ALASKA STATE LEGISLATURE

LEGISLATIVE BUDGET AND AUDIT COMMITTEE

THE ALASKA GAS PIPELINE

MAY 21, 2006

6:15 p.m.

Capitol Building
Juneau, Alaska

Reported by: Sandra M. Mierop, CRR, CCP

PROCEEDINGS

SENATOR THERRIAULT: ...to a section of the presentation where there will be open question and answer between the members of the Legislature who are here and the consultants.

Just very briefly, and I think all four of the gentlemen are going to introduce themselves and go over their resume and credentials. But we have Jim Barnes who is an attorney from the Houston area dealing with oil and gas contracts.

Rick Harper whose current employment out of his shop, he does arbitration work. He's the former president of ARCO Gas for a number of years. He'll also go over his resume.

Don Shepler who has been working with the Legislature for some time now. Don was very instrumental in the coordinated effort between the Legislature and the Administration on the FERC application and the FERC package that came out so favorable to the State last year.

And then, finally, Mr. Jim Eason who is the former division director of the State Division of Oil And Gas.

What we've done is asked them,

after they go over their -- their credentials to give us just a brief rundown of the way they see things sort of stacking up to this point, and the level of knowledge that they have with the -- the administrative proposal at this point.

And then once they each have had a turn doing that, they ask that we just take a short break before we get into the question and answer.

We don't have, unfortunately, a traveling mic to go up and down to make sure that we could hear the questions. What we like to encourage elected officials is to come forward to the witness table to either ask their questions so it's -- it's heard on the air, because this is being televised, or if you have just a short followup or short question you can ask it, and they'll try and repeat the question so that it's captured on the recording and also audible to those members who are watching on TV or the general public watching at home.

So, with that, I'll let them open it up and -- and go through or get started with the presentation.

MR. HARPER: Thank you, Senator.

My name is Rick Harper. I know many of you, but I don't know all of you.

I've been requested by the -- by Senator Therriault and Representative Samuels on behalf of the Legislature to look at this situation from an operating, contract administration, executive decision-making, and arbitrator perspective.

Generally, I have been in the energy -- involved in the energy industry for about 34 years both in corporate and noncorporate roles.

Corporately -- and I'll just hit the highlights as I'll see that they'll be relevant to the proceedings here -- I was with Atlantic Richfield Company for approximately 15 years. During that time, among other things, I was responsible for all of Atlantic Richfield's North American natural gas activities, including marketing, trading, pipelines, processing, and so forth.

Also, while at Arco, I oversaw regulatory affairs, strategic planning, and other functions as well.

My involvement with Atlantic

Richfield did not end at the end of that period. I remained continuously involved on an in-depth basis for nine years following that. And my total involvement with them ended, basically, with the acquisition of Atlantic Richfield Company by BP.

Other corporate roles that I've had, I served as president, chief executive of Canor Energy Limited, a fully integrated oil and gas exploration and production company with operations throughout the Western sedimentary basin of Canada, including Alberta, Saskatchewan, and British Columbia.

I also served as assistant to the president of United Gas Pipeline, one of the country's largest interstate pipeline companies. My principal role with them, in addition to assisting in the -- the sale of the corporation, was to oversee the expansion of the United's system.

My last corporate role that I will highlight. I was senior vice president of Northwest Natural Gas Company, a New York Stock Exchange Company, involved in gas pipeline, gas storage, and gas distribution operations.

From the noncorporate perspective, I've been involved in consulting continuously over the last 14 years. I have had a full-time consulting practice headquartered in Houston, Texas, for the last five-plus years. The scope of my activities have been both domestic and international.

My international activities have included Canada, Equatorial Guinea, specifically with the Alba field and adjoining prospects, a field with -- and surrounding prospects with potential not too much unlike the Prudhoe Bay area.

Most recently, I've been involved in a project in Bulgaria, Dobroudja field -- excuse me. Harder to spell than say, actually. Which, I think, may turn out to be one of the world's largest -- largest coal bed methane projects.

In my consulting practice, I'll just highlight a few of my constituents. They have been governmental and nongovernmental.

I've assisted the states of New Mexico and Louisiana as royalty owners.

I've assisted Chief Justice John

Duhe of the Fifth Circuit Court of Appeals as royalty owner.

I currently assist the family of Senator Lloyd Bentsen as -- as royalty owners.

I have represented Shell Corporation, Anadarko Corporation, Shell Trading Corporation, and Unocal as -- as producers in production-related matters, and pipeline companies such as TransContinental Gas Pipeline Company on pipeline matters.

So, hopefully, that's instructive in terms of at least understanding my biases and perspectives relative to the gasline and related agreements and documents.

I'm here today to share some general first impressions. This is a qualitative assessment. It's not meant to be a quantitative review.

As Senator Therriault indicated, my role is basically to -- at this point to identify, as I see it, issues and concerns, as well as areas where I -- I feel that the proceedings and the agreements offer some -- offer some benefits.

Generally, I would say that this is

a contract which seeks to redefine the State's legal, regulatory, administrative, taxation, and other rights to a business relationship. And I think the -- the agreement has been clearly constructed on that basis. And to that extent, I think it has been effective in achieving that objective of making that shift.

Now, the presumption as to whether making that shift, given the set of circumstances is -- is the most appropriate is -- that's not what I'm indicating. What I'm indicating is I think I basically understand the intention.

I do not believe that this is -- maybe using a different set of semantics -- moving from a litigation strategy to a nonlitigation strategy. But I do believe it -- its intent is to redefine historical relationships to a -- what I would refer to as a commercial or business set of relationships.

The contract has been negotiated based upon a -- separate tradeoffs based upon perceptions of the State's relative strengths and weaknesses in its negotiating position. And I think I have obtained a pretty good feel for what I feel the -- the Administration's view of the --

the strength of the State's position is, and that there are great concerns about the State's ability on timely basis to enforce its existing obligations.

I think the agreement was constructed on that basis.

I think a great deal of effort has gone into the construction of this agreement, and I think the producing companies involved have thrown a great deal of time and talent, and probably their top talent, at this agreement.

I am not in full accord, necessarily, with the set of assumptions underpinning the agreement, but -- but I do think that it was -- was done on that basis.

Now, moving in more specifics, I would mention to you the cover page of the contract, and I think generally coverage pages are not significant. In this case, I think it is. If you will notice that at the top of the cover page it says "draft," and at the bottom it says "all terms are subject to ultimate review and approval by all parties." This is not an agreement that's been executed by the parties that's contingent upon board approval by the producers and approval of the Legislature. It is in its purest form a draft.

And I raise that issue for purposes of clarity, and also to indicate that I have not seen anything in here that would provide that in the event that the Legislature would approve and the State would execute the agreement that if one or more of the parties decided not to execute or simply just to delay and not to commit one way or the other, I don't see a time frame by which this agreement would expire. That it may be an offer, an irrevocable offer. So I just sort of raise that issue.

The other thing I would note with the cover page is that the agreement is between -- between the State of Alaska and three subsidiary companies of BP, Exxon, and ConocoPhillips. And it is important to understand who you're doing business with, not only what the assets are, but any restrictions that may be in place in terms of the disposition of those assets, as well as the liabilities.

Traditionally, in my business activities for -- for transactions, even a fraction of the size of this, it would be important to know the credit -- the assets and liabilities, the credit worthiness, and any ability to transfer assets in and out of -- of these subsidiaries.

And I would also note that the LLC which is being set up in order to, basically, own the pipeline upon its construction will likely be owned by a different set of subsidiaries.

Commenting specifically on the context of the contract, and, again this is my -- my view. I don't see a work commitment. And I do not equate diligence with a work commitment. Normally, diligence is a standard by which you measure whether or not commitments are being made. And I don't think one -- if it's being suggested, that diligence is a proxy for work commitment, I would say that it is not.

Typically, in my experience, in agreements such as this, I would expect to see specific timelines, specific deliverables, and -- and a different -- and I've been more accustomed to seeing a different standard than the diligence standard that's being administered in this agreement. More typically, a due diligence standard or a prudent operator standard.

Also, I would have -- I would -- typically, what I've seen that I -- I don't find here, and, again, this is a total -- I will agree that this is a total business transaction, an integrated business transaction, so to comment on one part doesn't necessarily mean that -- that the whole is to be disregarded.

Also, there -- there's no standard for efforts. Often you'll see reasonable efforts, and in some cases best efforts, in terms of the actions of the parties, particularly the operating parties in an agreement; and I haven't noted -- noted that.

One thing that I would also like to point out, and I think I probably have already, is that this contract is -- is effective upon the date executed by all of the parties. Simply executing should all but one of the parties execute it, there are no remedies within the agreement one could look to, because this agreement is not effective until -- until all parties have signed it.

The diligence standard, and there's -- again, there's nothing wrong with specifically necessarily defining "diligence" in a way that's not in accord with industry custom and practice, necessarily. But I will note under this contract that "diligence" refers to what is prudent under the circumstances with some specific exclusions. And, most notably, in this regard, an exclusion concerning errors in judgment.

And I will contrast that with what is normally a due diligence standard which is the effort made by an ordinarily prudent or reasonable party to avoid harm to another party or himself. Failure to make this effort is considered negligence.

In this agreement, because errors in judgments and other -- there's other specific exceptions, I would -- I would suggest that probably negligence and possibly gross negligence is excused under the -- under the diligence standard.

I am an arbitrator and so I have spent some time focusing on the arbitration provisions of the agreement. It is a unusual one, in my experience, although baseball arbitration is not -- certainly not unusual in American business culture; but in oil and gas activities, it is one foreign to me. But I'm -- the concepts are certainly not foreign.

I would also offer that the -- this agreement, basically, seeks to avoid the parties looking to the courts for any redress and relies upon arbitration for the resolution of all disputes. And I think it's important to note that in the definition -- definition section of the contract the disputes mean matters, controversy, or claims between the State and a participant arising out of or relating to the contract.

So, it, basically, encompasses everything, and I would argue also encompasses payments.

The agreement also provides for a -- what is called an amicable resolution process. I've heard that referred to as mediation. I would suggest that that is -- is not mediation. It is simply a process established for the two parties to try to get together at a higher level within the organizations to seek resolution. That's certainly not mediation to me.

With regard to the arbitration, I

am concerned because it is the basis upon which all disputes are to be resolved in this agreement that the -- the time frames and the scheduling that are provided, including the selection of the arbitrators, is a very -- a very lengthy process.

A couple of other highlights I would like to hit is by way of observation. I do not see in this contract, for instance, any obligation on the part of the producers to produce once the pipeline is completed. Now, I also understand that there is an underlying presumption in negotiation of this contract that the economic incentives which are attendant to the agreement would motivate the parties' behavior.

But there is no specific requirement for production, nor is there any specific commitment or requirement for processing of the gas.

This has been an issue historically in the industry, and, in fact, there was a time -- in fact, a very long time in our industry's history -- where all producer sales under interstate commerce, had to be certificated before the Federal Energy Regulatory Commission.

And in the 1970s, as you might recall, when we hit a time in this country, in North America, generally, where there was a shortage of natural gas, the FERC imposed the standards of a reasonably prudent operator in ensuring that producers would timely deliver and to the best of their ability using reasonable efforts, deliver gas into interstate commerce. And so I am, at this point, and subject to more study and review, concerned about the fact that there is an absence of any production commitments.

I will point out with regard to the -- the pipeline, I think I mentioned previously, and has been covered thoroughly, I think, in the Administration's presentations, that pipeline -- the State will be owning a share interest in a -- in an LLC, a legal entity, that will own the pipeline. The State will not have ownership outright of the asset. That -- that certainly will need to be thoroughly understood.

Ownership rights on a share basis are different than ownership rights on an asset basis. And concerns about voting rights and operations and operating provisions, rights of transfer, rights of sale, and those kind of things, will be very -- very important to understand.

We have not seen the LLC, and it may be that the LLC will illuminate when it -- with regard to that issue and the underlying issues that -- that I mentioned.

I'd like to basically end my little piece of this by briefly talking about capacity management. There is a clear and conscious decision for the State to take its share of production in kind. And I certainly have no objection to that.

I would tell you that ownership of a pipeline and ownership of capacity rights on a pipeline are two distinctly different issues, and have to be looked at differently.

I will say that I have had a great deal of involvement over a long number of months with members of the Administration, including Ken Griffin, Kurt Gibson, and Anthony Scott, for instance, dealing with issue of capacity management.

There has been a conscious decision to take delivery of this production at a very upstream -- what I would call a very upstream point in the production chain, at or near the field.

By taking delivery there, it raises a -- a very host of very complex issues. And I will say that the -- the team that I have been dealing with -- I believe in that instance, has given -- given the assumption that that's where the point of delivery needs to be or has to be from a trade standpoint, I think they've done a very -- in my view -- thorough job of trying to manage that issue and quantify risk.

We looked at doing a risk assessment for what the management of one's own pipeline capacity when gas is delivered at an upstream point like that would entail, and about that time, the Lukins study that you've heard about was issued. We took a look at that. I think that's a very good piece of work. It suggests that there is -- it's very difficult to quantify the risk of managing capacity with deliveries at that point, but that -- that the range of uncertainty is broad and may range as high as from zero to as much as 11 percent shrinkage of net present value to the State depending upon how the permutations of managing that capacity unfold.

So, with that, hopefully, I have highlighted some issues for you and will look forward to the question-and-answer session.

Thank you.

At this time, I'll turn it over to Jim Barnes.

MR. BARNES: Thank you, Rick.

Good evening.

Thank you, Senator Therriault. I appreciate the introduction, and it's good to be here with you here.

I'm a bit of the new guy on the block and don't have the -- the extensive experience with this project that these other guys have. But I do have quite a bit of experience in international oil and gas matters. My background is that I've got a bachelor's degree in math, a master's degree in resource economics, a J. D. in law, and diplomas in international law from several European Universities.

I've basically worked for three companies: Florida Gas Company, which is a pipeline company -- or was a pipeline company.

It was -- it was acquired and it's now a part of another group.

Tenneco Oil Company, and my -- my first experience up here in Alaska was with Tenneco Oil Company about 20 years ago working up on some projects up on the North Slope.

And then with British Gas Company.

And all of those -- those companies I did work as a negotiator and lawyer, and mostly in the international division. And, in that capacity, I spent most of my time working with governments, relations between parties, doing financings, and, in general, working the -- the full gamut of international relation -- international oil and gas.

I've been on my -- my own in a law firm, both large and small, for about the past, oh, 12 or 13 years. And my clients tend to be -- range from large integrated majors to small independents, and working on the full spectrum of the sorts of agreements that you see before you today. Relation agreements between parties and with governments.

I would -- in looking at this agreement, I really would like to join Rick in commending the -- the negotiating team for persevering through a very complex series of documents and -- and pulling this thing together. We haven't seen all of the pieces yet, but they -- they clearly have -- have worked very hard at -- at pulling a set of documents together.

From my perspective, I thought it would be useful to -- to talk a little bit about how this transaction appears to me with the -- the international perspective that I can bring.

As you know, Alaska is a -- a lease structure with a tax royalty payment, and they manage through -- through regulation.

In the course of the past few days, we've seen lots of comparisons to various international deals, and it has been with the intent of showing that Alaska needs to compete with -- with other countries in order to be -- as the companies, the investors manage on a portfolio basis their various opportunities.

And so we've -- I think these are -- as I look back through the materials, these are the -- the countries that -- that have been -- analogies have been drawn. And I've split them into two groups. This group over here, which they all tend to be lease relations and -- and they don't have any stabilization.

And then this group over here, they tend to be production-sharing contracts, and they do provide for stabilization.

