Stranded Gas Hearings
(0410131630 Minutes)

Non-Recourse Bonds, Federal Loan Guarantees, and Innovative Financing by Host Governments – October 13, 2004.
Philip Korot, Senior Vice President, Lehman Brothers
Robert Milius, Senior Vice President, Lehman Brothers

PHILIP KOROT, Senior Vice President, Lehman Brothers, informed the committees that the committee packets should include fairly extensive written testimony from Lehman Brothers, from which Lehman Brothers representatives intend to highlight key issues. He explained that Lehman Brothers' comments are directed at an overview of the capital markets and public-private partnerships in the capital markets concerning the energy sector. He related that since 2003 Lehman Brothers has been the number one underwriter in the US equity and energy new issuance market. Furthermore, it has acted as a book-runner on 39 transactions worth almost $6 million. During that same period of time, Lehman Brothers has been the number one underwriter of US investment grade energy debt, acting as a book-runner on over 20 transactions worth $9.5 - $10 million of debt issuance. Lehman Brothers has also been named project finance house of the year. He noted that Lehman Brothers is involved on the equity side as well as the fixed income side with most of the major projects around the world as well as with most of the energy sector players around the world. Mr. Korot characterized the discussion [on Alaska's project] as a combination of what the state can do from a public finance standpoint or from a public venture standpoint, either in partnership or coordination with the energy sector, the producer, or the pipeline.

MR. KOROT announced that he would provide an overview of the market, some observations of the market, how those would generally impact Alaska's project, and how those would generally impact some of the negotiations and decisions yet to be made. Until the details are decided, it's hard to know exactly what direction the project or projects should take. In general terms, the projects that have been discussed, whether the LNG project or the pipeline through Canada, are economically feasible and financeable in the capital markets.

ROBERT MILIUS, Senior Vice President, Lehman Brothers, said that he would begin by relating some general conditions in the capital markets as well as certain trends that will impact the financings of the Alaska project. He noted that most of the time and effort spent on this matter was done before the federal guarantee was available. Therefore, the framework was in regard to what could be accomplished in the private sector capital markets without much government support or incentives. He related that he would also focus on how he believes the Alaska project will be received by the capital markets and the handful of issues that will require significant management in terms of driving the marketability and financeability within the capital markets. He said that he will also discuss specific financing structures, options, and alternatives available as well as how the Lehman Brothers sees the role of the state and federal governments in moving this project forward.

MR. MILIUS turned to the general themes of the capital markets, and acknowledged that some of the themes are fleeting. The first theme is that over the last year and a half the economy has been strengthening, although there has been a fair amount of volatility. The second theme is that energy has been "red hot" in the capital markets. Never before has there been such appetite for exposure to the energy sector, within the equity capital markets as well as the fixed income side. Virtually, all sectors of energy is trading at all time highs in the equity market.

REPRESENTATIVE CROFT asked if people want to push money into this or is there a lot of money that wants to enter into the energy equity market.

MR. MILIUS answered that he believes some of it has to do with commodity price fundamentals. Interestingly, if one were to look at the stock for Chevron Texaco, it recently reached more than $50 a share. The last time that stock was at that point, it was spring of 1999 when oil prices had dipped to about $10 [a barrel] at the end of 1998. When oil prices recovered and the price [per barrel] hit the mid to upper

teens was the last time Chevron Texaco was at the price it currently sits in the equity markets. Now it's a very different commodity price environment, and therefore one could argue that this market is under bought rather than needing to be sold. More relevant to this project is the most recent time of strong gas prices, which was 2001. At that point, gas prices were backward aided and the forward curve was a declining forward curve. However, today gas is in the $5-$6 range and oil prices five years out are in the $30-$35 range. There is no precedent for such perceived sustainability of commodity prices in the history of the energy markets. In fact, across the board this is an all time high of commodity prices and there's a strong view that these conditions are sustainable. The key message is: "The capital markets are very much aware of these trends in commodity prices, obviously, and also have a view with both equity analysts ..., fixed income analysts on Wall Street, and other industry experts sort of share the view that commodity prices are sustainable."

