GASLINE COMMENTS

ATTACHMENT

SPECIFIC CONTRACT CONCERNS

Article 1: Definitions

1. Wrong Parties to the Contract

   Discussion: Based on the definitions of "Participant" and "BP," "CP" and "EM" and other provisions in the contract, the State is entering into an agreement with corporate subsidiaries, not the parent companies. Without the guarantee of the parent corporation, the parent companies could take positions in conflict with the express and implied terms of the contract that would prevent fulfillment of contract terms. We note that BP's CEO, Lord John Browne, signed the BP and ARCO Charter for Development when the two companies merged, thus guaranteeing BP would adhere to the requirements of the charter.

   Recommendation: If the state enters into a contract with the subsidiary corporations, the corporate parent companies must also be signatories to the contract in order to protect the state's interest and ensure development of a gas pipeline.

2. Trust the Vote

   Discussion: The definition of "tax" includes any payment that could be imposed by the people of Alaska through an initiative or referendum. Under Article 11 of the contract, by making payments in lieu of taxes, the corporations (BP, Exxon and ConocoPhillips), their affiliates and their interests connected with Alaska are exempt from taxes as defined. Consequently, the corporations will be exempt from the proposed reserves tax if it passes via the people's initiative this fall.

   Recommendation: Do not contract away the right of the people to enact law through initiatives or referendums. The people of Alaska must be free to make their own choice, and to exercise their democratic rights.

3. Too Broad a Definition of "Force Majeure"

Discussion: **"**Force majeure" is generally used to excuse parties from liability if some unforeseen event beyond the control of a party prevents it from performing its obligations; and typically covers Acts of God, natural disasters, war or the failure of third parties to perform their obligations to the party. The definition in the contract is far broader in terms of the events that are covered and in excusing a party from its obligations for foreseeable events, including permitting delays by government agencies. This is not a typical provision in other nations' production sharing contracts.[1]

Recommendation: Narrowly define "force majeure" to conform with generally accepted definitions.

Article 3: Effective Date and Term of Contract

Discussion: The contract becomes effective when it has been signed by all the parties to the contract. The term begins on the effective date and remains in force for 35 years from the commencement of commercial operations (when gas starts flowing in the pipeline). Under the contract, a force majeure event may extend the term (except that the term may not exceed 45 years from the effective date). However, there is no provision for such an extension under the stranded gas act.

A draft contract for MidAmerican dated February 23, 2004, provides a specific end date (December 31, 2039) and provides specific phases for the term of the agreement – a planning phase, construction phase, investment recovery phase, and post-investment recovery phase (with dates specified for completion of each phase).

Recommendation: Make the contract term as specific as possible. While different phase descriptions may be appropriate for different proposals, having phases spelled out better defines the term of the contract and how it will be implemented.

[1] In his book about production sharing contracts, Daniel Johnston states, "Some negotiators would like to see bureaucratic delays included as a *force majeure* item, but in most cases that sort of language will not fly." International Petroleum Fiscal Systems and Production Sharing Contracts, page 168.

Article 4: Qualified Project Description

Discussion: The qualified project description is described as the project (including a pipeline and related facilities) consistent with the "qualified project plan." The qualified project plan is defined as the "Proposed Project Plan" described in section 5 of the corporations' January 20, 2004 application submitted under the stranded gas act.

Under the contract, the pipeline route is described as "generally along the TAPS pipeline and the Alaska Canada Highway." However, the proposed project plan that is incorporated into the contract examined both a Northern route ("over the top") and the Southern route (through Alaska and Canada). The plan recognized that current state law prohibits the issuance of right-of-way permits for a Northern Route pipeline until a Southern Route pipeline is built. But the plan also finds that both routes are technically feasible, and "therefore appropriate for consideration in the Qualified Project." As noted by legislative consultants, no state approval or consent is required for changes to the qualified project plan.

Recommendations: Provide a provision that, regardless of any changes to state or federal law, the pipeline route shall be as specified in the contract. Also, the state should have a meaningful role in accepting or rejecting proposed changes to the qualified project plan.

Article 5: Work Commitments

Discussion: Though titled "work commitments," this section provides very little in the way of specific commitments by the corporations. First, the performance standard of "diligence" is defined as "advancing the Project as diligently as is prudent under the circumstances." As noted by legislative consultants, "diligently as is prudent" as a standard of conduct, absent adequate performance measures, is vague, subjective, non-standard and uncommon in the natural gas industry.

Project planning activities are described in the "Qualified Project Plan," which, as noted under the Article 4 discussion, is defined as the "Proposed Project Plan" described in section 5 of the corporations' January 20, 2004 application submitted under the stranded gas act. A timeline of sorts is provided in the proposed project plan, but it is very general and does not provide any specific dates for accomplishing the identified tasks. This contrasts with the February 23, 2004, MidAmerican draft contract that provides specific dates for completion of each phase of the agreement.

The rest of Article 5 deals with termination of the contract by the state. It appears it would be almost impossible for the state to terminate the contract. The state has the burden of proof to establish by "clear and convincing evidence" that the corporations have not acted with diligence and that there is a material adverse impact to the project. A tribunal established under the contract, rather than a court of law, will make the determination whether the state has met this burden. In making its determination, the tribunal must take into account factors such as delays due to regulatory processes, construction costs, gas prices or other business considerations. The tribunal cannot consider as evidence to support termination, a corporation's errors in judgment, an unwillingness to enter into a commercial arrangement or settle a dispute, or suspension of its obligations when the state issues a termination notice, or suspensions under judicial challenges, administrative termination or force majeure.