For our purposes, because the SGDA contemplates that they -- the parties will be -- or the government will be entering into or may enter into a stabilization agreement, the fiscal contract, that it would be useful to -- to put this in context. These comparisons are -- are -- are all very -- well, as I say, they're powerful tools. But they're best understood if they're in the context.

And so what I thought I would do is go through in a few major subject matter areas, compare a production-sharing contract or a typical provision in the production-sharing contracts for, for instance, Angola, Azerbaijan, Nigeria, Kazakhstan, Qatar, and Russia with the fiscal contract that we are presented to take a look at.

First, with regard to the parties, under a typical production-sharing contract, the host government would appear as the granting party and as the regulator. It would typically be a national oil company who would act as the entrepreneur, the one that is actually participating in the deal.

The investor would appear as a local subsidiary, usually backed by a parent company guarantee or some sort of bank guarantee.

In the fiscal contract, the State is going to act as the entrepreneur, or appears to account act as an entrepreneur, and as probably a guarantor of some of the subs that will be formed. We're not clear on that. We haven't seen it. But it -- the agreement itself is written as though the State is the primary acting party.

The -- the various subs that Rick has indicated would be members of these midstream LLCs. The producers and the midstream LLCs are going to be the participants in this granting instrument.

And -- but there's no parent company guarantee on behalf of the participants. Ultimately, there may need to be, but as of yet there's nothing in the -- the document.

With regard to the area that is typically found in a production-sharing contract, it usually applies to just a single block. The fiscal and commercial terms are what has been called -- I call and, I think, Dr. Van Meurs has called -- ring-fencing. This is limiting the application of the contract to the area of the block.

And, normally, there will be a relinquishment clause that if the investor does not commit to develop within a finite period of time, then PSC terminates and the block must be relinquished.

Contrasting that to the -- the fiscal contract, the -- all of the producers' North Slope leases and units, are in the agreement at present. More can be added if necessary. Some will fall away if they're not actually produced.

It is not ring-fenced, as best I can tell, and there is no relinquishment.

The term of the PSC, typically, will have a primary term, four to eight years, and during that the parties need to perform -- MWC is a minimum work commitment -- and also finish their work and commit to develop within that period. If the investor declares commerciality -- and this is a financial feasibility determination made by the investor -- then the investor needs to prepare a plan of development, which would be approved by the host government. Once it's approved, then the investor has 20 to 30 years, typically, to produce and -- well, to develop and produce oil, and usually a somewhat longer period, 30 to 45 years for gas. And that's consistent with what I think you've been told and Dr. Van Meurs has presented.

With the -- the fiscal contract, as far as the qualified project program, the QPP, there -- there is no primary term that's associated with it. And there is no commitment to develop within any primary term. And I think that Rick talked a little bit about some of the other aspects of that -- or that work commitment, and the -- the difficulties. And I'll come back to that in a moment.

The -- this initial period, however long it is, will end when the mainline entity declares that they have reached project sanction.

Now, for this purpose, the AK PipeCo I think it's going to be called, or Alaska PipeCo, will be a participant in that decision, but they will be focused as a member on doing the work. It's -- although they're participating in that decision, their alignment and orientation is likely to be different than the alignment that the State as a regulator would have.

There does not appear to be any provision for approval of the QPP by the State.

The work commitment. During -- in a production-sharing arrangement, the minimum work commitment must be performed during that primary term. If the investor fails to do so, then the PSC terminates, and the -- the block is relinquished or is turned back.

If the investor does declare, then, of course, as we've said, he's got to go ahead and prepare a plan of development, and that plan of development is subject to host government approval.

If the plan is approved, then parties will go ahead. That is monitored on an annual basis by an approved work program and budget.

If the investor fails to commit within that primary term, or fails to perform the work, then the host government has the right to terminate the PCS, the granting instrument, and the block would be relinquished.

Under the fiscal contract, the -- as Rick has indicated, the participants are obliged to perform with diligence. There's no time period; and the diligence excludes the contemplation of -- well, he said -- I won't go into it in anymore detail.

The -- the mainline -- I think the point I would like to raise, though, is that the mainline entity LLC can modify that qualified project plan. It doesn't seem to require any approval other than by the parties to the mainline entity. And there is no State approval.

The -- the remedy is if -- the State's only remedy is if the -- the participants, which is the midstream entities and the produce -- and the producers fail to act with diligence. And they can establish it. Then they can terminate the fiscal contract and bring the project to an end.

The management and control tools,

under a normal PSC, the national oil company would participate in both upstream and midstream decisions. The host government would continue to have maintained its role as the regulator, and it would fully regulate in accordance with the law. The host government and the national oil company would participate in the annual work -- the approval of the annual work program and budget, and a plan of development.

Contrasting that to the management control provisions under the fiscal contract, the State and its subs do not participate in upstream decisions. The -- the subs will participate in the midstream decisions, but we don't know the extent of it right now. They will be a minority -- minority shareholder.

The -- the regulation has been put in the hands of FERC, and then for the Canadian segment, the NEB; and that's an exclusive grant of jurisdiction. The -- the contract actually removes jurisdiction from the RCA, and the DNR's authority appears to be fairly restricted.

The government take under a production-sharing contract, normally the -- the components would be royalty, profit-share, a local obligation to supply gas, and taxes.

On the royalty share, the -- the government would have the right to either take in value or take in kind. And if the national oil company takes in kind, then the -- it would take it when the gas or the oil is in marketable condition, and it would bear the transportation and marketing costs. The same thing would be true for the profit share. This is the production share, if you will.

The -- they can take in value, they can take in kind. If they take in kind, it's when the gas is at marketable quality, and they pay transportation and marketing.

There's usually also a local supply obligation that all of the producers have a commitment to supply proportionately the local economy with what is needed in terms of petroleum.

And then, finally, the tax structure that goes along with that.

In the -- the fiscal contract, the -- the royalty is just royalty in kind. And the -- the gas company will take it at a point where there are still impurities in the gas and so the -- the AK GasCo will have to pay gathering, treatment, transportation, marketing, and disposal costs. We don't know what the disposal costs will be. There have been some -- there are provisions in there that deal with the gathering and treatment costs.

On taxes, there will be tax in kind, or tax -- tax gas taken in kind, and the same thing is true: The delivery point will be the same point, and the same costs will burden that interest.

There is no local supply obligation.

The State will receive an impressive series of -- of payments in lieu of taxes, and other fiscal considerations. It is -- given the -- the assumptions, I agree with Rick, it is a very -- it is a very comprehensive contract.

The -- the last aspect would be on ownership of assets. Under PSC, the national oil company, or the host government, would own all of the assets. The investors would pay for them, and they would become the property of the State. The investors would have a right to use it. In some cases exclusive, but they would have a right to use those assets; but they wouldn't own it.

Under the fiscal contract, the -- the producers are going to pay for and own the production assets. The midstream LLCs are going to pay for the upstream, transmission, GTP, mainline and -- perhaps the NGL processing facilities. And then the State, as Rick has indicated, will own an interest in various entities that will, in turn, own interest in those midstream companies.

I think that takes care of it.

Don, I think you're next.

MR. SHEPLER: My name is Don Shepler. I'm a lawyer with the Washington, D.C. office of Greenberg Traurig. Before going to work there, I have accumulated approximately 30 years of experience in the Federal Energy Regulatory Commission proceedings.

I began my career as a staff attorney on the Commission staff; wrote opinions for the Commission; was a trial lawyer in the pipeline rate part -- section of the -- of the Commission; and then went on to work as, essentially, chief in-house regulatory counsel for, over the life of my -- my career, for three different interstate natural gas companies.

The first natural gas pipeline company I worked for was Northwest Pipeline Corporation, which is based in Salt Lake City. I left there and went to work for -- then called KN Energy, now one of the companies in the Kinder Morgan Pipeline family of companies. And, most recently, I've spent about 16 years as chief regulatory counsel for Colorado Interstate Gas Company based in Colorado Springs, providing gas pipeline service from the front range of the Rockies into the Midcontinent, and also providing gas deliveries to the -- the front-range Denver/Colorado Springs areas.

In this process, I participated actively in management decisions involving all aspects of the business, whether to build pipelines, whether to expand pipelines, the rate aspects of the -- the development of pipelines, and the certification process at the FERC.

As Bob Loeffler noted the other day, unlike oil pipelines, you have to have prior approval from the FERC in order to do anything in the interstate natural gas business. You have to have a tariff on file that covers all aspects of your services. And I was actively involved in all of that, including a key member of the -- the various management teams.

That all being said, I -- as background. I share the comments of my colleagues in the sense that having been presented here a week or so ago with 6 to 900 pages of -- of materials, that's -- that is clearly an impressive amount of work. It's an impressive body of work and is -- is clearly -- manifests lots of effort on the part of all of the participants, the State and the -- and the producers.

Given my specialized background, I'm going to focus most of my observations tonight on the FERC-related aspects of the contract. But before I get to that, I would like to note that I was -- I was taken by the -- the recognition earlier this week that we were -- we were told, and appropriately so, that the terms of trust and alignment are important in this process of doing a joint venture between the State and the -- the private companies.

But it occurred to me, based on my

experience working for the Legislature Budget & Audit Committee, in preparing our comments to the FERC in the rule-making proceeding a year or so ago, that, in fact, the State has a unique interest in this pipeline, and -- and, frankly, in my opinion, can probably never be totally aligned with the producers, the partners in this contract, because whereas both parties -- both sides of the equation have -- have as their mission the goal to get a pipeline built, and to be part owners of that pipeline, or joint owners of that pipeline, the State has a second agenda, at least in terms of what we have represented to the -- the FERC as being appropriate policy for them to facilitate, and that is that the pipeline ought to be expandable and ought to be expanded to the maximum extent possible to give rise to a robust industry of gas production on the North Slope.

That, I would submit to you, is an interest that the producers do not share or do not share with the priority that the State -- that the State brings to the table.

So, from my standpoint, I think it's important to start with the predicate that the State has an agenda that is different than the producers, and that I've comment -- my comments from that standpoint, I come at them from the State's goal from ensuring that there is, first of all, a pipeline, and secondly, that the pipeline can be readily expanded to accommodate the explorer producers that are -- are essential to maximizing the -- the State's resource base.

And while I am -- have an expertise in the FERC side of -- of the process here, like my colleagues, I was struck by the -- the work commitment that -- that's baked into this contract. And others have noted that the State seems to have no authority to approve any changes to the -- the project plan.

Notably to -- and from my perspective, most recently, on May 10th, the project plan was updated. From my standpoint, the timeline is -- is most significant. It's the same timeline that was reflected in, I believe, the application that the sponsors put forth at -- at the outset. But the fact that the -- that the project entity, the LLC that's going to be doing the project, of which the State has at most a 20 percent interest, it's contemplated in the -- the first pages of the substance of the contract, that this project plan will be amended and will be updated at least annually.

My concern is that there seems to be no provision for the State to be -- to acquiesce in material changes to the project plan.

Particularly, from my standpoint concerns historically, the question is when is -- when are activities going to start? Unless the State has some authority in excess of its 20 percent voting share in the LLC, or it has some authority by agreement that it has to consent to changes in the project plan, my concern is you've -- you don't have anything here that's firm and binding if the -- the producers can change the project plan, delay the project plan, redirect the project plan without the -- the consent of the State.

And, from my standpoint, the State would certainly be in a -- be inclined to consent to change the project plan to the extent that there were steel price increases or gas price decreases, but if the -- if the proposal was to change the project plan to -- to move this out and move the start date over to 2009 or 2010, you know, I'm concerned that the State just needs to -- to have some voice in that over and above its 20 percent share.

This goes back to the alignment issue and the trust issue, and I am reminded of President Reagan's comment dealing with Russians about trust, but verify. So that would be my first observation before I -- I move to the -- the issue of FERC-related matters.

And in that regard, I have focused primarily on the questions of access and expansion. Quite frankly, access was pretty well established by the FERC in their order issue about a year and a half ago, and the contract is -- is not inappropriately silent on that. It's -- there's not much to add to simply the question of access. The FERC established rules. There will be open seasons. Under discrimination prohibited by the FERC.

But one of the things that -- recognizing the State's unique interest that was -- was baked into the comments that were filed by a total of -- as I counted the signatures, we had 26 legislators actually sign -- physically sign the comments that were filed at FERC, including the members of the LB&A, and we stressed in those comments the importance of access and early and extensive expansion of the line.

As Senator Therriault alluded to at the beginning, the FERC listened to our comments, and those of the Administration. The FERC order was -- was highly favorable to everything we asked for. We got more, frankly, than I had advised the -- the committee that they could expect.

First of all, we obtained a promise from the FERC that they would focus on the sizing of the line when they got the certificate application. They indicated that they would focus on that, and that they committed to requiring potential design changes in the event that they established that the pipeline was not suitably designed to be readily expandable and of an appropriate size.

So that was the first victory, and it was a major victory -- victory is not the right word. A major benefit to the State that the FERC is going to look at the sizing of the pipe, to make sure that there's room for not just today's producers, but tomorrow's producers and the next generation's producers.

The problem with that is, as Mr. Loeffler noted last week, the producers have appealed that one section of the FERC finding.

Thus, inasmuch as the contract does not require that they withdraw their appeal, the Legislature may wind up having this component of the FERC package eliminated based on the outcome of the -- the court appeal.

Status of that is we are going to be briefing that case this summer. It will be argued in the fall; and decided, hopefully, before the end of the year.

But the reality is is that, unfortunately, from my standpoint, in working -- in negotiating this contract, that seems to me that the State had an opportunity to insist that the producers withdraw their appeal and -- and solidify that one piece of the -- of the FERC ruling.

The second profoundly important piece of the FERC ruling was their declaration that they would establish a presumption in favor of rolled-in pricing for pipeline expansion. I'll try briefly to explain in words what that means, but I've got a graph that I think will obviate a thousand of my words.

The -- basically, it's contemplated that the pipeline can be expanded at least a couple of times to take the capacity, as you see, for 4-and-a-half or 4 billion feet a day, up to about 6 bcf a day by relatively low-cost compression. This means that you -- you put new compressors or pumps on the pipeline. They're relatively inexpensive. They only cost in terms of 10s and 20s of millions of dollars. They provide lots of bang for the buck, more capacity for not a lot of investment.

In -- in those -- in those cases, whether you do rolled-in pricing or the alternative, what's called incremental pricing, the rate goes down. You have more volumes with relatively fewer costs being stacked on and having to be recovered.

But at some point, down the road, when a pipeline, you know, can go from 6 billion a day to, say, 7 billion a day, the low-cost expansions are no longer available. There's just an engineering limit to how much capacity, how high you can run the pressure, how many miles apart you could put the compressor stations. At that point you have to go to the expensive looping, which is described as putting more pipe in the ground. You know, you go back and you put miles and miles at various locations of the 42-, 48-, 52-inch, whatever the size of the pipe is, and that gets very expensive. It's like rebuilding the pipeline all over again for those miles.

Well, if you roll that -- that expansion in, which means you -- you take the new pot of dollars, all of the investment, all of the old investment, and all of the new investment, and you divide through by the new capacity, you get -- you get a lower rate -- well, for the new shippers than if the new shippers have to pay exclusively the cost of the expansion.

That's shown graphically on the -- on the right side of the graph here where if you're -- I think it's -- you can see that -- that while -- if you started with a 97-cent rate on Day One -- and these are illustrative -- you start with a 97-cent rate, the rolled-in treatment might push the -- the existing shippers' rates up a few cents to $1.02 in this illustration. But that's a rate that if you hold it in, everybody would pay. So you would have a level playing field.

