COMMONWEALTH NORTH

# A STUDY OF THE PROPOSED CONTRACT BETWEEN THE STATE OF ALASKA AND MAJOR NORTH SLOPE PRODUCERS

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# About Commonwealth North

The mission of Commonwealth north is to educate its members and others on significant public policy issues and to assist in their resolution. This mission is accomplished through forums and member briefings on relevant public policies, and through study groups that analyze various public policy issues and prepare written reports

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# Purpose of the Study

Since 1979, Commonwealth North has published five reports on North Slope resource issues. The last report was in 2001: "Bringing Alaska's North Slope gas to Market: Framing the Issues." These reports consistently urge development of production and transportation facilities to move gas from the North Slope to Market. Commonwealth North supports the current efforts to encourage construction of a natural gas pipeline. It will continue to support development that meets the basic principle that development must be in the best interest of all Alaskans.

The Governor, his staff and consultants have worked long and hard over two years to negotiate a contract with the major gas producers to bring the North Slope gas to market. The proposed contract changes the status quo of taxation and royalties based on existing lease agreements. Under the proposed contract, the State would own and finance 20% of the pipeline and would receive its royalty and taxes in gas rather than in cash payments. [1] These changes and other agreements included in the proposed contract raise several major public policy issues for the State of Alaska.

The purpose of this study is to review this proposed contract. This study does not purport to examine all provisions of the contract or all points of view about the contract. This study does attempt to identify several very important provisions of the contract and to present contrasting points of view about those selected provisions.

Commonwealth North acknowledges and respects the Administration's attempt to get a pipeline built. It firmly believes that the SOA needs to pursue timely construction of a natural gas pipeline. The proposed contract is an important step toward accomplishing that goal. It settles many issues necessary for project to go forward. However, it is incomplete and has provisions that raise a number of serious public policy issues. It is in the best interest of all Alaskans that these issues be re-examined and re-negotiated.

This report was approved by consensus of the Commonwealth North study group and subsequently the Commonwealth North board of directors. It does not represent the opinion of all members of the study group, the board, or the membership.

[1] Under the status quo the State may elect to receive its royalty payments as cash or as gas.

**Charge From the Commonwealth North Board to the Gas Pipeline Contract Study Group**

**Questions to be addressed**

- What are the major policy issues in the proposed gas pipeline contract?
- Are there provisions in the proposed contract that should be removed, amended, or added?
- What is the fiscal impact of the proposed gas pipeline contract?
- What amount of state investment in a gas pipeline is appropriate?
- Is it in the state's best interest to tax the gas reserves?
- What else can the state be doing to expedite bringing the gas to market?
- How can adequate continuing gas supply be assured along the railbelt?
- How can propane or other sources of fuel be assured for non-railbelt communities?

This report addresses most of these questions.

## What is the Stranded Gas Development Act?

The proposed contract is a product of the Stranded Gas Development Act (SGDA), now law and proposed to be amended. A contract may be negotiated by the Governor under the SGDA (AS 43.82.010—990) if the Commissioner of Revenue finds that the gas is stranded and that the proposed contract terms are in the long-term fiscal interest of the state. "Stranded gas" is natural gas that is not being marketed due to prevailing costs or price conditions as determined by an economic analysis by the Commissioner of Revenue for a particular project. Since January 2004, the Governor has been negotiating collectively with BP Exploration (Alaska), Inc., ConocoPhillips Alaska, Inc., and ExxonMobil Alaska Production, Inc. (the Sponsor Group). The outcome of these negotiations is a proposed contract between the state and the Sponsor Group. The Commissioner of Revenue has issued a specific finding that Alaska North Slope (ANS) gas is stranded and that the proposed contract is in the long-term fiscal interests of the state. [2]

For the proposed contract to be valid, the legislature must amend the SGDA, as well as approve a change in method of taxation for oil and gas.

## Is the ANS gas stranded?

**PRO:** According to William Corbus, Commissioner of Revenue, "The Alaska North Slope (ANS) contains vast reserves of natural gas resources that cannot be sold in the marketplace due to the absence of a transportation system to bring that gas to market. …

[2] Preliminary Findings and Determination of the Commissioner, FIF-ES-page 1

Until recently, commercialization of ANS gas has not been economically viable because of low market prices and high cost and risks associated with constructing the infrastructure to transport the gas to market, and competition from other gas resources."[3] Extensive analysis and sophisticated models developed by experts in the energy field clearly show that within a reasonable range of projected natural gas prices, a project to transport the ANS to market is not economically feasible without the contractual involvement of the State of Alaska (SOA). [4]

**CON:** SOA uses a stress or lowest price of $3.50 per thousand cubic feet in its economic calculations which is the estimated price that the SOA believes is used by the producers in evaluating projects.[5] However, current gas prices exceed that figure. Further, using a $5.00 per mcf price, the Legislature's expert consultants, Econ One, project that producers would receive an internal rate of return of 20.4 percent – without any SOA participation. The recent purchase of Burlington Resources by ConocoPhillips was based on a projected future gas price of $7.00 - $8.00 per mcf according to its Chairman, Jim Mulva. Assuming that demand for natural gas continues to grow, and that prices stabilize at or near the current rate, ANS gas is not stranded and the SOA does not need to provide incentives for the development of the gas pipeline.

