Stranded Gas Hearings
(0501210800 Minutes)

Informal Work Session on Stranded Gas Development Act Issues –
Bonnie Robson, Consultant to Legislative Budget and Audit Committee, Alaska State Legislature, January 21, 2005.

BONNIE ROBSON, Consultant, for Joint Committee on Legislative Budget and Audit, stated that she was to advise the committee on oil and gas matters related to an Alaska natural gas pipeline, specifically relating to negotiations under the Stranded Gas Act. She turned to the existing tax and royalty regime in the context of the Stranded Gas Act and in the context of negotiations occurring under the Stranded Gas Act.

MS. ROBSON relayed the history of the Stranded Gas Act, which was first adopted by the legislature in 1998. The Act required anyone wanting to negotiate a new tax or royalty terms under the Act, apply by 2001. There were no applicants during that time period. Subsequently, during the 2002 legislative session the Act was extended and made generally applicable to all North Slope gas development projects. The application for those entities interested in seeking tax or royalty revisions was extended until March 31, 2005. Ms. Robson related her belief that the Stranded Gas Act was intended to provide opportunity for improving the economics for a gas pipeline project. Thus, providing the opportunity for greater certainty for any entity that undertook the project.

MS. ROBSON highlighted that the Stranded Gas Act does not change the tax and royalty regimes. Instead the Stranded Gas Act allows applicants to come to the administration, apply under the Stranded Gas Act, and proceed with the negotiations. If the negotiations were successful, there would be a proposed contract under the Stranded Gas Act that would then come to the legislature for action

MS. ROBSON said the terms of the economic impact could improve under the Stranded Gas Act. There are several different approaches. One such approach would be that the parties can look for that win-win situation, which the economics are improved for both the state and the applicant or the party intending to build the pipeline. Another approach is to restructure the tax and royalty regime, which can provide a win-win situation or additional incentives for a party interested in facilitating the development of North Slope gas reserves. Ms. Robson related that she does not believe that any party would apply under the Stranded Gas Act if it was seeking neutrality in changes to the tax and royalty regime. There is a substantial requirement for reimbursement of state expenses as well as a substantial investment of finances and time for a Stranded Gas Act applicant. A party content with the tax and royalty regime would not take the effort to engage in negotiations under the Stranded Gas Act. The third approach, in which economics could be improved or affected under the Stranded Gas Act, is for the state to decide it was appropriate to provide some level of changes to existing tax and royalty regimes. Thus improving the economics to either someone intending to build the pipeline or to ship gas through that pipeline; and those changes could be at the state's expense. Currently, there are two applicants under the Stranded Gas Act who are actively engaged in negotiations with the administration. There is no obligation, either under the administration or this body to approve the contract. Ms. Robson stated that the committee may decide that the economics of today and the economics of the future did not justify a change to the existing tax and royalty regime.

MS. ROBSON explained that the second issue the Stranded Gas Act intended to do is provide the opportunity for increased certainty. The term "certainty" refers to the Alaska State Legislature's agreement for some term of years not to increase taxes on an Alaska natural gas pipeline project. The baseline assumption is that the projected economics for a project could be increased if there was some level of certainty as to the future tax and royalty obligations facing an entity interested in building a pipeline. Ms. Robson stated that there are problems with providing certainty.

MS. ROBSON informed the Joint Committee on Legislative Budget and Audit that she is present to protect [the committee's] interests and provide data on different scenarios.

MS. ROBSON pointed out that certainty or a long-term commitment not to change taxes has potential constitutional problems. There is an overall consensus amongst the administration, the legislature, and the applicants under the Stranded Gas Act, that they do not know what a court will decide in terms of the ability of the state to restrict its long-term ability to change taxes on the gas industry in the state.

MS. ROBSON pointed out the second issue about certainty is that certainty for one group of taxpayers necessarily entails some level of uncertainty for another. To the extent that the gas industry is assured that there will not be changes in its tax obligations and over time there is a restriction on the ability of Alaska to meet the states then current needs through modification of its tax regime. Increased uncertainty to the gas industry can be increased uncertainty to the state; it can also be increased uncertainty to other potential taxpayers.