The alternative, if you have incremental pricing, is that the existing shippers would pay the -- the rate they had before, back in the column to the left, the 91 cents, and the new shippers would pay $1.61 or something in those ballpark terms.

Well, the bottom line is that you can quickly figure out that that expansion is just not going to happen.

So, by determining how you're going to price that expansion capacity, you effectively determine whether or not that expansion is ever going to take place.

If that has to be priced on an incremental basis, it will never happen. The pipeline is capped at 6 billion a day. It will never go to 7.

So the FERC helped us out by ordering -- or setting a presumption of favorable rolled-in pricing which is rebuttable, but at this point the -- that's the FERC policy.

Now, as I look at the contract, with that in mind, I notice that the contract is silent with respect to any voluntary expansion. So there's no commitment in the contract to the terms under which a voluntary expansion might be undertaken. There's no commitment to the terms under which the expansions might be priced, and, basically, that, to me, was a -- is a bit of a gap.

The silence on the contract on -- on voluntary expansions surprised me because I would expect that there would have been a commitment to expand in engineering increments. And there are logical amounts of capacity you can create for logical amounts of expansion dollars At the request of -- of creditworthy customers on a rolled-in basis and -- and that's just simply not there. That, to me, was curious.

As Mr. Loeffler noted earlier in the week, there is a statutory FERC-mandated expansion vehicle available. That vehicle is not an easily-used vehicle.

You can go to the next slide.

There are at least eight conditions under which -- which the FERC must satisfy before it can mandate an expansion. Notably here is the second one that I've highlighted that existing shippers must not subsidize the expansion. Is a rate increase a subsidy? It depends on the magnitude of the rate increase. That's -- that's unclear.

But the -- the federal vehicle requires that all eight of these criteria be met before the FERC can order an expansion. And, as Mr. Loeffler noted, this statute has never been tested judicially. The FERC would act under the statute, there's the prospect of appeal, and delay.

Now, the contract is silent on mandatory expansions, as I would expect it to be.

But the contract creates a -- a State-initiated expansion alternative which was spoken about in the presentations. And as I count them, the -- the contract takes all eight of those mandatory criteria and adds at least ten more criteria to the hurdles under which -- before which the State -- a State-initiated expansion can go forward. Most notably here are the top two that not only must there be no subsidy, which was already in the federal legislation, but now the -- the State-initiated expansion need not go forward if there is a rate increase to -- in the existing shipper, or if there is an increase in the fuel retention percentage, which is another form of the component of the rate associated with the -- the expansion.

So, my -- my conclusion is -- is that neither the federally mandated expansion rule is particularly viable, nor do I think that the State-initiated expansion rule facilitates any expansion of the pipeline. The best vehicle for expanding this pipeline is voluntarily on the basis of economics. And, as I said, I see actually -- unfortunately, nothing in the contract that -- that describes the terms under which such an expansion would take place.

I'm going to stop here. There are other issues and, frankly, like all of you, we all got the contract a few days ago. We're still in the process of evaluating it. I will admit that I did see a draft of the contract in October. Quite frankly, the access terms have --

have not improved from what I saw then, nor have -- and the work commitment provisions have not changed appreciably.

So, more work to be done. Still trying to analyze this and look through it. But those are my initial impressions on the -- the one key element that the LB&A comments focused on, namely, the necessity for expansion in order to facilitate the State's interest in maximizing the -- the development of the gas resources.

With that, I'm turn it over to Jim Eason.

MR. EASON: This is strange, I have to turn to speak to you.

My name is Jim Eason, and by way of background, I think I know many of you, but many of you may not know me. I have both bachelor's and master's degrees in geology and for the -- for a number of years, which I'll tell you a bit more in detail, I've been employed in various capacities as a professional geologist.

I have about 34 years, now, of experience. It includes about 13 -- pardon me, about 32 years of Alaska experience. Most of that here on the ground in Alaska. My experience spans from industry to government, as well as -- as private consulting, which I have been engaged in for a number of years.

I worked with Atlantic Richfield Company, which originally brought me to Arco -- or to Alaska in 1974. I've worked with government. I've worked with the conservation division with the USGS which is now the Mineral Management Service in their leasing programs, and as a supervisory position there helping folks understand the resource potential in designing leasing terms and -- and conducting lease sales for those folks for a number of years.

I also served as the deputy director for the Division of Oil & Gas for a number of years, as well as for - as its director. As a matter of fact, I was there for about 14 years, I believe, as I recall. And about ten years as director. Leaving in 1995 to open my business. And I've been employed -- self-employed for about, I guess, that's about 11 years now.

In that business, I do consulting that's on technical issues related to oil and gas, as well as consulting related to efforts for people to understand the regulatory systems that they're going to operate under in helping them to comply with those.

I also, in that business, continue to consult with government, as well as with industry and others.

I have -- a fair amount of the practice over those years has been involved with not only the companies themselves, but law firms that represent oil and gas companies, both in the capacity of providing strategic advice, as well as assisting them in -- in litigation support and in serving as expert witnesses in some cases.

One of the things I wanted to talk about before I get started this afternoon was something that is a very personal thing. I think we all have it, but I don't think we have all talked about it. And, you know, I sat down and thought about the goals that -- given the project assignments that I've had -- that define what I am trying to accomplish and I think, probably, to some extent, all of us have similar -- similar goals and similar assignments. I think it's important to help folks understand some of those and hopefully it will help guide you for seeking whatever assistance we can provide for you in this process.

But I view them as -- as really consisting of, primarily, and first, helping folks assist in explaining, interpreting, and providing some more detail where people need it on the agreements to the extent I can, to the extent that those areas fall in my areas of expertise. And I think that is probably a goal, as I said, shared by all of us.

And -- and sort of scoping that down a little bit, I think it's an important part of it, though, to say that I think one of those goals is to -- to help identify collateral effects where we see them. Because there are many collateral effects in -- in what I refer to it as related effects that flow from the combination of this contract and its exhibits and -- and, of course, you know, if you broaden it out, arguably with the provisions that you're looking at now with the PPT, and a number of other agreements that we haven't seen yet.

And that brings up a very important point that I should just drop a footnote against that -- that this work is very preliminary.

Comments tonight, from my perspective, are preliminary, and -- and I'll let others speak for themselves there.

But in the absence of having seeing all of these agreements, it's -- it's certainly impossible at this point to -- to tell you with any finality where there are connections and linkages that -- that may be important to you in your decision going forward.

It's also to help identify where we can, the package of concessions and tradeoffs that have been made by both parties to the agreement. And that's something that's -- that's never entirely possible, because the ones that we'll note in finality what those were are the people that sat in the rooms over the last two years. And -- but to some extent, I think that's an important part of the analysis to at least provide you -- to give you resource to you if you have those questions. And one of my goals in this process is to -- is to work toward that end.

And in doing that, you know, there are going to be some fiscal consequences that need to be identified. There are going to be some nonfiscal consequences. And both of those are, I think, part of how I would view it as something I would want to look at if I were evaluating this deal from a commercial perspective or from a company's perspective.

And probably one of the guiding principles that -- that I'm working under is that our effort is to be constructive. And -- and by that I mean we're to help you to understand, from our different perspectives, the various linkages, connections, and -- and implications of the agreement. But where there are -- where there are options -- pardon me, where there are issues where one of us are critical or what we would view as red-flag issues, that we just don't tell you about them, but we be prepared to offer some constructive criticism -- constructive solutions or alternatives to you if -- if something like that is what you would choose to pursue.

And, finally, to be available to answer questions to the folks in the Legislature that -- that may need that.

Tonight, I'm going to focus, just in the interest of time, because everyone spent a great deal of time this week listening to many, many people, and you're going to have to spend more time in the next couple of days. I want to -- to focus on one of those issues that -- that I identified earlier on as very critical in -- in my review of the contract. And it's more of -- as an example to help give you a sense of the linkages that are important to understand here. And, in turning to that, I wanted to give you a quote, because it really summarizes my approach to everything I do. And I think it's important that you understand that.

Those of you that listened to the six hours of the actual contract interpretation, primarily by Bob Loeffler -- if you left early, you missed the quote -- but it was singularly important to me -- near the end of Bob's testimony -- or his comments, he said -- this is a quote: And when you look at it, in one sense, every part of the contract has some fiscal consequence.

And -- and that's something that, you know, it's sort of important to keep in mind, I think. And, with that, I would like to talk about the issue that is -- is not paramount, but it's certainly one of those things that -- that is on my list of four or five that if I were asked to write would be the -- would be the principal concerns and discussion points.

And it's the in-kind taking provisions of the contract. And I just wanted to spend a few minutes focusing on the implications and some of the things that I see in the contract --

A SPEAKER: Can you speak into the microphone?

MR. EASON: I'm sorry, yes. Yeah.

It's one of the -- obviously, one of the major provisions. It's a decision that was made, as I think we've been told in the briefings that we've had, one of the earliest decisions that was made in the negotiations. But from that decision, a number of things flow, and you've had a -- in the briefing, but probably spaced out in a number of different presentations, I think you've -- you've had a fairly comprehensive description of many of the things that -- that flow from that decision, and probably some discussion of the risks and the potential costs that are inherent in that to the State.

And starting by saying, you know,

it is -- it is something that was very important to the negotiators and it is what it is today in the contract. But those -- that decision, I think, needs to have some historical context to understand what it is as a matter of policy, but also what it has as -- not only fiscal, but nonfiscal consequences.

Starting with the status quo. Under the current law, and under procedures that have been in place for a long, long time in the state, the State has the option of taking its oil or gas in kind or in value. Those provisions are included in these leases, and those provisions are included all the unit agreements that have been signed and implemented and operated by the State.

It's at the State's election and with some variation in the unit agreements, it's on a fairly short notice, and it was identified fairly early on by the producers, and it's accurate to say that those notice provisions for a project like this are something that, you know, is very problematic, because you need definite longer notice than would have been contemplated under the unit agreements that are there now.

But in this case, you are going to a irrevocable commitment to take your gas in kind, both as royalty gas and as tax gas, for the term of the contract. And in doing that, a number of other things were negotiated that are, in my view, related to that.

Under the status quo, the point of delivery that is determined for where the State takes its gas or oil is defined by the lease, and it's also defined in the unit agreement. And I'm going to use shorthand, so -- so, you know, forgive me for that, because these are very technical terms but are very specific terms in the leases and unit agreement. By, as a general matter, I think an easy way of describing is that they're typically taken at the unit boundary. It's where the product is delivered and put into a pipeline and goes off or into a plant.

And, also, under the existing leases that have been issued, the obligation is on the producers to provide the -- the oil and gas, whichever, in good and merchantable condition. Again, in shorthand. And that means it's free of lease expenses. It's whatever lease expense is incurred from, you know, building flow lines to transporting on the flow lines, to conditioning it, to cleaning it, to removing impurities, all those things, those are responsibilities of the lessee.

And under the value provisions of the lease -- again, we're on the royalty side. Keep in mind, when we're talking about the value at this point.

But under -- under the value provisions of the lease, in shorthand again, the State has what I view and what I think probably most people who have worked with the State view, as very, very favorable lease terms. They were lease terms that were designed to fit the balance that was struck in a competitive lease where the State retained it's 1/8th royalty and -- generally, and the producers had 7/8ths. And they provide, essentially, that the State gets the higher of a number of different criteria that is set forth in the lease, or essentially on the newer leases, particularly the ones that are issued since, you know, the early '70s or so -- or late '70s, pardon me, and early '80s -- minimum value, essentially, that can be established by the Commissioner.

On the revenue side, they have a separate -- obviously, a separate set of principles that guided their evaluation, and -- and at least from my perspective when I sat in the State DNR role, I always viewed the -- the tax side as having a much more favorable set of circumstances, because, you know, they were the tax collector, and they could -- they could look at a lot of things, and they do -- they could make a lot of decisions. And they generally -- generally had a high level of deference to them, and particularly had a long history of decisions and appeals, and in some cases litigation that -- that supported positions they had taken. So that over time a -- a large number of questions had been asked and a large number of questions had been answered. Some to the State's favor; some not.

But, generally speaking, the ground rules have -- have evolved over time, but they are -- they are pretty good right now compared to where they started given all the unknowns that were unknown -- that were not known at the beginning.

And under the terms of contract --

I want to contrast now -- the things that -- that we see. The -- as I said, the first and major one is that the State, instead of its election ability of in-kind in value, commits to taking full volume, full-time, and it's a -- as I said, irrevocable condition.

The point of delivery for where it takes its gas, it moves very far upstream, and at first glance, it may not be significant, but by moving upstream, it also has the effect of adding some costs, and we'll talk a bit more about those as -- as we go on. And the State assumes, in doing that, that it's responsible under the contract for its lease expenses on the total volume which is -- which is 20 percent, including the royalty and tax gas.

The State assumes the responsibility, as I said, for marketing, transportation, and other things that -- that go along with that.

When it does that, it loses a number of things. And it's important, I think to the calculus to understand how those things have to be valued.

As I said, the Administration

has -- has identified several as we went through the process, including the loss of the provision of the higher-up -- the valuation provision, and there are ways of estimating how much that may be, or approximately how much that may be. So that that provision is gone.

It also -- in the process -- another feature of the contract that's related to the in-kind taking, is -- is a change in definition for how gas will be defined. Under the leases, gas is -- as is oil -- is defined consistently, and it's hydrocarbons -- again, using shorthand. Under the contract the -- the definition has been changed to include the gas phase or to include hydrocarbons as well as impurities, which has some effects.

And -- and the most obvious one is that by taking a volume of impurities as if it were gas, you are losing some volume of the merchantable gas, and so you need to -- you need to understand that that is a part of the calculus when you're -- when you're considering what you're getting with your volume. You would ordinarily be entitled to -- to something that is -- is not only free at lease expense but it's gas, it's merchantable, it doesn't have CO2 in it, it doesn't have H2S in it.

The State also, among the -- the panapoly of costs it's assuming that it would not have under the lease, is a separate cost for disposal of those impurities after it has received them. Technically, not after it's received -- after it has received the -- not physically, but literally -- those.

And the -- there is another provision of the contract that -- that looks to how you're going to deal with the disposal. And disposal is not a regulated activity. And, basically, again, as a shorthand, the history of disposal is going to be dealt with by commercial arrangement. And by commercial arrangement would, I presume, be negotiations among the parties that -- that are going to do the injecting, and that that rate is undefined. The tolls for that are undefined, but they will be decided at some point, and -- and those are also fiscal obligations that the State's assuming under this contract, and they're undefined, so, of course, we -- we can't help you with what that number is. But we can tell you that -- that it is going to be a number that -- that you may or may not want to figure in the grand scheme of things.

The other thing that is, you know, a significant departure from past practice, beginning -- I'll digress for just a moment, but bring you back. I digress at the risk of being -- of appearing to be someone who favors litigation, and I don't -- but we've had a lot of litigation -- I talked a little bit about it when I appeared before the Legislative Budget & Audit Committee back in -- whenever it was, February, March. And there was longstanding litigation over a number of these oil and gas issues on the royalty side, and, of course, there's been litigation on tax issues, as I've said.

But one of the things that happened when -- after the litigation was -- was filed. The Legislature in the late -- I think it was '78 or '79, I honestly can't remember. I keep confusing in my own mind the date. But when the major rewrite was done of the oil and gas leasing statutes, the Legislature moved to try to limit uncertainty about one of the major elements, and that was whether the State had any obligation to pay fuel costs. And it stepped in and told the Commissioner of Natural Resources in statute, which is still current law, that he could not issue an oil and gas lease -- a competitive oil and gas lease anywhere in the state that had a provision that allowed any fuel costs for the lessee. And that has been the law since. And, you know, I don't have a number, but I can tell you that -- well, there's a lot of leases that have been issued since -- since 1979. And all those leases have the same provision. And the unit agreements that have been done since then have the same provisions.