**CWN Statement:** No one can predict what natural gas market prices may do in the coming decade before any Alaska gas reaches the Alberta or Midwest markets. Nor can anyone predict natural gas market prices during the 35-year, or longer, operating period of the pipeline. According to Christof Ruehl, (BP economist involved in BP's Statistical Review of World Energy, 2006) when he spoke at the Anchorage Hilton on June 22, 2006, oil prices and gas prices traditionally "stay together." As long as oil prices remain high, gas prices will most likely follow suit. Yet as Alaska experienced in the 1985-87 period, and again in the late 1990's, prices sometimes fall further and faster than projected. It is appropriate to assume that the ANS gas is stranded.

## Major Public Policy Issues Arising From the Proposed Contract

### 1. Work Commitments: The contract does not require the Producers to build a pipeline or show specific performance by some future, predictable date(s).

**PRO:** The contract requires the Producers to move forward "… as diligently as is prudent under the circumstances." This project will be one of the largest and complex projects ever undertaken. Planning alone will be a multi-million dollar effort and will have clear deliverables. Efforts to advance the project diligently can not be disguised or faked by the Producers. The contract requires the Producers to report on these efforts

[3] Preliminary Findings and Determination of the Commissioner, FIF-ES-page 1

[4] Van Meurs economic model and analysis

[5] Preliminary Findings and Determination of the Commissioner, Appendix C, FIF C-12

through annual updates of a Qualified Project Plan and a public Project Summary. Project planning must start within ninety days after the contract is signed.

Schedule-driven commitments may seem valuable at first glance; however, setting a specific time table for project sanction and project completion can easily lead to massive cost overruns because schedule rather than sound engineering and construction practices would be driving the process.

**CON**: Without a firm start commitment, the contract does not assure that a pipeline will ever be built. The contract has no limit on the amount of time between execution of the contract and beginning design, permitting, or construction. Further, the SOA can not terminate the contract except by proving by "clear and convincing evidence" that the Producers are not acting with "diligence." Any such challenge by the SOA must be resolved by a three-person arbitration panel. Even if the decision is against the Producers, they have 90 days after an adverse decision to "cure" (i.e. act with due diligence). The contract gives up all right of the SOA to challenge anything in the contract in a SOA court of law.

**CWN STATEMENT:** The lack of definitive requirement to start actual construction of a pipeline and other necessary infrastructure is troublesome, especially when coupled with the length of the proposed contract and with the unusual burden of proof the SOA has to meet. SOA's sole remedy for non-performance of the contract terms is termination of the contract. SOA cannot collect any damages for losses incurred due to delays in building a pipeline. The contract should provide for work commitments prior to construction that have specific activities and timelines. Schedules and timelines can always be revised, as the need occurs, and the SOA should have a say in any revisions to the project schedule.

**2. <u>Duration of Fixed Tax Rates:</u> The proposed contract fixes tax rates on both oil (30 years) and gas (45 years). Article IX, Section 1 of the Alaska Constitution provides: "The power of taxation shall never be surrendered. This power shall not be suspended or contracted away, except as provided in this article." Section 4 provides for specific exemptions from taxes and concludes with this language, "Other exemptions of like or different kind may be granted by general law."**

**PRO:** The proposed contract is generated pursuant to the Stranded Gas Development Act. The SGDA is a "general law." Therefore the contract may fix taxes for 30-45 years. Further, the history of delegate comments at the constitutional convention indicates that granting tax incentives to new industries was envisioned as one of the exemptions contemplated by Article IX, section 4. The Attorney General has issued an opinion in support of this position. Fiscal certainty is one of the key points in the contract and is required by the Producers for this project to move forward. Revenues from oil and gas under the provisions of this contract will be comparable to revenues under the 2005 fiscal regime.[6] Fiscal certainty will also establish a positive fiscal environment, which will

[6] Preliminary Findings and Determination of the Commissioner, FIF-ES-page 154, Table 26

encourage additional exploration and investment in oil and gas development within the state.

