: Presented information on the possibility of a federal tax exemption for an Alaska-owned LNG project.

ERIC WOHLFORTH, Attorney
Jermaine, Dunnagan & Owens, P.C
Anchorage, Alaska

POSITION STATEMENT: Presented information on the possibility of tax-exempt financing for an Alaska-owned LNG project.

BILL MCMAHON, Commercial Advisor
ExxonMobil
Anchorage, Alaska

POSITION STATEMENT: Commented on a state-led Alaska LNG project.

DAVID VAN TUYL, Regional Manager
BP Alaska
Anchorage, Alaska

POSITION STATEMENT: Commented on a state-led Alaska LNG project.

DARREN MEZMARICH, Project Integration Manager
ConocoPhillips
Anchorage, Alaska

POSITION STATEMENT: Commented on a state-led Alaska LNG project.

NIKOS TSAFOS, Legislative Consultant
enalytica

Washington, D.C.

POSITION STATEMENT: Urged a careful analysis of multiple structures of AKLNG ownership, including the state-led option.

ACTION NARRATIVE

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CHAIR CATHY GIESSEL called the joint meeting of the Senate and House Resources Standing Committees to order at 1:00 p.m. Committee members present at the call to order were Senators Wielechowski, Micciche, and Chair Giessel and Representatives Seaton, Herron, Hawker, Tarr, Josephson, Saddler, Co-Chair Talerico, and Co-Chair Nageak. Senators Dunleavy and MacKinnon were also in attendance.

AKLNG Project Update: New Concept Plan for State-Led Alaska LNG Pipeline

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CHAIR GIESSEL said this is a continuation of yesterday's meeting about the AKLNG [Alaska Liquefied Natural Gas] project and the AGDC [Alaska Gasline Development Corporation] new concept plan. She noted that there were 170 phone and internet connections during yesterday's meeting.

CHAIR GIESSEL said that the committee was briefed by Mr. Steve Butt, project manager for AKLNG, about the ongoing Pre-FEED work by the producing partners and the state. He emphasized that now is the time to ask questions, because there is a spend rate to consider. Mr. Butt pointed out that early on \$30 million a year was spent on the project. It is now in Pre-FEED, and it is costing \$30 million a month, which is divided four ways, she explained. The project is at the decision point on whether to move into the next stage, which will cost \$30 million a week. The state is proposing going it alone. The actual construction will be \$30 million a day, so this is not a small undertaking, thus the reason for these frequent meetings. The consultants from Wood Mackenzie (WM) said the project has one of the highest costs in the world and suggested that AGDC could lower costs by getting a third party to take on the debt and the risk, as well as accepting a lower rate of return. The consultant suggested that state ownership could possibly allow for a federal tax-exemption, and it could remove all state taxes from the project. She quoted from the WM presentation yesterday: "Even the removal of all taxes on pipeline and plants is insufficient to reduce the cost of supply below the current level of LNG prices."

CHAIR GIESSEL said that the committee then heard from AGDC, and they have ideas about seeking funding from foreign utilities, pension funds, and other investors who would be willing to take on the risk and take a lower rate of return. The AGDC is opening an office in Houston, Texas, to market the project. She noted that committee members had multiple questions, and there was not enough time to answer them all. She noted a document on the website dated August 23 containing the answers to eight questions to AGDC. She will forward more questions to AGDC as they come in.

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CHAIR GIESSEL noted that AGDC said they plan to solicit a project management contractor (PMC) to have on board by the end of 2016. The AGDC also said, "We will develop cost estimates for the PMC in future phases of the projects." She referred to the Lummus Report, which was contracted by the administration but not yet seen by the committee. Former DNR [Department of Natural Resources] Deputy Commissioner Marty Rutherford previously referred to the Lummus Consultants International, which was contracted to opine on the feasibility and economics of the gas pipeline project. The report was supposed to be completed eight months ago. Last Friday, Chair Giessel renewed the request for access to that report, and yesterday DNR Commissioner designee Andy Mack responded by sending a letter to Lummus asking them to complete the revisions to its report as requested by the administration. "I appreciate Mr. Mack's attention to this and look forward to seeing that final work product," she said.

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CHAIR GIESSEL said this meeting will begin with two law firms that were asked about the state's use of a federal tax exemption that could potentially reduce the cost of supply for a gas pipeline project. She noted that she went through the Legislative Budget and Audit Committee chaired by Representative Hawker to secure the services of the two firms.

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REPRESENTATIVE HAWKER said the administration introduced a new direction a month ago, which differs from SB 138. He said he got the impression that the administration "had a sure thing—a very distinct process forward." It was determined there was not an issue of seeing the concept document, and once legislators saw the document, it raised past concerns regarding "the tax status of both AGDC and whether or not we could see a tax-exempt project under that proposed concept document." To get prepared for this meeting, he approached these two law firms, and both

have extensive history with tax status in Alaska and are very familiar with these issues. He heard yesterday that the board of directors is considering different options, so, although the gentlemen before the committee have done an outstanding job of analyzing the taxability of projects like this, he expects to see things evolve as the administration provides additional specificity.

Legal discussion of State Tax Exempt Status

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CHARLES SCHUETZE, Attorney, Manley & Brautigam, Anchorage, said he has been asked about the federal income tax issues raised by the concept document and the Heads of Agreement for a potential company formed by the AGDC to own, develop, and operate the AKLNG project. There are three primary ways to get a tax exemption for an entity that the state would own. One would be if the entity were to qualify as a political subdivision of the state. Under case law that has existed for "quite a few decades," the entity is required to have been conferred sovereign powers. (This is called the Shamberg Rule). That case dealt with the Port of New York Authority, and the Second Circuit held that [the Authority] had two sovereign powers: the power of eminent domain and certain police powers. He said AGDC has been granted those powers, so it would appear to qualify as a political subdivision.

MR. SCHUETZE said that the [Internal Revenue Service (IRS)] is starting to be concerned about political subdivisions for the purpose of tax-exempt bonds under Sec. 103. In February 2016, the IRS issued proposed regulations defining what a political subdivision would be for that purpose. He noted that the regulations are not final, but they give an idea of how the government might look at a private letter ruling request. The proposed regulations would add a new subsection to say that a political subdivision for purposes of Sec. 103 requires the entity to not only have one or more sovereign powers, it would also have to have a governmental purpose and be governmentally controlled, and it involves showing that there is no private benefit, he added. That could pertain to some options being proposed for owning an interest in an LNG project. The other way an entity can be treated as tax exempt is if it is an integral part of the state, and that generally means that the entity is wholly owned by the state under [26 CFR] 301.7701-1(a)(3). He said that regulation can be relied on as authority.

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MR. SCHUETZE said that private letter rulings tend to go a little further to see if there is sufficient state control and whether the state has made a financial commitment to fund the entity. Both have been established for AGDC, but "it is another question as to other planning options." Finally, an entity could qualify for tax exemptions under Section 115(1) of the IRS code if the income is derived from any essential governmental function and accrues to the state or any of its political subdivisions. For ruling purposes, he said, the IRS also asks for confirmation that private interests will not materially benefit.

MR. SCHUETZE said the AGDC concept document raises certain tax issues of its own. It states that AGDC would organize the company that would own, commercialize, finance, design, build, and operate the project. It does not state what kind of company AGDC would organize to own and operate that project. Currently, AS 31.25.120 empowers it to form subsidiary corporations for an LNG project. If an entity is going to own and operate the project, it is probably not going to be a corporation. Typically oil and gas development ventures in the US are organized as tax partnerships or maybe co-tenancies in order to provide flow-through tax treatment to the owners of all the tax attributes of the venture. They don't have to be organized that way, he said, but they tend to because the investors usually want the benefit of the tax deductions that are thrown off by the venture.

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MR. SCHUETZE said it is likely that AGDC would be thinking about if it owns an interest in the LNG project, it would own it through a subsidiary corporation. If it is wholly owned, then it would likely be tax exempt to the state, but the actual interest in the operating entity itself would be something other than a corporation.

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MR. SCHUETZE said applying the test of whether the operating entity would be a political subdivision and if there is interest in getting a private letter ruling, which most investors will want, then it will be important to look at the IRS position on issuing private letter rulings. The proposed regulation by the Treasury says that a tax exempt political subdivision would need sovereign powers as well as a governmental purpose, and it would need to be governmentally controlled. The organization that would own, develop, and operate the project may be able to show that it has public purposes—the statute tries to address that, he said. It would hopefully be able to show that it exercises

its powers for the benefit of Alaskans: for their well-being and prosperity and for the improvement of their social and economic conditions. However, it will be harder to show that the project does not provide more than an incidental private benefit, considering AGDC may have one or more third parties as owners. The document talks about producer parties, he said. The proposed regulation also requires that a state or local governmental unit exercise control over the organization. Control is defined as an ongoing right or power to direct significant actions of the entity, including the right or power to elect a majority of the governing body of the entity in periodic elections. The concept document states that one or more of the producer parties will be invited to become members of the organization that operates the project. Control will become much harder to establish at that point, he said. For example, the document states that the annual work program budget has to be unanimously approved by the parties each year, which gives all a veto over work program and budget. It is not something that the State of Alaska will be controlling indirectly or directly.