So, the contract will reverse the provisions of those unit agreements, as I said, as far as fuel costs. And one of the things that comes -- is specified in the contract, that there will be a cost allowance, payable by the State, and that will be payable on all State gas for the entire term of the project. And that number is -- is set at 22.4 cents per mcf, and it escalates with the Consumer Price Index.

That is -- there's an exception in the -- you know, to be -- as technical as I can here without -- you know, I don't want to misrepresent this, you know, but there's some gas that is -- except gas that is subject to an upstream facility gas payment and tax gas subject to Article 14.

But, generally speaking, it will be the -- it also includes folks that, you know, may come in -- leases that may be expanded to this agreement, as well as leases that, in theory, are out there today that may come in.

In addition to those fiscal consequences -- and I don't -- I don't represent that that's a comprehensive list. That's a list that, at this point, you know, I've -- I've identified and -- and it's a very preliminary list. But -- but it's there, for whatever.

In addition, the State, as I said, has some nonfiscal policy considerations that -- that are triggered by this provision to take in kind. And that is, you know, the -- the same principles that led it to establish in-kind and in-value taking have been -- you know, there's documentation of those in your historical record. And as legislators look at it, you know, they have -- probably each one of you will have a different view, or maybe not, of whether or not there is importance to retaining that right. But -- but, obviously, that right's gone, and -- and as I've said, it's clear that -- that however, even if you retained that right, it would be proper, I think, under the circumstances for a long-term gas contract to -- to be ready to make long-term commitments.

But the question to you is whether those terms are -- are the appropriate terms, and whether it's something that should extend for the life of the -- of the project.

The -- the other concern -- it's not just a concern here, but -- but a concern that sort of is overarching, and I think Rick addressed it, and probably all of us have some concern about it in one respect or another, is that these -- the in-kind taking provisions, however they're implemented, go from administration by the agencies, by Revenue and -- and DNR, to an arbitration or tribunal panel. And there are people much more qualified than I am to talk about arbitration and how it's structured, but -- but it just appears to me when I look at it from someone who's had to administer leases and has had appeals and those sorts of things in front of -- that -- that the procedures are very limited and may not capture fully what -- what you would hope.

Finally, the -- just a brief discussion of -- of which of these leases are involved with these costs that the State will assume under the obligation.

As you've been told, there is an exhibit -- or as, I think, you've seen, there's an exhibit to the agreement, Exhibit D, and, you know, I -- when I looked at it, I wasn't sure, but I -- but I confirmed with the deputy commissioner of Natural Resources that that list is all the North Slope leases that are -- that are currently owned by the participants.

And, of course, there is the -- as I said, future leases acquired by the participants would also come into the agreement, and there are -- there is the potential with the companion agreement or the companion legislation, the -- the uniform upstream fiscal contract of bringing in a number of other leases as well. So it's hard to -- you know, it's not just hard, it would be impossible to give you just some sense of just how broad that range may be.

One of the things that was pointed out in the discussion with legislators and during the briefings this past week was that there is a a cap on the volume of gas. As I recall, it's 70 or maybe 75 trillion cubic feet of commitments that would be entertained as -- and then -- there would be no longer any eligibility for people to bring leases in under that as I -- as I recall the comments.

But that doesn't fully capture the importance, just the fact that leases don't come in doesn't limit the gas volume that is going to be subject to -- to lease payments, and to these differences that have some fiscal consequences. Because, as I said, and again, it was confirmed by the DNR's deputy commissioner, that -- that the intent is under the agreement that this 22 -- for example, the 22.4-cent mcf cost allowance would apply to each mcf of the State's royalty and tax gas.

There are, I think, with all of us, other concerns that -- that we are -- or apparent concerns, I think, is the way I would say them now, because we are in a preliminary stage looking at this, and that we will be looking at, and I want -- I don't want to try to -- to go beyond that. I don't want to use your time, because I think it's important that -- that folks have the opportunity to do that.

In closing, I just would say, that I think this is an extraordinarily seamless agreement from my -- my experience, it is a -- it is a long agreement. It has been the product of at least two years, is my understanding by a number of people. And I think many of us know many of them personally. And they're all very good people. And they've done a tremendously difficult and arduous task of bringing in a lot -- a lot of considerations, a lot of detail, and, you know, that's exactly what you would expect of the kind of agreement that you're looking at it.

And with that, I'm through.

SENATOR THERRIAULT: Why don't we take a break and come back in five minutes?

[Break]

SENATOR THERRIAULT: We'll get started again.

Before we get into the question and answers, and we would really like this to be --

to be interactive. So if you have a followup question, we want to make sure that you get the -- the answer, if you feel that your question was misunderstood.

Also, after the presentation, a number of people asked about the -- the Power Point presentation. We will have that available. And probably get it submitted to offices via e-mail so that you will -- you will have the different slides, so if you weren't able to jot it all down in notes.

Okay. So, with that, why don't we see who's got questions. I'll just recognize people. Representative Samuels.

REPRESENTATIVE SAMUELS: Thank you.

I've got two questions, and I'll let everybody go, I'll come back if I've got something more.

The first one was to clarify something that Rick Harper said. You said there's nothing in the contract that said the producers had to produce once the pipeline was built. But I must be missing something. In order to get the financing they had to sign up for FT, and if they had FT, why wouldn't they?

What would be the scenario where they wouldn't want to produce if they had FT?

MR. HARPER: I understand your question clearly. One can presume that if a pipeline is built and placed and are sitting on their doorstep and that they are paying for capacity on an ongoing basis that they would produce. But you could rhetorically say, well, Midamerica or TransCanada or Kinder Morgan, somebody else simply built the pipeline today, just on their own, at risk built it. Parked on their doorstep, would -- would this produce? There has been a debate about that.

I think that the situation you're going to find yourself potentially is no different than the scenario I just outlined. You have an agreement, it's executed, it's delivered upon, and a pipeline is built. You're still going to be in the same situation contractually, as I understand this agreement, with no affirmative obligation to produce.

REPRESENTATIVE SAMUELS: Okay.

Second question, Mr. Chairman, this is for, I guess, Mr. Barnes, but whoever wants to jump in.

On the work commitments, if -- if we were a country, we could speed up our regulatory process, we could speed up our judicial process, even a western democracy, we could -- we could speed these things up, but we have to be essentially deal with two foreign countries, we have to deal with the United States of America, and we have to deal with Canada. So it came up with the last LB&A meeting with the antitrust, somebody will file suit, antitrust, if a producer project goes forward. And the FERC will say one thing, Department of Justice doesn't have to agree, so, therefore, it's another X number of years delay, and then the Canadians -- don't have any idea how their judicial system works, but you can see a series of delays that have nothing to do with -- with either the State, the producers, if it were TransCanada, if it were LNG project, any of these projects you have to go through this regulatory environment which you have absolutely no control over.

So how do you balance out the fact where you want a start date or gates to walk through or a start date for gas with a fact that you have this plethora of potential lawsuits and regulatory problems that aren't really within the State of Alaska's realm?

MR. BARNES: I understand your question. Typically, in the international arena, these -- these minimum -- minimum work programs and whether -- or the equivalent, if you will, where it requires regulatory approval. There's nothing directly analogous, because the -- the extent of regulation in the United States over gas pipelines is -- well, I guess Europe would have something comparable, but generally most countries don't have that. But every time you cross a boundary, you have extensive problems on these cross-boundary situations, the negotiation of the treaty and so on.

What usually happens is rather than trying to, at the front of the project, plan out exactly what is the timeline, which is the not possible, the parties, the Government, will impose a reasonable estimate -- efforts, deadline, maybe four years, maybe three years, whatever is the period of time, and say this is what needs to be accomplished.

As you get towards the end of that period, if there has something -- if there has been something that has taken place, you manage an extension on an exception basis rather than trying to stop it on an exception basis.

SENATOR THERRIAULT: Thank you.

Do we have another question?

I'll jump in -- I'll jump in with one -- Representative Samuels, come on up.

REPRESENTATIVE SAMUELS: The State's monitored expansion, the way that I read the contract, you've got the mandatory, you've got the voluntary, which is generally what the feds already said, and the State sponsored, you go through your series of 18 different criteria, some which were very simple, and some which weren't. But then after all of that, you -- you get back to if the FERC changes something that the original pipeline company doesn't like, they have veto power over it anyway, so -- the way that you're reading it at first blush, what's the point?

MR. SHEPLER: Well, I think, Representative Samuels, you're correct. Can you get my last slide?

Next one. Two more after that.

There is a provision in the Article

8.7 which -- which basically says -- you can read -- this is the text of it -- that this -- this section which has the -- the 8, plus the 10 conditions for the State-sponsored expansion is effective unless -- if the FERC issues a certificate on a basis different than -- so, let's say the contract provides for no rate increase, so the application to be filed on the basis for incremental pricing, and if the FERC said, no, we told you that we meant rolled-in pricing for Alaskan pipelines, that the project entity says that they will reject the certificate.

So, you're right in your assumption that -- that you could get into a situation where even with the State-initiated expansion, you would not have an expansion, except on these very limited terms, if -- and if the FERC approved that sort of limited expansion.

REPRESENTATIVE SAMUELS: Thanks.

SENATOR THERRIAULT: Question for Mr. Barnes.

Can you discuss a little bit about if we go to an arbitration system, that means that things are -- are pulled out of the judicial process, and as a sovereign exercising its power to tax, there's a general concept that the courts will offer some deference to the governmental entity, as long as their system is fairly reasonable, applied -- applied fairly, and are not arbitrating capricious. So that deference will be lost to the State, won't it, with arbitration?

MR. BARNES: That's my understanding unless there would be -- arbitration is dispute resolution by contract. And so the -- the terms of that dispute resolution will be governed by the arbital rules, whatever the jurisdiction that you take -- not the jurisdiction, but the arbital body that you take, and unless you provide by contract for deference to the State's regulatory decisions, or the arbital rules themselves would so provide, which I don't -- I don't believe they do. We could check that, but that would be very unusual. Then you have lost that -- that presumption.

SENATOR THERRIAULT: Other questions?

Representative Seaton.

REPRESENTATIVE SEATON: Thank you.

Jim, just following up on that a little bit. Because there's been some -- been some question about arbitration. Since we're doing that under contract, I presume that's under the constitutional provision that contracts will -- will hold. Does that mean that we give away or renounce our use of the courts if the arbitration doesn't come up to where we wanted to go?

MR. BARNES: Yes, the -- the provision -- and I have to admit, I have not studied the -- the fairly complex dispute resolution provision. But, in general, arbitration is thought to be binding, and at that point, the adjudication of the facts is over.

Now, arbital panels do not have an independent ability to enforce an award. And so the provision in the agreement says the parties can take that arbital award and they can register it in a court, but they cannot raise new issues.

So when you -- when you go through -- excuse me, not registration -- certification in a court. When you certify it is simply that the arbital panel has now issued its award, and the Court is going to lend its authority to the enforcement.

Typically, if the parties to the arbitration, one has lost and the losing party would just pay the terms of the award. But if, for whatever reason, it wouldn't happen, then that's when you would take it and certify the -- the arbital award with the court. But it's not a -- what we would call a hearing de novo, where you start with the facts and go over.

It's a very, very restrictive process, and it's simply to say, "Court, here is the -- you know, the award, now please enforce it."

REPRESENTATIVE SEATON: To continue, to Jim Eason.

I was somewhat concerned about, you know, talking about Exhibit D, I believe it was, that listed all the properties on the North Slope and the current producers, and the upstream cost allowance, field allowance provisions on gas and how that would interact with oil and what impacts that -- those upstream costs that we would now be allowing in the fields, if it's an oil and gas producer, both, how that impacts oil and what those ramifications are.

MR. EASON: My reading of the contract, I don't see that there's any effect directly flowing from the contract on -- or any allowance for oil fuel cost. It's for -- and -- and there essentially is an allowance, a per mcf allowance. There's no distribution or continuing in auditing or inventorying, if you will, of whether it's for oil or gas, but it's just an agreed-upon amount that people have negotiated that they will pay for each mcf that flows.

Now, there are some agreed-upon amounts for -- at Prudhoe Bay, for example, that were done in this settlement agreement for the royalty share from Prudhoe Bay, not for the tax gas. But the agreement provides that those amounts will continue for those that have existing cost allowances, those cost allowances will continue, and in that case, there are some cost allowances for oil as well as gas, and these new cost allowances will -- will apply to the remaining leases as well as, as I said, any new leases that are brought in that may be issued tomorrow and that are brought in under the terms of the contract by those three participants in the contract. But, again, if you go to the next step and -- and do the companion -- or the related legislation for the uniform upstream fiscal contract, those leases are candidates as well, and the universe of those leases, I think, it -- you could get some idea by just -- you know, a simple look at the DNR inventory of North Slope leases to find out how many of those are involved.

It's -- but, again, that's something that people elect. They decide to make a decision that they want to sign a letter of intent, I believe, is the controlling language, that if they sign a letter of intent to make a firm commitment for the pipeline, they bring those leases in, and there the application, of course, then depends upon whether they do, in fact, continue with that. Their ability to gather that allowance depends upon them actually doing gas when it's been produced.

So, the simple answer is I don't see any -- I don't see any attempt to -- to leverage or to change any existing provisions for oil cost allowances, and I don't think that there's anything in the language of the contracts that I've seen so far -- and again, with the same caveat, I need to read and reread many of these provisions, and I'll do that with that in mind to be sure that -- that it' s something that I haven't missed.

REPRESENTATIVE SEATON: Just to followup.

Is there any interaction, then, with the -- with the cost deductions that an oil company that produces oil and gas could take on their expenditures, or would the 22-and-a-half cents be subtracted from those costs, or -- what would be that interaction?

MR. EASON: As I understand the interaction, Representative -- Representative Seaton -- the -- you're referring now to the deductions that will be available under the PPT?

REPRESENTATIVE SEATON: Right.

MR. EASON: I believe those are separate and cumulative. That the allowances that you are making for the people to deduct there will -- operating costs and capital costs, and those sorts of things, will continue. Or will -- will be in addition to the allowance for the fuel costs.

REPRESENTATIVE SEATON: Okay.

Thank you.

SENATOR THERRIAULT: Next question. Senator Wagoner.

SENATOR WAGONER: Thank you, Senator Therriault.

I don't know who to address this question to, but maybe it's more seeking information, additional information. But right now we've got 7.25 percent of the gas is our PILT for in-kind -- our gas.

That's before the liquids are taken out. So, if you subtract that, you're down to 6.225 percent of the gas. I guess my question is: What's going to be the cost to have that gas cleaned up? A lot of us are thinking we've got 7.25 percent of the gas as a payment in lieu of taxes, and we don't. We have 6.225 if you take the liquids out. And I'm sure we're going to get credited someplace along the line for those liquids, I would think. But I'm not sure. I don't see anything in the contract that says the State gets the value of the liquids. And then we're going to pay for the injection of the CO2 back into the -- the ground, and we're going to probably be billed for that. In some cases, I'm sure, when they use that for additional recovery, people -- the oil companies pay people for CO_2. So I think this is something I'd like to see fleshed out a little bit. I -- I think we're a little early right now. But I think before we get to the final decision, this -- this is going to be a big number when you take over 1 percent of your PILT away from calculating what the value of that gas is going to be overall for the State of Alaska. And then we've got to make sure that we don't bite -- or take capacity of the pipe and ship the gas we aren't getting.

So -- so I'd like an answer on that eventually. Jim, is that going to be you?

MR. BARNES: I'm not sure I can answer the question. As a matter of fact, I'm sure I can answer the question.