MR. MILIUS turned to interest rates, which are at close to 40 year lows. However, within the energy [market] the supply of new corporate debt issued into the capital markets has declined meaningfully. Just a couple of years ago, new supply was in the $30-$35 billion a year range, while today it sits at $12-$15 billion. There is a fundamental supply-demand tension that works to the benefit of issuers, and because of the strength of the commodity prices, he viewed it as sustainable. What's happening is that all the energy companies are generating tremendous amounts of cash that they are using to pay down their debt or buy back stock. For example, Chevron Texaco, ExxonMobil Corporation, and BP all have negative net debt, which means their debt is approximately zero. The aforementioned is important to understand because investors in the fixed income markets essentially have no opportunity to gain exposure to big oil because there are no bonds to buy. Therefore, the only opportunity the capital markets have for exposure to these companies in the fixed income side is this type of non-recourse project financing type debt that may be issued for Alaska's project.

MR. MILIUS turned to the re-emergence of non-recourse project financed debt, specifically within the energy sector. The last time there was a significant amount of new issuance of this non-recourse debt was in the late 1990s when there were a number of project financings in Venezuela to finance the public-private partnerships in the oil sector. At about the same time, the first LNG project in Qatar was financed in the capital markets. However, in the late 1990s there was a tough period in the economy when Russia defaulted on its debt and the capital markets had limited appetite with regard to placing money in emerging markets. Obviously, Alaska is in a different situation than in other parts of the world. He predicted that in the near term there will be a significant amount of new issuance of this sort of project finance debt. He provided examples.

REPRESENTATIVE CROFT remarked that those examples could mean that there's a market for it or that it has been used up. He surmised that Mr. Milius means that there is significant unmet demand for even a project of the size of Alaska's project.

MR. KOROT answered, "Significant capacity to take it in." He estimated that the cost of capital for a project of this size and complexity is probably in the 8-9 percent range on a blended basis. Obviously, the aforementioned would vary depending upon when the project comes to market, the interest rates at that time, the extent of the federal loan guarantees, and the various participation of other pieces of debt. "There's a significant positive aspect in the market, both for this type of project finance as well as the various segments of the project finance, whether or not they have federal guarantees," he said.

MR. MILIUS, in further response to Representative Croft, related that Lehman Brothers believes that [the Alaska project] is eminently financeable in the capital markets, both in the fixed income side and the equity side. The later is important because there still remains a fair amount of uncertainty regarding who will ultimately own the equity in this project. There is the potential for a significant amount of equity ownership in this project in the capital markets. He reiterated that he sees an incredibly robust appetite for exposure to a project like this. Investors understand the dynamics in the natural gas markets in the US and increasingly understand the structural deficit that is faced in the US. The investors also see this as a market that will continue to be strong from a commodity price standpoint.

MR. MILIUS turned to the key selling points and key considerations with Alaska's project as well as the framework Lehman Brothers would suggest. If one observes the fundamentals in the US natural gas markets today, one would see that the production in the Lower 48 market is in the neighborhood of 19 tcf a year and pipeline imports from Canada have been fairly consistent over the last 2-3 years at about 4 tcf per year, which amounts to a market of about 22-23 tcf a year. He related that LNG has been a miniscule part of the equation and only in the last two years has it averaged 400-500 bcf total, which is less than 2 percent of the total market. Over the next 15 years or so, Energy Information Administration (EIA) projected data shows production in the Lower 48 at about 18-19 tcf and pipe imports from Canada at about 4 tcf per year, both flat. Assuming demand rises to 30-35 tcf, there is a potential gap of 12-16 tcf per year that needs to come from somewhere. While the first-mover advantage is very important, he emphasized that it's also important to remember that if the true projections are that demand will rise to 32-35 tcf per year and if EIA data is correct that Lower 48 production is flat, the US will need all the gas it can find from all possible sources. Therefore, even with the potential in Alaska of a 4-5 bcf per day range, which would increase [the Lower 48 production] to about 2 tcf per year with LNG imports of 6 tcf per year 7-10 years out, there is only 9-10 tcf total and that amounts to about 32-33 tcf per year going forward.

REPRESENTATIVE CROFT asked if 6 tcf is an optimistic number for LNG.

MR. MILIUS replied yes, for the near term in the next five to seven years.

REPRESENTATIVE CROFT related his understanding that Mr. Milius believes there is a potential market with just equity investors.