REPRESENTATIVE VASQUEZ joined the committee.

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MR. SCHUETZE said the concept document does not assure that AGDC would control the organization, as it provides for a management committee, and if each member pays its fair share of the fees, each would be able to participate on the committee. Section 5.4 requires that the organization that owns, develops, and operates the project shall conduct all operations. It does not say the state controls the project through AGDC. Conceivably, the operating entity might try to be treated as an integral part of the state. Favorable private letter rulings from the past ask for sufficient state control over the entity and that the state has made a financial commitment to fund the entity. The state may be able to show it has made a financial commitment, but under the concept document, state control over the entity is uncertain. Mr. Schuetze turned to the option of the entity becoming tax exempt under Section 115 of the IRS code, and that requires that private interests do not materially participate in the organization and do not benefit more than incidentally. This comes from Revenue Ruling 90-74, which the IRS frequently cites when it issues rulings under Section 115. Additionally, the entity must be exercising an essential governmental function.

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MR. SCHUETZE concluded that unless AGDC or a wholly owned subsidiary owns the entire project for the project's lifetime,

the operating entity will likely be subject to federal income tax. If AGDC or its wholly owned subsidiary qualify for a tax exemption either as a political subdivision, as an integral part of the state, or under Section 115, the interest itself of the state indirectly through AGDC may be exempt from federal income taxation. He said there is an issue as to whether the government would be willing to issue a ruling under Section 115 on that. If the ruling request were only under 115(2), it may be possible, but it depends how the IRS is going to assert its non-ruling position, because this year, in Revenue Procedure 2016-3, the government indicated that it would decline to issue a tax exemption ruling in a situation where less than all of the income from an entity is being earned by a subdivision of the government.

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MR. SCHUETZE added that if AGDC or its wholly owned subsidiary own a discreet portion of the project for the lifetime of the project, it appears that that discrete portion could qualify, as long as the standards are met. That would likely leave the other parts of the project subject to federal income taxation.

CHAIR GIESSEL asked him to explain a private letter ruling, its importance, how long it might take, and any associated costs.

MR. SCHUETZE answered that private letter rulings are administrative grace from the [US Department of] Treasury. The rulings are issued on specific transactions where the taxpayer asks to be treated as having specific tax characteristics. These cannot be hypothetical, there has to be a specific transaction that has been negotiated and is presented to the government. There is a \$28,300 fee for a ruling like this. If a ruling is substantially identical to another, the cost is \$2,700 for the added one. He gave the example of AGDC, the state, and a wholly owned subsidiary all asking for the same ruling.

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MR. SCHUETZE added that attorneys will charge for preparing the ruling request. The IRS can revoke a private letter ruling if facts were misrepresented or if the government made a mistake, but that is not common. Generally, it is the only way to get certainty, and it is often required as part of business transactions when a major commitment is being made, he said.

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REPRESENTATIVE JOSEPHSON asked if the three contingencies are disjunctive tests or if AGDC must pass through every hurdle.

MR. SCHUETZE said they are disjunctive.

REPRESENTATIVE JOSEPHSON suggested that Mr. Schuetze would not advise that AGDC police powers be weakened. "If anything, they need to be robust and strong." Is that true?

MR. SCHUETZE agreed.

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REPRESENTATIVE JOSEPHSON said it seems as if Mr. Schuetze comes close to recommending that Title 31 be amended to make it clear that there was less separation between AGDC and the state.

MR. SCHUETZE noted that the state has a lot of issues, and many are not tax related, including whether the state would be liable for the operations of AGDC. The Shamberg test is satisfied if there is substantial sovereign powers, he said. The next thing to look at is the ruling position of the IRS as well as the proposed regulations where the IRS would consider whether AGDC has governmental control and a governmental purpose. That would be the primary focus, he said. To show a political subdivision and get a ruling, Alaska would have to look very carefully at the proposed regulation.

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REPRESENTATIVE JOSEPHSON referred to other partners, like ConocoPhillips and BP, and asked if those complications are dispensed with if the sovereign immunity provision is overcome. "We don't need to worry about the second and third parts of your memorandum?" If the tests are disjunctive, and if the state could get a ruling relative to the question of implied statutory immunity, then would the tax exemption be enjoyed?

MR. SCHUETZE said the question is if AGDC would get a ruling under implied statutory immunity. For instance, when the Alaska Gasline Port Authority applied for a ruling in 1999 based on being a political subdivision, the IRS issued a ruling saying that they would be tax exempt based on the representations in the request, but it was not under being a political subdivision. The IRS said it was for purposes of Section 103. He added, "So the very fact that you ask for a ruling ... does not, by any means, guarantee you'll get that ruling from the government. They may grant you a ruling that says that the entity is exempt from federal taxation, but it may be for another reason."

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REPRESENTATIVE SADDLER said Mr. Schuetze gave several reasons how the state could get a tax exemption for this project, and they are very complicated. One thing that piqued his interest is that the AKLNG project must remain wholly state owned in order to be tax exempt. One of the precepts for these types of mega-projects is that financing is aided by carving out and selling elements of it, which is a way to help pay some costs and share the risk. If the status of the LNG project changed such that it did not enjoy a federal tax exemption, would there be a retroactive penalty from the beginning?

MR. SCHUETZE asked if Representative Saddler is talking about getting a ruling first.

REPRESENTATIVE SADDLER said he does not know the regulatory process but assumes it would be getting a private letter ruling first. To retain the status, Mr. Schuetze made the point that the project had to remain wholly owned.

MR. SCHUETZE reworded Representative Saddler's scenario: The state starts out owning, directly or indirectly, the entire LNG project, and at some point in the future, as laid out in the plan, the state will sell off parts of the venture. Mr. Schuetze said he suspects that the government would view that as a negative factor in considering its ruling. Revenue Procedure 2016-3 states that the government would not rule under Section 115 as to whether some but not all of the income from an entity is from exercising an essential governmental function. "They may think that that applies to this example that you gave." There is a vaguer statement in that procedure, he said, about not issuing rulings where the project is designed primarily to avoid the tax. He noted that all business transactions try to limit taxes, so this is in the eye of the beholder, but it indicates possible skepticism in granting a favorable ruling under that circumstance. He stated that there is no way of knowing until the facts are presented to the government.

REPRESENTATIVE SADDLER asked Mr. Schuetze to characterize how difficult it is to obtain a private ruling. Also, is an entity locked into the terms presented in the ruling request?

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MR. SCHUETZE explained that every private letter ruling is based upon the representations of the requestor. If things materially change, a second ruling could be requested.

REPRESENTATIVE SADDLER asked how durable and reliable the ruling would be for the life of the project.

REPRESENTATIVE SEATON asked about the definition of private benefit and if it only applies to ownership and not to investors or things like shipping commitments.

MR. SCHUETZE said it refers to "no more than an incidental private benefit. It's really quite wide open." They are just looking at whether distinct, private parties, as opposed to the population as a whole, might have some particular benefit from the project, he explained.

REPRESENTATIVE SEATON said if the North Slope producers are able to monetize their gas, will that be a private benefit?

MR. SCHUETZE stated that if it is a matter of Alaska, through AGDC, investing in a project to make money for the state, it may be satisfactory. Everyone who lives in Alaska would benefit from the state generating more revenue. But, if it is an entity where the state owns an interest and there are private parties owning interest, "then it becomes a very real concern that there is more than an incidental benefit—if you're talking about the tax status of that entity, itself, that's operating the venture."

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REPRESENTATIVE SEATON surmised that it is the ownership of the pipeline and the money generated from it and the liquefaction, and not that Alaska has 25 percent of the gas and three or four other parties have the rest of the gas. He questioned if private entities shipping their gas down through the pipeline would not influence the tax exempt status for the state if it owned all of the pipeline, and if producers monetizing their gas would not be considered a private benefit. Getting the answer in writing would be fine, but if monetizing the producers' gas is considered a private benefit on this project, that is key.

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CHAIR GIESSEL said the witness is not the IRS and cannot provide a ruling. As professionals, the attorneys are not going to mislead the committee. She introduced the next witness.

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ERIC WOHLFORTH, Attorney, Jermaine, Dunnagan & Owens, P.C, Anchorage, said he has practiced public finance law for "so long you wouldn't believe it—it's actually 60 years this year." He said he was asked about tax-exempt financing where the interest

is exempt from federal income taxes. As currently configured, tax-exempt financing of the gas pipeline is not possible under general tax law. With the use of the line by the three producers, the interest on Alaska or AGDC bonds to finance the project could not be exempt, he explained. Bonds issued by the Alaska Railroad Corporation (ARRC) under special permission in the Federal Railroad Transfer Act may possibly be tax exempt. Obligations issued by the state would be "private activity bonds," and under Section 103 of the tax code, the tax-exempt interest exclusion does apply. Section 141(b) sets up private business tests to define "private activity bond" and is defined under "private business tests," which are twofold: One is the "private business use test," and the other is the "private security or payment test." He explained that both tests must be passed for the exemption.

