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NEGOTIATING FIRM WITHDRAWAL TERMS: KEY ISSUES

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EXECUTIVE SUMMARY

Since taking office in December 2014, Alaska Governor Bill Walker has expressed a major concern with the Alaska LNG (AK LNG) project: that the State of Alaska has no assurance that the three producers will continue to advance AK LNG versus other projects worldwide and that the unwillingness of any party to proceed would halt progress on AK LNG. The governor has, therefore, explored various options to ensure that the state is not disadvantaged in the event that one or more producers choose to no longer pursue AK LNG. Most recently, the governor proposed that any party choosing not to advance AK LNG should make their gas available to the project—for example, by selling their gas at the wellhead or by tolling the gas through infrastructure built by others. The details of any potential deal are unknown at this point, but it is likely to involve a conditional gas sales and purchase agreement between the state and a producer with gas sold at the wellhead. The governor has stated his desire to secure such a deal by December 4, 2015. The purpose of this report is to explore the opportunities and risks in such a deal at this stage of the project's life. Generally, we find that the **risks decisively outweigh the benefits in securing such a transaction at this stage**:

- The state might secure a right but not an obligation to buy gas by paying a large premium; in most likely scenarios, however, the state would instead have to make a conditional but firmly binding commitment to buy gas.
- Such arrangement would involve a major commitment for the state, even though the accounting implications will depend on how the deal is structured (impacting whether it is recognized as a contingent liability, for example).
- There is limited time to conduct the necessary due diligence to model and fully understand all the risks involved in making such a deal; however, it is very likely that any deal would favor the producers over the state.
- While these agreements are meant to ensure continued progress on AK LNG, they are likely to have unintended consequences that disadvantage the project.
- Withdrawal terms are common in most joint-venture agreements; however, there is no clear benefit in securing a detailed sales and purchase commitment from the producers at this stage of the project's life.

RIGHT VS. OBLIGATION TO BUY

The State of Alaska wants to negotiate an option that would allow it to buy gas in the future. It seems likely that the starting point would be a trigger event such as: (a) the decision by a producer to withdraw from AK LNG; (b) the failure of any producer to vote in favor of a major project milestone (such as voting to advance the project from the pre-FEED phase to FEED); or (c) a set date (since many projects are often stalled with parties neither withdrawing nor holding votes to advance the project).

At that point, the state seeks to have an option to purchase gas from one or more parties at terms negotiated today. But can the state negotiate a right to purchase gas without the producers also demanding an obligation from the state to purchase this gas?

From the state's perspective, having the right but not the obligation to purchase gas would be ideal: the state would retain the opportunity to advance AK LNG even if one producer withdraws; but, at the same time, it would avoid the risks and liabilities of committing to buy gas for a project with many unknowns at this stage.

From the producers' perspective, however, it is almost impossible to believe that an open-ended right with no corresponding obligation could possibly represent the "mutually agreeable and commercially reasonable" terms that they have committed to negotiate. Were they to agree to such a scenario they would then be binding themselves to a deadline or risk being "forced" to sell their gas; at the same time, they would have no assurance that the state would buy their gas, and they could find it hard to sell it to any other party so long as such an option existed.

Given this reality, there are two possibilities: a small chance that the state might negotiate to pay a major premium in order to secure an unusual and one-sided agreement that entails the right but not the obligation to buy gas; or, more likely, the state would have to make some binding conditional commitments to buy gas. There is no other way to structure this transaction on mutually agreeable and commercially reasonable terms.

FINANCIAL COMMITMENT VS. DUE DILIGENCE

Buying gas from one or more of the producers represents a major transaction. The table on the next page summarizes the amount of money the state would pay to purchase various amounts of gas at different prices. For example, a deal to buy, at \$2/MMBtu, all the gas that ConocoPhillips would make available to AK LNG (assuming 22% of 3 bcf/d for 20 years), would cost the state \$9.6 billion over 20 years. At prices closer to the historical average of Henry Hub (\$4.50/MMBtu), the benchmark price for the Lower 48, the state could be assuming liabilities of tens of billions of dollars. These numbers by themselves call into question the feasibility of such a transaction; to make such a long-term commitment without any form of bankable plan in place for infrastructure development or ultimate sale of the purchased gas, the state would need a balance sheet strong enough to bear such a massive contingent liability.

