

STATE OF ALASKA

DEPARTMENT OF LAW

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October 27, 2005

The Honorable Tom Irwin
Commissioner
Department of Natural Resources
400 Willoughby, 5th Floor
Juneau, AK 99801

Re: Response to Memorandum dated
October 20, 2005 on the Alaska
Stranded Gas Development Act
Negotiations

Dear Commissioner Irwin:

You have asked for my advice on whether the Administration is operating within the limits of the law as it negotiates proposed contract terms with certain applicants under the Stranded Gas Development Act, AS 43.82 (SGDA). Since my appointment as Attorney General on March 31, 2005, I have personally participated in the SGDA negotiations. I have received daily reports from my staff and contractors about the progress and content of any negotiations in which I have not participated. I will address the legal questions that you raise in your memorandum.

Executive Summary

The Administration has both broad authority under the Alaska Constitution to execute the laws to the fullest extent, to negotiate contracts on the State's behalf, and to propose legislation, and specific authority under the SGDA to achieve its purpose of encouraging development of the State's stranded gas resources through development of fiscal terms tailored to the economic conditions of a proposed project. These authorities make it lawful for the Administration to negotiate terms and propose legislation if the Governor finds this necessary to fulfill the purpose of the SGDA. Because the Administration possesses authority to negotiate contracts and propose legislation, it can propose a contract that relies on the enactment of accompanying legislation to become effective. Moreover, because no SGDA contract can be executed without legislative authorization, no

proposed contract—and no judicially reviewable action—could violate the SGDA. The Administration's course of conduct on the SGDA negotiations is both authorized and lawful.

The fact that you and your staff may have a different vision of what best serves the interests of the State as compared to others in the Administration does not make their judgments—or yours—on fundamental policy issues either unlawful or improper. Ultimately, after considering the concerns of his advisors, the Governor is charged with the responsibility to negotiate terms that best serve the long-term interests of the citizens of Alaska, and submit those terms for public comment and legislative review. That is the course of action the Administration is pursuing, and it is the course contemplated by the Act. In short, the points you raise in your memorandum are primarily policy matters within the discretion of the Governor, rather than legal issues.

Certain specific questions that you raise about the consequences of your signing the preliminary fiscal interest findings are premised on an incorrect reading of the statutory language. The SGDA authorizes the Commissioner of Revenue, not the Commissioner of Natural Resources, to make preliminary findings. Nonetheless, I will address your concerns.

The Administration has authority to negotiate contract terms on the State's behalf and propose legislation to achieve the purpose of the SGDA to encourage development of the State's stranded gas resources. The SGDA expressly provides for development of contract provisions that may require modifications to taxes, leases, and unit agreements. It follows that such actions may require amendment of applicable laws. The Administration's course of conduct on the SGDA negotiations is, therefore, both authorized and lawful.

As to personal liability, the law is well established that state officials are immune from personal liability and suit with regard to official actions when they act under the cloak of authority of their offices, pursue legitimate state objectives, and act in matters that are discretionary, involve personal judgment and deliberation, and require interpretations and applications of a statute. This immunity extends both to you as Commissioner and to those of your staff who assist you.

Discussion

I. The Administration's Authority

The Executive Branch has authority to negotiate contracts on behalf of the State. This authority is derived directly from the Alaska Constitution, article III,

sections 1,16, and 24 (vesting the executive power of the State "in the governor," making him "responsible for the faithful execution of the laws" and for "compliance with any constitutional or legislative mandate," and designating each principal department under the supervision of the governor), and from the SGDA itself. Moreover, article VIII, section 1 provides that it is the policy of the State to encourage development of state resources consistent with the public interest. Finally, article III, section 18 imposes a duty on the Governor to recommend measures he considers necessary for the legislature to consider, and, consistent with that duty, department commissioners are authorized to develop proposed amendments to existing laws.

The Administration's actions in negotiating an SGDA contract comport with both the preceding authorities and the legislature's intent in passing the SGDA. The legislature articulated the purpose of the SGDA as "authorizing the state, through the executive branch, to develop a contract establishing the fiscal regime that would apply to a qualified stranded gas development project." See SLA 1998, ch. 104, §§ 14, 15 (printed in 1998 "Temporary and Special Acts and Resolves").

