Stranded Gas Hearings

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Is the Lowest Cost Pipeline Necessarily the Lowest Tariff Pipeline? – How Debt/Equity Ratios, Differences between Taxable and Tax-Free Debt, and Potential Federal Loan Guarantees Impact Tariffs

Nancy Rohman, Vice President, JP Morgan Chase and Co.
Garth Salisbury, Managing Director, JP Morgan Chase and Co., June 16, 2004.

GARTH SALISBURY, Managing Director, JP Morgan Chase and Co., clarified that he and Ms. Rohman are financial experts, and therefore both would focus on the financial aspects of building a natural gas pipeline. He utilized a booklet entitled "Interim Hearings: Alaska Natural Gas Pipeline Issues" that was provided to the committee. He began by specifying that the final outcome of a gas pipeline will be dictated by a large group of stakeholders, some of which are listed on page 4 of the booklet. Mr. Salisbury opined that current market prices certainly would support building a pipeline.

MR. SALISBURY turned to some of the assumptions he [and Ms. Rohman] used, the largest of which is project cost. The projections for the cost and scope of the pipeline vary widely. For the purposes of this presentation, Mr. Salisbury specified that he is assuming a treatment plant cost of about $2.6 billion and a project cost assumption of about $11.6 billion. He noted that he [and Ms. Rohman] have no opinion with regard to the actual costs of these facilities, the aforementioned are merely assumptions. He emphasized that the focus will be in regard to the relative differences for various financings of any given costs. Therefore, the total cost for this entire project is $14.2 billion with a throughput assumption of 4.5 bcf a day. The project life/term of debt assumption is 30 years, which is a bit conservative from a project life standpoint, although it's a bit aggressive from a debt standpoint. The assumption for the initial term is 15 years. He highlighted that any pipeline owner would want to block in shipping contracts before the contract was completed and have an idea of the tariff in order to obtain financing. The assumed project bond rating for the entire financial package is an "A". He acknowledged that many pipeline projects are in the "B," "AA," or "BBB" category, which [provide] lower rating and higher financing costs. The debt to equity ratio for the base case will be 60 percent debt and 40 percent equity. The return on the equity will be 12 percent on the assumption. Furthermore, the depreciation methodology assumes a straight line for 30 years.

MR. SALISBURY echoed earlier remarks specifying that a number of factors go into a tariff, as specified on page 7 of the booklet. Mr. Salisbury said that he would like to isolate the financing components of the tariff, and therefore he was going to focus on the cost of the project, a tax rate, contract term/asset life, and the annual throughput. For purposes of this presentation he focused on the capital expenditure, the return on the equity, whether there would be a federal guarantee on the debt, and the tax status of that debt. He clarified that he is referring to tax exempt debt rather than the tax status of the pipeline owner; this presentation will strictly refer to the tax treatment for the debt that's issued. The presentation will not focus on the operating and maintenance costs, general administrative costs, or any additional capital expenditures made to improve or expand the pipeline.

MR. SALISBURY turned to debt to equity ratios. Generally speaking, large gas pipeline projects in the U.S. range from 50-67 percent debt. Therefore, common debt to equity ratios for pipeline projects range from 50:50 to 70:30 debt to equity. For this analysis, the range assumed will be 50:50 to 67.67 and 33.33.

MR. SALISBURY went back to page 9 of the booklet regarding financing assumptions. For a base case, the capital structure will have a debt of 60 percent and 40 percent equity and the return on the equity will be 12 percent. It will also be assumed that the debt issued will be standard corporate taxable debt and that there is no federal loan guarantee. The aforementioned will be the base case from which variations will be taken. He noted that the base case incremental financing tariff, an average tariff over a 30-year project life, produced a tariff of about $0.79 MMBtu [one million British thermal units]. He returned to the debt to equity ratios, which is outlined on page 11 of the booklet. From the base case scenario, as the

equity component is increased at a 12 percent return on the equity, the tariff will increase because the remaining component of that capitalization is at a much lower cost, somewhere in the 6-7 percent range. Therefore, how this pipeline is financed and its capital components are going to be very important. If the equity is increased to 50 percent, the tariff would be increased to $0.85. The analysis illustrates a couple of different debt structures, one of which is amortizing tranches, which produces a lower overall debt cost. The base case scenario uses the amortizing tranches, and therefore the debt component is about 6.4 percent under an "A" rating. Therefore, as the equity component is varied from a high of 50 percent to a low of 33 percent, the range is about $0.9. The deviation between the equity components is $1.2 billion to $1.5 billion.