**CON:** The proposed contract may be authorized by the SGDA which in turn, may be characterized as a "general law." However, locking up Alaska's tax structure for oil and gas for 3-4 decades is not being done by "general law." It is being done by a negotiated contract provision. Further, the oil industry is not a "new industry" in Alaska. Consequently, even if a contract could be considered as "general law," locking up taxes on the well-established oil (not just gas) industry does not comply with the delegates' seeming intent to provide incentives to encourage a new industry. Fixing tax rates beyond the time frame required for the Producers to recoup their investment or to depreciate the pipeline may not reduce the financial risk of the project.

**CWN Statement:** The arguments both pro and con have reasonable points. This is an issue which the Alaska Supreme Court must resolve. Consequently, if the contract is signed, the question should be presented to the court as soon as possible. If this provision remains in the contract, it should be amended to a shorter time period, and it should be severable from all other parts of the contract.[7]

### 3. <u>State Ownership:</u> The State of Alaska (SOA) will be a 20% owner in the project. Must the SOA pay 20% of the costs of the project to get Alaska's natural gas to market? Is this a good investment?

**PRO:** The State's ownership provides economic incentives to the Producers to enhance the project. Producer economics are improved because they are not required to make firm transportation commitments on gas in which they have no economic interest. It also means that each Producer's pipeline affiliate can hold a lower ownership in the midstream assets (pipeline segments and gas treatment plant) whose regulated rate of return is lower than that required by the Producer's shareholders.

The SOA will receive a regulated rate of return on its investment in the pipeline. From its share of tariff income, the State will benefit from a cash flow independent of the price of gas. Owning a portion of the pipeline is appropriate for the SOA as an owner of the underlying resources.

**CON:** Pedro Van Meurs, the governor's expert, cites the following factors that create risk with this project:

- the high costs of building a pipeline in Alaska
- the high risk of significant cost overruns
- future volatility of world market price for gas
- world-wide competing natural gas projects

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7 See "A note affirming Commonwealth North's traditional position on using Alaska's resources for the good of all Alaskans" for discussion of the significance of negotiating Alaska's governing powers

However, those risk factors will always be present in any pipeline analysis. Econ-One, the Legislature's expert, constructed economic models that demonstrate building a pipeline and taking Alaska natural gas to market is economical. Because the contract for the limited liability corporation (LLC) that will own and operate the project has not been completed, there is no way of knowing the details of the proposed ownership arrangement. The SOA has never invested in an operating business of this magnitude and does not need to expose itself to the inherent risks associated with such a large capital investment. Federal loan guarantees of 80% financing of the project should reduce the cost of borrowing, but not necessarily reduce the risk to the SOA and the Producers.

**CWN STATEMENT:** Too little information is known or understood about the economic consequences of SOA both being a part owner of the pipeline and taking all its gas income in-kind. The factors relied upon by both groups are persuasive depending upon (1) the assumptions each makes in creating its economic model; (2) the weight it applies to each of the risk factors; and (3) the data selected and the analysis it makes of the selected data for its model. If the Governor is right, Alaska has no choice but to invest billions of dollars and must make that commitment now. Otherwise, no pipeline will ever be built. If the Legislature's experts are right, a pipeline can and will be built with far less dependence upon SOA financing. Although other pipeline builders have expressed interest in building a pipeline, none will be built unless (1) North Slope producers agree to market the gas they control through North Slope leases; and/or (2) future oil and gas discoveries in quantities sufficient to support a gas pipeline project involve leases that require gas to be marketed. (See Exhibit A for further discussion about financing a pipeline.)

**4. <u>Additional Costs to the State of Alaska</u>: Several provisions require the SOA to incur additional financial liabilities beyond its 20% ownership share. In addition to investing in the pipeline, what is the "cost" to Alaska for deductions, allowances, credits, and indemnifications of the producers?**

These financial liabilities include:

- upstream cost allowance,
- commitment allowance,
- capacity management costs,
- marketing costs,
- reductions in oil taxes by deductions, credits and allowances for gas investment,
- costs to separate and dispose of impurities,
- potential reimbursement (local taxes, impact funds) and indemnity for producers costs
- loss of "higher of" value computations under current leases
- loss of option to take royalty gas in value

**PRO:** The high costs of building a pipeline in Alaska, high risk of significant costs overrides, future volatility of world market price for gas, and world-wide competing natural gas projects require the SOA to bear some of the cost of a natural gas pipeline. These costs are necessary if Alaska wants a pipeline built. Without these deductions,

allowances, credits, and indemnifications, the Producers do not consider the pipeline project to be economically feasible.

**CON:** As these provisions demonstrate, Alaska will be spending, giving and forbearing collection of unknown amounts of money. The contractual obligations for the SOA exceed the benefits it derives from the contract. There is not an adequate quid pro quo from the Producers.

