Presentation to House Finance

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Roger Marks - Background

• **Since 2008**: Private consulting practice in Anchorage specializing in petroleum economics and taxation
  – Clients include: State of Alaska Legislature, federal government, local municipalities, University of Alaska, oil and gas explorer/producers, pipeline companies, commercial/investment banks, private equity firms, hedge funds

• **1983-2008**: Senior petroleum economist with State of Alaska Department of Revenue Tax Division
  – Fiscal development
    • Statutory and regulatory design
    • Petroleum economic and commercial valuation of exploration, development, production, transportation, refining, marketing, taxation
    • Analysis of international competitiveness
    • Oil and gas valuation
  – North Slope gas commercialization
    • Economic valuation
    • International competitiveness
    • Pipeline financing
    • Taxation
    • Tariff design

• **1977-1983**: Petroleum economist with United States Geological Survey
  – Resource evaluation of unleased acreage on Alaska federal Outer Continental Shelf
  – Design of bidding systems

Outline

1. Introduction: Market and Timing Landscape
2. High-level Decisions
   - A. In-Kind Gas
   - B. Regulation
   - C. Ownership (and Partnerships)
3. Role of AGIA in Proposal
1. Introduction: Market Challenges

• Competition
  – Twice the amount of supply as there is demand in Asia in 2030

• Pricing
  – Prices appear to be falling
    • Buyers realize sellers were making windfalls at prices linked to high oil prices and increased competition among sellers
  – Compete based on cost

• Size Burden
  – Need to capture large incremental share of market in short amount of time
  – Higher breakeven price than much of the competition
New LNG Projects are Expensive

Asia Pacific: Breakeven FOB Costs at $90/b

Summary from North Slope Gas & LNG Symposium | © PFC Energy 2013 | Page 26 | November 2013
Timing Landscape

• Terms set up today will determine
  – Risks to state
  – Cost of capital
    • Long-term gas revenues
    • What Alaskans pay for gas in the future

• Options: A modified deal which may take a few months to put together could create more long-term benefits to state
2. High Level Decisions under Proposal

- State takes its production taxes and royalties as in-kind gas
- Tariffs and expansions will not be regulated
- TransCanada (and perhaps SOA as partner) will own share of GTP and pipeline, and SOA will own share of LNG facilities, commensurate with state’s share of gas (about 25%)
- Designed to amicably transition out of AGIA
A. In-Value vs. In-Kind Gas

• Helps out the economics of the project considerably
  • If the state takes its royalties and taxes in value:
    – The producers pay for 100% of the capital cost, incur 100% of the capital risk, but only get 75% of the revenues
    – Producers pay to state in taxes and royalties an amount of money equal to 25% of the gas
    – They slowly recover over time the cost of the 25% of the capital costs they laid out for the state’s share through the tariff deduction
    – But at a midstream rate of return, which is lower than the upstream
    – This waters down their rate of return
  • When the state takes its taxes and royalties as in-kind gas, the state assumes the capital commitment for its capacity either through ownership or taking on a firm transportation commitment with a third-party
• The state does not need to own the pipeline to take the gas in-kind
Firm Transportation Commitments

• When the state takes its taxes and royalties as in-kind gas, the state will take on a long-term firm transportation liability (debt) to TransCanada (on the portion of the 25% the state does not own)
• Ship or pay regardless of cost, market, reserves
• Used by pipeline company as collateral for financing
• TransCanada will have priority claims on project cash flows
Debt Capacity and In-Kind Gas

• State policy is for debt service to be no more than 8% of general fund unrestricted revenues
• Investing in the project will put the state 2-3 times over that amount
• It has been suggested that having TransCanada as a partner would reduce the debt service relative to state ownership
• The debt from taking the firm transportation commitment with TransCanada will have a greater impact on the state's debt capacity than debt used to finance ownership
Marketing the In-Kind Gas

• By taking gas in-value the state benefits from some of the best marketers in the world

• Consider linking in-kind provision with agreement by producers to market state’s gas with their gas at the same price they get
  
  • Otherwise, risk that state may be marketing at prices considerably lower than producers, which could result in losing money
B. Regulation

• Proposal under HOA is for FERC to regulate under Section 3 of the Natural Gas Act
  – Mainly designed for licensing the siting, construction, expansion, and operation of LNG import or export terminals
  – Terminals include facilities used to transport and process gas
  – Appears this would be the only pipeline in the U.S. where tariff for consumers’ gas is not regulated

• No regulation of tariffs or expansions
  – To get reasonable tariffs and expansions, state ownership necessary
  – Unclear what happens as in-state needs expand:
Example