MR. SALISBURY moved on to the return on the equity. He highlighted that FERC allows a specific return on the equity component in the tariff. The return normally ranges from 10-14 percent. With the base case, the $0.79 tariff is produced. However, as the equity component is increased to as high as 50 percent and the return on the equity to 14 percent, the difference in total debt and equity costs over the life of the project amounts to about $6 billion. Mr. Salisbury stated that the producers and explorers will be concerned with regard to the debt to equity percentage and the return on the equity allowed in the tariff.

MR. SALISBURY addressed the issue of tax exemption, with the focus being on tax-exempt debt, the debt issued to finance the pipeline, rather than the tax status of a producer or someone using the pipeline. He directed attention to the graph on page 14 of the booklet, which is a comparison of the 30-year Treasury rate to the 30-year Revenue Bond Index. As the graph illustrates, in higher interest rate environments, the relative spread between taxable and tax-exempt rates is higher. Over the last 20 years as rates have steadily declined on average, there has been a compression on the tax-exempt and taxable rates such that the value of tax-exemption today is worth quite a bit less than it was 10-20 years ago. On average, the spread between a 30-year taxable bond and a 30-year tax-exempt revenue bond has been about 50 basis points, one-half of 1 percent. Currently, the spread is around .3 percent. He noted that there have been a number of times when the taxable rate has been lower than the tax-exempt rate. Therefore, there wasn't much benefit to financing the taxes in that market.

MR. SALISBURY provided the committees with a basic overview of municipal bonds. He explained that municipal bonds are debt securities that are only issued in the U.S. by a U.S. state, a local government, or a governmental entity. Municipal bonds are typically used to raise capital for building roads, schools, and other public infrastructure projects. He further explained that the exempt notion is that the interest paid to investors is exempt from income taxes. Therefore, as mentioned earlier, tax-exempt rates are generally lower than taxable rates. Since this tax exemption is considered a subsidy by the U.S. Treasury, there are strict regulations governing the use of tax-exempt bonds. Mr. Salisbury highlighted the Alaska Railroad Corporation's ability to issue tax-exempt debt for a project like the gas pipeline, which is important and unique. He specified that municipal bonds are often secured by tax revenues, although in this case the discussion is about a bond that is secured by a stream of enterprise revenues.

MR. SALISBURY turned to the reason why investors are willing to accept a lower interest rate on a tax-exempt bond. He noted that the value of the exemption is based on the tax rate of the holder of the investment, which is why certain investors are part of municipal bonds or not based on their tax rates. For example, the after tax yield of a 35 percent tax rate investor who would purchase a taxable bond at 7.5 percent would be 4.88 percent, and therefore, this particular investor would be better served by buying the municipal bond at 5 percent and paying no taxes because the net yield is 5 percent afterwards. However, the average investor who is in a lower tax bracket is better served by purchasing a taxable bond because his net yield after paying taxes is higher. Therefore, the investors in taxable bonds are generally wealthy individuals who are paying near the maximum tax rates.

NANCY ROHMAN, Vice President, JP Morgan Chase and Co., turned to the value of tax exemption [page 18 of the booklet]. Obviously, tax exemption can significantly reduce the interest cost and the debt service on the financing. Historically, tax-exempt debt has been worth more than it is in the current market. As rates rise again, there may be a return to normal spread levels where tax exemption will be worth more. She compared the base case scenario to a tax-exempt deal and estimated that the tariff will

be reduced.

MS. ROHMAN said that if one were to return to the normal spread relationship, the value would be $0.04. She then turned to the advantages of tax-exempt debt, which would include lower interest costs. Furthermore, tax-exempt debt provides more structuring opportunities. In municipal finance there is the concept of "serial" bonds for which the debt can be amortized quicker over time. Another advantage is the flexible call options, which is the notion that once the bonds are issued, municipal tax-exempt debt typically provides more flexibility to restructure financing. Tax-exempt debt also provides a favorable "capital charge" and an active "retail sector." She explained that the corporate market is an enormous market that is run by sophisticated institutional investors and corporations. Because of the notion of "Bill Gates versus Average Joe", there is a very active retail sector in the tax-exempt market. A retail buyer base is an advantage because when one prices a deal, one would be dealing with a broader buyer base. Clearly, the disadvantages of tax-exempt debt are the significant tax law constraints that accompany tax-exempt debt. Furthermore, there are fewer "deep pocket" investors with tax-exempt debt because the municipal industry is a lot smaller than the corporate industry.