**CWN Statement:** No financial commitment should be made without a reasonable projection of the size and duration of these financial liabilities. Alaska relies upon revenue from its natural resources to fulfill its responsibilities to all Alaskans. It needs future revenue from its natural gas, but not at a price that reduces its revenue below what it could achieve by investing prudently to get a higher rate of return. Great caution must be exercised before entering into any very large, very long-term financial commitments. Alaskans need to have information about the potential range of Alaska's projected total and annual cash liability for the pipeline project. It is insufficient just to have economic models that project estimates of annual revenues. The use of different discount rates as well as the mixed use of nominal and real dollars is confusing in the SOA explanation of the contract. The public should see charts that project a reasonable range of how much SOA will be required to spend/forgo/invest annually for the next 40 years. The public likewise should see charts that project a range of the total revenue the SOA can annually reasonably expect in return for the next 40 years. Some projection of the likelihood of such costs and revenues is also appropriate.

**5. <u>Taking State Royalty and Tax Gas In Kind</u>: The SOA will take 20% of the gas at wellhead instead of collecting any cash payments for its role either as an owner of the gas (royalty) or as a government with taxing authority (severance, property, corporate income tax). The SOA will pay all costs to clean, transport, and sell its gas.**

**PRO:** Producer economics are improved because they are not required to make firm transportation commitments on gas in which they have no economic interest. Building the pipeline is a very risky economic project that will not be done unless SOA takes gas in-kind in lieu of cash payments for royalty and tax revenue. It is necessary for SOA to take more risk in order to make the rate of return for the Producers high enough to make the project feasible. By controlling 20% of the gas, the SOA will be able to offer gas supplies for instate use.

**CON:** SOA has always had the lease option to take royalty oil in-value or in-kind. In most cases, the State has collected royalty and tax payments rather than taking oil in-kind. Alaska will incur substantial costs to treat the gas to make it marketable and then to market it. The Fiscal Interest Finding notes that the state will loose approximately 2% of the net present value of potential income by taking its gas in-kind because it will no longer have the right to take the "higher of" various value measures.[8] In addition, SOA is

[8] Preliminary Fiscal Interest Findings, page 114

faced with the liability of long term shipping commitments for its share of the gas. This liability can become a substantial burden on the SOA finances depending on access to gas supplies and markets.

**CWN STATEMENT:** It would be appropriate for economic models to be created to project at least a range of net revenues Alaska can reasonably expect to get from its 20% gas in-kind taking and the potential loss of revenue compared to receiving cash payments. This provision does not significantly increase the Producers projected net revenue, [9] but it adds a risk factor that has a potentially high negative impact on the SOA. [10]

## 6. Alternative Project Proposals: **This contract excludes the possibility of negotiating with other alternative project proposers or opening the way for alternative ways of moving ANS gas to market.**

**PRO**: The SGDA had a limited duration and additional proposers are not permitted to apply under that act. There is no way that gas will be developed without a contract negotiated under the SGDA. The Administration examined several alternative proposals and determined that the Producers offered the most viable alternative for actually getting a gas pipeline built.

**CON**: By limiting negotiations to one group, the Administration has taken away any possible benefits that might have accrued to a competitive selection process. The State has created a barrier to entry for any alternative gas transportation system. How do Alaskans know that we are getting the best deal possible?

**CWN STATEMENT:** The Administration considered other proposals but chose to negotiate with the Producers. Whether additional negotiations could have been pursued does not address the merits of the proposed contract. (See Attachment B for illustration of alternatives.)

## 7. Point Thomson Unit: **The Point Thomson Unit lease and associated development requirements are subsumed within the proposed Gas Line Contract.**

**PRO:** The viability of the project is dependent upon the Point Thomson gas resources which represent approximately 25% of the known gas volumes available for the project. The lease holders of Point Thomson natural gas are not able to economically develop the natural gas without the proposed gas pipeline. Therefore, to make the development of Point Thomson natural gas economic, the gas and associated lease development terms need to be subsumed within the overall development requirements of the contract.

**CON:** A material portion of the Point Thomson natural gas appears to be economic to develop as a Natural Gas Liquids (NGL's) project that would use the existing Trans-

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[9] Econ One Research, Inc. presentation to the Legislative Budget and Audit Committee, June 14-15. 2006
[10] See "A note affirming Commonwealth North's traditional position on using Alaska's resources for the good of all Alaskans" for discussion of the significance of negotiating Alaska's power to tax.

Alaska Pipeline System (TAPS) and tankers to move the NGL's to market. Most of the balance of the natural gas would remain available for shipping down a gas pipeline. If current lease terms were enforced, development of the NGL portion of the Point Thomson natural gas could occur well ahead of a gas pipeline without having a materially detrimental impact on gas pipeline economics.

**CWN STATEMENT:** The lease process for developing Point Thomson is being sidestepped by including it in the proposed contract. The public interest favors removing the Point Thomson unit from the contract in order to encourage timely economic development under the existing or renegotiated lease terms.