MR. MILIUS said that what he is talking about is similar to independent pipeline companies. The potential market that is potentially interesting is the master limited partnership (MLP) market, which has grown to be about a $60 billion market. Historically, the MLP market has been sold into the retail marketplace and its investors seek yield. The MLPs are tax efficient entities that are publicly traded partnerships that don't pay taxes at the corporate level, although the partners are taxed individual. The MLP market is potentially a very "deep one" for a project such as this, although he surmised that there might need to be changes to parts of the tax code to broaden the market to potentially draw more money into a project like this. The Alaska project is exactly one in which the MLP market will be very interested. Therefore, he related that there are pockets of equity capital beyond the sponsors and immediate stakeholders who are interested in owning a piece of this project.

MR. KOROT remarked that just as there are different types of fixed income or debt instruments in financing the project, Lehman Brothers believes there are different ways in which to bring the parties together to provide the equity. Having a capital market component of the equity is an alternative that is attractive. The question is how to bring the lowest cost of capital to the project on a blended basis while taking advantage of all of the benefits available so that the tax law changes on depreciation mean that the dividends on an MLP are basically equivalent to a tax-free return for a potential equity investor. Therefore, the rates of return could be offset because [the investors] are lending the money, putting in equity, and receiving a tax-free return.

REPRESENTATIVE CROFT surmised, "In effect, the accelerated depreciation cannot just be an incentive to get this thing started; we can almost sell it. ... that becomes something that can lower our cost of capital because of its tax advantages to individual investors."

MR. KOROT agreed with Representative Croft to the extent that the producers don't own the equity in the project. "And we've, in essence, securitized it in the capital markets; that sort of benefit which we pass through to those owners on their pro-rata share basically gets their returns to be lowered based upon the fact that those returns now are sheltered or tax free." The goal is to bring down all of the costs of capital such that the project is at a lower [risk] point.

MR. MILIUS reiterated that to some extent there is a first-mover advantage. However, he predicted a very meaningful structural deficit that worsens over time and thus results in tremendous potential for Alaska's

project. Mr. Milius announced that he would now discuss how this project would be perceived in the capital markets, the strengths of the project, the risks of the project, and general ideas regarding how the risks could be managed. He opined that this project would be very well received in the capital markets on the equity and the debt side. Industry fundamentals are compelling and robust and many believe those fundamentals are sustainable and will potentially improve. Another positive for this project is the incredible sponsorship this project will have when taken to the capital market. He clarified that the sponsorship refers to the state, all three of the producers, and the pipeline operator. Mr. Milius related the belief that the capital markets will be somewhat route neutral when viewing this project. In addition to this tremendous stranded gas resource being commercialized and developed, there is the national energy security aspect to this project. Whether the project is a pipeline that moves through Canada or an LNG-oriented project, it will sell well in the capital markets if it's structured appropriately.

MR. KOROT interjected that either of the routes, from a capital market standpoint, can be financed for both the debt and the equity. Certainly, the guarantees and the accelerated depreciation make it more financially attractive while lowering the cost of capital. Mr. Korot related that the ability to structure both in today's marketplace makes them attractive investments for the various classes of investors. Moreover, the ability to start a project relatively soon would be of utmost importance from a capital market standpoint.

MR. MILIUS turned to the risks associated with a project the size of the Alaska project. There is some resource and geology risk associated with the North Slope gas reserves, as well as environmental, regulatory, legal, and permitting risks. To a lesser extent there is some political risk. Moreover, there is technology- and facility-related risk related to whatever project is developed. Mr. Milius said that he wanted to focus on the project completion risk and market risk, which will drive the marketability and financeability of the Alaska project. The aforementioned will be the two things on which the rating agencies will focus the most when rating the project. With regard to the construction risk and the completion guarantee, project finance lenders don't typically take construction risk. Usually a completion guarantee from credit worthy parties would be required in order to provide a standby equity commitment to place more money in the project to fund cost overruns. Although it's most likely that the equity holders of the project would provide the completion guarantee, it doesn't necessarily have to be. A completion guarantee is also [required] because the debt holders want to know in a "dooms day" scenario how they would obtain their money back. The potential for federal loan guarantees is very significant, although there is probably a fair amount of details regarding how they exactly work. Preliminarily, Mr. Milius said that the federal loan guarantee will make investors comfortable during the construction period because those investors will receive their money back. However, because only up to 80 percent of the overall cost is being guaranteed, all of the cost overrun risks associated with the project haven't be underwritten. Therefore, the equity holders or whomever would provide the completion guarantees would bear the cost overruns. The federal loan guarantee has significantly cut the level of risk for whomever bears the completion guarantee. The most logical parties to bear the completion guarantee would be the equity holders, who would likely include the producers.