Initial Gas Disposition (billion cubic feet per day)

Total Gas: 2.4 bcf/d
State Share: 25%
State Gas: 0.6 bcf/d
To Fairbanks: (0.05 bcf/d)
State Gas to Asia: 0.55 bcf/d
Benefit of Regulation of Monopoly

• Precedent for RCA to regulate in-state and export pipeline and gas treatment under AS 42.08
• Regulation is the trade-off for privilege of natural monopoly
• May enhance market efficiencies to have a transparent pipeline cost
• State may be conflicted as pipeline owner or partner to pipeline owner for accountability
C. Ownership and Partnership

• Need for ownership due to no regulation on tariffs and expansion, and for lower tariffs

• State does not necessarily need partner for expertise assistance
  – Producer expertise
  – AGDC expertise
  – TransCanada’s expertise in gas treatment unclear
  – To the extent there is not a need for expertise, if the state needs a cash partner, it does not necessarily need a pipeline company partner, but a general investment partner
State Does Not Necessarily Need Partner for Cash or Lower Tariffs: 2011 Citigroup AGDC Financing Plan

• Possibility of 100% debt financing
  – Combination of revenue bonds and state backing
  – Appears to be less risky than ASAP plan
  – Possibility of deferring most cash outflows until gas starts flowing
  – May have short-term impact on credit rating that would reverse once gas revenues start coming in

• Possibility of tax-exempt bonds through Alaska Railroad
  – Directed at industrial development projects
  – Requires IRS private letter ruling
  – Reduces cost of debt about 25% relative to taxable debt

• Would require potentially no or little equity (cash) before gas starts flowing

• To the extent the state does not need a cash partner, its good credit rating and potential for tax-exempt debt could result in a lower cost of capital
Ownership: Risk of Failure to Sanction

• Sponsors could spend over $2 billion to get to FID and have a project not materialize, of which SOA would be responsible for 25%, regardless of whether it exercised ownership option with TransCanada

• Are producers better equipped to handle that risk?
  – Diversification – some of their other prospects will get sanctioned
  – Finite capital competing not only for gas, but for oil
  – Where other countries do share this risk, the takes are higher

• Will this money make a material difference to the viability of the project?
  – The more interested the producers are in the project, the less they need state money. The less interested they are, the more the state should avoid this risk.

• Balance:
  How near tipping point  Probability of Project
  Size of the prize  How material is $600 mm

• Could pursue arrangement with producers to buy in to project once it is sanctioned (or at least after pre-FEED) and re-pay feasibility costs with interest
3. Role of AGIA in Proposal

- Public comments by administration:
  - Aggressive time frame to get gas to market
  - Desire to avoid potential lengthy and costly legal fight over ending AGIA license
  - Proposal designed to end AGIA license amicably

- Appears plan was crafted (at least in part) around giving TransCanada a material role to avoid potential AGIA liabilities

- License project assurances (treble damages) clause in AGIA

- Could there be better terms if state was not so constrained by AGIA?
Areas Where State Could Possibly Have Better Terms If It Had No Partner

• Possibility of full ownership of 25% share of GTP/Pipe with 100% debt financing and possible tax-exempt debt
• Lower cost of capital: higher gas revenues/lower cost gas to consumers
• There is a misalignment of interests between shippers and non-shipper partners
Areas Where State Could Possibly Have Better Terms If It Had a Different Partner (or could re-negotiate MOU)

1) Sharing failure to sanction risk

2) Share in benefit of lower interest rates

3) Higher ownership share than 40% (of 25%)

4) Better cost of capital terms in tariff
   - TransCanada’s terms are about the same as other Canadian pipelines
   - 100% or tax-exempt debt may be preferable
   - Given producer involvement, terms on existing pipelines may not be relevant
How Bound is State by AGIA?

• The easiest way out of AGIA is abandonment of the project as uneconomic (AS 43.90.240)
• Official project plan is still the pipeline to Alberta
• Uneconomic defined as:
  “predicted costs of transportation at a 100 percent load factor, when deducted from predicted gas sales revenue using publicly available predictions of future gas prices, would result in a producer rate of return that is below the rate typically accepted by a prudent oil and gas exploration company for incremental upstream investment that is required to produce and deliver gas to the project.”
• If parties disagree it is settled by arbitration
• If it is found uneconomic – treble damages no longer apply
• Economically, this would not be difficult to show
Fiscal Stability

• Producers have continually expressed necessity
• Some fiscal stability may be necessary
• SB 138 not stable
• Scope out producers intentions as to what constitutes adequate stability