**8. <u>Using Alaska's "In-kind Gas" In-state:</u> The proposed contract does not address instate use of gas except the provision for off-take points within Alaska. The costs of building treatment facilities and pipelines to transport the gas in Alaska will be born by in-state users.**

**PRO:** Alaska does not need to decide at this time whether or where it might take gas off the pipeline for use in-state. Those decisions and cost models can be developed before SOA must make a commitment during the first "open season" as to how much of its gas will go to Alberta.

**CON:** FERC requires gas shipment commitments to decide both capacity of the pipeline and amount of tariff that can be charged. Pedro Van Meurs projected that permitting process could be as short as 18 months from the day the contract is signed. That means SOA must assemble an expert group of consultants to do the feasibility and design work necessary to resolve the many issues surrounding in-state use of its gas.

**CWN STATEMENT:** It would be appropriate for economic models to be created to project at least the range of costs Alaskans may reasonably expect to pay to use any of its gas in-state. Several issues need to be addressed including (1) loss of revenue to the entire state from gas used in-state; (2) the likely differences in cost of subsidizing use of Alaska's gas in Fairbanks, or Anchorage bowl, or rural Alaska or Southeast; (3) should Alaska's public policy be to make cheaper energy available to all or parts of the state or to maximize its rate of return on its investment; or (4) should the state make its gas available for in-state use at the same netback wellhead value as gas delivered to Alberta or Chicago? These policy issues must be resolved before Alaska makes its first open season commitment as to how much gas it will ship how far along the pipeline.

**9. <u>Regulation of the Project</u>: The contract provides that the Federal Energy Regulatory Commission (FERC) will have exclusive jurisdiction over the project. The State and Producers must "seek and support" FERC's exclusive jurisdiction in any proceedings. If the Regulatory Commission of Alaska (RCA) asserts jurisdiction and acts inconsistent with FERC or contract provisions, the State will indemnify the Producers for any damages.**

**PRO:** Clarifying the role of RCA will lead to a more efficient, faster, more predictable process for development of the pipeline. FERC will provide under its existing authority all necessary regulations for pipeline construction and operation.

**CON:** The SOA will be out of the loop in regulating the upstream activities of the Producers and other explorers. This will create an unlevel playing field for competition. If the SOA is looking for exploration, upstream Basin control by the Producers would disadvantage companies for the right to explore and develop. The contract provision calling for the State to indemnify the producers for anything that RCA imposes is contradictory to the concept of a level playing field. RCA gives fair treatment to all projects that cross state-owned land, over which it has jurisdiction, and restricting this authority violates state constitution provisions relating to access to resources.

**CWN STATEMENT:** FERC regulation and RCA regulation should be clearly identified. No indemnification should be required by the SOA for a state agency exerting jurisdiction over any intrastate project. [11]

## <u>10. Study Group Charge Question</u>: Is it in the State's best interest to tax the gas reserves? [12]

**<u>PRO</u>:** Leases pertaining to gas development in the SOA have existed for the past thirty years. No efforts have been exerted to develop Alaska's North Slope natural gas resources. Some pressure must be brought to motivate development particularly in today's global gas market. An effective way to accomplish development is to require the Producers to pay the SOA for keeping the gas in the ground.

**<u>CON</u>:** The Producers have clearly explained that such taxation is a disincentive and will defeat any attempt to negotiate the building of a pipeline to deliver Alaska's gas to market.

**<u>CWN STATEMENT</u>**: The negative use of taxing authority is poor public policy. Implementing a reserves tax on any resource will send a message globally that Alaska is not encouraging exploration or development of its resources. It will also discourage financial market participation in the gas line project.

[11] See "A note affirming Commonwealth North's traditional position on using Alaska's resources for the good of all Alaskans" for discussion of the significance of negotiating Alaska's governing powers.
[12] See "Charge, From the Commonwealth North Board to the Gas Pipeline Contract Study Group", page 1

## A note affirming Commonwealth North's traditional position on using Alaska's resources for the good of all Alaskans

When Alaska sought Statehood, the U.S. Congress was concerned that Alaska was not likely to generate either a sufficient population or economic base to meet the financial obligations that accompany statehood. Consequently, Congress not only gave the state millions of acres of land, it gave the state ownership rights to the subsurface resources under those acres. As a result, the state of Alaska has the right to the owner's revenue from the development of subsurface minerals. This principle is written into our state constitution. In this, Alaska is a unique state.

To date, Alaska has exercised its ownership rights primarily by entering into lease agreements (bid or negotiated) that seek the most revenue at the least risk – just as any private owner of mineral rights seeks to do.