MR. KOROT clarified that Lehman Brothers' views the pipeline as a transportation mechanism. While it's logical for the producers to be involved in that transportation mechanism to get the assets out of the ground, it isn't the only way to do it. Still, it remains reasonable to assume the producers would participate and their participation has been significantly reduced by the participation of the federal government.

MR. MILIUS reiterated that whoever provides a completion guarantee upfront will expect a disproportionate share of the rewards on the backend. "Those rewards come in the form of ... participating some way in the benefits of this overall project ... when gas pri

ces are above the ... operating costs and capital costs of the project ...," he said. MR. MILIUS informed the committee that there is precedence among gas developments and pipeline financings in which fixed income capital market investors have taken on some of the risk. For example, the Express pipeline done in 1988 had multiple traunches of debt of which some of the more senior traunches of debt were secured by contracts that were taker pay, hell or high water, floor price type contracts. The same pipeline had a

more junior traunch of debt in the capital structure in which investors were taking "merchant risk." More recently and more relevant to Alaska's project, Qatar's initial financings back in 1996 and 1997 were all supported by fixed-price contracts with specific off-takers and long-term contracts.

MR. MILIUS related that the direction that market is moving in and the structure in which it looks to put in place is one in which more of the risk will be borne by the capital market investors around gas prices, which he said is true for a variety of LNG projects around the world. Furthermore, the trend is that LNG contracts are shorter in duration while the spot market for LNG is growing. Mr. Milius opined that the markets are moving in a direction in which more merchant risk is something the capital projects will be willing to bear around gas projects or LNG projects. A key question that will drive an investor's willingness to take on that risk is regarding where the project fits on the overall global cost curve for gas on a delivered basis to the end markets.

MR. MILIUS turned to the issue of managing the risk and how it would be apportioned among the stakeholders, and related that there are a lot of options. The most obvious option is that the state or federal government would underwrite some floor price for natural gas. However, he said he understood that the federal government isn't interested in the aforementioned for this project. Therefore, he opined that Alaska would also want to avoid that option. Another option would be in which off-takers of the gas would provide a floor, which would be done through a taker-pay contract. In the aforementioned option, the investor would need to closely review the creditworthiness of the off-taker. A third option would be a "collar structure" in which there would be a floor and ceiling price for gas. Under the aforementioned option, the [producers] would approach the off-takers and in turn for a long-term commitment to a price, the producers would be willing to cap the price. Therefore, there would've been some discussion regarding how to structure the risk and whether a government would need to bear some of the risk. Effectively, the risk would be apportioned to the private sector, who would bear it through commercial arrangements through which they shared [the risk]. With gas prices in the $5-$6 range, there is the potential that utilities and municipalities in the Lower 48 would have significant [incentive] to sign long-term contracts with favorable prices. The challenge is that the trend with gas supply contracts has been toward shorter duration. Therefore, the utilities and the municipalities in the US will likely view that as a significant risk for a 20-year contract. The fourth strategy would be one similar to that of the Express pipeline in which there were multiple tiers in the capital structure and each supported by different kinds of contracts with different elements of certainty around gas prices.

MR. MILIUS said that UBS didn't come with all the answers regarding how [a contract] could be structured. However, the issue around gas price risk is one that the capital markets increasingly understand and are willing to bear a meaningful amount of risk around gas prices, provided that the project is reasonably competitive on the cost curve. Furthermore, he opined that there are many potential solutions and routes to be explored where this risk would be borne among the commercial private sector parties rather than in the public sector.

MR. KOROT opined that the biggest risk is to do nothing because the long-term economic viability of the state and its revenues will be impacted if nothing is done. The risks associated with this project don't jeopardize any of the state's other programs or revenues. The question is how to take an asset in the ground that doesn't have a value and move it to market so that it generates revenues and provides the services in a timely fashion. The window, he opined, isn't open forever. The types of financing one reviews for the Alaska project are bifurcated and structured such that the cost of capital is lowered, but not by increasing the risk on a recourse basis to the state or potentially putting the future programs of the state at risk. Rather, he suggested creating a financeable project that can be split into many segments, including a public-private venture. This is a process done in many industries. Mr. Korot said that it's not Lehman Brothers' job to tell the state what to do, but rather to relate that the capital markets understand that this type of project is feasible and can be done in today's market with relatively attractive overall costs of capital.