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MR. WOHLFORTH said the private business use test is passed if more than 10 percent of the proceeds of the issue is to be used for private business. An issue meets the private security or payment test if the payment of principal or interest is directly or indirectly secured by or payable from property or payments used for a private business use. For this project, an issue of Alaska or AGDC bonds might finance the entire pipeline to be used by the state for its share of royalty gas and by the producers for their share. Producers using over 10 percent of the pipeline capacity meets the private use test, which denies a tax exemption. Likewise, payments for such use by the producers would meet the security or payment test.

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MR. WOHLFORTH said one might ask why \$1.4 billion of bonds were financed on a tax-exempt basis for the TAPS marine terminal in the 1970s. At the time, he explained, they were qualified bonds, and they are called exempt facility bonds. In 1977, those were facilities for providing local energy or gas. Additionally, the docks and wharves were a permitted purpose for tax-exempt financing even though privately owned. That exemption went away with the Tax Reform Act of 1986.

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MR. WOHLFORTH said the federal transfer legislation endowed the railroad with unique tax provisions unencumbered by the above restrictions. Recognizing this, the state gave ARRC state financing authority of gas pipelines in 2003. However, tax-exempt financing for this purpose would likely require a ruling by the IRS, and it would be very difficult, if not impossible,

to obtain such a ruling. The IRS has been dedicated to limiting tax-exempt financing. According to the Congressional Joint Committee on Taxation, the tax-exempt bond subsidy is generally considered to be inefficient, because the forgone tax revenues often exceed the value of the subsidy to the governmental issuers, "even though, in our estimation, it may be essential to the vitality and continuance of state and local governments." He said, "In our view, both the intent and the letter of the authorizing state law and that project must be congruent with federal tax law, regulations, and rulings for a positive ruling result." Rulings are typically given only when there is a measure of certainty on financing arrangements. Every ruling request must contain a full description of all facts relevant to the transaction. The IRS is not bound by a ruling if there are undisclosed facts, and any substantial change in the financing arrangement jeopardizes the exemption. He explained that a ruling request for such a large and complex project would take time to prepare, and the IRS response may take a year or more. He opined that there is "only a possibility" that the IRS response would be positive.

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MR. WOHLFORTH said attorneys have been working on the ARRC tax-exempt financing issue since the transfer legislation in 1982. It is possible that congressional intent was to give broad authority to the ARRC. The transfer legislation states that it is "intended to confer upon the state-owned railroad all business opportunities available to comparable railroads, including contract rate agreements..." Historically, railroad holding companies have financed and operated both railroads and pipelines. He said the problem is that when the railroad received tax-exempt financing permission, it was simply a railroad. Other railroad holding companies operated pipelines, but the ARRC was neither a holding company nor did it operate a pipeline at that time, and the IRS could cite this fact in ascertaining the intent of Congress. "In our opinion, the IRS is ultimately unlikely to find authority for a very large pipeline financing to have been within the ambit of this language."

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CHAIR GIESSEL said [the committee] hears a lot about using ARRC bonding authority.

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REPRESENTATIVE JOSEPHSON put forth that there is no doubt that the state and the industry would benefit from a tax exemption. (Mr. Wohlforth agreed.) Regarding the use of ARRC bonding, "what

do you think about the other memorandum from Mr. Schuetze that discusses the implied statutory immunity?" Is that a separate argument that could stand on its own and could be effective?

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MR. WOHLFORTH said the law to issue tax-exempt bonds and the law regarding other tax exemptions have some commonality, but, essentially, the project either qualifies under Section 103 or there is specific permission under the railroad legislation. He said he is not referring to the tax exemption of the income as Mr. Schuetze presented; "I'm talking solely about whether or not interest on bonds could be tax exempt." Some comments apply to both, he said, particularly if a tax-exempt deal suddenly changes character. Bonds may have to be called at that point and can be a huge financial event.

REPRESENTATIVE HAWKER asked Mr. Schuetze if he would reach the same conclusions if project owners with the State of Alaska are institutional investors and are not the producer parties.

MR. SCHUETZE said his memo would pertain to other private backers as well.

REPRESENTATIVE SADDLER asked if it would be futile to apply [for a ruling] based on the ARRC bond authority.

MR. WOHLFORTH said there is always a possibility, but he is providing his best judgement. Other bond attorneys might have a more positive outlook, he said.

REPRESENTATIVE SADDLER asked how much it would cost to make the application to the IRS.

MR. WOHLFORTH said the real money goes to the attorneys. "We're talking in the nature of \$100,000 plus, and maybe even \$200,000."

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SENATOR MACKINNON thanked Mr. Wohlforth for participating as co-chair on a fiscal policy subcommittee "some years ago." She said, "It seems like our worst fears during that committee process as we served together have come true for Alaska." She noted that Mr. Schuetze said AGPA [Alaska Gasline Port Authority] had received a private letter.

MR. SCHUETZE said the number is "2000 20001708."

MR. WOHLFORTH said it is not to be relied on as precedent, but everybody does anyway.

SENATOR MACKINNON said she asked because the governor believes that there is hope in the AGPA proposal, and the letter may still be relevant. She said she has heard the soundbite: "It's our oil. It's our gas." She said she was smiling during this conversation, because the state will be penalized for not taking its oil through the pipeline, because "the premise of getting our fair share that has been argued, at least, in the previous election cycle, was that it's our oil." This legal opinion today, however, is that state cannot get a tax exemption on the state's oil or gas, because a private entity might benefit more than 10 percent or get more than an incidental benefit "when we can't monetize our gas and our oil for the people of Alaska, because someone else has purchased a lease space to try to remove our gas or our oil."

MR. WOHLFORTH said he does not exclude the possibility—and only a possibility—that there could be a tax exemption of a portion of the line that equals the state's 25 percent share.

SENATOR MACKINNON asked if the state could take a segment of the project to make it more cost effective. The state was originally partnered with TransCanada, "and we stepped up and said we were going to take a greater share of the pipeline." She said she supported that because the pipeline is the backbone with a solid 8 percent rate of return, so it seemed fairly secure that once there was a gas commitment and shippers, the people of Alaska would benefit from an 8 percent rate of return through tolling. "Is there a component of the pipeline that would be more advantageous or easier to get a tax-exempt portion on?"

MR. WOHLFORTH said he has not considered that question, "but that would be something to look at."

CHAIR GIESSEL announced that the Legislative and Budget and Audit Committee has a copy of the AGPA application for the private letter ruling, and she will put it online.

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REPRESENTATIVE TARR noted that yesterday Mr. Meyer put forward the idea of having one entity own the pipeline, one own the GTP [gas treatment plant], and one own the liquefaction facility, but it sounds like Mr. Schuetze is saying there is no possibility for tax exemption unless each is a wholly owned state entity. "If the state is one of the owners, and each of

those individual units has other private investment, it sounds like what you're saying is none of them, then, would be eligible for the tax-exempt status."

MR. SCHUETZE said yes. "Those individual operating entities for each part, I would expect that those would be taxable if private parties were members of them." There is still the issue of if the income that flows through the state is exempt from income tax.

Producer Partner Comments on Transition Issues

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BILL MCMAHON, Commercial Advisor, ExxonMobil, Anchorage, said he has 34 years with ExxonMobil, and during his last testimony in June, he discussed the misalignment that was developing between the state and the producer parties on entering FEED [front-end engineering and design] in 2017. The administration was pressing for certain agreements to be in place by the end of the regular session without including a fiscal agreement, which is necessary for entering FEED. Two concepts to progress the project were then presented, he said. The first was transitioning to a state LNG project, so that AGDC could enter FEED in 2017. The other was to pace the four-party Alaska LNG project to match the current market conditions, while continuing to advance the regulatory approvals, reduce project costs, and work on the fiscal and commercial agreements to provide the necessary information for all four parties to make a FEED decision.

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MR. MCMAHON said he wants to set the record straight. At no time has ExxonMobil said the AKLNG project should stop or be put on the shelf. Now that the Walker administration has decided to pursue a state LNG project, ExxonMobil is actively engaged in the plan to bridge from the four-party joint venture agreement (JVA) to a state project. Key components include completing the pre-FEED deliverables and filing the remaining draft resource reports, which are on track for completion in a few weeks. Next, a target date needs to be selected for the handover of all of the JVA lead party responsibilities to the state, and AGDC's target appears to be sometime in the fourth quarter of 2016. Lead party handover sessions need to be scheduled, and the FERC and NEPA progressions need to be handled. ExxonMobil needs to support pre-FEED data access to the state project. "And, then finally," he said, "we need to sell the Alaska LNG project LLC to AGDC," and that will allow Alaska to have access to the land for the LNG plant. The state will also have to buy from them the

DOE [Department of Energy] export authorization, the AKLNG website, and the logo.