As you know, the need for amendments to the SGDA to develop such a contract became clear early in the negotiation process. For example, as was widely reported in the press, the Governor decided to seek a substantial ownership interest in the gas pipeline project. The SGDA does not expressly contemplate that the State seek such an ownership interest, but expert advisers recommended this to the State to reduce the risk and increase one measure of return to the industry participants. Determining that an ownership interest is in Alaska's best, long-term interest and identifying what statutory amendments would be necessary to achieve that goal is neither unlawful nor improper; it is precisely what the Governor has been charged to do. And, as discussed below, the legislature must enact any changes in the law, which serves as a fundamental check on the process.

II. Response to Your Questions

In your memorandum, you requested advice with respect to eight questions pertaining to your involvement in the negotiations. The issues raised fall into two broad categories. First, you disagree with either the substance or the adequacy of certain draft preliminary findings that the Commissioner of Revenue is preparing pursuant to AS 43.82.400 (your first, third, fourth, and eighth questions). You inquire whether you could be exposed to any personal liability if you approve such findings despite your misgivings. Second, you specifically identify three provisions of a current draft contract being discussed with the producers that you assert are not authorized by the current version of the SGDA, and you wonder

whether approving findings related to a contract with such terms is outside the confines of the law. You also generally question whether the Administration's plan to submit a bill providing for conforming amendments to the SGDA provides adequate legal authority for continuing current negotiations and issuing preliminary findings in conjunction with a draft contract dependent upon such future legislation (your second, fifth, sixth, and seventh questions).

A. Questions About the Adequacy of Preliminary Findings.

Your question concerning whether you or your staff might face liability if you were to sign a preliminary fiscal finding with which you do not agree is a hypothetical question, because AS 43.82.400 gives this authority and discretion to the Commissioner of Revenue, not to you.¹ In any event, to the extent that your direct participation is required, the SDGA is premised on the principle that state officials will make findings consistent with their perception of the truth and with the best interests of the people and the State of Alaska.²

Moreover, your concerns must be considered in the context of the SGDA's overall public comment and legislative approval process. When the State and a sponsor reach final agreement on the terms of a fiscal contract, the Commissioner of Revenue issues preliminary findings and makes the findings and proposed contract available for public and legislative comment. AS 43.82.410. Before

¹ AS 43.82.220 gives the Commissioner of Natural Resources, with the concurrence of the Commissioner of Revenue and affected parties, the authority to develop various royalty contract terms and conditions.

² Given this premise, the actions that you and your staff perform in assisting the Administration with negotiating an SGDA contract are within the scope of your authority under the SGDA. They also involve personal judgment and deliberation, and interpretation and application of the SGDA and other laws. Therefore, your actions are discretionary. *See, e.g., Aspen Exploration Corp. v. Sheffield*, 739 P.2d 150, 154-157 (Alaska 1987) (holding that the governor's direction to the DNR Commissioner to reject a permit application was discretionary because he was engaged in supervisory authority over his subordinates that involves fundamental policy determinations, which in turn require the exercise of personal deliberation and judgment). Discretionary actions are given absolute or qualified immunity. *Id.* at 156-157. Various factors go into the analysis of whether the immunity would be qualified or absolute, but we believe that it would likely be held to be absolute. *See, e.g., id.* at 160 (The governor has absolute immunity to reject an application for an offshore prospecting permit.).

making final findings, the Commissioner of Revenue must consider all comments and prepare a list of proposed amendments, if any, to the proposed contract. AS 43.82.430. After this public process is concluded, the Commissioner of Revenue may make final findings and submit the proposed contract to the Governor. The Governor then must approve the final terms of the contract and seek authorization from the legislature to execute the contract. AS 43.82.435. Thus, the Administration presently is engaging in a process to negotiate terms of a contract that will not be executed absent significant further review and action by the Alaska Legislature.

The question you ask about the adequacy of the proposed draft findings and whether they will include a quantitative evaluation of the alternatives such as those embodied in the other applications submitted under the SGDA is premature. AS 43.82.400 does not require that the Commissioner of Revenue make such a comparison. In any event, it would be premature to evaluate whether the findings are adequate until the Commissioner has completed them and provided them to the Department of Law for legal review. Moreover, the preliminary findings will be subject to public and legislative review and comment. If any question exists as to their adequacy to support the proposed contract, the public and the legislature also can raise these concerns.