MS. ROBSON stated that the third aspect about certainty or uncertainty is that if you move to a new tax or royalty regime through a contract process results in the use of new words. The mere existence of new words or a new regime creates some level of uncertainty in regard to royalties. A new regime creates the possibility for a new level of uncertainty as to what the new words mean, how they are interpreted and implied, and the economic impact of them over time.

MS. ROBSON commented that since the initial enactment of the Stranded Gas Act, and the 2002 extension of that Act, some changes have occurred. One such change is the projected economics of the gas pipeline project. Currently, there has been a sustained period of high gas prices, which impacts economics. Another change happened in October when the federal government passed an incentive for the Alaska natural gas pipeline project. The federal government's incentive will influence the profitability of any gas pipeline project. The final change is that at the time of enactment of the Stranded Gas Act there was limited interest by entities to proceed with construction of a pipeline. However, now the tables have turned and there are currently a minimum of four entities or groups actively pursuing the possibility of construction and they are: TransCanada, and the producer group composed of BP, ConocoPhillips Alaska, Inc, and ExxonMobil Corporation.

MS. ROBSON commented on the voter initiative creating the Alaska Natural Gas Development Authority (ANGDA), which is considering state ownership and construction of a pipeline.

MS. ROBSON mentioned that the Stranded Gas Act is not the only way to develop the gas pipeline. Currently, there are two applicants for a pipeline project under the Stranded Gas Act and two entities that are pursuing a pipeline or enhancement of a pipeline project outside the Stranded Gas Act. The two entities are proceeding outside the Stranded Gas Act because they are not tax and royalty payers. The fundamentals underlying the Act were addressing the tax and royalty regime, as it existed.

MS. ROBSON stated that there are active ongoing negotiations under the Stranded Gas Act with the producer group and TransCanada. The administration has publicly stated that it would like the legislature and the public to consider partial state ownership of this gas pipeline. The administration has also stated that it would like the legislature and the public to consider the state taking its royalties and its production tax long term as gas. Under the status quo, taxes are taken as money only and not as oil or gas royalties. The administration has asked Alaskans to start thinking about a willingness to move long term to a regime under which both the production taxes and the royalties were taken as gas.

MS. ROBSON believed the earliest possible date under which the legislature could expect the release of the Stranded Gas Act contract for public review could be the beginning of March 2005. Simultaneously there has been additional movement with the port authority, thus the Joint Committee on Legislative Budget and Audit may be asked to evaluate one or more pipeline projects either under the Stranded Gas Act or outside the Stranded Gas Act. The committee should be expected to do three comparisons in making that evaluation: compare alternative pipeline proposals currently being advanced by the four parties actively pursuing construction of the pipeline, compare what is being proposed either under the Stranded Gas Act or outside the Stranded Gas Act with the existing tax and royalty regime, and finally compare any proposed contract or arrangement outside the Stranded Gas Act with the alternative investment opportunities available to the entities considering construction of the gas pipeline.

MS. ROBSON related the administration's proposal for a potential Stranded Gas Act contract. The administration has proposed production taxes and royalties could be taken as gas as opposed to money, or in the case of royalties with the option to switch on six-month notice between cash and gas.

MS. ROBSON explained the different terms of possibilities for the first production taxes through a Stranded Gas Act contract. First, taxes historically taken as money could be taken as gas. A second possibility is that there could be a change in the existing tax rate. Third, there could be some change in the ELF [economic limit factor], which is used in calculating production taxes, is calculated or the practices surrounding it. Fourth, there could be a change in how the value of the gas is ascertained at destination. Fifth, there could be a change in what is permitted as allowable deductions when calculating the tax value of gas. Sixth, the state could theoretically lock-in on a pipeline tariff, either a specific dollar amount or a methodology. Seventh, the state could change its ability to change taxes by making a shorter long-term commitment that it would not increase the tax burden on a gas pipeline project. Finally, the state could also choose to change its methodology with regard to oil as it looks at changing its methodology on gas.