However, in addition to owning the subsurface resources, Alaska, like all states in the U.S., also has all the powers necessary to govern. Thus, when any natural resources are developed in the state, Alaska is a permitor, a regulator, and a taxing authority. These are vital powers exercised by the Executive and Legislative branches of state government to assure the health, safety, and general well-being of all Alaskans. Consequently, in the development of the state-owned natural resources, Alaska "wears two hats" – has two separate kinds of responsibilities. Alaska must function like an owner and it must also function as a government to assure that all development within Alaska meets established standards and criteria and generates fair tax revenue. These are typical governance responsibilities exercised by every state in the U.S. In this, Alaska is a typical state.

Since its founding in 1979, Commonwealth North has consistently maintained that the government of the state of Alaska must diligently meet both of these responsibilities. However, Commonwealth North has also recognized that "acting like an owner of natural resources" requires goals, skills, knowledge and infra-structure that are different in kind and in scope from the goals, skills, knowledge and infra-structure required to govern. What is in the best interest of Alaska as an owner may not be in the best interest of Alaska as a state.

Because both of these state functions are important to the welfare of all Alaskans, and because the two do not, and should not have the same processes or goals, Commonwealth North has urged that Alaska establish by law separate entities to fulfill its ownership responsibility to develop its natural resources. (The Permanent Fund Corporation (PFC) is an excellent example of Alaska fulfilling its owner responsibilities by establishing by statute a separate corporate entity that functions like an "owner" of Alaska's Permanent Fund assets. The PFC must meet certain standards of investment performance and reporting obligations in managing Alaska's oil revenue savings account. Its decisions, however, are required to be "reasonable and prudent" business decisions -- not political or governance decisions.)

The Stranded Gas Development Act (SGDA), on the other hand, is an example of Alaska telling the governor to "act like an owner" to get Alaska's natural gas to market without providing the governor with a separate ownership entity to fulfill those responsibilities. Consequently, the governor is susceptible to demands that both Alaska's "ownership interest" and Alaska's "government powers" be "on the table" and negotiated.

As a result, several issues surrounding the proposed natural gas pipeline contract arise from provisions that deal with the powers and responsibilities that Alaska only has because it is a government, not because it owns the leased North Slope natural gas. These provisions are most difficult to evaluate because in asking whether such provisions are "in the best interests of Alaskans" it is necessary to weigh whether Alaska's legal authority to govern should be eliminated, restricted or amended through contract negotiations. Is it in the best interest of Alaskans to:

- fix government tax rates on oil for 30 years and on gas for 45 years?
- waive the state's sovereign immunity from lawsuits allowing it to be sued anywhere in the U.S.?
- restrict local governments' power to raise their local taxes?
- extend tax exemptions to contractors and subcontractors of the producers?
- restrict all judicial review of legal issues to only the Supreme Court?
- limit executive branch review of development activity primarily to one administrative agency?
- shield producers from citizen initiatives?
- eliminate Alaska Regulatory Commission jurisdiction?
- require amendment of existing law to legalize provisions of a contract?

The producers -- like any good business negotiators – must act in their own interests. It is good business for them to try to bargain for changes in the way Alaska *governs* development by including those changes as express provisions in the contract. Such negotiation is possible because the Governor wears both Alaska's ownership and governance "hats" at the same time in the negotiations. The result, however, is a confusing array of proposed changes to Alaska's executive, legislative and judicial governing powers intermingled with provisions of what Alaska, as the owner of the natural gas, is willing and able to do as an investor in a gas pipeline.

This situation also causes the Legislature to weigh various contract provisions with different measurers and apply different values. For example, one set of financing issues applies only to Alaska as a proposed 20% owner in a pipeline. A few of those issues include the following questions. What are the risks and the reasonably projected costs for Alaska as an owner-investor? How much influence does that percentage of ownership give Alaska over the project? What is the rate of return on Alaska's investment dollars? Could Alaska get a safer, better rate of return from a different investment?

On the other hand, as the appropriation and taxing branch of government the Legislature faces a different set of financing issues. A few of those issues include the following questions. How much should the state subsidize this eventual project? What form should those subsidies take? Are the subsidized pipeline owners required to be sufficiently accountable to the State of Alaska? Can the Legislature exercise reasonable oversight of this use of public money? How much and how long should the Legislature forego its power to set taxes for Alaska?

Since statehood and since oil became the major source of Alaska's revenue, the state has engaged in many projects intended to spur economic development in Alaska. Some succeeded; some did not. However, this is the first time that Alaska has considered owning a part of the economic project. New issues are before the governor, the legislature and the people of Alaska. All are important to not only the current but also future generations of Alaskans.