SENATOR WAGONER: It's going to take some time to flesh that out and come up --

MR. BARNES: Parts of the equation are just not knowable at this point, because under the terms of the contract, for example, the cost of disposal is going to be borne by the State for its 20 percent or its -- however you characterize it, for its share of the royalty and tax gas, State gas for shorthand. That's clear. That's an obligation you have under the contract. Again, which you don't have today, but you will have with the contract.

And it's also clear that -- it's not even clear where disposal will take place because that's a decision that under the contract is specifically noted will be made at some point in the future. And the cost of doing that will be negotiated in -- in -- what are, I think, referred to, as commercial negotiations. And to the extent that that cost is something you bear is something you can't know at this point. You will -- under signing -- when you sign the contract, you will have those costs. And you will find out what they are at some point in the future.

The -- the compositional issues are certainly beyond my scope, but, you know, there are some folks that could be called on to give you -- to give you a hand on what the estimates are for the liquids contents as well as the impurities contents which, again, are -- you know, are substantial. And, as I said, under the -- under the lease, those are -- those are removed. They are not part of your royalty or tax volume. But under the contract will be, and -- and, again, it's just one of those things that I think that part of it can be quantified for you to some greater extent. The -- the cost of injection just simply can't unless someone is willing to tell you what they will do it for now.

MR. HARPER: Senator, if I may add on, that, notwithstanding the agreement -- and I don't -- I haven't seen anything that explains to me exactly how liquids and impurities will necessarily be handled, which is your question. And it will be important -- and I would separate out treating of the gas, which is removal of impurities and disposition, with processing the gas, which is the for-profit removal of valuable liquid hydrocarbons such as ethane, propane, butane, and natural gasoline.

The location and ownership of a natural gas processing facility have not been determined, whether it will be in Alaska, whether it will be in Canada, whether the ownership of such a facility will be within the confines of the LLC or not. It's not clear. Whether the LLC would contract with, you know, a third-party processing facility, not determined. In that situation, often, of course, the processor keeps a cut of the liquids. So, I share your concern about what the net net is from a State perspective.

There are many unanswered questions at this point with regard to that.

SENATOR WAGONER: Might have been better off taking the 7-and-a-quarter percent methane gas.

Okay. Thank you.

SENATOR THERRIAULT: Another question?

Go ahead. This is Representative Mike Kelly.

REPRESENTATIVE KELLY: Thank you, Mr. Chairman. Just a couple of maybe schedule and procedure comments.

The identification of the red flags and then recommendations on what to do about each of them, and I assume each of you will have a batch of those. How's this all going to tie together and in what sort of a time frame? Would be -- would be one question.

And then we're kind of changing out

the -- the team here as we switch from PPT to -- to the gas contract, and on issues such as -- I'm concerned about progressivity on -- on the gas piece so that we don't -- you know, if 20.06 Henry Hub $15 gas occurs 24 months into this thing right off, am I happy about what we did, or am I rushing into work to see what we need to do?

So the progressivity piece, is that going to be -- with this team to some extent, a question like that, or will we retain Econ One or Johnson or somebody to look at that as well?

Just a couple questions.

SENATOR THERRIAULT: Well, Econ One is still under contract. They're -- they're still running graphs of different proposed versions of the PPT language. Mr. Harper, actually, is part of the overall Econ One team. He was part of their -- their overall proposal. But, Mr. Finizza, who's been here before, was more involved in the modeling of -- doing the modeling on PPT. He'll also be involved in -- in modeling -- some modeling under the -- the gas contract. But they're still onboard. Any questions that you have on PPT, you know, are still able -- we're able to get responses to you.

These gentlemen, as we take a break here over the holiday weekend, they're also going to be taking a break. I'm sure they -- as they wing their way home, they're going to be taking their contract and documents with them. And when they return, when we return, they'll probably be a little farther down the line as far as a little bit more specificity as far as the areas they want to flag for us, whether it's -- you know, as Senator Wilken has indicated to me, is it a green light, a yellow light or a red light issue. You know, that type of thing. And as they've indicated, we've asked for not just a flag, but is there a way of mitigating the concern so that if you individually wanted to talk to the Administration about that, you could. Or if you're shaping comments to submit during the public comment period, you can do that and take advantage of -- of their advice.

We do anticipate, of course, under the terms of the Stranded Gas Act there's a duty for the Commissioner of Revenue to come and make himself available, and the State's team to the Budget & Audit Committee to answer questions.

We know -- I've heard a lot of

positive comments on the roundtable discussions that took place on the PPT discussion where you had industry representatives, agency representatives, and -- and consultants there, and they can question each other, and as one or two of the consultants have indicated to me, quite often they feel that they're not actually that far apart. But if you don't get to hear them speak one right after the other, you try to remember what was said three days ago, it might appear like they're disagreeing, but maybe they're a lot closer than you think.

So I think that roundtable-type discussion we will try and facilitate that before the end of the public comment period, or certainly when the contract gets put in for the Legislature's consideration of -- of approval or not.

REPRESENTATIVE KELLY: Thank you.

SENATOR THERRIAULT: Additional questions?

Representative Coghill.

REPRESENTATIVE COGHILL: I'm a little nervous getting in front asking questions that I -- I think that might be something I should have already known.

But probably one of the broad questions is on the -- on the work commitments issue. So, maybe I'll just go there first.

They made the comparison that the diligence standard is not even in some of these other world-class agreements. And yet this is probably a little different animal than some of the things they've showed us. So you talked about deliverables.

And was it you, Mr. Barnes, that talked about that?

Can you give me some idea of what you meant when you said "deliverables"? I think I know what you're talking about, because you started kind of outlining some things. But I want to hear it again.

MR. BARNES: Right. What -- what normally happens in a production-sharing environment is the -- it arose out of a situation where the State wanted to have more control over the investors in their country. And so the -- the regime was created to effect that greater degree of control. So the result is in each step approvals are -- are required.

In particular, there's a -- the environment is that there is a finite period of time, a primary term in which certain work needs to be done to get to the point where the decision is either to make -- you know, commit to develop the big-dollar commitment or not. And the deliverables at that point in time, are largely a plan of development. And the plan of development would include not only the field development, but how that -- that oil and gas is going to be taken to market. So it's a midstream question as well.

The plan of development is then presented to the -- to the State, and the -- let me just point out, that the national oil company is participating in this process, because they're frequently a member of the contractor group. But the State is then maintaining its regulatory authority. So, the -- the control, if you will, is -- is effected in two ways. One, it's through the participation, but it's also the standard regulatory control done through approvals.

REPRESENTATIVE COGHILL: Mr. Chairman.

Maybe that's one of the things I'm struggling with. It may be the nature of the beast in taking -- taking our gas in kind and becoming an a part owner together with them. Then does it seem like we are sacrificing the ability to get to a more definitive work commitment? Or is it not a nature of that beast?

MR. BARNES: Well, I think that, as I understand the -- the existing -- the status quo, certainly, the ability to -- to approve this project where a pipeline project exists -- you know, I mean, that is part and parcel of what -- what you have. There's a regulatory environment here that I don't pretend to -- to be an expert in. But most of these -- these foreign jurisdictions don't have the extensive regulations, so it's all done in the form of a combined and extent -- comprehensive plan that talks about how these things are going to be moving forward.

Now, with regard to your comment about diligence, the -- it's just a -- throughout the production-sharing contract, the contractor, the investor party, is obliged to act with diligence.

Now, it's not diligence as in a defined term; it's just simply a -- a standard of conduct that they are expected to do. They're expected to act as a reasonable operator in performing these things. And, as Mr. Harper has indicated, sometimes there's a higher level of standard of conduct that is imposed.

But, in my experience, the -- the significant thing here between the work program and -- and what is in the fiscal contract that has been submitted to you for consideration, is the burden of proof has been reversed.

In the situation with the production-sharing contract, the investor is driven by a -- a deadline, and they have to perform within that deadline.

Can they get an exception? Can they get an extension? Yes, but they have the burden of proof to show that they haven't been just warehousing, that they have, in fact, moved forward diligently, and that they have justified on an exception basis to the government that they need more time, or they need whatever they -- you know, they need more -- perhaps more financial concessions. But it's done on an exception basis.

In the present situation, the --

the presumption is that the -- the participants, which includes the producers, as well as the midstream entities, are moving ahead with diligence. And the burden of proof is placed upon the State to show that they haven't been moving with diligence.

And, like any proof of a negative, it's hard to do. Proving that someone was not diligent is going to be difficult.

And I think Mr. Harper has indicated what some of the specific problems associated with that proof of a negative are.

MR. EASON: Something -- maybe I could take a crack at that, too, because I think we all -- I think we all identified that as an issue when we first looked at the contract. But, from, again, different eyes, we've each got different experiences, and -- and we've seen different contracts and different agreements and we've seen see people do different things under -- to try to meet the standards.

And the -- the thing that was -- you know -- this is, first of all, a unique -- sort of like -- and everybody can speak to themselves -- the actual language of -- of what is diligence for the purposes of this contract, and thereby for the purposes of a work commitment, however you describe it, that you're getting for this -- this project.

And it is -- you know, there was some discussion about why different terms weren't selected, because there are diligence standards that -- you know, that are -- in some cases, are very widely used, and very widely understood and, you know, the argument has been made that -- that there are always disputes about them and there's courts and there's challenges and legal things. But, in fact, you know, there are prudent -- for example, as Rick pointed out, there's a prudent operator standard and there are -- there are other standards that apply to diligence. And, in some cases, there are standards that are widely used in the oil and gas industry so that, you know, there may be some dispute about them, but in certain -- especially in certain jurisdictions, those disputes have been very narrowed over time because there's lots of decision, lots of court precedent, and, you know, when you sign a contract that has that in it, you know that you're going -- you know, you know the limits of what you're going to be arguing about with a greater detail than you would if you were just starting with a clean slate.

And this -- and this one is not only a clean slate, it's a -- it's a uniquely clean slate from my perspective. From the things I've seen and from -- if I -- if I just stood back and said how would I enforce this, if I had to enforce it and make a -- you know, if I were in a regulatory setting where you weren't doing arbitration, how would -- how would, you know -- if I decided on behalf of the State that you weren't being diligent, what would I -- you know, how would I have to make that argument and how would the attorneys have to make that argument and that sort of thing?

And this, again, starts with a -- with an -- a different standard than -- than we see anywhere else. It modifies it by saying that its -- its diligence is prudent under the circumstances, and that -- you know, it seems, well, what difference does that make?

It makes a difference when arbitrators are given this standard -- and Rick can speak to that -- versus one that is -- is more in -- aligned with industry practice. But also, the -- the standard then is qualified further, by providing a list of things that are to be considered by the arbitrators as potentially ameliorating circumstances to -- that even though they might have wanted to say that this wasn't diligence, and they look at this other list -- and Rick is the only person among us, I think, that has direct experience about what those instructions mean and -- and how they influence arbitrators.

But they're given a list of things so that it -- it almost seems -- it seemed to me at first blush, when I -- when I first saw the provision, that it was -- it was a bit asymmetrical. It was designed, it appeared to -- to provide lots of caveats that seemed to go in one direction and -- and, of course, as is pointed out, the burden of proof is -- is fairly high, and -- and couple that with the arbitration procedures where people -- where the arbitrators are limited to a very narrow consideration. It's -- it's, you know, it's a different provision than I've seen. And others can address what they think about it.

MR. HARPER: I have -- I have one thing to add.

Ours is not to make a policy call. Ours is not to say something can't be defined differently. Our mission in this regard, in this regard, I think all of us view, is to raise the issue so that you maybe will focus on it in your deliberations. I'd like to have the opportunity to tell you what the prudent operating standard in the industry is.

It is presently, in my view, in effect now are your leases and the covenant to develop, the covenant to market, and the covenant to account accurately.

So, I'm going to read this -- this is not a comprehensive definitive legal opinion. I'm not a lawyer. But I'm going to read the normal explanation of what the prudent operator standard is, so that you can contrast, as you view this, because I feel that's probably what the responsibility is. It's not to condemn what's here. It's to make it clear it's a difference and it's a significant difference over industry custom and practice.

The prudent operator standard,

analogous to the reasonable man standard in negligence, governs the performance of covenants in oil and gas leases, as I mentioned. The standard obligates the lessee, the producer, in developing and protecting the lease premises to do whatever in the circumstances would reasonably be expected of operators in similar circumstances of ordinary prudence, having regard for both the interest of the lessor and the lessee with a reasonable expectation of profit, recovery of cost and profit.

Now, recovery of cost and profit -- profit doesn't mean profit above the corporate hurdle rate. It means a profit. So that's -- that's what the prudent operator standard is.

It's been made very clear, very openly by the -- by the Administration team that that's not the standard here. That's okay.

Just understand the distinction as you -- you know, as you think about it, as Jim said.

MR. SHEPLER: I would just jump in and add one further point that, in terms of trying to be educative here -- to inform you, as to what the contract provides --

SENATOR THERRIAULT: Mic closer.

MR. SHEPLER: -- is that prior to project sanction, which is essentially making the go decision to start -- to start picking dirt, that the contract provides that the State's exclusive remedy for a claim ultimately established through the tribunal, that the participants have not been diligent -- diligent, that the State's exclusive remedy as said in Section 5.5 is termination of the contract.

In the point I made at the beginning of my remarks talking about the timeline, if the goal, as it appears to be, of the State is to get a pipeline, something more akin to specific performance, to enforce project plan rather than to terminate the contract might be more in order.

But, as I said, in Section 5.5 it's very clear that if the State pursues lack of diligence and prevails against the odds that Mr. Harper's discussed, what you've done is sort of exercised the nuclear option. You've torn up the contract, and you're back to square one.

MR. HARPER: I have one pertinent thing, Representative, if I might add.

I would ask you to also direct your attention whenever it's appropriate to Article 37, 37.2. This contract, unique to my experience, which, again, is okay, has a very specific limitation on damages and remedies. And it precludes the arbitrators from granting any consequential or incidental damages, including lost profits, No. 1, and No. 2, any special or punitive damages.

And this is not -- these are very fine companies that we're dealing with. We don't know who their successors in interest might be, but these are very fine companies that I have respect for, so I'm not -- my comments are not meant at all to cast aspersions on them.

But sometimes in this industry, which is a very, very litigious industry, if a -- an operator, oil and gas operator, gathering, processing plant operator feels that if he elects not to do something he's supposed to, that if he's called to task, his only penalty is told to go and do it. He might risk that.

If he knows the hammer -- particularly where royalty owners have been concerned -- and I've been involved in extensive royalty litigation -- the hammer has always been fear of consequential punitive damages. And on the case of other operators, lost profits.

It's okay that it's here. Just understand that it's there. How it might or might not govern the behaviors of the participants in this when weighed against all of the other provisions as a part of the total.

SENATOR THERRIAULT: Followup question?

REPRESENTATIVE COGHILL: Would you like your chair?

[Chuckles]

Sorry.

SENATOR THERRIAULT: Other questions?

Representative Gara. And then Representative Ramras will be next.

REPRESENTATIVE GARA: I'm just going to ask about the royalty in kind provisions. Royalty in production tax in kind provisions, as opposed to what we normally do which is value or in kind.

And there are three areas that you or the other presentations have been identified as places where it seems like, but I could be wrong -- it seems like in kind is worth less potentially to us than -- than in taxes. And one is, Mr. Eason, you had mentioned the point where right now we're entitled to essentially the higher of value when the companies sell it to the Lower 48. Under this, we market it and we don't get the higher of.

One is, we get our production taxes and royalty with the impurities and -- and instead of the full 7.25 or whatever percent.