If these are to be the hurdles for state termination of the contract, it is again imperative that the parent corporations are signatories to the contract. Otherwise, for example, a business decision by a parent corporation to not provide funds for a contractual obligation might fall under the category of "business considerations," and would have to be taken into account by the tribunal.

Recommendations: Follow the lead of other nations' contracts and establish specific dates for completion of work commitments, with terms for extensions. Turn the burden of proof around so that if a deadline is not met, the pipeline sponsors must show why the deadline should be extended and the contract not terminated. Do not give up the right to take a dispute to the state courts. Impose meaningful penalty and damages provisions as deterrence to failing to proceed with construction of the pipeline.

Article 6: Alaska Hire and Content
Appendix E: Alaska Hire and Content

Discussion: Under AS 43.82.230 of the stranded gas act, the commissioner shall include a contract term that requires employment of Alaska residents and contracting with Alaska businesses. A provision that maximizes, to the extent permissible, the use of hiring through Alaska-based hiring halls and that does not undercut Alaska's prevailing wage rate would help meet this requirement.

The proposed contract requires that, to be competitively priced, a resident or business must offer goods or services "at a total cost that is equal to or less than the total cost of equivalent goods or services offered by a non-Alaska resident or a non-Alaska business." The proposed contract does not reference the state's proprietary interest to secure a skilled and qualified Alaska workforce through the use of a project labor agreement; and that out of a $20 - $25 billion-dollar project there is only $5 million committed by the corporations for training Alaskans.

Recommendations: More work should be done to determine how to achieve the greatest amount of Alaska hire possible. Including the requirement of a project labor agreement could help in this regard – not enough discussion has taken place on why this requirement is not in the contract. More work should be done to determine the optimal level of job training the state and corporations need to provide to ensure the highest number of trained Alaskans are ready for work when planning and construction begin. Very little evidence has been presented that the current provisions are adequate, or will lead to the optimal level of job training needed to ensure that as many Alaskans as practicable are hired on this project and that prevailing wages will not be undercut.

Article 7: State Ownership

Discussion: Whether the state owns a piece of the pipeline must be considered very carefully. A significant question is the impact the contract proposal could have on the state's credit rating. There does not appear to be a credit rating analysis in the preliminary fiscal interest finding.

State ownership of a gasline has been considered in several reports within the past six years. In 2001, the Alaska Highway Natural Gas Policy Council stated

> The [State Pipeline Ownership] committee believes the pipeline is economically feasible for certain investors and should be undertaken with private financing. We recommend against direct State investment unless there is clear evidence of economic benefits to Alaska that cannot be achieved through other regulatory or political mechanisms.[2]

In 2002, the legislative Joint Committee on Natural Gas Pipelines recognized that arguments in favor of state participation include the state having greater control over its destiny

[2] Alaska Highway Natural Gas Policy Council Report to the Governor, Executive Summary, November 30, 2001; page 16.

and resources and it would be a good investment for the state.[3] The committee went on to say that "there may be substantial risks to the state in taking such a role. The legislature will have to balance the risks and rewards."

These risks and rewards were examined in a 2002 study titled "State Financial Participation in an Alaska Natural Gas Pipeline." The study cautioned that "just because the state *can* invest on some modest level does not mean that the state *should* invest." [emphasis in original]. The study advises the state consider the following:

- The substantial risk of investment – the study states, "Unlike a major oil company or integrated natural gas pipeline, the state has little capability to monitor or control those risks and does not have the financial strength to absorb large capital or operating losses."
- The need to borrow or have readily available funds for continuing calls for capital expenses could "substantially" infringe on the state's flexibility to meet public service needs.
- That participation by the state as a minority participate would likely result in limited management rights and restricted access to information and the state frequently would be outvoted in the event of a dispute.
- That there would be a conflict between the state's duties to its citizens as sovereign and the fiduciary obligations of the state as a partner with the corporations.
- There is no applicable precedent for government participation in a natural gas pipeline project.[4]

The preliminary fiscal interest finding for the proposed contract supports state investment primarily to improve project economics for the corporations, as a source of "stable" revenue to the state, and to expedite the project.[5] Section 6 of the finding identifies the risks to the state. It is not at all clear from the finding that the benefits of a 20% minority interest outweigh the risks in the context of the proposed contract. Rather, under the proposed contract, the risks of state ownership outweigh the benefit the state will receive. Under the contract, the state will have a minority vote on too many important issues, and this will frequently render the state's vote

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[3] The committee recommendations can be found at
http://www.arcticgaspipeline.com/Reference/Documents&Presentations/StateOfAlaskaInfo/10-02LegislativeGasPipeRecommendations.doc

[4] "State Financial Participation in an Alaska Natural Gas Pipeline," January 31, 2002, pages 8-4 to 8-6.
[5] Preliminary Fiscal Interest Finding, page 103 [emphasis in original].

irrelevant. Likewise, the income projections by EconOne do not show a benefit to the state that outweighs the risks of ownership.

Recommendation: Before committing to state ownership in a gasline project, the proposal should be analyzed for its impact on the state's credit rating. An in-depth analysis should also be done to establish that the economic benefits of even a minority interest substantially outweigh the risks to the state and its citizens. The current state ownership proposal provides for risks that outweigh benefits.

Article 8: Regulation of and Access to Project Facilities and Disposal Services

Discussion: The proposed contract anticipates the U.S. Federal Energy Regulatory Commission (FERC) will provide for regulation of and access to the pipeline and facilities. The contract specifically disallows the state from seeking or supporting regulatory authority by the state's Regulatory Commission of Alaska (RCA). And if the RCA does assert its authority, the state will have to reimburse the corporations for any losses they incur.