MS. ROBSON examined the details of the various possibilities for the first production taxes through a Stranded Gas Act contract:

> First, if the state takes its taxes as gas - we are talking about a substantial volume of gas - and typically production tax rate expected or tax expected for the Prudhoe Bay and Point Thompson units, which is where the parties anticipate the majority of gas flow will initially come from the gas pipeline are anticipated to be in the 8-9 percent range. If you combine that with potentially taking royalties as gas long-term and royalties, while typically 12.5 percent, run on average across all leases more in the range of 13 to 14 percent because there are leases of more recent vintage that call for royalty rates of either 16 2/3 or 20 percent. Combine your production tax rate with your royalty rate and you add 8 or 9 percent plus 13 to 14 percent royalties you come up with a combined 21 to 23 percent range implicit in the administration's proposal to take gas long-term. So if you are talking about a pipeline somewhere between the vicinity of 4 to 4.5 cubic billion feet a day the state could be in the position of now taking one billion cubic feet a day on the North Slope of Alaska and of course that puts the state into the business of marketing gas. It then becomes the obligation of the state to transport that gas off the North Slope to find buyers for that gas. And to recover its financial due from that gas.
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> It is also possible, with regard to production taxes, that the underlying tax rates can be changed and that is something that is authorized by the Stranded Gas Act. Negotiations on that subject are authorized by the Stranded Gas Act. So if there is a blended anticipated rate at the end of the day after application of ELF of 8 to 9 percent taxes on Prudhoe Bay and Point Thompson production, that rate could be theoretically... changed under Stranded Gas Act negotiations.

MS. ROBSON explained that there is also the ability to change the way in which ELF is calculated. The current formula is provided by statute and there are generally three things necessary to implement that statute. The three factors that need to be considered in regards to the calculation of ELF are: the [value of the] property for purposes of the assessing tax; the volume of the gas being produced from that property during the production tax month; and the number of wells operating during that tax month or more specifically the number of well days within a tax month. The property range for calculating ELF varies depending on the situation. The property could be as small as an oil and gas lease, as big as an oil and gas unit, the entire North Slope, or a per reservoir basis. Theoretically, the larger the property the larger the amount of reservoirs, the higher the tax rate. Another factor influencing the ELF is the volume produced from the property during the tax month, and in this instance the higher volume, the higher the tax rate. The last factor is the number of wells operating during the tax month, since wells are cost center so the more wells operating the lower the tax rate due to the lower ELF calculation. In regard to the Stranded Gas Act, the ELF formula calculations or practices could be altered through the Stranded Gas Act contract.

MS. ROBSON stated that other areas that could be altered through a Stranded Gas Act include how the gas is valued. The question of gas value becomes less of an issue if the state decides to take its production tax long term as gas, because then it becomes the state's responsibility to market that gas for maximum value. According to Ms. Robson:

> Under the existing regime, and it has been an area of some contention for a period of time, there is a question on valuation and generally the practice has been to look to its value at final destination and to subtract from that value certain allowable deductions to arrive at a field value, shall we say, which is used in calculating the production tax liability. We will talk a little bit more about valuations issues in the context of royalty. As, I mentioned one of the subtractions from destination value is allowable deductions, so something again that could be done through the Stranded Gas Act process is take a look at what are currently provided as allowable deductions. What is the current methodology for allowing deductions? And that could be altered too. And again ultimately alter the cash flow to the state if a pipeline is constructed.