And then one is taking it in kind, we -- we run the risk that the value that we get in the Lower 48 when we sell it and a low price scenario might be less than the cost of removing the impurities and transporting.

And in those three areas, the -- the losing the right to the higher value, the taking it with impurities, and then the risk of getting less than the cost of transportation and production.

Can you give us some sort of quantification? I know you can't do it in dollars. But can you give us some sort of quantification? Maybe what percent, Mr. Eason, in your -- in your experience we might lose by not getting the highest value? Maybe what percent we might lose by having to take the impurities? And then maybe what the risk is in terms of maybe dollars of -- in a low-price scenario, of having to only get in-kind in a low-price scenario? Maybe that might be less than transportation and production.

MR. EASON: The -- it's a loaded question than one.

Let's try them one at a time, if you will.

If you don't mind, if you could just restate the first one, because I'm following your prologue, and then the number -- you know they sort of merged in my mind, I apologize for that.

REPRESENTATIVE GARA: Sure. The first one is if you can give us a thumbnail of what percentage or value we might lose by losing the right to get the higher-of value as opposed to us selling it on our own.

MR. EASON: The -- the experience with gas is -- is virtually limited, you know, almost total. Because we've -- the State's experience so far has been primarily oil and -- and with the exception of Cook Inlet. And the -- I'm not privy to the information, for example, that Revenue would have on -- on the tax values for -- for gas in Cook Inlet. Much of the gas in Cook Inlet is -- you know, has, of course, moved under some long-term settlements for the urea plant and other -- other purposes, LNG.

So, there is a -- there is a record that the DNR folks could -- could -- I think could provide you with the range of -- of reported prices on the gas that's -- that's sold other than that. And when you -- so, going forward, it's -- you know, it's difficult to forecast at this -- not difficult, impossible to forecast at this time what the range of prices may be.

I can tell you from the oil side, over time there's been substantial differences, you know, in some cases, even at lower oil prices, as much as 2 or $3 a barrel can -- can occur between the reported prices on -- at sales.

So, you know, those numbers are whatever they are, they're going to -- they're going to recognize what happens commercially in -- in the market, and, you know, I think there's -- there's probably a fair spread that -- that you're looking at. I can't really give you any more definition than that. Revenue may very well, you know, be able to provide that, you know, in respect -- in response to a direct question. But I just don't have that background and data available to do that.

And the second?

REPRESENTATIVE GARA: Second one was, if we're getting 7.25 instead of -- of the value for taxes, 7.25 which includes the impurities, was Senator Wagoner right, do we lose about 10 percent that way or -- impurities?

MR. EASON: That -- I'm not going to be real helpful to you here either. It's more an engineering question and, I think, we're going to have to -- I've identified that as an issue that we're going to have to try to provide some quantification for.

But, you know, it's related to -- you know, the composition of the gas, and we will be able, I think, to provide you some information on that. At this point, we don't know -- I don't know what that number is.

MR. HARPER: It's ascertainable. We just haven't -- we just haven't gotten there. We're very early in this. It's ascertainable.

If the underlying source data is made available, it's ascertainable.

REPRESENTATIVE GARA: I guess the last would be the least ascertainable.

In -- when we do it -- when we get the value in kind, we're going to get -- we're going to sell it and there's, I guess, the chance that the cost of transportation and removal of the impurities might be greater than the sales price, in which case we would lose money. But what prices -- where's that price risk? Is that 2.50? Is that at $2 gas?

MR. EASON: And, again, I think that's probably more an Econ One question, that they should be able to give you some boundary there.

In the increments that you use to get there, you know, the Administration has talked in terms of -- I think the number was, you know, perhaps 5 cents or 5-and-a-half cents per mcf on marketing and -- and other costs associated with taking the gas in kind. But as -- as Rick pointed out, there's also, you know, some data from the Lukins study that looks more at, you know, the possible risk that -- that you're entertaining in trying to quantify that.

Associated with that in-kind taking and transportation and marketing, that -- that provided a range of -- of potential fiscal impacts, and they were -- again, was it as high as --

MR. HARPER: 10 percent, net present value decrement.

MR. EASON: Which is a substantial -- very substantial number. But that's their forecast extreme range. And I don't think that anybody at this point could do better than they can do at providing an answer.

MR. HARPER: One thing, too, to bear in mind as and I do agree that the Econ -- Econ One work may already be in place on where we can examine on where you go upside down question.

But when you make a decision, remember, owning a pipeline and subscribing to capacity are -- are two different issues. One can be a pipeline owner, and not subscribe to any of your own capacity, that's not what proposed here, but I'm just separating the two.

When you make the decision to sign up the long-term firm transportation, it's a two-part rate: There's a demand charge, and there's a capacity charge. And, for the most part, the demand charge has got the fixed costs loaded into it and a rate of return.

Participants in the industry who buy long-term firm transportation and make that commitment are going to make that demand payment whether they move any gas or not. So it's a sunk cost.

So when you're viewing your decision, go/no go, it's just like, you know, you built -- you drill the well. You might want to amortize those costs for tax purposes and SEC net income purposes. But the fact of the matter is when you make a decision to sell or not sell, it's a cashflow decision, and that's a sunk cost.

So, it's not a simple question, but it's absolutely answerable. And it's -- it's a calculation that's made every time somebody enters into one of these things.

REPRESENTATIVE GARA: Senator, just so I can ask. The answers aren't available one, but it would be something I would be interested in is trying to compare what we might lose or gain by taking it in kind as opposed to in value as we analyze that decision point.

SENATOR THERRIAULT: Yeah. If you would just followup, we'll see if we've got modeling done already to get answers to some of those questions, or if that's something that's being developed.

Representative Ramras.

REPRESENTATIVE RAMRAS: Good evening. I think, Mr. Chairman, I've got just -- two related questions, and then a less related question, please.

The related question is the antitrust dialogue that we heard about, Brad Lui, great speaker, but all of his remarks seemed to concentrate the antitrust issue on the consumer end of the pipe, and not on the wellhead end of the pipe which is of considerable concern. I'm not worried about what they'll do to the consumers. I'm worried about this -- you know, this PPT debate is so much about incentivizing -- incenting smaller explorers to come in, and I'm worried that -- that a considerable antitrust challenge could be mounted on the wellhead side of the pipe.

Furthermore, when Senator Wagoner -- I wish he was still here -- when he took me to the Cook Inlet last year, one of the things that we learned in the inlet is that part of the reason that they're out of gas in the year 2012 is that nobody's incented to look at gas in the year 2006 because there's no market for it net -- you know, discounting the value of time and money back. You can't find the gas inventory out through the year 2012. So I get concerned that as we're at 35 t, but the pipe is full, how do you find that 36 to 70 t of gas, and so I have the antitrust question. And then I have the -- how do you incent the small guys question. And then -- and the unrelated question I want to ask you that I'll repose for you is on the fiscal certainty piece that we're affording the producers in their range between a -- a Yugo and a Cadillac, where is -- where is that piece. But I'll come back to that in a moment, please.

Thank you.

MR. SHEPLER: I'll try with the antitrust piece. As you know, Representative

Ramras just came up, that fact that our law firm had done some work on the antitrust issue, came up about a week ago. And I suppose you -- you are right, that there is a -- there's two ends of the pipeline, and there are -- are questions about impacts on competition depending on who owns the straw between the -- the supply and the consumer.

Having said that -- and I think maybe Rick can speak to that in more of a real-world sense -- but the question that we focused on was a followup to the question that had been posed to the FERC about going back to the 1970s and a prohibition on producer ownership suggestion, I guess, comes out that is that you eliminate that issue to the extent that you had an independent pipeline rather than a pipeline that was affiliated two-thirds or 80 percent with the producers.

But the reality of the facts are that -- that we're not dealing with an independent pipeline; we're dealing with a contract with the -- with the producers. So, whether or not there's more or less competitive regulation issue associated with the producer pipeline than an independent pipeline, that's really become irrelevant now that we have the -- the proposed contract with the -- with the producer group.

But I think Rick can talk about kind of the risks of strangulation or control over that -- that tube that is -- is a legitimate question.

And before he starts, I would add that -- that in the Lower 48 it's -- it's very uncommon for producers to own a pipeline. In fact, there may be one or two. All of the pipelines are owned by independent pipeline companies and the producers take out transportation contracts.

The pipeline companies have in the last decade or so come to have established marketing affiliates that are trying to buy and sell gas to hold capacity on the pipeline, and -- and I will tell you that -- that the producers in the FERC regulatory proceedings are very mindful of circumstances when a pipeline's marketing affiliate holds capacity, the terms under which it was acquired, whether they got a sweetheart deal, whether there was backroom communication, and in the context of, you know, the biggest pipeline in North America that is owned 80 percent by the producers that own 97 percent or something of the -- of the assets, this is a setup for the mother of all marketing affiliate issues at the FERC, and -- and simply because of the magnitude and the issues -- and those issues have been litigated and are -- are the genesis of proceedings in the Lower 48.

Rick, maybe you can talk about the risks of the -- of the squeezing of the tube.

MR. HARPER: That -- that's an issue that probably has dominated a lot of our discussions. The discussion that you heard earlier about concerns about expansions and how expansions are priced, how expansion filings are made are vital to understand, because how expansions are priced, whether the incumbents, the existing producers on the Slope, have a lower price than anyone else, whether they have an advantage in getting expansion capacity, whether or not the field is level fiscally, are really important determinants on how new entrants -- what we're referring to as independents -- are going to evaluate Alaska.

I think 35 trillion cubic feet that we're talking about here is one of the biggest proved resources that's available. No question about it. The biggest.

But I personally believe it's the tip of the iceberg in Alaska, and the focus of our looking at this contract has been on the issue that you raised.

And so issues of expansion and how that occurs and how those are priced and whether the field is level for new interests fiscally, to me, is critical.

MR. EASON: I think the producers, the so-called explorers will tell you, they've got a long -- it's common knowledge, they have a long lead time between when they're going to start an exploration program and the time that they can commercialize that. And -- and, quite frankly, if that's a seven- or eight-year process, they've got to know on Day One that if they -- if they go forward and are successful, that they're going to have some chance of getting into the pipeline.

Now, if the pipeline is fully subscribed, which it presumably would be on -- on

Day One, and -- and runs full for 15 or 20 or 30 years until the -- the 35 tcf somehow runs out, you know, they're -- they're not going to do that next week. They're going to wait years down the road. So, expansion, availability, and expansion pricing are key to facilitating more drilling going on, which comes back to this -- this other interest that the State has that's separate and distinct from the interests that the producers have.

The question you had related, I think, about incentivizing the additional gas. Every -- the notion, from my personal perspective and from my experience, the notion that you're going to have to do a great deal to incentivize exploration on the North Slope for gas if the pipeline's available is much secondary to the concept of having adequate and fair and balanced access to the pipeline and to expansion.

I think that's -- I mean -- that's what Cook Inlet's telling you. It's accurate, in Cook Inlet, there's not much incentive to go out and do anything of substance there until there's -- there's a way to get it out of Cook inlet.

But with the North Slope Pipeline, the world changes and, you know, you -- it's just, from my experience, it's just counter to everything I know and have done for 34 years, the goal of explore -- you know, of oil and gas companies is to explore, find, produce, and keep the cycle over and over and over again. And I think that's -- that's going to take care of itself.

REPRESENTATIVE RAMRAS: It just -- it just strikes me -- pardon me for followup -- but it just strikes me that the -- the whole nature of the credit side of this PPT debate is about unlocking the resource value of the basin, and a great deal of this fiscal contract that we're contemplating seems to be about locking up and controlling the value in the basin.

Whether that's an unintended consequence or not, it's just -- am I mistaken to keep drawing that conclusion from where a lot of the dialogue that's gone over the last week and a half -- we keep talking about what a great value there is in the known reserves that we're going to load into that pipe. But we also keep having the shadow dialogue, it seems like, about putting a lock on the basin.

MR. HARPER: I would say, undoubtedly, you're going to hear from the independents soon through this comment process, and I think it is absolutely, for you, key policy question, as to how -- how that sorts out. And whether it's intended or unintended, to me, I haven't really tried to view it from that way, just whether it's going to occur or not, and the probability.

MR. SHEPLER: It goes back, I think, to the point I made in the beginning that the State and the producers are aligned on step one. We need a pipeline. We need to get a pipeline in there. But that's -- and the State has yet another policy issue, and the State needs -- has to focus, should focus, in my opinion, on how do you get that pipeline expanded so as to maximize the -- the competition that takes place in the -- in the basin on the North Slope.

REPRESENTATIVE RAMRAS: Thank you. And then if you can just comment on the fiscal certainty piece in the range of what is offered other countries. Is this the minimum or the maximum? Is it the -- the Cadillac or the Yugo?

SENATOR THERRIAULT: Mr. Barnes, before you jump in, when you had the slide, I think instead of certainty, I think maybe you had it labeled stabilization --

MR. BARNES: Stabilization.

SENATOR THERRIAULT: -- on your slide. Okay.

MR. BARNES: The notion of fiscal certainty is also routinely called fiscal stabilization or just stabilization.

The -- basically, there are two types of stabilization that -- that are used.

One is that a -- a standstill version or a -- you know, the prohibition. No further changes will be made. The -- the legislation, the fiscal legislation that's in place is all that will -- that can take place.

The -- the disadvantage of using that type of stabilization is it requires one legislature to prohibit future legislatures from acting, and that usually has some constitutional questions. It is possible, as has been said, to contract away the -- the State's prerogative to change. But, basically, the longer the term the more uncertain that becomes.

The other way that stabilization occurs is the -- a renegotiation or a reopener type of mechanism. And what it would -- and it's also known as an economic equilibrium provision.

And the way economic equilibrium works is the State tells the producer or the investor that if the fiscal laws change and you are adversely impacted, we will meet and renegotiate to achieve economic equilibrium as it was before the -- the enactment of the new law, a road tax or an increase -- income tax, whatever it happens to be.

The -- going to whether this is a -- a Cadillac or a -- I forgot what else you said -- but, anyway, this is one of the most sophisticated provisions. It -- it is the most sophisticated stabilization provision I have ever seen. It is -- it clearly contemplates that the Legislature could make further fiscal changes, but by indemnification and by the -- the mechanism -- the contract mechanisms, it -- it effectively limits the economic effect in a very sophisticated manner.

That cascade -- I think it's in

article -- waterfall -- the waterfall in Article 22 addresses how those different types of taxes are going to be dealt with so that on a net net basis the burden does not increased.

REPRESENTATIVE RAMRAS: I'm sorry, just so I'm clear though. The benefit of the complexity accrues to whom? The State or to the -- the national oil companies?

MR. BARNES: Well, I think it accrues to -- to both. I mean, the -- as I understand it, the intent of the -- of the Stranded Gas Development Act is to provide fiscal certainty. Now, it's up to you to -- to make a judgment about what is an appropriate balance, but -- but that's a unique piece of legislation in a lease-type situation such as the United States.

But that's a decision that's been taken, and -- and, you know, we're evaluating this in the context that Alaska is willing to undertake fiscal certainty in order to get the gas reserves developed.

So, what has come back is the producers and the Administration have -- have negotiated that fiscal certainty. And it is --

it is advantageous to the -- the State, if you're going to get your pipeline on the terms that you think are appropriate. And it is advantageous to producers in that it is -- it appears to be a -- a fiscal stabilization mechanism that because of its -- its comprehensiveness is likely to function.

Now, whether it's, in fact, durable or constitutional, I think there's been some debate about that, and the Attorney General, of course, has opined that he believes that it is constitutional to gather, from reading between the lines, there's likely to be a challenge. But I don't know anything about that.