Under state law, the RCA regulates intrastate pipelines to protect the interests of in-state users (AS 42.06.055-42.06.640). The 2001 Alaska Highway Natural Gas Policy Council envisioned an expanded role for the RCA over a North Slope gasline. The Council expressed concern that an Alaska gas pipeline would be subject to FERC jurisdiction "on issues important to Alaska without a defined role for the State with FERC," including tariffs on intra-state shipment of gas, and access to and from the pipeline.[6] The Council recommended the state seek federal legislation creating a joint board between the RCA and FERC to give the RCA joint jurisdiction with FERC on issues affecting Alaska, including setting "just and reasonable" rates for shipment of gas over the Alaska section of the pipeline and for lateral pipelines that serve in-state users.[7]

The proposed contract takes the exact opposite approach that was recommended in 2001 by eliminating all RCA authority, and requiring that the state indemnify the corporations for any losses they might incur if the RCA somehow manages to assert any jurisdiction. This violates the constitutional provision requiring actions be taken consistent with Alaska's public interest.

Article 8 also deals with expansion of the pipeline to ensure access for other gas producers other than the corporations. Legislative consultants have identified numerous

[6] Gas Policy Council Report to the Governor, Volume 1, page 27.
[7] Council Report, Volume 1, page 27, 32 and 43.

concerns with the expansion provisions including that there is no affirmative commitment to voluntary expansion, the state initiated expansion provision is restrictive, there are no sole risk expansion rights available to the state and no commitment to a "rolled-in" tariff.

Again, the 2001 Gas Policy Council recommended RCA involvement to ensure fair access to and from the pipeline.[8] The Council also recommended that Alaska consider including a "fairness" clause in the granting of State right-of-way approvals across state lands to guarantee fair access. The Council pointed out that Texas has similar provisions and states, "[s]uch a clause will give the State valuable leverage in negotiating fair access rules" and would "provide an avenue for appeal to the RCA in the event of disputes."[9]

In terms of access, an independent pipeline company has far more incentive to maximize access both prior to construction and over the life of the project than the corporations. This is exemplified in the draft MidAmerican February 23, 2004 contract that provides for the company initiating an expansion of pipeline capacity whenever demand suggests that expansion may be commercially viable.

Recommendation: Rather than ceding away RCA authority, seek ways to increase their involvement in order to protect the state's interest and ensure fair access to the pipeline. Heed the concerns raised by the legislative consultants on this subject, incorporated by reference. Review and consider recommendations in the 2001 Alaska Highway Natural Gas Policy council report.

Article 9: In-State Markets

Discussion: The proposed contract does not ensure Alaskans fair access to North Slope gas. The contract specifically states that no party to the contract is required to sell gas to an Alaska purchaser. That means there is no guarantee of in-state use of gas shipped on a North Slope pipeline. Recognizing that gas offtake points are expensive, it is appreciated that up to four offtake points may be funded if requested by the state. However, offtake points do no good if there is no gas available to make use of them.

Under the stranded gas act, AS 43.82.130(3) requires that a qualified project plan describe "satisfactory methods and terms for making gas available to meet the reasonably foreseeable demand in this state for gas within the economic proximity of the project during the

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[8] Gas Policy Council Report, Volume 1, page 25.
[9] Council Report, Volume 1, page 43.

term of the proposed contract." The 2002 legislative Joint Committee on Natural Gas recommended that the legislature require that any applicant for an Alaska right-of-way lease show that the applicant has a plan to meet the reasonably projected needs for local consumption. The committee also recommended that the legislature should ensure that Alaska communities, businesses and residents have access to gas from a pipeline for in-state use. And legislative consultants have recently shown that other nations' production sharing contracts generally include provisions that deal with local supply obligations.

Recommendation: In conformance with the stranded gas act and in keeping with other nations' production sharing contracts, any fiscal contract should include a provision that ensures gas will be available for in-state use at a price that is fair to all parties, and that recognizes the state's interest, as a sovereign, to provide for local power needs. All Alaskans deserve to have affordable energy – access to the gasline would help many Alaska communities that are currently struggling under the burden of high fuel prices.

Article 11: Fiscal Stability
Exhibit G: Amounts Payable to Political Subdivisions and State

Discussion: The provisions in the contract dealing with fiscal certainty are in potential conflict with Alaska's state constitution. More importantly, the contract seeks to lock in tax rates that vastly shortchange the state. The debate centers on our constitution's explicit prohibition against surrendering, suspending, or contracting away the power of taxation. Article IX, section 1 states: "The power of taxation shall never be surrendered. This power shall not be suspended or contracted away, except as provided in this article." This provision has been called the 'no surrender' clause. Many state constitutions have them. Our constitution does allow for exceptions to this rule, provided that the exceptions are done by 'general law.' The exact sentence under Article IX, Section 4 states: "Other exemptions of like or different kind may be granted by general law."

Our courts have consistently defined "general law" to mean "statute." Here is an example from the Alaska Supreme Court: "The basis for a home rule charter may be either a constitutional grant of authority, a general law enacted by the state legislature, or a combination of both." The obvious point to remember about laws enacted by any given state legislature is that they can be changed by the next one.

Former Assistant Attorney General Jack Griffin put it this way: “To the extent the legislature may ‘contract away’ the taxing power, it may do so only by general law, which is to say that the ‘contract’ is subject to repeal or modification by any future legislature.”