**Attachment A: Financing the Gas Pipeline**

Appendix F - Finance Plan Report to the Proposed Gas Contract States:

> "A current draft of Section 5.2 of the LLC Agreement provides for the establishment of a 'Management Committee' (the "Management Committee"), which is composed of representatives of each of the Members, that will make all decisions for Alaska LLC according to the voting procedures set forth in the LLC Agreement. The current draft of Article XI of the LLC Agreement provides for the establishment of a 'Finance Committee' (the "Finance Committee"), which will be composed of a representative from each of the Members and will be charged with investigating and developing the initial plan for the financing of the Project, including how to best utilize the DOE Guarantees. Once such a plan is approved by the Management Committee, it will be deemed to be the 'Finance Plan' for Alaska LLC (the "LLC Finance Plan"). We understand that the voting procedures with respect to the selection of the LLC Finance Plan have not been finalized. The LLC Finance Plan will determine the form of the debt financing component of the Finance Plan and will set forth the proposed sources, structure, tenor, terms, covenants, restrictions, collateral and timing for the debt financing of the Project."

On FIF-F-11, it is stated that based on deal precedent, it is likely that debt financing would be guaranteed severally by the Producers and the State and each would likely have to provide completion guarantees. On FIF-F-13, mitigation of completion risk is discussed. These factors include providing a two-year construction cushion, a 12-month debt service reserve, putting complete risk on the contractors, etc. Lender collateral required would include assignment of (1) Alaska LLC's Firm Transportation Contracts; (2) Alaska LLC's Revenues, etc.

The Report discusses how the State's debt might be rated on a par with the Producers debt, possibly if the State were secured by a "moral obligation of the State to replenish a reserve fund."

The Report says that an LLC financing rather than a Member-level financing is the preferred option, largely because Lenders would consider the "blended credit" of the shippers under the Firm Transportation Contracts when assessing the stability of the Alaska LLC's revenue stream.

It has disadvantages to the Producers but the impact on the State's borrowing capacity and credit rating is significantly less than if the State borrowed 20% of the total Project costs. The Producers and the State would approach the market jointly for financing.

The authors of the Report believe that the Producers will opt to finance the Project separately as will apparently be their right under the proposed LLC Agreement. They

*Written by Eric Wohlforth

recite the disadvantages of this approach which include the possibility of a 70/30 (instead of 80/20) debt/equity ratio.

The Report states:

> "The Financial Advisors have concluded that at the high end of the range of potential Project costs, there is a significant risk that the State will not be able to raise sufficient debt to cover its cash call obligations (or raise debt on terms acceptable to the State." (FIF-F-25)

The Report discusses four ways in which the State's $800 million equity contribution might be funded. These are:

- Proceeds from a direct appropriation from the State's general fund.
- Proceeds from the issuance of State bonds.
- Funds available under a revolving loan facility
- Proceeds from the Permanent Fund as an equity investor or a lender.

Direct appropriation is the current preferred option. The report mentions that the State has appropriated $1.7 billion to capitalize State appropriations.