REPRESENTATIVE RAMRAS: Thank you, Mr. Chairman.

SENATOR THERRIAULT: Thank you.

Other questions?

Senator Wilken, and then we'll have Representative Kertula.

SENATOR WILKEN: Good evening.

First off, let me just say on behalf of the 32,700 people that I'm honored to represent in this temporary part-time job, I'm -- I'm encouraged and appreciative of your participation tonight and the method in which it's been delivered. I'm energized and comforted at the same time. So thank you very much.

And I guess wrapped around that thought is that for every hundred good reasons why this pipeline should be built, there's a thousand reasons why it won't or can't or shouldn't or wouldn't.

And we as a Legislature aren't going to fix that. We are going to have to assemble a team, including the Administration, that -- that wrestles with every one of those reasons why we can't or we won't.

It seems to me that until May 10th this tennis game has been played on one side of the court. And on the 10th, the people got on the other side of the court. And that's the Legislature.

And this game isn't one to beat the other. This game is different from a tennis game in that what we seek to have here is two winners.

So I guess my question then is -- and perhaps it's -- it's directed to Senator Therriault with the help of you other four.

How do we see us now incorporating

the people through the Administration and the Legislature to march ahead as we validate this contract, and perhaps implement it?

What are the methods by which you -- and you've worked on different big projects -- interfaced with -- obviously, the people you worked for, information, dialogue is very easy. But how do you reach out to those that are part of the team that perhaps have a little different look?

Senator Therriault, how do you see us moving ahead over the next three months, and perhaps years?

SENATOR THERRIAULT: Well, I think that certainly in this public comment period, your constituents are likely to have questions, as you are as their representative. We want to make these gentlemen available to you when these questions come up, and if a question comes from your constituent that you have not already anticipated or asked on their behalf, you can certainly -- you -- they could ask through you to try and get that the answer.

I think for myself, I'm looking at the -- trying to quantify the -- the various policy calls that are embedded in the contract. Trying to quantify the pluses and the minuses and how the overall document stands up as far as pluses and minuses on the two sides.

I think on behalf of the constituency, and perhaps more from Fairbanks and Interior than another area of the State, there are going to be questions about were there other alternatives that offered more protection to the State that could also deliver -- get the commodity monetized, but with fewer of these, perhaps, concerns, about does the steel straw control the basin, things of that nature.

And I'm not sure how that information -- or if -- if there will be a presentation from the Administration with any of that. But I -- I think that -- you know, the way I'm going at it is I need to start quantifying where were the policy calls and how does the information appear to stack up on whether the particular call that was made and is now embodied in the contract was a fair one, and will be fair to the State and its citizens long-term.

REPRESENTATIVE WILSON: And how do we Senator Terriault, how do we pull in -- how do we pull in the Administration to our side of the court? Will there be open and free dialogue with the Administration? Will we have scheduled meetings? Will you folks be able to pick up and talk to their negotiating team free -- freely? Are there going to be some rules that we march ahead on behalf of the people for these folks and the team that -- that we've assembled?

SENATOR THERRIAULT: Well, these gentlemen, in fact, did meet with the -- a number of folks with the Administration's negotiating team early in the week.

And we had hoped to set up another meeting, but just with them trying to be prepared and read through the contract, unfortunately, that didn't happen as we went into the weekend.

There's still, hopefully, an opportunity to have that happen before anybody leaves for the -- the holiday break.

We certainly -- I didn't want them utilizing their time on a concern that was based on a misunderstanding. And so I -- I think a number of these gentleman have been -- have had opportunities, and I think e-mailed some individuals in the Administration to put questions to them from time to time. But also they've expressed to me that there's nothing like a face-to-face sitdown, and we want to try and facilitate those.

Now, through the Stranded Gas Act amendments, those would be dumped into our regular standing committee process. These gentlemen can -- will be made available to any of chairmen that are overseeing pieces of legislation going through our committee process.

The chairmen, of course, have the -- the right to call administrative folks, call industry folks to the table. And maybe that might be a forum that -- that brings together one of these sort of roundtable where you have the different points of view sitting at the table or at least present in the room at the same time so you can get questions and answers from the committee members at the same meeting, and not have to remember, you know, three or four days later.

So, there -- that piece is going to go on.

And, certainly, when it comes time for the -- the Legislature to consider the contract and based on comments that you may make, the public may make in the public comment period, there may be modifications to the contract. But, ultimately, when it's delivered for our -- for our deliberations, if we want to have a continuation of these discussions and bring Administration point of view, which is not necessarily counter to our point of view, but to have them sitting at the table to be part of the discussion, I would certainly be willing to try to facilitate that.

SENATOR WILKEN: Thank you. Senator, last question.

Mr. Barnes, on your slide No. 4 when you were doing your -- your comparison, you had a slide that said -- I'll find my notes -- it had to do in the lower right corner, let's see -- that's all right.

Lower right corner it said: No commitment to local consumption.

And we know, I think, that when -- lower right -- one more. There.

No local supply obligation. And what we learned this last week was they have to supply at least four flanges. But by that it tells me that they don't have -- we don't have to have -- either through the producer or the shipper, we don't have to have a -- we don't have to have the gas available at the flange.

Is that what that says?

MR. BARNES: Well, the -- as I understand it, there is no obligation to supply the local market. I'm not talking about pipe or an open flange, but to put something in it. Many of the -- the contracts that PFC that you see around the world, the duty is for all the producers in the country, whether it's to a refinery or whether it's a national gas grid or what have you, to provide -- to provide the proportionate share of the local demand.

And there is -- as far as I can tell, there's no provision in this contract that would put that -- that obligation on the -- on the producers.

The State, I guess, is free to sell its gas, but that area which -- of local supply in a national contract or in a PFC, it just isn't addressed.

MR. SHEPLER: Senator, if I may, Jim is right, there is no obligation. Section

9.4 of the contract provides, in part, any party my supply gas to Alaska purchasers, but no party is required to sell to an Alaska purchaser. It goes on, an existing shipper transporting gas out of Alaska may choose to make deliveries in Alaska so that that shipper continues to satisfy -- so long as that shipper continues to satisfy its shipping commitments outside of Alaska.

So -- and I think it was explained to us that -- at one of the sessions last week that this says nobody is obligated as to where they sell their gas, either the State or the producers, but they could sell it wherever they get the highest market.

So, I guess, I think that answers your question. It clearly -- there is no obligation commitment in the contract for them to make gas available for local Alaska uses unless the price is -- is, you know, competitive. Commercial deal.

SENATOR WILKEN: Thank you for clarifying that.

Thanks, again for your help.

SENATOR THERRIAULT: Thank you.

Any questions?

Representative Kerttula, you had some questions.

REPRESENTATIVE KERTULA: A lot of mine got answered. Thanks for coming tonight. I really appreciate it. Thank you, Senator Therriault, for doing this.

I think I heard this before but I just -- for all of you, have you ever seen a contract of this nature where the only remedy is termination as with this one?

MR. EASON: No.

MR. SHEPLER: No.

MR. HARPER: No.

REPRESENTATIVE KERTULA: Or a contract with a diligence requirement like this one?

MR. BARNES: No.

MR. HARPER: No.

MR. SHEPLER: No.

REPRESENTATIVE KERTULA: And finally -- and this one, really, Representative Ramras got, where there's an indemnification of the municipal taxes, as with this one. And I guess that all plays together because it really was so complete. But have you seen that, where there has been that kind of indemnification with -- let's say just for municipal taxes on the industry?

MR. BARNES: I have -- I've not seen this comprehensive sort of proposal. I've seen, certainly, where it talks about an indemnification mechanism and you're trying to establish fiscal certainty through a -- an indemnity mechanism. There's obviously multiple jurisdictions at play here. And in listening to the Administration's explanation of all those different categories and baskets that they -- that they establish for -- for different types of taxes, it was a very logical explanation as to why they treated some in some way and some in another way. And then you had to net them all out.

But I -- I've never seen anything this comprehensive.

REPRESENTATIVE KERTULA: And this may go into what Mr. Eason was talking about in terms of the antitrust and the access issues, but how -- how does the contract affect the bidding on future leases? I mean, is -- is that all wound up in what happens if the independents start to look at access issues?

MR. EASON: I think all the related -- the related initiatives that are underway now, the PPT and particularly the possibility for participating in the -- in the upstream -- uniform upstream provisions, they will factor into each company's analysis of how they approach competitive bidding differently. I would think that they will see them as beneficial. I think that would be uniform throughout the -- that's a qualitative answer.

But, you know, it would depend on their individual strategies and considerations.

REPRESENTATIVE KERTULA: Some beneficial, but when -- this is more maybe to Mr. Shepler -- but the access issues in terms of access to the pipeline, that can -- I mean, if it's -- let's say the -- we lose at the FERC, that couldn't be seen as beneficial.

MR. SHEPLER: Well, the -- there's only one issue that's currently on appeal from the FERC, and that's the issue on whether the FERC can order the -- the initial design be made a little bigger.

If -- if that is lost, you know,

that's -- that's a loss from the State's standpoint, but, you know, the rest of the rule-making still stands.

The -- the issue that I focused on was essentially the issue that you're raising, that the State has this other agenda here to facilitate this pipeline not only coming into existence, but also being expanded. And that's going to be driven largely by the decisions of the LLC, whether to expand, the incentives they have to expand, and the -- the provisions of -- of the contract with respect to whether they are required to expand.

MR. EASON: Also, I think, you know, generally speaking, the answer is, again, it will be uniform as far as the expansion provision. I mean, obviously, if -- if there are concerns about access, they will certainly factor into bidding decisions in the areas that are known to be more gas prone, like foothills and, you know, some of the properties there and other areas of the Slope where the likely -- the likelihood of major gas discoveries is -- is higher. That will definitely flow through to those kinds of decisions.

MR. SHEPLER: Now, you will be hearing presumably from the constituency that the State is trying to protect here in this process. You know, we've simply been the spokesmen so far or one of the spokesmen for the -- this issue of access and expansibility. But it's really not ours or necessarily yours. It's their issue to -- to carry forward on.

REPRESENTATIVE KERTULA: But it is sort of one of the issues we learned from TAPS as well. I mean, this is sort of one of the historical perspectives in Alaska. It just seems like we're seeing this play out in some way again. So I appreciate your answers.

Thank you.

SENATOR THERRIAULT: Representative Kerttula, on that front, when the -- the application or the input was put into FERC, there was a -- sort of a unified voice from the Administration, the Legislature, and the independents requesting, you know, favorable treatment. And, particularly, the full -- the full utilization of the language that was somewhat unusual coming from Congress that -- that the line itself be developed in such a way to foster competition and expansion or exploration.

So I think --

MR. SHEPLER: There's clearly Congressional policy set forth in the 2004 statute, which I can't recite for you, but, basically, that the FERC's open season rules broadly defined are required to facilitate the exploration and development and production of North Slope reserves.

SENATOR THERRIAULT: And, mind you, the roll-in pricing is a presumption, and it's a rebuttable presumption, so it's not -- it's not locked in.

Do we have other questions?

Representative Seaton.

REPRESENTATIVE SEATON: Thank you -- thank you, Senator Therriault, and gentlemen. It's been really informative tonight.

I have two other questions. And one of those, I'm trying to get a handle on the cost and the revenues, especially on some of the items like what is the cost of not taking the -- our gas at the unit boundary and in a marketable condition versus what is that taking it upstream and shall we say dirty? And I'm wondering if -- as -- as we go forward, I probably can't do this tonight, but if we could define that in a percentage of our tax rate. So, you know, I mean, we're talking about a 6.2 percent or 7.25 percent, whatever that percentage is. But what is the cost of that negotiated strategy of taking upstream and impure gas versus the current statutory language we have in -- expressed in the kind of percentage that we can balance that with what our -- what PPT or what our tax is going to be?

And so, anyway, that's -- I presume that Mr. Eason is writing that down for -- for future contribution here.

But -- and then the other -- the other thing I'm trying to get a handle on is just industrywide or internationally, basically, what we're looking at here is a situation where we're going to allow all the costs to be deducted. We're going to give a 20 percent credit. We're going to have an upstream allowance. We're going to have upstream cost, 20 percent in the feeder line. And then we're going to have a 7-and-a-half or 6.2 percent tax rate.

And can you give me some kind of international comparison as to where that falls as far as, you know, excluding the royalty portion, but as far as the tax goes and all the things that are with credits and allowances and -- and these other expenses, and where that would compare in what's happening internationally?

MR. BARNES: Well, certainly, I can't give you a a quantitative answer. I think that as -- as I looked at Dr. Van Meurs' presentations, he -- he certainly endeavored to show that -- that at low prices the -- the situation required some sort of State support or assistance in order to -- in order to have this project meet the portfolio hurdles of the producers to get them to the investor stage.

And then at higher levels it wasn't necessary.

But how that compares on a -- a -- I don't recall seeing anything on a -- on a combined -- I think this is what your question is. If it's not, stop me. But what is the combined effect of the fiscal contract and legislation and that in terms of providing price support at a low price environment or a cost overrun environment? I don't -- I don't know. And I'm not sure -- I don't remember it being addressed.

MR. EASON: Representative Seaton, I -- I don't think you're going to find anything in the world like this contract. Because, you know, it's -- as the Administration has told you about, Dr. Van Meurs, and I believe it's confirmed, you're looking -- as I understand all of these comparisons. They're comparisons of a very limited area and how the parties are going to share the resource and -- and that, by definition, I guess, defines -- is defined in part, how they're going to bear costs, if any, between the host government and the -- and the producers. And they are done specifically tailored to a project.

In this case, what you're being asked to do in total -- in the totality of the package is -- is to take a number of steps to get this project, and they include changing, you know -- they either do or do not, depending on how you view it, but -- but you are changing your severance tax provisions to a net -- a net profits tax, essentially, which is a -- you know, which is an extraordinarily large decision with fiscal implications which will become more apparent as -- as time plays out. Because all you have now are a series of models that tell you what the range people think will be of the costs and the revenues and the taxes that you'll receive as a result.

Nobody can -- nobody can predict with any certainty there.

But you're applying it across the board statewide, and that's -- that's a part of the calculus, and then you're also providing as -- you know, as I talked about earlier, a list which isn't complete yet, by any means -- I can't certify it is -- of any known fiscal incentives that are built into the -- the contract itself. And they cover the North Slope rather than a project. They cover all the existing fields and units, and they recover things -- they will cover things that have yet to be discovered, and by definition they're going to cover things much in total quantity, productionwise, much more than the gas you have today.

I mean, it's -- you are -- you're

looking at a package of provisions and then being asked for fiscal certainty that I don't -- I don't think that any -- I don't think that if you ask Dr. Van Meurs in that context, you can point to anything in the world that rivals that in scope or inclusion.

So I don't think there's going to be a meaningful way to compare it to anything. But -- but it's a question that I think is -- you know, is --

REPRESENTATIVE SEATON: And if I can followup. I guess part of my problem is that -- that we have seen some comparisons, but it's all been for oil. I mean, you know, we've seen worldwide percentages on oil. We've seen government take percentages. But everything has been based on oil, and now we're taxing this at a third of the rate of the oil, but the credits are the same and -- and we haven't -- at least I haven't seen any modeling, any comparative modeling of what this really does. I mean, we just heard, well, you know, dollars made off of gas are worth less than dollars made off of oil, so, therefore, we're going to tax it at a third.

But, I mean, we haven't seen

anything. Or maybe I've missed it. But I've been trying to follow it fairly closely, and if there's any way that -- that you guys can get us anything on gas so that we know -- we're comparing apples to apples instead of looking at PPT, which is all -- all the models that we had were all based on oil, and government take issues and all those. And so -- so I'm kind of in the dark here. So I'd appreciate it if it comes up we'll get it.