MR. MCMAHON said AGDC will then be able to establish its standing with FERC and DOE and demonstrate to potential investors and customers that the state LNG project is open for business. Once the project is up and running, and the JVA pre-FEED winds up and the project management team is disbanded, ExxonMobil will still have a major role in the development of North Slope gas by making it available for sale to the project. The producers have invested billions of dollars at Prudhoe Bay and Pt. Thomson. Pt. Thomson requires additional investment, and much of the current equipment installed can be used for gas sales, including the Pt. Thomson export pipeline. At Prudhoe Bay, the gas has been used for oil recovery, and by using gas for oil recovery the working interest owners have provided over three billion more barrels of oil than originally expected.

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MR. MCMAHON said investment is necessary to allow gas to be produced for a state LNG project, and "we expect AGDC to approach Prudhoe Bay about potentially handling the by-products from its gas treatment plant." Before committing to these investments, ExxonMobil will need robust gas sales and purchase agreements with assurances that purchasers will pay for ExxonMobil's gas. The corporation has always been willing to make its gas available for any project for reasonable terms. "You've been provided copies of various letters that we've sent to the State and to AGDC," he said.

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MR. MCMAHON noted that in July, ExxonMobil sent a letter to Keith Meyer that included an offer to reengage on well-head gas sales negotiations. In December 2015, ExxonMobil sent a letter to Governor Walker saying its gas was available for well-head purchase by the state. In October 2015, the corporation sent a letter to Marcia Davis and to Rigdon Boykin with an offer to negotiate a gas sales and purchase agreement. Finally, "you can go back to 2008 after receiving inquiries from Senate and House Democrats, ExxonMobil provided letters on our willingness to sell or ship gas on commercially reasonable terms" for the AGIA pipeline.

MR. MCMAHON stated that last year Governor Walker sought assurances from each producer that they would make gas available if they are no longer part of the LNG project. ExxonMobil immediately established a negotiating team, executed

confidentiality agreements with the state, and had several preliminary meetings. With the advent of a state LNG project, ExxonMobil remains ready to negotiate gas sales and purchase agreements—under commercially reasonable terms. "And, of course, ExxonMobil has had confidential, bilateral gas marketing conversations with the state as contemplated under Senate Bill 138," he said. The conversations have been on hold, but the company stands ready to restart them. ExxonMobil remains committed to commercializing the natural gas resources on the North Slope and is willing to work with any interested parties to explore all options.

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DAVID VAN TUYL, Regional Manager, BP Alaska, Anchorage, said BP has always seen a tremendous opportunity for getting Alaska's gas to market, and it still does. The opportunity for gas is of such a scale that it is unique on the planet. Alaska gas is the single, biggest undeveloped resource in BP's portfolio. If it can get the gas to market, BP can sell over 1 billion barrels of oil equivalent. "That is huge to BP," he said. This can become Alaska's reality. In 1977, oil producers all thought Prudhoe Bay gas would be sold into Lower 48 markets within five years. When the market was deregulated, gas price collapsed, and the project was put on hold. The timing was not right, and it is absolutely better that Prudhoe Bay gas was preserved in this way. "We were all blessed with a silver lining." Commissioner Cathy Foerster of the Alaska Oil and Gas Conservation Commission (AOGCC) said if BP sold gas in the early 1980s, Prudhoe Bay would have produced only 8 billion barrels of oil, and other fields likely would not have been developed. The gas was used to increase oil recovery, he said. "We have produced, to date, over 12 billion barrels of oil." There are still about 2 billion barrels more to produce, and there are over 4 billion barrels of oil equivalent in gas. This Prudhoe Bay gas combined with gas from Pt. Thomson can underpin an Alaska LNG project, and BP has invested billions of dollars at those fields and continues to invest to help make gas available.

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MR. VAN TUYL said there have been other attempts to monetize North Slope gas. This current effort began in 2011 when gas in Asia was over \$15 per million BTUs. Governor Parnell asked BP and others to work with the state to determine the feasibility of a new project—called AKLNG—that could get gas to Asia in mid-2020. In January 2014, the parties signed a heads-of-agreement and asked the legislature to pass SB 138. The confidential bilateral gas marketing conversations between BP and Alaska were

important. He said BP is willing to make its gas available to a project under commercially reasonable terms. It has spent over \$600 million, and AKLNG continues to make good progress.

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MR. VAN TUYL said that the shale gas revolution in the Lower 48 has changed the gas supply picture. The cost of supplying Alaska gas to Asian markets is estimated to be too high to compete. That's the reality, and in its current form, the project does not compete, but there are game changing opportunities for Alaska LNG that are worth pursuing. He said LNG is a commodity. "We want to be able to make a competitive offer." He said BP understands the state wanting to move ahead. It also understands Alaska's fiscal needs, and Alaska should know that BP wants to move the project forward. The FEED phase will cost a lot and deserves a careful evaluation before BP commits. "We don't want to rush into the largest energy project in North America only to end up losing lots of money," he said, and now is not the right time for BP to make a commitment. He suggested reducing the cost of supply with a state-led project, "and we support the state's efforts." He said BP is determined to find a way to lower the cost of supply.

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MR. VAN TUYL suggested a more commercially-efficient structure, and it is not unusual for a large project to restructure as it matures. A state project could be the best structure. Why? "Well, we heard from Wood Mackenzie yesterday that if the AKLNG project were restructured with the utility-like toll, it would represent a major step-change in cost of supply," he stated. State ownership could provide that structure. That step alone—converting the upfront capital into a toll over time—could allow the project to compete globally. He said it was clear that the many details will matter. State ownership could lower federal taxes. As a tax-exempt entity, the state may be able to deliver this important cost reduction, he said, but, obviously, a tax exemption is very much fact dependent. The state-led approach allows the state to shape its policies to improve the competitiveness of the LNG project, he added. Since BP thinks the state-owned structure can improve costs, it has been working with the other parties to achieve a number of things, like transitioning, finding other concepts that have been successful in global LNG projects, transferring information, and providing access to assets so AGDC can file a successful FERC application.

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MR. VAN TUYL noted two things important to BP: project financing and efficient advancement and delivery at or below its estimated cost. The company is considering what form of support it will provide. "We want the project to seamlessly continue and maintain momentum." If the project is successful, BP can sell its gas. The project's success is good for BP, the state, and many Alaskans, but the core facts are the same. Prudhoe Bay is one of the world's most prolific basins. The Pt. Thomson gas condensate field is producing now and has even more gas to play for. "We are aligned on our need to continue to look for opportunities, to reduce the cost of supply for Alaska LNG, to provide a solid future for BP Alaska and the state."

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DARREN MEZNARICH, Project Integration Manager, ConocoPhillips, Anchorage, said he is leading the company's efforts to monetize North Slope gas. ConocoPhillips supports the completion of pre-FEED work, which is expected to be done in the next few weeks. He noted the significant contribution of the project team; however, ConocoPhillips is unlikely to directly participate in FEED for the project in 2017 due to the significant economic headwinds and other challenges. If one or more of the parties, including AGDC, wants to proceed, ConocoPhillips is willing to cooperate in a transition, including the sale or other transfer of ConocoPhillips assets related to the project.

MR. MEZNARICH said the state and AGDC have indicated an interest in continuing under AGDC's leadership, and ConocoPhillips is working with all parties to facilitate that transition. The new concept of a state-owned project and tax-exempt entity is a paradigm shift, and they recognize the creativity of the state and AGDC for offering these concepts, which may improve the project's competitiveness; however, there are many questions. Also, AGDC has identified a series of questions they are pursuing to prove out the concept. These types of management questions seem reasonable if the legislature and administration make decisions as the project moves forward.

MR. MEZNARICH said ConocoPhillips is willing to make its gas available on commercially reasonable terms, and it expects to support AKLNG through its ongoing North Slope investments. He recognizes that the legislature has questions as it considers this plan going forward, and ConocoPhillips' actions are intended to help the legislature and the administration get the necessary information.

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REPRESENTATIVE SADDLER said he heard Mr. Van Tuyl say that state ownership was the best course of action and asked if there are any factors other than the state's desire to progress in the face of the economic conditions that make the switch to a state-owned project the best course of action and why that wasn't the first concept.

MR. VAN TUYL said he will answer why BP didn't look at this different structure first if it now appears to be the best. Typically, he explained, in any major energy project, BP looks at an equity model and emphasizes alignment in interests among the parties. That is the pathway set out in the HOA and that is what was envisioned under SB 138. He said BP spent \$600 million and then found out that the project does not compete, which was compellingly shown by Wood Mackenzie consultants yesterday.