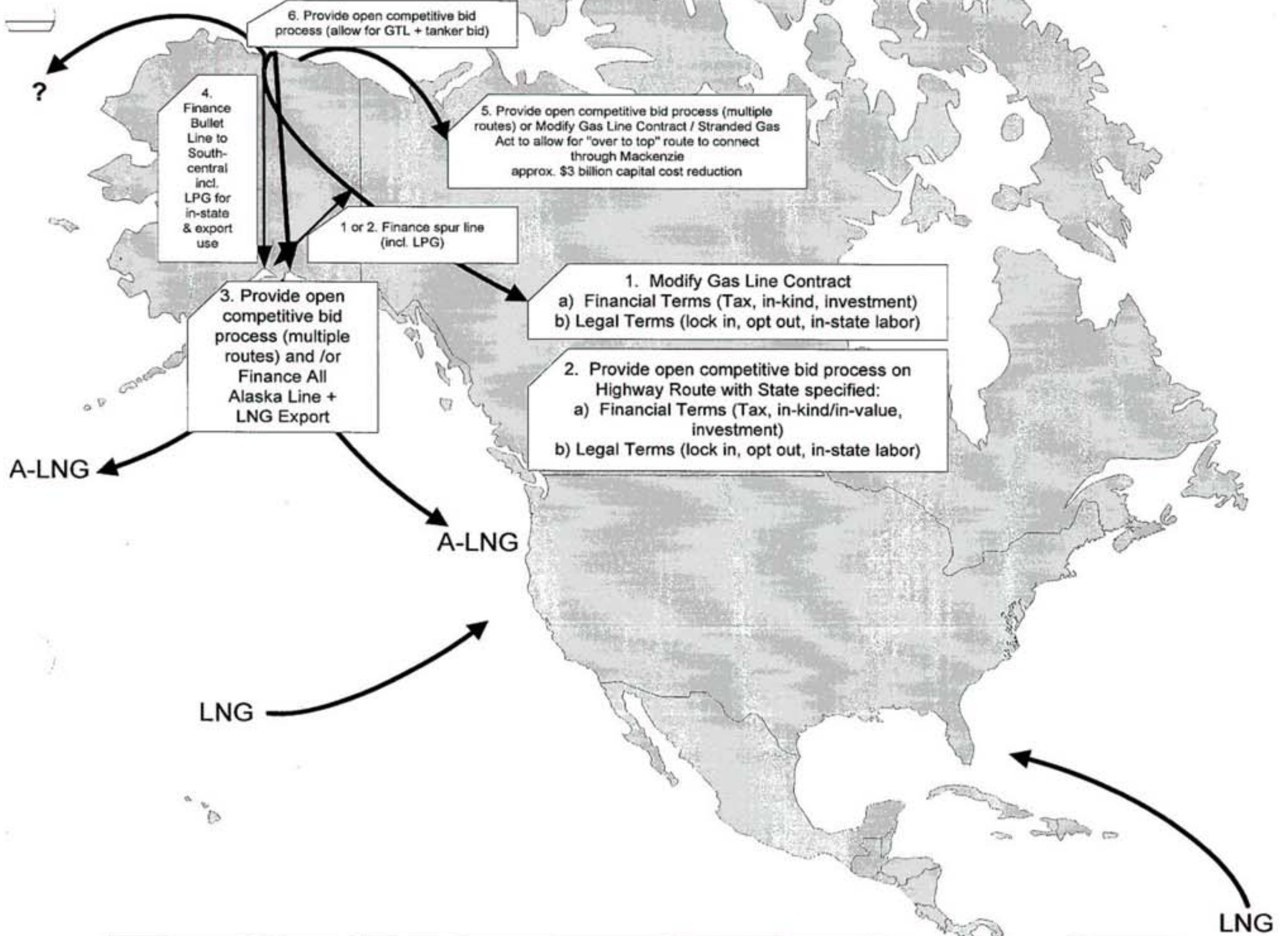
The Report recommends that the State consider financing a portion of Pipe Co's equity contribution with a combination of a revolving loan facility and long-term bonds. The facility would mature at completion and be replaced with long-term bonds secured by a moral obligation to replenish a reserve fund and a "subject to appropriation" pledge.

The Report mentions the possibility of the Permanent Fund as an equity investor and mentions several issues which need resolution before this source could be utilized.

It recommends use of DOE guarantees on cost overrun financing.

Attachment B

## Figure 1: What are the basic alternatives to the proposed Gas Line Contract with Alaska North Slope Gas Leaseholders (PBU, PTU)




NOTES:

1. What is the basic standard? Is this the best alternative? or Is this a viable alternative?
2. What are the evaluation criteria? Principles, Modified Principles, New Principles
3. Other considerations:
   a. Exclusive negotiation vs. competitive bid process
   b. Relative share of risk/reward for: State, Federal Gov't, Leaseholders/Producers
   c. Public transparency
   d. Build on existing terms and conditions in leaseholder agreements
   e. What is the schedule risk? If you don't do "it" now, how much exposure do you have to "losing the market opportunity"
   f. What is the State's Best Alternative to A Negotiated Agreement (BATNA)?

*Provided by Mark Foster

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| **Date** (All in 2006) | **Speakers at Commonwealth North Events and Guests of the Study Group** |
|---|---|
| March 14 | Jim Clark, Governor's Chief of Staff |
| May 18 | Pedro Van Meurs, Consultant and Chief Negotiator for the Administration |
| June 2 | Bill Corbus, Commissioner of Revenue<br>Ken Griffin, Deputy Commissioner, Department of Natural Resources (DNR) |
| June 7 | Mike Menge, Commissioner, DNR<br>Harry Noah, former Commissioner, DNR |
| June 9 | Tom Irwin, former Commissioner, DNR<br>Marty Rutherford, former Deputy Commissioner, DNR<br>Mark Myers, former Director, Division of Oil and Gas |
| June 23 | Dave Marquez, Attorney General<br>Charlie Cole, Former Attorney General<br>John Havelock, Former Attorney General |
| June 29 | Governor Murkowski |
| July 11 | Harold Heinze, CEO, Alaska Natural Gas Development Authority (ANGDA)<br>Carolyn Dunmire, Dunmire Consulting<br>Bill Corbus<br>Ken Griffin |
| July 14 | Joe Marushack, Vice President ANS Gas Development, ConocoPhilips Alaska, Inc.<br>Ken Konrad, Sr. Vice President, BP Alaska<br>Richard Owen, Alaska Production Manager, ExxonMobil |
| July 20 | Jim Whitaker, Chairman, Alaska Gasline Port Authority (AGPA)<br>Bill Walker, General Counsel, AGPA |