Since statehood, there has not been a direct court challenge to an attempt to take away the future taxing power of voters and legislators. Yet there are many signals from our court that all point in one direction: a statute that makes a promise of a long term tax freeze will not survive in the face of our “no surrender” clause. This line of thought was captured by our supreme court when it wrote, in a tax dispute between the oil industry and the state, “the state could not, and did not, contract away its power as a sovereign to tax.” While not a final statement of law on this subject, this sentence spells trouble for those seeking to bind the state to a promise of tax certainty for a decade or longer.

It is not just courts that view a long term tax freeze skeptically. Many experienced Alaskan legal observers have expressed grave doubts about the legality of the long-term tax promises desired by the corporations. Moreover, two of Alaska’s constitutional founding fathers have weighed in on the subject. In a Compass article that appeared in the Anchorage Daily News on July 19, 2006, Vic Fischer and Jack Coghill wrote that “Alaska achieved statehood in order to control its resources after decades of outside exploitation. No delegate would have considered turning over Alaska's oil and gas resources or stripping the Legislature and voters of the right to control the state's tax system – as would happen if the governor, oil companies and their agents manage to stampede the Legislature into a deal that is neither good for Alaska nor will advance pipeline construction.”

Recommendations: The provisions that prevent future legislatures and voters from modifying or fixing problems in our oil and gas tax laws when the need for changes become evident, should be deleted. Locking an a tax rate that vastly shortchanges Alaskans is poor policy, and might render a contract unenforceable.

Article 12: Royalty Payments

Discussion: Under the proposed contract the administration negotiated away the state’s ability to receive royalty payments for its resources. “The State should not negotiate away its right to take its royalty share of gas in-value or in-kind."[10] That is the conclusion in the 2001 report by the Alaska Highway Natural Gas Policy Council. Yet that is exactly what is being done under the proposed contract – right to switch between taking in-value and in-kind gas, opting to take royalty gas in-kind throughout the life of the contract under terms that will effectively reduce royalty revenues to the state. Those terms include the state taking on field expenses and marketing costs for royalty gas, costs currently borne by industry as an accepted condition of certain leases. The state is also giving up the benefit of receiving the "higher-of" value of its royalty gas (existing lease terms and statutes allow the state to receive royalty payments on the "higher of" actual proceeds or market value). As stated by former DNR officials, this provision billions of dollars in revenue loss for the state.

In 1998, the Alaska North Slope Gas Commercialization Team recognized that the state's ability to switch between taking royalty gas in-kind or in-value with six months notice added uncertainty to a gasline project. The team suggested that amendments to the North Slope oil and gas leases, gas royalty settlement agreements and oil and gas statutes could be made to help reduce project risk and uncertainty. However, the team also said, "[n]one of these actions or options are meant to unilaterally change or amend the leases or settlements as to the oil and gas that is already subject to existing settlements."[11]

The commercialization team suggested that one option would be for the state to agree to leave all of its royalty gas in-value in exchange for a promise from the producers to agree to sell gas to local communities and users. They also stated that any revised terms and conditions must be tied to a specific project scope with time and volume considerations; and that the in-kind, in-value split would have to be set for a given time period.[12]

Partly based on the commercialization team's recommendations, the legislature passed the stranded gas development act. In regard to royalty, the act provides the commissioner of revenue with the authority to develop terms relating to the timing and notice of the state's right to take royalty in-kind or in-value. That authority is limited in that the state's commitment to

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[10] Alaska Highway Natural Gas Policy Council, Report to the Governor, Volume 1, November 30, 2001, page 39. Among other things, the Council felt that retaining the flexibility to switch creates marketing competition and maximizes the resource value (page 38).

[11] Alaska North Slope Gas Commercialization Team Report to the Governor, January 7, 1998; page 36.

[12] Commercialization Team Report, page 35.

take royalty gas in-kind or in-value may not exceed the term of purchase and sale agreements (AS 43.82.220(a)). The commissioner was not granted the authority to do completely away with the state's right to switch between in-kind and in-value for the entire contract term.

In 2002, in response to the suggestion that the state give up its right to switch between in-kind and in-value in the name of fiscal certainty, the legislative Joint Committee on Natural Gas found that the right to switch between taking gas in-kind and in-value provides the state with the ability to foster in-state development. The committee stated that "[t]he legislature should not allow this right to be given up without careful consideration and adequate justification."[13]

The administration's justification for giving up the state's long-standing rights (and potential revenues) is "it eliminates the uncertainty that makes it more difficult to get financing if the gas volumes the sponsor group commit to the project can be changed by the state every three months."[14] In other words, the state is committing to taking its royalty gas in-kind and making significant other concessions for the sake of the industry's bottom line – with no guarantee that a gas pipeline will ever be built. In exchange, the state takes on additional costs and risks, including the costs incurred to produce and market the gas, and the risk of losses from high costs or poor market conditions. Not only is this a bad deal for the state, but it may not even be necessary. In its report to the Governor, the 2001 Natural Gas Policy Council concluded that

> The current North Slope producers have complied with the "in-kind" or "in-value" lease terms and statutes in other states and on federal offshore leases for decades and have instituted internal procedures that allow them to process the selection of "in-kind" or "in-value" promptly. Other states and the federal government also have internal processes for administering the switch between "in-kind" or "in-value" as does the State of Alaska for its royalty share of oil. The producers' arguments that Alaska must decide up front on "in-kind" or "in-value" to ease marketing and sales administration or to bring more certainty to gas transportation or marketing are not valid considering the same producers' decades of experience successfully administering such programs for transportation and marketing elsewhere.[15]

No adequate justification has been given for changing the current law that gives the state the option to receive its royalty in the form of a royalty payment. The revenue loss and risks of

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[13] Recommendations of Joint Committee on Natural Gas Pipelines to the Twenty-third Legislature.