MR. VAN TUYL said he also made it clear in testimony that that alone doesn't say it is time to stop. This incredible resource is available, and BP wants to get it to market. If that method doesn't work, is there another way to be competitive in the global marketplace? "It looks like we've identified, at least, an option that was outlined by Wood Mackenzie in a tolling model that seems to, at least to us, to be worth pursuing." That is why BP will continue to cooperate and see where this potential might lead. Regardless of the commercial structure, BP needs to make sure the project is financeable and technically executable, which is really important for mega-projects. This pathway is worth pursuing, he said, because the stakes are worth it.

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REPRESENTATIVE SADDLER noted that the two tax attorneys told the committee that getting tax exemptions for this project could take a year or more. He asked what BP could do in that year if the process was held in abeyance while the tax exemption questions are answered.

MR. VAN TUYL answered that much work needs to be done in framing out the specifics of this structure. While a tax exemption would be a great benefit, it is not the only biggest benefit. Wood Mackenzie's work showed that 80 percent of the benefit was derived from the tolling structure, and the balance was from federal and state taxes. Is it an avenue worth pursuing? Sure, but there are technical challenges and details that have to be worked out in specificity to be able to make a cogent request to the IRS to enable such a ruling. "You have to do quite a bit of homework to earn the right to ask to begin with."

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MR. MEZMARICH added that ConocoPhillips still sees the producers as participating in the project. Wood Mackenzie estimated \$10 billion in upstream investments, so there would be that investment as well as making the gas available. "It's not like a stoppage of the upstream participation," he clarified.

MR. MCMAHON said he thought the State of Alaska could do three things during that time, including pursuing the NGA Section 3 application. He explained that the AKLNG participants understood that the regulatory process was a critical path for this project. Another thing that could be pursued during this time is to secure gas supply for the project through either purchases or tolling agreements. And then, finally, for customers to be able to use the project, either by selling gas or tolling, they will need to understand the fiscal terms so that they have confidence that when they receive a check for gas or when they receive an invoice for tolling that they know what they are paying for and that it is not eroded by changes in taxes.

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SENATOR DUNLEAVY asked for clarity for the average person on the street. Is the project envisioned under SB 138 now dead because of economics? From the producer's perspectives, is the project not moving forward as a result of the work done in the pre-FEED?

MR. VAN TUYL answered that BP's perspective is that the project struggles to compete in the global marketplace.

SENATOR DUNLEAVY said that some can interpret "struggling" to mean it is dying; it's dead. He said he would get calls from the average person on the street asking, "What did they say?" So, the project is dead, and now "we" are talking about looking at a different way of doing it?

MR. MCMAHON responded that the nice thing about the gated process is the checking points after each major expenditure. "We spent \$500 million on pre-FEED," and now ExxonMobil is looking at what the commercial structure will be for governing FEED, the fiscal terms, and how cost of supply competes against other projects around the world. At this juncture, ExxonMobil needs to stay in pre-FEED before making an affirmative decision to move into FEED. This was discussed in February, and one thing the company offered at that time was to continue to stay in pre-FEED, keep the four parties' interests together, and work through until all parties say yes to move into FEED. An alternative was discussed where the state could move into FEED.

MR. MCMAHON stated his understanding that AGDC intends to build on all the work that has been done in pre-FEED. It is the same LNG plant, the same gas treatment plant, and the same pipeline that connects Prudhoe Bay and Pt. Thomson. What will be changing are the participants, project funders, and how the gas is going to be accessed. Under the four-party arrangements all parties have gas, all four invest, and all four have capacity, and now AGDC is looking at a structure "where they will have to access gas to go through a 100 percent state-owned project."

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MR. MEZNARICH said he does not see this as dead. "We are not going to give up on this resource. The resource is too big for all our companies; it's too big for the state, so I'm never going to say it's dead." The technical work is done and now ConocoPhillips has to look at the economic headwinds and the agreements, which are not ready. It is not economic right now, so the company is trying to find a way to move forward.

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SENATOR DUNLEAVY said no one is giving up on the resource, because it's there, but the envisioned project is not going to move forward. "I don't see you folks investing the money into it at this point as it was envisioned." It is important to say that Alaska is probably the only sovereign that chases you guys to make you do something. All over the world there are resources that the producers see that they want to develop, "and it just seems that there are times in Alaska, and this is, I think, what we're seeing unfold here in the last two days, is a situation where it is not economical from your perspective, which is understandable. The question is going to be, if it's not economical from your perspective, how is it economical from the state's perspective?"

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REPRESENTATIVE HERRON noted that Mr. McMahon referred to mischaracterizations and that he wanted to set the record straight, but he testified that he very much supports this project moving ahead although it is state led. "Is that true?"

MR. MCMAHON replied, yes, that is true.

REPRESENTATIVE HERRON asked if he is talking to contractors or other people to help in this transition.

MR. MACMAHON answered that the conversations he is involved with on this transition from a four-party to a state LNG project have been primarily with AGDC to make it a smooth handoff. He knows that Steve Butt and the project team are having similar discussions to make sure that the technical work can be handed off seamlessly and efficiently, as well as the regulatory work. Of course, the AKLNG participants do have contractors involved in that work, and some of those contractors are involved in those conversations. "We do have the full team, both commercial and project, working to build a successful bridging to a state LNG project," he explained.

REPRESENTATIVE HERRON asked if there are other entities outside of those two groups of people.

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MR. MACMAHON said no.

REPRESENTATIVE HAWKER noted that Mr. Meyer at AGDC discussed the actual marketing of Alaska's gas, and it sounded like he said that AGDC is actively marketing gas, not only the state's gas, but he referenced marketing "a company's gas," which he didn't name, and that other companies might want AGDC to market their gas. He asked the witnesses if they agreed with the state for joint marketing.

MR. VAN TUYL answered that the short answer for BP is that marketing of gas is a sensitive issue subject to U.S. anti-trust laws and other law, and BP takes it very seriously. If there was implication that there was some sort of a "joint marketing arrangement," it is nothing that BP would be involved with. He heard the testimony and didn't know if Mr. Meyer was referring to marketing of gas or, more generally, marketing of the project and of an awareness of the project.

MR. MCMAHON responded that he has just explained how ExxonMobil continues to make its gas available to the State of Alaska and AGDC. Perhaps, Mr. Meyer was relying on those offers from ExxonMobil.

MR. MEZMARICH agreed that marketing is sensitive to talk about. ConocoPhillips feels that JV [joint venture] marketing would have been the best method for the project to have a single face in the market and jointly work together. But there is no agreement now to pursue joint venture marketing.

CHAIR GIESSEL thanked the witnesses and said their testimony will be available to the public online.

Legislative Consultant Comments: analytica

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CHAIR GIESSEL welcomed the next witness.

NIKOS TSAFOS, Legislative Consultant, analytica, Washington, D.C., noted that analytica is a consultant to the legislature, contracted through the Legislative Budget and Audit Committee. He said this is a big project, and if it gets built, it will be around for a really long time, "and stuff's going to change." People will come and go, as will investors. The gas might be on line in 10 years and run for 20 years, "so we're talking about getting our money back by 2046." He said that 2046 forward is kind of the same thing as 1986 backward, and in 1986, there was a Northwest Shelf project in Australia that had just made a final investment decision where investors were looking at getting their money back in 20-25 years. The Cold War was going on; Chernobyl had not happened. China was just opening up, and the European Union was about 10 members. There was no Google or cell phones, and this Northwest Shelf project would have to survive through all that. He said that Kenai goes back to 1969 and shipped its first gas during the Vietnam War. His point is, he said, is that "stuff is going to happen; you're going to have to pace yourself." It is difficult to manage this process if every time the commodity goes up or down, everyone throws their arms in the air and wants to start over. It takes patience and powering through.

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MR. TSAFOS referred to a state-led project and said there is merit in an expanded state role, and he has no philosophical objection. He has worked with national oil companies and state institutions around the world, and some are great and some are terrible. "There's nothing beforehand that tells you how it's going to end up." There are things the state can bring to the table that are really valuable and worth exploring. Listening so far, he said, he has way too many questions about how this will work, who is taking on what risk, and how things will play out; therefore, it is important to remember the core principles.

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MR. TSAFOS referred to Slide 3 of his presentation. He said Option 1 is where AKLNG becomes a state-owned tolling project. He clarified that he is speaking to his interpretation of "what

is going on," and it is not necessarily exactly what is on the table. Alaska LNG has a treatment plant, an 800-mile pipeline, and a LNG facility, with 75 percent owned by the producers and 25 percent owned by the state. "Throw that [plan] out," and now it is 100 percent owned by Alaska. As the owner of the infrastructure, the state will find people to use it and get long-term commitments. They will pay "your tax." If the state decides to take its gas as gas, the royalty-in-kind, and the tax as gas, then the state may sign up with itself. The departments of natural resources and revenue could sign up with AGDC to use the facility, and they could pay a tax. These contracts—whether they are with the producers, departments, or other folks—can be taken to banks or investors when asking for money.