SENATOR THERRIAULT: Representative Seaton, Econ One is supposedly working with PFC, a firm that the -- the Administration has on board to try to pull together that -- some of that very information.

In addition, of course, last year we had purchased some information from Wood McKenzie that has some limited information with regards to tax rates around different jurisdictions. And that's available in a secured room here for you to get access to.

Of course, that -- that report is not available to the general public, but it can be made available to you.

Do we have additional questions?

Mr. Barnes, one of your slides that -- that did some comparisons on different jurisdictions around the world and whether they have certainty or stability, if you could flip back to that one. Because it seemed like it kind of broke down between -- you know, western versus none --

MR. BARNES: This one?

SENATOR THERRIAULT: Yeah. That one and the one back. We've got Canada, Norway and U.K. with no stabilization, and then you go to Angola and Nigeria and Qatar. So -- now, Qatar, fairly stable country, is my understanding.

But, just one thing that I think really jumped out when I saw it listed like that is in those areas that give -- offer stabilization or certainty, they have a very strong reversionary language. So we have heard that, well, this contract has the strongest work commitments of any contract around the world. But in many of those areas, because you've got very strong reversionary language, the clock is ticking; and if you don't move something to production by the ticking of the clock, you're going to lose it. And so that's the motivator.

MR. BARNES: Right. It's a combination of things. But the primary motivator is to get to a development decision within the primary term and -- and in a lease environment, once YOU have started production, all you have to do is commence just some production during the primary term, but then it's held by production indefinitely, so long as you're producing and paying quantities.

At least I think that's probably the terminology that's used in -- in Alaska. It's true elsewhere in the United States.

But in these -- these jurisdictions, as I said, there's a -- a marked difference in the -- the paradigm of the administration of those -- you know, the government of those jurisdictions to control their natural resource, the national patrimony. And you're absolutely right, they -- they -- they do not want the investor to be warehousing these assets.

So it's -- it's actually even more restrictive than you stated. What happens is, for instance, in an eight-year term on that primary term, after the first four years, the investor needs to give back a quarter of the original acreage. After another two years, perhaps another quarter. And then at the end of the term, the investor has to give back all of the acreage that is not being currently utilized so that there's no inventory being held out there.

It is -- it focuses the mind of the -- of these investors when they are confronted with having to do this in a timeline. Now, that's not to say that the -- the governments are -- are impossible and, you know, they don't create exceptions if there are -- are difficulties. For instance, you know, pipeline difficulties.

I think that Exxon recently brought on a -- a project in Chad, and Chad is a landlocked country. They eventually brought the pipeline last year coming out through Cameroon. But, I mean, it took, I think, 20 years before the -- and this was oil -- before the pipeline and the treaties could be put in place. I don't think it was an economic decision there, but I -- I think it was just -- it was just the difficulties associated with it, and they were able to hold on to it through that period.

SENATOR THERRIAULT: Thank you. And if there's no other question -- go ahead. Representative Wilson.

REPRESENTATIVE WILSON: The question I had, and several people --

SENATOR THERRIAULT: Get closer to the microphone there.

REPRESENTATIVE WILSON: The question I had, and several people have brought it up, but I'd like to go just a little bit further, is if we're taking the gas with the impurities in it clear upstream, and what I would like to know -- first of all, I'm not sure when you take out the impurities. Is that a separate process from liquids and the hydrocarbons? Can it be all done at the same place, or is it done at several places? I don't know those -- so those are things I'm thinking of. And -- because we probably want to keep the hydrocarbons.

So I'm just trying to think that if we were looking at something and trying to say, okay, maybe it's better that we move down a little bit and -- and get -- without the impurities. If we did that, because this contract is so convoluted on everything, would that totally unravel everything?

MR. EASON: From -- as I understand the negotiating positions of the producers and Administration, since this was the -- if not the first, one of the first decisions that was made to agree to -- to the in-kind taking, and then the other provisions have sort of flowed to accommodate that, and how it will happen. I would think that that's a major, major issue for the -- for the Administration. Every reason to believe it is.

But there are ways to accommodate the concerns that we are raising, and there are -- to answer your first question, you know, are the simplest question, easiest one to answer is whether or not these things all happen at the same place or close. There's -- we don't know where it will happen under the project proposal. But there are provisions in the contract that -- that contemplate an integrated facility where everything happens or, you know, it could be a couple of standalone facilities, or in the case of multiple fields it -- you know, it could be a host of facilities at one field and then -- and then others as you come down further and further downstream. So there are -- there are solutions to -- to each one of the problems that are -- I don't like to refer to it as a problem, but they are -- they are issues that are going to -- that affect your fiscal interest and at the point we are now, they are elements of the contract that -- that the -- that the Administration's agreed to. And whether or not it's practical to make changes to those is -- is a question that -- that only they can answer.

MR. HARPER: I have maybe a little additive to that, if I may.

The contract contemplates a natural gas liquids study. No -- no commitments around that study. But as a minority interest-holder, how that plays out is really important, and how the voting for how minority interest-holder rights are administered in decision-making in terms of how studies are done, what choices are made as a result of that study, how information is or isn't disseminated, is vital.

And it's not much different than this body, you know, where if you have an 80 percent majority and 20 percent, it will work fine. But there have to be very clear -- very, very clear understandings about how that's protected. So, as you view it, think of it in that context.

SENATOR THERRIAULT: Additional questions?

I had -- let me see.

Mr. Eason, can up give us a -- perhaps a little bit of quick primer on production of oil and gas from the same reservoir. I'm sure there's -- there's an ideal point where you can squeeze out as much oil as you can. You're reinjecting gas to flush more oil out. Before you get that last drop of oil, there's probably a part -- a point in which you want to start producing both, otherwise you run the risk of actually losing value from the total mix of hydrocarbons. I'm just wondering, is there any general rule of thumb, or it really is different from field to field?

And then if you expand a little bit into we right now are recycling in excess of 8 bcf of gas a day. Is there any idea of at what point we will have flushed out as much oil as possible, and then we do get to a point that we might be losing value from the total hydrocarbon mix by not delivering gas from the fields in question?

MR. EASON: There is -- there's certainly for -- the answer to the first question is every field is unique. And, obviously, with -- with large fields like Prudhoe Bay there's -- there's generally a tremendous amount of effort to answer that question. It begins early and continues throughout the life of the field.

But -- but, generally speaking, as you produce the gas and as you've seen historically, as you produce and reinject the gas, you have to continue to make very large investments, expansions of your injection capability simply to keep up. Because as -- as production goes through the years, you get more and more gas and more and more water and more and more other things with the oil per unit volume of oil and you've got to dispose of them or reinject them to maintain the reservoir pressure and to simply handle those things, because you don't have any alternative.

The AOGCC, obviously, has the primary responsibility of trying to make sure that those things are done properly and the timing of that is -- is considered by them.

But the producers certainly have, as I said, a continuing model for Prudhoe. It will be, I'm sure, a very, very complex model because it is -- it is a very complex reservoir. There are many fault segments throughout the reservoir and -- and I don't want to say that it's uniquely complex, because it's not, but there are lots of unknowns that you have to test by testing and monitoring in a continuous manner. But it is certainly true that you are approaching, at some point, a point where the value of the gas is -- is going to -- to be -- have to be recognized, and it's -- it's a balancing act between the timing for how much you're having to invest to get the oil out and how much response you're getting for that, how much timing is involved in doing it. And that decision is -- is going to have to occur.

I think that, you know, most people I've talked with believe that -- that you are approaching that if -- and some people would say that -- that, you know, in the time frame of the project that's proposed, you're -- you're there. I think there -- again, it's like I'm punting, but I'm -- I'm not. There are some folks that could provide you a very -- as good an answer as you're going to get for that independently of the producers that are available to answer those questions.

Long answer.

SENATOR THERRIAULT: Thank you.

Representative Crawford.

REPRESENTATIVE CRAWFORD: I had a really basic question because that's where I am is -- is really basic. We -- we've been almost asked to take as a matter of faith that 7-and-a-quarter is the -- is the right amount for the tax gas to receive in kind. How does that compare with similar projects around the world? Is that generous? Is that -- is that toward the middle? How -- how often does this sort of agreement happen at 7-and-a-quarter for tax gas given the -- the royalty share that we have?

MR. EASON: I don't have any personal experience with -- with worldwide -- with that. So I wouldn't be able to help with that answer.

MR. BARNES: I've not actually never seen tax gas per se, or tax in-kind gas. If the question is what is a typical severance rate, there -- I don't think there is a consistent pattern on severance taxes as to whether they -- they are applied to a gross or whether they're on a -- a net profits sort of tax. There's advantages going both ways.

Typically, when a -- an investor goes into a new jurisdiction, goes into what's called a new-country entry, they'll evaluate the entire fiscal package as -- as part of the -- the transaction. The fiscal and the commercial package. But I'm -- I'm just not familiar with a -- a consistency that just runs across all jurisdictions.

REPRESENTATIVE CRAWFORD: I didn't say anything about consistency. All I was saying was is that generous in the worldwide spectrum? Or is that in the middle? Is that low? Do we have anything to compare that to? How can -- how can I make a -- a reasonable decision based on -- on your expertise where 7-and-a-quarter falls?

MR. BARNES: I guess I've not

looked into that. So, I mean, I'm not trying to dodge the question. I just -- I don't know. Pedro has -- or Dr. Van Meurs has -- has endeavored to provide some of that information, but I don't think he's broken it out, or at least I don't recall it --

REPRESENTATIVE CRAWFORD: I haven't gotten it.

MR. BARNES: Okay. Well, I'm just not in a --

REPRESENTATIVE CRAWFORD: I'd love to have it if you can enlighten me in any way.

SENATOR THERRIAULT: Representative , I think that that might be some of the work that Econ One is working on with PFC in -- in addition. I do think we have some limited information in the Wood McKenzie study that we can direct you to, and then if it needs to be refined a little bit further to try and answer that question, we can -- we can help you with that.

Other questions?

Just before we go, I've got just a couple in wrapup.

Mr. Barnes, just in -- in your

particular blend, the legal aspect and advising companies, the companies that we're proposing to enter into an agreement with here, they enter into agreements with each other all the time, and we certainly hear, you know, the expressions of frustration from time to time, that companies express in having to deal with each other. When they enter into contracts, do they enter into generally long-term contracts? If they're long-term, do they have periodic reopeners? If they do, what kind of matrix or what type of econometrics trigger the reopener?

MR. BARNES: Are you talking about, like, on a gas contract, or are you talking about a joint -- or just, what sort of agreement are you talking about when you -- between these companies?

SENATOR THERRIAULT: When they're developing a field, they have joint ownership in a field or going together on a pipeline project. Do you have experience of them dealing with each other, and what kind of safeguards they put into such an agreement?

MR. BARNES: Well, typically, the -- the principal agreement between the parties is going to be a joint operating agreement or a unit operating agreement, and the -- the principal -- there'll be a decision-making mechanism in there that will try to -- well, I guess, from an individual investor's point of view, they would love to be able to make their own unilateral decisions and have the other party brought along whether they wanted to or not -- or the other party brought along. That doesn't occur very often.

The -- the more typical situation is that you have a -- a super majority decision-making level. And it would say, for instance, two or more nonaffiliated parties having 65 percent of the -- of the interest in the field.

Now, what that -- that means, depending on how -- what your percentage ownership is, that a party, for instance -- if we use that 65-percent level -- a party having more than a 35-percent interest would have what is called a blocking vote. They could stop a decision, but they don't have the affirmative ability to carry something forward.

And so the fallback to most of

these -- these decision-making mechanisms is for the companies to position themselves to have a blocking vote. Now, the typical range of -- of decision-making, these are called passmarks, the typical range of passmark decision-making is in the 60- to 75-percent range, and two parties where that would leave, of course, is -- one of the possible concerns. We haven't seen the LLC agreements, but one of the possible concerns is that -- with only a 20 percent voting share, the State wouldn't have a blocking vote.

MR. HARPER: If I might add on, I've had a great deal of involvement in interpreting and negotiating joint operating agreements. The direct answer from my -- my management perspective is that there are -- there's all kinds of flexibility built in. In addition to what Jim mentioned, and I agree with what he said, there's opportunities, for instance, to go nonconsent. There's something that's going to be done, you have the opportunity, you know, simply not to participate. The parties that do participate then get to earn beyond what they normally earn for your not having stepped up, but there's those things.

There's opportunities to replace the operator. There's opportunities to reconsider how a lot of things are done over time.

So, there's -- there's a great deal of flexibility and a great deal, as Jim said, of protections that are built in to those.

MR. SHEPLER: Senator, on the pipeline, the straight pipeline side, they're not terribly common, and I don't hold myself out as an expert, but there are occasional joint owners in a pipeline that potentially competing pipelines that are forced, by one reason or another, to jointly own a piece of the tube, and in those contexts there are what are called sole-risk provisions which allow one party to expand the pipeline on -- on their own investment even if the other party joint owner is -- is inclined. Again, they are not common, but they -- they do exist.

SENATOR THERRIAULT: And one last one, Mr. Shepler, I think the question came up the other day about this contract being put together under Delaware LLC. I believe your firm did a -- a little bit of a look at Delaware versus Alaska and what might be gained or lost.

MR. SHEPLER: Right. Now, my understanding of that is very -- very minimal, but there is a distinction between Delaware LLC law, which is equivalent Delaware corporate law and sort of like equivalent being an Alaska corporation or a Delaware corporation, being an Alaska LLC or a Delaware LLC. We were told at the briefings that the LLC for the midstream element is going to be a Delaware LLC. Our firm had done work earlier on in the process and concluded that the -- that the Alaska LLC statute required much higher duty of care and duty -- just a duty to the entity from the -- the entities that make up the LLC than does a Delaware LLC.

That -- you know, I'm shooting from recollection of something I saw maybe a year ago, but that -- there is a difference -- it makes a difference, potentially, in terms of the duty of care that the participants have to the LLC depending on whether you're an Alaska limited liability company, Alaska-chartered limited liability company or a Delaware LLC.

Again, I don't have that at the top of my head. We have done that research. And I believe there -- we have done a memo on that.

SENATOR THERRIAULT: Okay. I think we'll wrap up if there's no other question. I did want to let you know that my staff is working with Representative Samuels' staff doing the best we can to make sure that any questions that come in for these individuals as answers are developed get sent out to everybody so you can track the different question and answers that are coming in.

In addition, we have made an inquiry to the Administration on what memos, e-mails, documents that were put together in the past still need to be covered due to sensitivity on -- on confidentiality. We're intending to develop that and trying to get as much as the previous work, questions and answers and documents also distributed. We're trying to err on the side of maximum distribution. But, as we discussed at the LB&A session about a week ago, there is still a little bit of sensitivity that we have to work with the Administration on what still needs to be covered and cannot just be put out to the general public access.

If there is some -- a document that

you've heard of that is not in general distribution yet, if you want to either inquire through Representative Samuels' office or mine, it may, in fact, be a document that -- that you, the elected official, can get access to while we still try and figure out how to go to general release.

With that, I thank these gentlemen for staying up longer than we anticipated. We got started a little later, but we ended up going about three-and-a-half hours instead of the planned three, and, hopefully, this is -- well, this is not planned to be the last of -- of this type of forum, and I know that Representative Samuels and myself are soliciting input from elected officials on what types of forums going forward would be helpful to you to help you digest the document that's been put before us, and help you come to reasoned policy decisions as we move forward.

So with that, thank you, gentlemen, and we'll wrap up for the evening.

[Legislative Budget and Audit Committee meeting adjourned at 9:46 p.m.]