[14] Preliminary Findings and Determination, May 10, 2006, page 114.

[15] Council Report to the Governor, Volume 1, page 40.

requiring the state to market its gas as provided in the proposed contract, and the revenue loss that will occur, are not justified.

Recommendations: Any provision regarding royalty gas should be negotiated so that at a minimum it meets the limitations imposed by the stranded gas act as it was enacted in 1998. The state should not concede to pay field costs or take responsibility for disposal of impurities in contradiction of most lease terms.

There are other options as well. In addition to the 1998 commercialization team's suggestion that the state take its royalty gas in-value, the 2001 Natural Gas Policy Council provides several recommendations, including adopting a mixed portfolio of in-value and in-kind sales and enforcing the "higher-of" clauses on natural gas royalty.[16]

More recently, Jim Eason, a legislative consultant, has suggested that the point of in-kind taking could be shifted from as far upstream as possible (and thus putting additional costs on the state), to a point as far downstream as possible. He suggests the AECO Hub in Alberta. Eason states,

> The Participants would still have the certainty of the State's royalty and tax gas being available for whatever term is appropriate. The State would still be responsible for paying for the transportation of its share of costs in moving its gas to Alberta. It would not, however, have the increased risk and exposure that flows from the capacity management responsibilities of the current proposal, nor would it need an expanded bureaucracy and a host of consultants through the term of the ASGFC to manage the capacity of its royalty and tax gas sales.[17]

Eason also suggests that the state could make a commitment to leave its gas in-value for the same term as is currently proposed.

Article 13: Tax Bearing Gas Payment

Discussion: Many of the concerns regarding a commitment to take royalty gas in-kind apply to taking tax bearing gas in-kind. There is no justification for the requirement that the state pay to sell, market and transport its gas, while foregoing the right to tax our natural gas resources. Under the proposed contract, the state could end up receiving less revenue than it would if the corporations paid their tax.

[16] Council Report, page 39.

[17] Memorandum, Jim Eason to Senator Therriault, June 3, 2006. Eason notes that this alternative would not address the reasonableness of other royalty-related changes that have been proposed.

There is also this comment in the preliminary finding:

> On state-owned lands, the effect of the contract's tax and royalty provision will result in the state receiving slightly less than 20 percent of the total gas produced. The amount of gas received by the state is expected to decline as gas from federal lands subject to federal royalties is developed and becomes a larger share of the gas shipped through the mainline.[18]

No explanation is provided regarding the meaning of this statement but it raises an additional concern.

Recommendation: In the context of the proposed contract, the state should not contract away its right to impose a natural gas production tax, nor should it assume the costs of selling, marketing and transporting the gas.

Article 14: Payment in Lieu of Production Taxes
Exhibits P, Q, R, X and Y

Discussion: Even if it was constitutional to include the oil tax in the contract, the stranded gas act specifically forbids changing the tax structure of oil as part of a fiscal contract. AS 43.82.010 of the Act states:

> The purpose of this chapter is to (1) encourage new investment to develop the state's stranded gas resources by authorizing establishment of fiscal terms related to that new investment *without significantly altering tax and royalty methodologies and rates on existing oil and gas infrastructure and production*… (emphasis added).

In contradiction of the law, a petroleum production tax (PPT) is provided in the proposed contract that changes the tax structure for current oil and gas production. It appears that if the legislature approves the proposed stranded gas act amendments and allows the administration to change the oil tax structure, the contract provisions will supercede any tax the legislature enacts. In effect, the tax structure passed by the legislature would apply to any producers who are not part of the contract while the contract provisions would govern production by BP, Exxon and ConocoPhillips for the term of the contract.

If that is the case, the oil tax structure that is included in the contract, found in Exhibit P, reflects the administration's proposed PPT legislation, including a tax rate on the net profits at 20% with a 20% tax credit. That is a tax rate that falls below the world average tax rate by more than $1 billion (at $60 per barrel of oil). But the contract goes further than the administration's

[18] Preliminary Finding, page 51.

proposed legislation. In the legislation, the department of revenue is directed to give "substantial weight" to billable costs under unit operating agreements when determining what expenses can be deducted for determining a corporation's net profits. Under Exhibit R of the contract, costs that may be deducted are those costs that are billed under a unit operating agreement. In effect, the taxpayer will be setting their own deductions, and each taxpayer will have different deductions depending on which operating agreements apply.

The administration has assured the legislature and the public that the state will be able to audit the expenses that are deducted. However, under Exhibit R, the costs allowed under the unit operating agreements are presumed to be allowable deductions; the state may not disallow a cost unless the expenditure is specifically listed in the contract as a disallowable cost (these include the disallowed costs currently in the administration's proposed PPT legislation).

The administration has also assured the legislature and the public that the penalties for nonpayment of the tax that apply under current law will continue to apply. Under current law, debts can be collected by lien foreclosure or through a civil action (AS 43.10.032). Under Exhibit Y of the contract, the only remedy is that provided by the contract which appears limited to a tribunal requiring that the payment be made.

Recommendation: The legislature should not agree to the proposed amendments to the stranded gas act or the administration's proposed tax changes; nor should the administration include changes to the oil tax structure as part of the gasline contract.