MS. ROHMAN moved on to the Federal Loan Guarantee, which is discussed on page 21 of the booklet. Section 386 of the Energy Policy Act of 2003 provides for Federal Loan Guarantees. Basically, [the Act] says that the guarantee can't be greater than 80 percent of the total capital costs of the project, including interest. Furthermore, the Federal Loan Guarantee is capped at $18 billion and the term of the loan agreement shall not exceed 30 years. Ms. Rohman pointed out that the Federal Loan Guarantee pledges "the full faith and credit of the United States to pay all of the principal and interest on any loan or other debt obligation entered into by a holder of a certificate of public convenience and necessity." Although she characterized the aforementioned language as a sure thing, she noted that it's not a sure thing. In terms of the amount, the Federal Loan Guarantee has ranged from $10-$18 billion. She highlighted that the Federal Loan Guarantee can have a significant impact on this financing. Since all the pipeline scenarios call for a debt to equity ratio of less than 80 percent, the pipeline may be able to issue all of its bonds with a Federal Loan Guarantee. Furthermore, the U.S. government's strong credit provides the potential for much better financing, which will reduce interest costs. The tariff with the Federal Guarantee is $0.78 [as illustrated in the chart on page 24 of the booklet]. With a $1.00 cost, she estimated $540 million. She emphasized that this is a ballpark estimate that [would change] based on the ultimate structure of the deal. "What you actually achieve in the interest rate savings is going to be highly dependent on the final structure," she pointed out. Furthermore, she informed the committees that the Federal Guarantee should be measured on the effect of the tariff reduction as well as whether the deal can be accomplished.

MR. SALISBURY interjected that the spread presented is very conservative. In the real world the magnitude of financing a $15 billion project the value of that exemption would most likely be multiples of this.

MS. ROHMAN returned to the booklet, page 25, which discusses the value of the Federal Loan Guarantee on tax-exempt debt. If the benefit of the exemption is obtained as is the Federal Loan Guarantee, the base case would stay in the same spot and the tariff would be reduced by $.04; it's the combined value of the two. She estimated a total debt cost savings of $1.8 billion.

SENATOR OGAN related a situation in which a state entity is used to issue tax-exempt debt. He asked if it would be commercially reasonable or whether there has been precedence for the state to receive an equity interest in the pipeline in exchange for making the project more reliable.

MR. SALISBURY replied that there is very little precedent for state involvement in a natural gas pipeline. However, there are examples of state entities that have assisted utilities. Most often all of the benefit garnered by having state involvement has been passed on to ratepayers/users, such as in the case of the electric utilities. There isn't a good example in which a state exemption was utilized to garner profits for the state.

SENATOR OGAN turned to Mr. Salisbury's forecast of interest rates, and asked if he believes it's important to get the project financed as soon as practical. He also asked if Mr. Salisbury feared that rising interest rates would make the project uneconomic.

MR. SALISBURY opined that JP Morgan believes that interest rates have been and will continue to increase. However, interest rates are still very, very low. Even as interest rates rise over the next couple of years, they won't have the type of impact on this tariff that many other components do. Components such as the debt to equity ratios and the return on equity are much more important to a project such as this.

SENATOR DYSON directed attention to page 9 of the booklet, which he understood to mean that over the projected life of the project it will cost $14.2 billion just to "rent" the money to do the construction.

MR. SALISBURY clarified that the $14.2 billion is the total project cost, which includes the estimates for the treatment plant and the "A to B" components. He further clarified that doesn't include the interest component related to the debt.

SENATOR THERRIAULT turned to the chart on page 25 of the booklet. He asked if the deviation in costs from the base case of $1.84 billion is a reduction in the total project cost or just in the financing.

MR. SALISBURY answered that it's a reduction just in the financing component, the interest costs related to the different scenarios.

SENATOR GUESS, in reference to the chart on page 24, asked if the financing charge would increase from the base case scenario to the Federal Loan Guarantee when there is more equal debt to equity ratio.

MR. SALISBURY replied yes. He added that presumably the Federal Loan Guarantee is always going to be helpful, but that's related to the base case scenario of 60 percent debt. If it's 50 percent debt with more equity with a higher return, it will cost more.

SENATOR GUESS asked, "If you go over from that base case ... on a 50:50 Federal Guarantee to none, ... am I reading it correct that the difference between those two is an increase in finance costs of $715 million?"

MR. SALISBURY replied yes.

SENATOR DYSON recalled the [assumption] that the pipeline costs would be [$11.6 billion], and asked where the pipeline would terminate.

MR. SALISBURY answered that the pipeline would terminate at the Alaska-Canadian border, and therefore he assumes that Canada will build the pipeline to the Alberta terminal.