MR. TSAFOS stated that Option 1 relieves the producers from spending between \$45 and \$65 billion, because the state will. Like deciding between buying and renting, it depends on what the numbers are. He said renting a house could have much less stress, so companies who ask their board for 30 percent of \$45 billion will get different responses than asking for 30 percent of \$10 billion, which is what Wood Mackenzie said is the upstream costs. Additionally, Option 1 takes away some of the project complexity. The state will not sue itself over property taxes, for example, so payment in lieu of tax is unnecessary, but there will still be proportion questions for the state and local communities. The state has to do that anyway, "you just can get rid of the producers ... so that simplifies things." The need for fiscal stabilization may change. "If you spend \$45 billion, you want fiscal stabilization," but spending \$10 billion over 15 years, may lower the demand for stringent stabilization. He said he is just speculating, however. None of this does anything about the cost of supply, except maybe a federal income tax exemption. "I don't know what your take-away was from the previous presentation [on tax exemptions]. My thinking was: I have no idea."

MR. TSAFOS noted the above benefits, but if this is an uneconomic project, all the state has done is take over an uneconomic project. Option 1 shifts some responsibility from the producers to the state, and how much it shifts really depends on the structure. There are ways to protect the state, he stated. In Indonesia, the state owns the liquefaction facility, but it is operated by a consortium of the suppliers. The suppliers' goal was to make sure the facility worked well, so they wanted "to be in the room," and it works for them. Option 1 has some benefits, but it does not go very far, he summarized.

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MR. TSAFOS turned to Option 2, which is similar, but the state is "starting to treat the formula to really do something to the cost of supply." He said the committee was essentially provided that information from Wood Mackenzie in trying to make the project more economic, but there are risks. The state could lower its return to 7 percent—or keep lowering it until it works, and that is not a good position to be in. At this point, there is a delta between the price and the cost, and the state is the one that will absorb the delta. He asked what kind of return is acceptable. It is easy to build a \$50 billion project, "if you're willing to lose \$50 billion." Knowing the desired return is a really good conversation to have.

MR. TSAFOS said that the price of LNG will go up again, and when it does, because the state has lowered the tariff to match the current price, all of the money will go to BP, ExxonMobil, and ConocoPhillips. The state will be very upset and will try to raise taxes to get that money back. In this structure, the state has no production tax, and "you're not really making any of the upside." After taking all of the risk and accepting a low rate of return, the money will all go to the producers, and that will not be sustainable. It is important to talk about risk and return and how to balance it. "How do we talk about that?" He urged the state to really bring the producers on board and say, "Okay, what are you guys doing to make this more competitive?" It should not just be the state accepting a low rate of return; the producers need to commit to doing something, because if the state makes the project economic by lowering its return, the producers do not have to put any effort into reducing costs.

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MR. TSAFOS turned to Option 3 on slide 5: "the scary scenario." It is unnecessary and super scary, he said. It is called the merchant plan in the LNG business, where the state would still own everything, but rather than charging a toll, the state would just buy the gas. There are endless ways to do this, but the state could buy the gas at the wellhead and sell it in Nikiski. In one scenario, the transactions are linked. For example, the state buys the gas at the Henry Hub price and sells it for Henry Hub plus x. In that case, the state is performing an unnecessary function, because if that makes sense, the producers will do it themselves. The only question is whether x is a good enough number, and that can be tweaked by lowering the rate of return—so, really, it is completely useless to do this.

MR. TSAFOS said, alternatively, the state could buy at Henry Hub and sell the gas at an oil-linked price. This is probably the scariest of all options. It is a cross-commodity risk that no oil company would take on. "I'm not saying that you're going to do this, partly because nobody would lend you money to do this," but he gave an example: The project is running and the state buys 75 percent of the gas at Henry Hub. It is financed on debt, because outside of the permanent fund, Alaska does not have any equity. The state pays a little property tax and runs the facility. If the state then sells this gas to Japan at the market rate of \$7, Alaska would be about \$1 billion or \$1.5 billion in the red for the year. He said, "Cash, not profit." The state would need that much money just to pay the bills. He purported that no one would do this, but there might be a chance that this is being contemplated.

MR. TSAFOS noted that he has said this before: If the producers are willing to sell you the gas, don't buy it. If they are willing to sell the gas to the state, it means that they think they can get a better deal than if they had built the project and sold it on the market. The only way the corporations will sell the gas to Alaska is if it is unprofitable. "Don't buy it."

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MR. TSAFOS said his final topic is the duty to produce. "It's sneaking up on us." When he thinks about the duty to produce, he assumes a court has ordered someone to produce and sell the gas. He cautioned that he is not a lawyer, but he assumes also that there is someone that has to buy the gas. A court would be telling Alaska to buy it. He provided the following scenario: In round numbers, there are 30 TCF [trillion cubic feet] of gas on the North Slope, and Alaska has 25 percent. So, Alaska would buy the other 75 percent, or 22.5 TCF. If Henry Hub was \$3.00, Alaska would pay \$66 billion and would have to build another \$50 billion worth of infrastructure, "so on Day 1, you're minus \$116 billion." He said he is not saying this will be the structure, but when starting down this path, this is where it will lead, and he cautioned the state to be careful what it gets into.

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MR. TSAFOS turned to "Core Principles" on Slide 6. He said if the LNG project is led by the state, it really needs a credibility boost. He noted that he hangs out with people in this industry, and people often ask him if "that Alaska project" is ever going to work. When he says that ExxonMobil is the lead party, that there are 80 people on the project management team, and the parties are spending \$700 million on FEED, people

conclude that if anyone can make the project work, it's ExxonMobil. The question now is if the state can pull it off. He stated that there is a slight deterioration in confidence, so Alaska needs a plan to address that.

MR. TSAFOS turned to the topic of outsourcing risk. Outsourcing construction risk depends on the costs, and there is the question of what happens if things go wrong. A lawsuit in Australia has been mentioned here, and there are other projects where contracts go wrong in spite of an agreement. "At least the lawyers are going to make money," he said. If the state has to pay 25 percent or so to fix the price, then what is the benefit? The idea that someone else will take the risk and that it will be cheap, "I think really has to be demonstrated." What about other folks willing to participate for a low rate of return? He said this has been a cornerstone [of the new plan] that there are all these infrastructure funds, pension funds, and others "that are really going to look at this and think it's great." He said he has about six responses to that notion.

MR. TSAFOS said, first, he looked at who owns LNG around the world, and he may have missed something, but he found three instances of an infrastructure-type fund that have really invested in LNG facilities. One is the Yemen Pension Fund investing in Yemen LNG, and it is not applicable, he said. China Investment Corporation is a Chinese sovereign wealth fund that manages the foreign reserves that are accumulating through the trade deficit. It bought a 10 percent share in Atlantic LNG in Trinidad in 2011, 12 years after the project came on line. It was part of a corporate deal with GDF Suez (now called Engie). The third example is the Yamal LNG in Russia, where China's Silk Road Fund, another sovereign wealth fund, has taken a 9.9 percent share of Yamal LNG as part of a broader financing packet of Chinese banks to Yamal and as part of Chinese NOCs [national oil companies] buying Yamal gas and equity. He said that is the only example that looks a little bit like "what would happen here." There are not many examples, so Alaska needs to really talk about exactly who these players are.

MR. TSAFOS noted that TransCanada wanted a 12 percent return without taking any risk. The legislature had asked enalytica if 12 percent was legitimate, and after looking at FERC regulated pipelines, enalytica concluded it was. The range was from about 9 to 18 percent return on equity, and weighted average cost of capital, when debt was added, was around 10 percent. Canada regulates return on equity, and it is about 8 or 9 percent.

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MR. TSAFOS said his third point, "when I look at the Wood-Mack number, it comes down to about \$4, if you eyeball it, if you do the 8 percent rate of return plus a 70/30—remember that dark blue thing." Mathematically, that is totally legitimate; however, the Corpus Christi LNG facility developed by Cheniere, which is completely greenfield, is charging \$3.50 for liquefaction. There is no pipe or GTP [gas treatment plant], he added. "This is essentially what you hope a third party would be." In earlier deals, Cheniere was more desperate so it charged as low as \$2.25 and \$2.49 for brownfield, and by the time it got to greenfield, it was \$3.50. He said he would like to see more data before understanding the likelihood of someone offering a \$4.00 tariff for this entire facility, because "that's not really the number that I see out there."