Article 22: Payment of Fiscal Obligations

Discussion: The proposed contract imposes far too many fiscal obligations on the state. Under the worst case, the state will be paying the corporations without any compensation for depletion of the state's resources. According to former DNR officials, the state is subsidizing the contract up to $13.25 billion for the following: upstream cost allowance ($5.45 billion); upstream credit ($4 billion); midstream pipeline and gas treatment plan ($2 billion); processing subsidy ($440 million); and costs to the state for selling its in-kind gas ($1.4 billion).[19]

In addition, provisions under the contract could impact the state's ability to sell its royalty gas – the corporations may choose to recoup or offset an amount due from the state by reducing the amount of royalty or production tax gas it is contracted to deliver. This could put the state at

[19] Petroleum News, June 18, 2006.

a competitive disadvantage for selling its gas if it appears to purchasers that the volume cannot be guaranteed.

Recommendation: All provisions regarding state fiscal obligations should be revisited to limit the state's liability as much as possible. The option for the corporations to recoup or offset an amount due from the state with royalty or tax gas taken in-kind should not be permitted.

Article 23: Point Thomson

Discussion: The Point Thomson unit is a high-pressure gas field east of Prudhoe Bay and is expected to be a key supplier of natural gas for the pipeline. Leases in the unit are primarily held by ExxonMobil, BP, ConocoPhillips and Chevron. Since 1977, the state has worked with the leaseholders to get the unit developed, including "use it or lose it" provisions in various lease agreements. Though the leaseholders have not met many of the required work commitments, numerous extensions have been granted so that they continue holding the rights to develop the gas.

Under the proposed contract, the state suspends most of its authority to enforce development of the Point Thomson unit through lease requirements, including relinquishment of the leases if work commitments are not met. Instead, the contract calls for a commitment of a minimum amount of gas for the project and a requirement that the leaseholders apply to the Alaska Oil and Gas Conservation Commission for an authorized gas off-take rate.

Given the lack of success in getting Point Thomson developed even with fairly strong lease terms, it is questionable whether the state will see more action taken under the less stringent contract provisions. The result could be a lock up of the unit for the term of the contract – up to 45 years.

It should be noted here that if the administration's petroleum production tax is enacted and Point Thomson is developed, the state will pay at least 40% of the development costs through various deductions and tax credits. Combined with state ownership commitments in the contract, that amount will be more than forty percent. Subsidizing a project the state has previously ordered to proceed with no subsidies is a cause for concern. It is estimated these concessions will cost the state approximately $1 billion or more.

Comments regarding Point Thomson by legislative consultant, Jim Eason, dated June 3, 2006 are specifically incorporated here by reference.

Recommendations: Maintain state control over development of Point Thomson. It is worth investigating whether other developers are interested in the lease tracts and whether development would occur faster than relying on the current leaseholders.

Article 26: Mandatory Dispute Resolution

Discussion: All disputes under the proposed contract will be resolved by amicable resolution and arbitration procedures, except disputes to judicially enforce or vacate any award, order, or judgment rendered under the mandatory dispute resolution procedures. If amicable resolution fails the only remedy is full arbitration.

The proposed contract calls for "Baseball Arbitration" in significant disputes. This is very restrictive and not customary for oil and gas contracts. Arbitrators are limited to choosing one of the "final offers" of each of the two parties in ascribing a remedy and are precluded from assessing the equities and remedies themselves.

In most cases, discovery is limited to three requests for production and five depositions. Often in the cases of oil and gas disputes between the state and the corporations, the issues are complex and usually require significant discovery. The State as a minority shareholder in the mainline entity will not be in a position of having the information it would need to formulate its case without the ability to conduct extensive discovery. Removing the ability to resolve disputes through the court system limits the state's options in seeking a remedy for any corporation's wrongdoing.

Recommendations: Maintain the option of dispute resolution, but continue the ability of the state to settle disputes through the court system, under established legal rules.

Article 28: Administrative Termination

Discussion: The proposed contract violates the provisions of the stranded gas act regarding administrative termination of a contract. AS 43.82.445 states:

> (a) The commissioner shall include terms in a contract developed under AS 43.82.020 that provide for administrative termination of a party's rights under the procedures and conditions set out in this section if the party has
>
> > (1) ceased to meet the requirements of AS 43.82.110 as a qualified sponsor or qualified sponsor group;
> >
> > (2) intentionally or fraudulently misrepresented, in whole or in part, material facts or circumstances upon which the contract was made;

(3) failed to comply with a condition or material term of the contract or a provision of this chapter; or
(4) failed to comply with the approved qualified project plan or any updated project plan.

(b) Before administrative termination of a contract under this section, the commissioner shall give notice to the parties of the commissioner's intent to terminate the contract and an opportunity to be heard. The commissioner may also provide the parties an opportunity to cure any deficiency that is the basis for the termination if the commissioner determines that curing the deficiency is appropriate under the circumstances.

(c) Notwithstanding (a) and (b) of this section, the commissioner may not administratively terminate a contract after the party has committed full project funding except as provided in (e) of this section.

(d) A party to a contract who is affected by the commissioner's action to terminate under (a) of this section may file an appeal with the superior court under the Alaska Rules of Appellate Procedure.

(e) The commissioner may provide terms and conditions in a contract developed under AS 43.82.020 upon which a party's rights under the contract may be administratively terminated after the party commits full project funding.

Under the proposed contract, the administration has provided for administrative termination only if the commissioner believes that the participants have ceased to meet the requirements of a qualified sponsor group or that a participant intentionally or fraudulently misrepresented material facts or circumstances upon which the contract was made. The contract does not include the other two causes for termination required by the law – failure to comply with a condition or material term of the contract or failure to comply with the approved qualified project plan.

Under the contract, the administrative termination period begins on the effective date of the proposed contract and ends on the day the corporations have spent a cumulative total of $125 million to plan for, build or operate any part of the Alaska project. Again, this runs counter to the law that provides administrative termination may occur up to the point that a party has committed "full project funding."