MS. ROBSON explained that another possibility with regard to production taxes under the Stranded Gas Act is the state could agree to lock-in either on a specific pipeline tariff or on a methodology for calculating that tariff. Under existing law the Federal Energy Regulatory Commission (FERC) sets those tariffs and if there is not an agreement when the parties go to FERC, it will use its existing statutes, regulations, and precedent to arrive at what it determines to be a just and reasonable rate for pipeline transportation. There is also the possibility that could not be something resolvable before FERC but instead FERC could bless a methodology or an absolute rate agreed upon in the Stranded Gas Act negotiations. With regard to production taxes, it is possible to limit ability to increase those taxes over time. Ms. Robson stated that it is important for the Joint Committee on Legislative Budget and Audit to recognize:

> That a pipeline itself may not be operational on first flow and gas for up to 10 years from the date of approval of a contract, potentially longer. And then a contract has a statutory outside limit of 35 years from that commencement production that you could at least enter into agreement subject to first challenge on this constitutionality that would restrict the state's right to increase its taxes on the gas industry. And so, it becomes very important that you take a long term look at the state's economic needs and see whether you feel comfortable in exchange for providing an incentive for the pipeline in giving up what is typically your right to change taxes as needed to meet the then-current financial needs of the state.

MS. ROBSON stated that under the existing oil and gas leases issued at the time a company requires the right to go in and explore and develop on acreage, the state has the right to take its royalties either as gas or as money with six months notice to the lessee. The state can change the proportions with six months notice. The state's ability to take petroleum as petroleum or as money has been extensively utilized by the state. The administration's proposal would now have the state taking 100 percent of its gas from the Prudhoe Bay and Point Thompson area or from the applicants under the Stranded Gas Act, in particular BP, ConocoPhillips Alaska, Inc, and ExxonMobil Corporation as gas. The state has been able to take its oil or money to meet its needs for the in-state refineries and to meet other needs of the state. It has also left some of its royalties as money as a benchmark for the value of that production.

MS. ROBSON said that under the administration's proposal to take 100 percent of its gas, the state would have to undertake transportation of that gas to market and the marketing of that gas. Currently, the state has the right to leave its petroleum with the producers who have the obligation to market without charging marketing fees. Ms. Robson stated "Same thing with production taxes in a sense, taxes are taken as money and ultimately the valuation of use and calculating taxes reflects the fact that you have some extremely professional experienced international companies marketing that gas ultimately for benefit of the state." She stated that it is necessary to ensure that the state markets that gas with a manner that is competitive with global powerhouses. In order to address this issue the state could either build a marketing organization to undertake that task or to retain outside expertise.

MS. ROBSON explained that the administration's proposal to take royalties and production taxes long-term as gas means that the state would be on its own essentially for getting the gas off the North Slope. She aforementioned means that the state would have to obtain pipeline capacity to transport its gas. Gas pipelines are regulated differently than oil pipelines, she noted. Ms. Robson explained how gas pipelines are regulated:

> They are contract carriers, [which] means that the state if it has on the order of a billion cubic feet of gas, that it now must dispose of off the North Slope it means that it would have to go to what is called an open season. Many years on the order of perhaps four to seven or more years before pipelines start-up and make a long-term commitment to ship a specific volume of gas to a specific destination, and it would be obligated to pay the tariffs associated with that long-term commitment. Regardless of whether it shipped the gas, and regardless of whether it changed the destination to which that gas went, this has a number of implications that you [the committee] should be aware of.

MS. ROBSON explained the implications of the open season process. The state would have to know how much to ship since it has to commit to a specific volume through the open season process. And if the state takes its royalties in production taxes as gas and the state does not control production facilities, since there is no control over gas stream, there is an inherent danger in making a volumetric commitment for how much gas is shipped. Ms. Robson stated that it is important to think about "the potential liability for having to pay for capacity that you do not fill with your gas and that being a direct subtraction from revenue that would otherwise come to the state as a result of gas production."

MS. ROBSON related that Governor Murkowski has publicly advanced equity ownership or percentage ownership in the pipeline as something that is being considered. The state would be required to make a substantial financial commitment to own a share of pipeline, she remarked.

CHAIR THERRIAULT stated that the Joint Committee on Legislative Budget and Audit last year procured the Wood Mackenzie study, which is an oil and gas global comparison on competitiveness. By contractual arrangement with Mackenzie, this information cannot be made public. There are restrictions on the information from the Wood Mackenzie study and there is a confidentiality protocol, so that members of the legislature can go and view the information. Chair Therriault encouraged legislators to view the information, for which Ms. Robson will assist the members with any questions on the report.