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MR. TSAFOS turned to construction risk. He said he asked a noted LNG company why it was building a project on its balance sheet. "Why can't you just bring in an infrastructure fund and have them buy some of the equity and take it off your balance sheet?" The answer he was given is that the company will not take construction risk, but when the project is up and running, proven, and operational, it will sell off 10-20 percent, and "we're going to keep operatorship, there will be contracts, and at that time we may be able to monetize and sell down." Mr. Tsafos pointed out the Queensland Curtis project in Australia. It is a BG-led project (now owned by Shell), and it built a massive pipeline gathering system. It built the pipe and sold it to a pipeline company after it was operational. It was fully contracted with tariffs and was sold for about \$6.4 billion. Turning to "this question of 8 percent," he said the permanent fund makes about 5 to 6 percent, and about 20 percent of it is US treasuries, which do not really earn anything. To get to an average of 6 percent, "there's lots of stuff that are way higher," so it is difficult to justify an 8 percent return with a commitment to a project of this complexity. He said he is not saying it is impossible, but most of the data points that he has gathered makes him question whether there is a strong appetite for this type of investment.

MR. TSAFOS turned to the topic of veto rights. He has noted a huge emphasis in Alaska about "not letting anyone hold you back." However, no one is going to just come along for the ride without having a say. No one will buy into a \$45 billion project and surrender their right to say no. He said the question is not having veto rights, "it is how much you have a veto over."

Building the project is the only thing that no investor would ever surrender. "It's hard for me to see a restaurant deal where you would surrender to your two partners that have 60 percent the right to build the restaurant, and you have no right to say whether you want to do this or not." There is no way an investor would do that, so either you do it alone or you do it with others, and they have veto [rights]. It is difficult to see any middle ground, he stated.

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MR. TSAFOS turned to financial engineering. The return is supposed to be driven by the project risk, not by who is investing. When permanent fund investors look at an investment, they do not ask how it can make a 6 percent rate of return, they ask, "What is this investment?" If it is a US Treasury, there is a lower threshold than a bridge in the jungle. Rate of return is a project level concept. Additionally, when someone borrows, expected equity has to increase. "If I go into a project, and I put in 20 percent equity and borrow 80 percent ... it means that I am not going to see any money until the bank gets paid, and if it's 80 percent leveraged, there is a good chance it might be years I don't get any money, which means that the risk of that 20 percent is much higher than if we'd done it 50/50." He referred to his corporate finance textbook, which basically says, "Don't think that you can just lower the cost of capital by adding debt." By adding debt, you have to increase the return on equity, he explained.

MR. TSAFOS said that it all comes back to risk and return. If Alaska will accept an 8, 10, or 12 [percent rate of return], what is the upside? What will it get out of this? Why have state ownership? There is a spectrum from the current structure to the state taking over the project, and he can think of about six permutations between those two options. "We've gone from one to the other, and I have no idea why we're not doing any of the things in between." At the beginning, it seemed to be a way to avoid delay, he said, and Alaska is now looking at a mid-2018 FEED decision, which seems like some of the companies "could have gone there on their own." It is not clear why Alaska has gone to this extreme. "I'm not really a big fan of windows; as you saw from Wood Mac, it is not really a window, it's a wedge, and it always keeps growing." He described it as an opening that can just get wider. "If I try to sell you gas for 2040, it's a really big window, because no one's there." There is no one on the other side to buy it, because no one cares about 2040. Trying to make a window is an invitation to make bad decisions. Ten or twelve years ago, someone might have claimed there was a

window to build a pipe to the Lower 48, and Alaska would have lost considerable money if it had.

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MR. TSAFOS referred to a letter from ExxonMobil to AGDC where it seems like there is a 2017 work program and budget. Before that is all tossed out, it would be interesting to know what is in that. "How far did it get us? What kind of progress did you make? Can you build on that?" He said he would love to know more about that and if there is something between where the project is right now and where the state takes everything over. There are options between those two, and he wants to know why Alaska is not pursuing them.

MR. TSAFOS spoke to organization. Frankly, he said, for the three years he has been [on this project], the same one or two people have been representing each of the producers, but on the state side, there have been numerous people representing its interests. But in all that time, Steve Butt of ExxonMobil has been representing the project. He said he understands political changes, but there have been many others. He suggested understanding the organizational plan. Mr. Butt said that there are about 150 people working on the project, and when it gets to FEED, there will be up to 600 people. "Where are they? Who's going to pay for all these folks?" That is something to talk about. He said it is difficult to go to the market with 10 permutations of the plan.

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MR. TSAFOS turned to questions about financing plans and tax exemptions. It has been two years since the Joint Venture Agreement and almost two and half years since SB 138, and "I don't think we have any better idea about the answer to these two questions than we did on SB 138." He spoke of all the discussions and studies that occurred without gaining more information. The testimony an hour ago on tax exemptions was the first new information on taxes. "It's been two years, right? At the same time the project has gotten a DOE export application started, FERC has bought up half the Kenai. There's kind of like steps to that process, and you have to go there." Regarding tax exemptions, he asked about the compatibility of telling the IRS not to tax AGDC because it is basically the state, and then when dealing with the debt, claiming that AGDC is on its own. Another question he has is if the tolling structure gives all the upside to the producers, would it be a private benefit? If Alaska is buying and selling gas, unlike infrastructure, is it really a core state function?

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MR. TSAFOS asked who the target investors are. There seems to be a lot of emphasis on the ability to attract investors, and he would like to see more case studies where this has worked. He said he wants to revisit the risk sharing strategy, which is key. "How far are you willing to go to get this [project]?" Who will share the risk, and how are they doing their part? But he cautioned not to forget the upside—it is easy to be pessimistic, because the price of gas is low and the state is in trouble, but this is a 30-year endeavor and prices will go up. All of the committee discussions are about making the project competitive at the low end and allowing the producers to capture all of the upside. That doesn't sound right, he concluded.

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REPRESENTATIVE TARR noted that the state now shares the risk equally with each of the producers with all parties wanting the project to come in under budget. What is really troubling is putting the state at risk. She asked Mr. Tsafos if a state-owned project would put all of the risk on Alaska.

MR. TSAFOS said Alaska would likely not have 100 percent of the risk. The market could tank, for instance, so the producers will have some risk. Or the state could raise taxes if the producers make too much money, but, really, the overwhelming amount of risk will shift to the state. To pass risk to parties other than the producers, the state will have to pay for it in the form of higher costs, higher debt, or giving up equity, for example.

SENATOR MACKINNON asked if the length of gas contracts has changed. When these discussions started, Mr. Tsafos said that contracts that were coming due for renewal in the 2020s were typically 20- to 25-year contracts. Does that hold true today with the flood of gas on the market?

MR. TSAFOS explained that the average duration of contracts are going down. People want shorter contracts and flexibility, but new projects are still generally anchored with long-term contracts. He stated that some folks sign up for long-term contracts and then regret it. It happened in the Gulf Coast with some companies. At times a project will get a 20-year contract, but a middleperson will sign the contract and control and distribute the gas. He does not know of any project since a few years ago that took FID [final investment decision] without any contracts. Most are still anchored by 20-year contracts.

SENATOR MACKINNON stated, "If contracts for already-in-existence projects or gas that's being produced elsewhere in the world is going to shorter contracts, then we go to a middleman—my guess is. People continue to refer to these flexible terms, and we have had some indication on what those might be. It might be a destination where you drop and deliver the product. It might be the quality of the project if you mix the molecules differently." She asked about the flexible terms that have been referred to in the last two days.

MR. TSAFOS said there are a number of things that buyers mean by "flexibility." The biggest source of flexibility is destination. Generally, if a buyer no longer wants a contract and wants the gas shipped elsewhere, the buyer has to break the contract. Destination flexibility removes that clause, which is illegal in Europe, because it is anticompetitive. "Asia hasn't gone there yet, but they're waking up to it." Basically, it allows a buyer to sell unwanted gas to someone else without consulting with the seller, he said. Volume can also be flexible. In a typical contract there is "downward" flexibility, and a buyer usually has to make that up later. The flexibility would be in the ability to take less if the buyer does not want it. In the Gulf Coast, for example, if someone buys LNG at a certain price plus a liquefaction fee, the seller may say that the liquefaction fee is how it pays its debt, so that part must be paid; however, the buyer is not forced to take and pay for all of the gas. In other words, "You still have to pay the tariff, but I'm not going to force you to take on a cargo that you don't want." That is a form of flexibility that buyers really like, he stated.

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SENATOR MACKINNON said the price could dive or spike incredibly. Sometimes there are relationships and risk and reward on both sides of that contract, "so is price ...?"

MR. TSAFOS said the price is negotiated, and it comes down to how the price is set and the price boundaries. If Alaska were to ask for a minimum price, the buyer may agree but then hold down an increase if gas prices go up. That is a form of risk sharing where the seller wants a price to be protected from the downside, and the buyer gets protection at higher prices.

SENATOR MACKINNON said her understanding is that the global supply of gas is starting to stabilize—demand is beginning to meet supply. Will Alaska see a discounted rate for the project to get a 20-year contract when using a third party financier?