The law also provides that appeals of a termination decision may be appealed to the superior court. The proposed contract requires that disputes be resolved under the Article 26 mandatory arbitration provisions.

Recommendation: The administrative termination provisions should comply with the requirements of the stranded gas act.

Article 35: Force Majeure

Discussion: During a force majeure event, an affected party's obligations, including fiscal obligations, are suspended. "Fiscal obligations" include volumes due to the state under Articles 12 and 13 (royalty and taxable gas payments) and payments in lieu of taxes. Consequently, when a force majeure event adversely affects the flow of crude oil or gas, the affected party's obligation to provide state royalty and tax bearing gas and make payments in lieu of taxes is suspended – this includes payments in lieu of municipal property and sales taxes and the oil and gas production tax (PPT). It appears that under the expansive definition of force majeure, an event such as a foreseeable labor dispute that affects oil or gas production could result in revenue loss to the State and municipalities.

Question: Could this provision also impact royalty gas dedicated to the Permanent Fund?

Recommendations: As discussed under Article 1, narrowly define "force majeure." Also, make provision for continued payment of fiscal obligations to the state during force majeure events.

Article 40: Representations and Warranties

Discussion: The corporations represent and warrant that they have the power and authority to execute and deliver the proposed contract; and that the signatory "has been duly authorized by all necessary corporate, state, or other action to execute and deliver" the contract. The corporate signatories are the Alaska subsidiaries to the parent corporations of BP, ExxonMobil and ConocoPhillips.

Recommendation: As discussed under the definition section, the parent corporations must also be signatories to a contract along with the subsidiary corporations in order to guarantee the contract provisions will be fulfilled.

Article 41: Relationship to Law and Other Agreements

Discussion: The proposed contract says that the state's equity participation in the project does not restrict or limit the state's sovereign power to regulate the project under applicable law. But the contract also amends all rights, privileges or obligations of the corporations in a lease, other agreement, regulation, rule, order or decision to the extent necessary to conform to the provisions of the contract. If there is a dispute regarding whether there is a conflict between the contract and one of the listed documents, the parties are instructed to attempt to resolve the dispute by harmonizing them and giving reasonable effect to both. If the parties cannot harmonize them, the contract controls. In effect, this provision could mean that the contract overrides all applicable laws despite the assertion that the contract does not override the state's sovereign power.

Recommendation: The state should not cede its sovereign authority to regulate corporate activities on the gas pipeline project.

<u>OTHER ISSUES</u>

Indemnification Provisions

Discussion: Indemnification is a promise protecting one party from financial loss. This is sometimes stated as a requirement that one party "hold harmless" the other. Indemnification is a type of insurance that protects one party at the expense of the other. Indemnification can either be through direct payment or reimbursement for the loss.

Indemnification provisions appear in several portions of the proposed contract. Under the contract, the state would pay the corporations for losses as a result of:

- The imposition of a gas reserves tax (Article 11.2(b)).
- Actions the RCA might take (Article 8.3)
- A corporation capacity holder's performance of or failure to perform any of its capacity obligations (Article 10.10)
- Claims that a political subdivision asserts against a corporation related to that corporation's fiscal obligations (Article 21.3).

Beyond the indemnification provisions, there are several articles that call for the state to reimburse the corporations for losses. For example, Article 11.5 requires the state to reimburse the corporations if a contractor or subcontractor has a tax imposed upon them that is not of general application and unlawfully discriminates against a gas pipeline related business, and that results in a loss to the corporations ("loss" is broadly defined to include, for example, litigation expenses.)

The proposed contract sets out a system in Article 22 where all the payments due the corporations from the state, including the indemnity and reimbursement payments, are set off against the payments in lieu of taxes that the producers owe the state each month. The contract explicitly envisions the likelihood that the state will owe the corporations money at the end of each month. If the state's obligation to the corporations goes unsatisfied for three months, "the State shall notify the Legislature of the Amount Due so that an appropriation may be made if no appropriation exists that authorizes payment."

These provisions are bad policy, and they are questionable from a constitutional point of view. On pure policy grounds, these indemnities have the potential to cost Alaska millions without any control by Alaskans. In some years, they may threaten to reduce or eliminate oil tax revenue to the state.

The constitutional issue springs from Article IX, section 13, which provides that "[n]o money shall be withdrawn from the treasury except in accordance with appropriations made by law." In other words, the state cannot spend money unless the legislature appropriates it.

A 2005 Attorney General Opinion (#661-05-0132) addressed this issue by setting out the general rule that "a state official may not enter into indemnification agreements." There are two exceptions to this rule. The first exception requires that an appropriation be made at the time the indemnification agreement is entered into. In this case, that would require money be appropriated by the legislature concurrent with the ratification of the contract to cover potential losses.

The other exception is a so-called "qualified" indemnification agreement, which states clearly that "the legislature has unfettered discretion as to whether to appropriate the money." The opinion gives an example of the language that should attend every contractual grant of indemnification:

> Subject to a specific appropriation by the legislature for this purpose, the [agency] agrees to indemnify [the party] for [the liability]. All parties to this agreement recognize and agree that the agency has no appropriation currently available to it to indemnify [the party] under this provision and that enactment of an appropriation in the future to fund a payment under this provision remains in the sole discretion of the legislature and the legislature's failure to make such an appropriation creates no further liability or obligation of the agency.

While Article 37.3 of the contract does set some limits on indemnification, the article is specifically contrary to the above language in that it notes that "[t]he Legislature's failure to make such an appropriation does not … extinguish the underlying obligation for which the appropriation is sought."