You further state that you disagree with certain economic analyses and policy determinations, and ask whether to continue negotiations under the Act would be lawful when "all analyses indicate that the project gas as a whole . . . does not" meet the definition of "stranded gas."³

As you are aware, over the past three years, the Administration's internationally renowned expert economist on the development of stranded gas, Dr. Pedro van Meurs, has produced a number of analyses on the economics of marketing Alaska's gas reserves that provide a solid basis for the Administration to determine that the gas meets the statutory definition of "stranded gas."⁴ You express concern that consultants and staff have since determined that those economic conditions on which those analyses were based no longer exist, and you believe their opinions are correct. Yet, as you are aware from your participation in the negotiations during the past year and a half, knowledgeable experts, including

³ The SGDA defines "stranded gas" is gas that "is not being marketed due to prevailing costs or price conditions as determined by an economic analysis" conducted by the Commissioner of Revenue. AS 43.82.900(13).

⁴ Dr. van Meurs has presented some of his economic analyses in public hearings of the Alaska Legislature.

Dr. van Meurs, still hold the opposite view on whether North Slope gas is "stranded gas."

More fundamentally, given the requirement that the Administration present a proposed contract to the legislature for approval, whether the gas is "stranded gas" at any particular point is not determinative. If the legislature enacts legislation approving the terms of an agreement to develop a gas pipeline, it will have determined either that the gas is "stranded gas," or that whether the gas is "stranded gas" does not matter. Regardless of how the gas is characterized, a decision by the legislature to go forward would reflect its determination that the terms are beneficial to the State and worthy of implementation.

You also question whether the State must take its royalty in-kind over the life of the agreement to make the project economically viable, and you suggest that the contract as a whole is not in the long-term fiscal interest of the State. Again, these issues involve complex economic, commercial, and ultimately political judgments. Other officials and experts differ with your opinions on these important questions. Because you and your staff have participated fully in these policy discussions, you are aware that officials within the Administration have continually had a vigorous and healthy debate on all of these issues. This debate will continue if and when a proposed contract is submitted to the public, and it can be resolved by an act of the legislature.

B. Questions About Differences Among Contract Terms, Current Lease Provisions, and the SGDA.

The second category of questions you have raised concerns the necessity of a bill to amend the SGDA and other laws to conform to the proposed project.

You point to provisions of the draft contract that you believe are not authorized by, or may conflict with, certain provisions of AS 43.82. You have inquired as to whether adoption of preliminary findings in connection with a contract that contains such provisions is lawful. Because the State and the producers have not finally agreed on precise contract language, I will not discuss the specific provisions noted in your request. I will, however, address your questions about the authority to continue negotiating.

First, the SGDA provides the Administration broad authority and great flexibility to negotiate the terms of a fiscal contract that will substantially advance the likelihood of a gas pipeline project. This is the paramount intent of the legislature and that intent is being pursued in the course of the current negotiations. Specifically, AS 43.82.200(7) authorizes the Commissioner of

Revenue to consider contract terms that are necessary to further the purposes of the SGDA or that are otherwise in the best interests of the State. Second, as discussed at the outset, the Governor and the Departments of Revenue and Natural Resources have broad authority outside the SGDA to consider and propose changes in state tax and royalty regimes. Given that state commissioners are generally authorized to develop proposed legislation, including statutory amendments, you and the Commissioner of Revenue are implicitly authorized to develop proposed SGDA contract terms that rely on the enactment of such proposed legislation.

While I disagree with your opinion that AS 43.82 provides no authority for the contract terms mentioned in your memorandum, I will nonetheless address the underlying issue that you have raised. As you comment, the Administration plans to confirm through legislation that the State has authority for all contract terms submitted to the legislature for authorization under AS 43.82.435. Thus, if a provision of the proposed contract conflicts with a provision of the SGDA, the legislature can either suggest that the specific contract term be amended or enact conforming legislation. The Alaska Supreme Court approved this type of process, in *Baxley v. State*, 958 P.2d 422 (Alaska 1998) (also known as “the Northstar case”). In *Baxley*, the Commissioner of Natural Resources negotiated proposed terms to amend royalty provisions of oil and gas leases, then submitted those amendments to the legislature for approval. *Id.* at 427. The court upheld the statute authorizing the amendments against a constitutional challenge, finding that the statute’s modifications to the subject leases were narrowly tailored to a unique situation and were substantially related to legitimate state purposes. *Id.* at 430-33.