COST FOR STATE OF ALASKA TO BUY AK LNG GAS (3 BCF/D) FOR 20 YEARS GIVEN SALES PRICE, IN $ MILLION

	$2/MMBTU	$4/MMBTU	$6/MMBTU
EXXONMOBIL (32%)	14,016	28,032	42,048
CONOCOPHILLIPS (22%)	9,636	19,272	28,908
BP (21%)	9,198	18,396	27,594
TOTAL	32,850	65,700	98,550

Despite the size of the commitment that the state is proposing to undertake, there is limited time to conduct the necessary due diligence and model all the risks involved in such a transaction (if there is to be agreement by December 4, 2015). Typically, counter-parties take months and often years to iron out such a sizable sales and purchase agreement, and their negotiations often involve several rounds (for example, signing a non-binding Heads of Agreement, followed by a firm Sales and Purchase Agreement). **There are so many unknowns at this stage:**

- If the gas is to be sold at a benchmark price, what is the outlook for that benchmark and what are the drivers that will determine the benchmark price?
- How much can the State of Alaska afford to pay for this gas? What prices can Alaska hope to earn in the market, and what are the projected costs along the chain (gas treatment, transportation, liquefaction, shipping)? How well are those costs understood at this point?
- What will happen to the CO_2 from Prudhoe Bay and Point Thomson? Will the state sell the CO_2 back to the producers? At what price and under what terms?
- What kind of fiscal certainty might the producers require in order to enter into such an agreement?
- What are the conditions precedent for triggering the sale?
- How will LNG buyers react to producers marketing gas that has an option attached to it (thus complicating legal title in the future)?

The parties need good answers to these questions in order to progress, which is why these negotiations typically take many months or years to complete, even for projects far more advanced than AK LNG. Compressing the timetable into a few weeks will **advantage the producers who understand better what this gas will cost to produce and transport as well as what price it could earn in the market.** Given the producers' superior knowledge, it is **difficult to see how any terms the producers might be willing to agree to at this stage could possibly represent a good deal for the state**. So long as project development is viewed as a viable option for gas commercialization, terms commercially acceptable for wellhead sale or tolling would be terms which producers believe to be preferable to project development; in other words **terms at which the state is not**

adequately compensated for the major capital commitment or commercial risks involved in project development.

UNINTENDED CONSEQUENCES

Given the complexity of the deal to be negotiated, the parties will need to devote considerable resources to reach an agreement. This is time taken away from other work such as negotiating the foundational project agreements or the pre-FEED work. In short, **the parties are focused primarily in defining a detailed scenario for what to do if the project fails rather than working the issues to make sure the project succeeds.**

Moreover, securing firm withdrawal provisions will change the calculus that the producers make from now on. The state is best served by having all producers focused on advancing AK LNG and resolving the risks involved in developing the project. Firm withdrawal provisions offer each producer a way out: a way to monetize their gas and secure the upside while having someone else shoulder the risks of development. For any producer, selling gas at the wellhead might seem a preferable option to taking on the risks of development. **Instead of working hard to identify and resolve risks, parties can choose instead to stand on the sidelines and let others solve the problems of development.**

More importantly, the producers would only agree to a sales price that is higher than what they could earn by developing the project. **In short: by signing firm withdrawal provisions, the state offers the producers an easy way out from developing AK LNG—and in doing so, it loses the expertise that the producers bring while being left to monetize gas that the producers think cannot generate sufficient returns in the market.**

NOW VS. LATER

Planning for failure is a fact of life, and Governor Walker is right to be concerned about the possibility that one (or more) producer chooses to not pursue AK LNG. The state, however, has several options to deal with this eventuality. First, it can try, at that point, to resolve the reluctant party's concerns and help increase their comfort level in moving on with AK LNG. Second, the state can negotiate the specific terms of withdrawal at that point, when there is more information known about the project and the risks are better delineated. In fact, several LNG projects have seen partners depart even at late stages of project development. The state can even explicitly set a framework for such an eventuality—for example, it could create a process by which the state and the reluctant producer enter into exclusive negotiations, in good faith, for the state or another nominated party to purchase the producer's gas. **It is hard to see how the state's current path is preferable to a more standard approach whereby parties negotiate withdrawal provisions if and when there is deadlock.**