Recommendation: If indemnification is provided, a contract's indemnification provisions should comport with the policies set out in the Attorney General's Opinion #661-05-0132. Indemnification should not be used to undermine the voter's right to adopt an initiative.

Anti-trust Issues

Discussion: In 1977, the U.S. Attorney General recommended that ownership of the Alaska natural gas pipeline by the major North Slope producers be prohibited in implementing the Alaska Natural Gas Transportation Act (ANGTA) due to antitrust concerns. Based on these recommendations, President Carter prohibited ownership in any ANGTA pipeline. President Reagan waived the prohibition on producer ownership, but only on condition that FERC consider the views of the Department of Justice on the issue and "upon finding by the [FERC] that the agreement will not (a) create or maintain a situation inconsistent with the antitrust laws or (b) in and of itself create restrictions on access to the Alaska segment of the [proposed pipeline]."

In response to Representative Berkowitz's January 4, 2005 letter to FERC questioning the ability of the North Slope producers to own the pipeline, FERC Chairman Pat Wood stated, "it would be prudent to conclude that the antitrust issues which concerned Congress and the President over twenty years ago are still valid and will be addressed by our Commission in our proceedings."

FERC will regulate the terms of access to the pipeline and has been directed under the Alaska Natural Gas Pipeline Act in 2004 to issue regulations that shall "promote competition in the exploration, development and production of Alaska natural gas." While the FERC Open Season regulations are designed to accommodate competing producers, a fair and competitive gas pipeline is by no means assured.

Serious competitive issues include the producers incentive and ability to use their control over the pipeline to discriminate against competing producers and delay or defeat an expansion as well as the ability of the producer-owners to raise the rates on the pipeline.

A producer-owned pipeline also has the potential to encounter more delays as compared to an independent pipeline company due to the large potential for litigation on the part of competing producers.

Whoever owns the Alaska gas pipeline will have market power and incentive to disadvantage their rivals. The administration argues that the producer-owners do not have a sufficient market share to give them an incentive to use the pipeline to discriminate against rivals. However, if the market is more narrowly defined as Chicago and other "Mid-Continent" areas, their share of the market increases to the point where we can assume they would not favor the production of additional gas which could drive the price down they receive for their gas.

There have been instances in the history of the TAPS oil pipeline where the major producer-owners have engaged in anticompetitive conduct. The RCA recently found that the TAPS owners over-recovered $9.9 billion by charging unreasonably high transportation rates over the course of many years. In light of their behavior with regard to the TAPS oil pipeline, it is even more crucial the producer-owners affirm their commitment to a fair and competitive gas pipeline.

According to legislative consultants, possible bad behavior on the part of the producer-owners could include imposing an artificially high tariff for all shippers, delaying interconnection to independent third-party producers' wells and attempting to use FERC procedures to delay third-party requests, thereby further increasing rivals' costs. Any delays or other tactics resulting in less gas produced will result in a loss to the state's revenues through fewer royalty payments.

Recommendations: An independent pipeline is the preferred option from a competitive perspective. If the state does decide to go forward with the producer-owned pipeline, there have been several suggestions put forward by the legislative consultants including a partial divesture to an independent pipeline, or establishment of an independent system operator, with the power to require expansions and creation of an independent market monitor. A producer owned pipeline brings the need for contract terms that would safeguard against anti-competitive behavior by the producers.

Alternatives to a Producer Owned Gasline

Discussion: In 2004, the administration called for applications under the stranded gas act for the development of a fiscal contract for a natural gas pipeline from the North Slope. Besides the three major corporations' application, four other applications were received: Alaska Gasline Port Authority, TransCanada, Enbridge, Inc., and MidAmerican Energy Holding Company.

Early in the process, the administration appeared on track for considering and presenting all viable alternatives. In a governor's office news release dated December 16, 2004, the governor stated:

> TransCanada has prepared a very responsible proposal which we expect to present to the Legislature this session," Murkowski said. "We are also very pleased that the Alaska Gas Port Authority continues to work on an 'All Alaska' project that is not exclusive and could provide many benefits to the state."

But exactly eleven months later, in a November 16, 2005 speech to the Resource Development Council, the governor changed course in favor of BP, Exxon and ConocoPhillips, stating "The Stranded Gas Act does not tell the governor to make a business deal with interests who first need to sue in order get the gas."

However, as noted in the 2001 Gas Policy Council report,

> Leases signed by the producers on the North Slope legally stipulate there is an implied covenant to market gas produced within a "reasonable time" and at a "reasonable price." It is assumed that 34 years since the start of production at Prudhoe Bay meets the reasonable time stipulation. Producers will thus have to sell their gas to pipeline companies or third parties if "reasonable price" offers or bids are received for their gas and assuming other bid terms are acceptable.[20]

In other words, if the state asserted its authority under the leases, the corporations could be compelled to market the gas to an independent pipeline project. Instead, the administration has ceded the state's power to force the corporations to sell their gas. The administration has weakened its negotiating power by waiving its right to force the corporations to sell their gas to an independent pipeline.

Independent pipeline developers have other advantages for the state, including the motivation to develop the project and get the gas to market as soon as possible and a strong commitment to provide access to all producers, from start to finish of the project.

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[20] Gas Policy Council Report, Volume 1, page 37.

There are possible disadvantages to an independent pipeline as well. However, without knowing the terms of any agreements other than the proposed contract, it is not possible for the legislature or the public to arrive at the best project for the state and the nation.

Recommendation: As part of the public and legislative review, the administration should prepare a comparative analysis of the proposed contract with other qualified proposals, and present negotiated proposals from independent pipeline operators to the legislature for a vote.