MR. TSAFOS said he does not know. In the Gulf Coast, there is no price difference for a buyer who is buying the gas for someone else. The price depends on the market, and generally there are four-year or five-year cycles of high and low pricing. It is really down now, but that is what determines the price. There are times when companies choose to make disadvantageous deals to be the first to capture a market or such.

SENATOR MACKINNON said the producers have said they need a 20-year contract from the state. They are asking for financial conditions that constrain the state through a vote of the people of Alaska to a fixed price. Please comment.

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MR. TSAFOS said he suspects that their requirement for fiscal certainty will change if their capital commitment goes down to \$10 billion over 10 years relative to \$50 billion over 5 years. He said he is only speculating, but a bigger commitment would call for more certainty. If the producers are shipping through Alaska's facility and the price goes up, all the profits go to them, so there will be a great temptation to increase taxes. With buying the gas, there is no upside or downside—there is just a transaction that might not have the same exposure to potential tax changes. The tolling model shifts revenue to the resource, so if the price goes up, the resource makes all the money, and that would be good for everyone—except Alaska.

REPRESENTATIVE JOSEPHSON referred to the change in the gas team lead for the Alaska administration. Even though this new pathway could affect the ultimate timeline, do you agree that there is nothing the administration has done that is prohibiting FEED from occurring as originally scheduled next spring? The committee hears repeatedly that Alaska's partners are not ready to enter FEED, and the administration has not done anything to cause that.

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MR. TSAFOS said he is absolutely correct. The question is how the state responds to the producers' decision to not go to FEED.

REPRESENTATIVE JOSEPHSON said his colleague made comments about the new director of AGDC that troubled him. "We voted for the power to hire him by a vote of 52 to 3, and I think the record should reflect that." He said that Mr. Tsafos has made some good arguments for the state to be cautious. He noted that AS 31.025 empowers AGDC to do what it is doing, and the legislative role

is the power of the purse. He asked if Mr. Tsafos believes that nothing that AGDC is suggesting in this pivot is prohibitive.

MR. TSAFOS said that the legal interpretation of SB 138 is above his pay grade.

REPRESENTATIVE JOSEPHSON noted that Mr. Van Tuyl said, pretty effusively, that the state-led project could be the best structure going forward, "and I think he was the most effusive of the three." What do you make of his testimony relative to your very compelling precautionary statements?

MR. TSAFOS said he has no qualms with what Wood Mackenzie presented yesterday. "I started off by saying I think there's a good merit for the state to consider a bigger role. I have no objection to that. I think that makes a lot of sense." His message today is that, "If I was taking over a \$50 billion project I would be a lot more worried than I feel folks are worried." There is so much that comes with it, and most of the things that have been offered as reassurance have yet to reassure him. He said he does not necessarily disagree with Mr. Van Tuyl, but he is not sure if a state-led project is the best way. There are possibly other ways Alaska could approach this. It is a whole other world that Alaska is getting into, and until more questions are answered, be skeptical.

REPRESENTATIVE SADDLER noted that Mr. Tsafos is an informed observer of the oil and gas industry. This process has stage gates that assume that every step is going to have a decision to continue the project. It called for the four parties to spend about a half million dollars to get reliable answers about whether to continue or to stop. The producers seem to be saying "no" or "not yet," but the administration is insisting on saying "yes, now," and proposing to change the structure. He said there are a lot of questions that need to be answered before agreeing to support that change. He asked, "Do you see any justification for changing the structure other than the slow down and the charge toward FEED?" Are there any technical, political, or global market changes that might make this a wise move?

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MR. TSAFOS said he buys the cost of supply issue. At the same time, the Wood Mackenzie work shows that nothing breaks even, so \$45 oil equivalent does not work, because it is not a sustainable price. His understanding from reading public statements is that all three producers have different perspectives about going into FEED. "I don't think anyone really

wants to go into FEED, but I think they have different views as to how much they would like to keep working on this." He referred to a letter from ExxonMobil that says there is a 2017 work program budget, and "I don't want to put words in their mouth, but if I'm ExxonMobil and I prepare a budget, I assume I like the budget, otherwise why would you prepare it and put it forward?" He also has read from AGDC that the JVA says if two parties want to go forward, they can go forward, but if only one party wants to go forward, the JVA gets dissolved. He said he is trying to explore that space between where the project is and where it is headed, and there is a lot in the middle. For example, the main benefit of a state-led project is a tax exemption. Otherwise, the producers would be better than the state at finding third party investors; they can do better at selling the product to the market; and they can find contractors better than the state. So, he said, he is thinking that rather than take over the project on the premise of an unsure tax exemption, "why don't we figure out what we can keep spending? Can we make sure that they don't ship Steve Butt off to somewhere else?" He suggested having Mr. Butt see what else he can come up with, as he has already gotten the project to the lower end of the \$45 to \$65 billion cost. "Send him back to do some more homework, and you do your homework." There is plenty the legislature could be doing, including the question of tax exemptions. He understands that the state is looking at a FEED decision in the middle of 2018 with the state-led scenario, "which you could probably get to anyway, at least with some of the parties if you were to keep working this approach." He said there is a huge space in between, "and I don't really know what happened to that space."

REPRESENTATIVE SADDLER said Representative Hawker encouraged everyone to read the industrial megatrends book. The book taught him that "you can be driven by time, in which you trade money for time, or you can be driven by money, which you would play for time. So, trying to adhere to a firm timetable irrespective of the global considerations exposes you to tremendous financial risks."

REPRESENTATIVE HERRON noted that the attorneys said that the IRS tends to regard anything that makes or saves money for a political subdivision as an essential government function. Interestingly, Mr. Tsafos' Option 2 showed that a 12 percent return is important for the viability of the project. Shaving that down would be problematic, he opined. Option 3 dealt with Alaska buying and selling gas, and based on what the attorneys said, he wondered if that is an essential government function

that makes or saves money. "Are those a couple of holes that we must consider?"

MR. TSAFOS said absolutely. Those are two of the many questions that Alaska should figure out.

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SENATOR DUNLEAVY noted that Mr. Tsafos was around during the construction of this bill. He asked, "Are we getting to the end of what was embedded within this law?" He asked if SB 138 still allows different options to be explored and to keep spending money, or does SB 138 need to be revisited?

MR. TSAFOS said the discussions of SB 138 did not include this option. That does not mean SB 138 negates it, but it was not "what we were sitting around talking about." Is SB 138 dead? It seems to be in its last gasps, he said, but there are things that can be done to save good parts of the process, like the alignment with producers. "You had three of the best companies in the world having your back, and now they're on the other side of the table." Judging from testimony, SB 138 seems to have come to an end, "but I don't really understand why."

SENATOR DUNLEAVY said the checks and balances in SB 138 got him to reluctantly vote yes, because of the history in Alaska of projects that just don't pan out or are not thought out. "We've reached that gate where it appears that at various levels the private partners have basically said they're not comfortable investing more in this concept that was envisioned under 138." If the vision and concept is changing, we can have that discussion. He has concerns that the bill is open-ended and allows almost anything to be contemplated.

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MR. TSAFOS said specific checks and balances were in the legislation. For example, contracts longer than two years had to come back to the legislature, but the members were not contemplating this concept deviation. The blueprint is different, and it would be nice to know what the new one is.

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CHAIR GIESSEL said she posted a letter for yesterday's meeting from the Department of Law that opines on whether SB 138 allows this level of flexibility. The letter says that it does, but it points out that the legislature has controls put in place.

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SENATOR MACKINNON said she does not believe that the legislature ever voted on President Meyer. We vote on board members who actually hire [the president]. It has already been stated why the producers may feel like the state has not fulfilled the obligation to go into FEED. The analytica contractor has stated that there is not fiscal certainty and there are some other things that the state hasn't done "in the form of PILT and other things that we haven't come forward with," but there are also things that the producers have not done, like the gas balancing agreement and some other things. There are equal fingers to point at each other for completion prior to going into FEED, she said. There is a JVA with a small group of people who advocates for the parties that remain—the three producers and the state. The management team is much larger.

MR. TSAFOS said there are about 130 people on the management team that report to Steve Butt.

SENATOR MACKINNON said today the committee heard that ExxonMobil has 80 people on that team who need to transition to the state. She asked how many people on the team are from the state.

MR. TSAFOS said he does not know, but he saw one company breakdown during the TransCanada negotiations. At that time, AGDC had zero people on the team.

SENATOR MACKINNON said her point is that she wants a pipeline, but she wants it to be competitive, and she wants Alaska to responsibly take on any transition that the administration is proposing. It is a huge ask of the legislature given its current involvement in that management team.

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CHAIR GIESSEL said this concludes the two-day meeting on the transition to a new Alaska LNG plan, which will take place next month. She thanked participants. She said she will submit additional questions from committee members to AGDC.

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There being no further business to come before the committee, Chair Giessel adjourned the meeting at 4:12 p.m.