This procedure is legally appropriate for changes to the SGDA as well. The SGDA expressly provides for development of contract terms that require modifications to taxes and royalty provisions of lease and unit agreements, which may, in turn, require amendment of applicable laws. For example, AS 43.82.210 specifically authorizes the Commissioner of Revenue to develop “periodic payment in lieu of one or more of the following taxes that would otherwise be imposed by the state.” The list of taxes that may be altered or replaced includes both oil and gas production taxes, oil and gas exploration production and pipeline transportation property taxes, and Alaska net income tax. *See, e.g.*, AS 43.82.200 and .210. Thus, the Act, in turn, contemplates modification of tax laws for oil and royalty terms.

Because the Act grants the Administration authority to decide which proposed project best promises the development of a gas pipeline and to negotiate a complete package of terms to achieve that goal, the SGDA does not require the

Administration to negotiate with all applicants. Additionally, judicial recourse is available to an allegedly aggrieved person. *See* AS 43.82.440.

The state officials involved are working within the scope of their broader authority to prepare legislation and propose lease or royalty amendments in areas of their statutory responsibility. This is an effort to fulfill the primary legislative purpose of AS 43.82, which is to bring back to the legislature a fiscally certain arrangement that will result in a gas pipeline project. The Administration has not attempted to bind the State to any contractual obligations that will not ultimately be authorized by law. Throughout the negotiation process the Administration has informed the legislature, including members of the Legislative Budget and Audit Committee, of the course of the discussions and various positions proposed, including major developments in the negotiations.⁵ Again, the terms of the fiscal contract that is now under discussion have always been conditioned upon approval by the legislature. The legislature has acknowledged through appropriations of funding that the negotiations underway were to proceed.

Finally, in addition to your concerns about conflicts with the SGDA, you reference AS 43.82.130(2) and suggest a legal problem if the terms of a proposed contract materially conflict with the obligation of an oil and gas lessee to the State under an existing lease or unit agreement. Here, too, the legislature can determine whether there is a significant conflict between subsection .130(2) and a specific contract term, and, again, either suggest that the specific contract term at issue be amended or amend the Act. Moreover, subsection .130(2) is inapplicable to a proposed contract. Its subject matter is the Commissioner of Revenue's approval of the initial submission of a proposed project, not a proposed contract. That approval occurred in January 2004. After that approval, AS 43.82.220 authorizes the development of contract royalty terms and the modification of lease provisions relating to the decision to take royalty gas in-kind and to valuation methods for the State's royalty share of the gas. In any event, again, any proposed modification of royalty arrangements, lease, or unit agreements will be submitted to the legislature for approval.

Conclusion

The Administration has authority to negotiate contract terms on the State's behalf and propose legislation to achieve the goal of the SGDA to encourage development of the State's stranded gas resources. The Administration's course of conduct on the SGDA negotiations is, therefore, both authorized and lawful. The

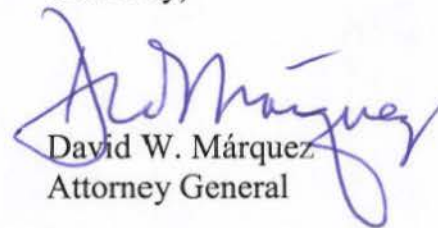
⁵ *See* AS 43.82.310(e) for disclosure to legislators consistent with the provisions to protect confidential proprietary information and negotiating positions.

issues raised by the Commissioner are largely policy questions, not legal questions, and as such are within the purview of the governor and the legislature to resolve.

As discussed above, the Commissioner of Natural Resources and department staff need not be concerned with facing personal liability for participating in this process so long as they continue to act within the scope of their authority as state officials. Your concern regarding the adequacy of the preliminary findings for a proposed contract is premature; the contract negotiations are ongoing and the Commissioner of Revenue has not given public notice of preliminary findings as is required under the SGDA before a proposed contract is submitted to the legislature. Moreover, the SGDA does not require that the Commissioner of Natural Resources sign the preliminary findings.

Finally, the concerns you raised about policy and gas cabinet decisions with which you disagree are being addressed in the ongoing negotiations. Following that, if a contract is proposed, the Commissioner of Revenue will publish the preliminary findings and proposed contract for review by the public and the legislature. To the extent that Alaskans disagree about the best course of action for the State, those differences will be aired and resolved as the process progresses to public comment and legislative consideration.

Sincerely,



David W. Márquez
Attorney General

DWM:cmg