TransCanada's AKLNG Participation: Financing Issues

Special Session

October 24, 2015

Introduction

An exit by TransCanada (TC) from the AKLNG project has financial implications to the State of Alaska:

- Immediate impact: The State will be responsible for funding the reimbursement of TC's Midstream development costs, as required under the Precedent Agreement (PA)
- Going forward: The State will be responsible for funding its share of the Midstream project costs, which would have been funded by TC

This presentation addresses the following issues/questions related to the impact of TC's exit on the State's financial position, credit rating and borrowing capacity:

- What will be the **impact on the State's credit rating and borrowing capacity**?
- **At what cost** is the State expected to finance its share of Midstream costs, and how does such cost compare with the cost of financing provided by TC under the PA?
- **How can the State fund** its share of Midstream project costs?

What will be the impact of TC's exit on the State's credit rating and borrowing capacity?

- Will the State's requirement to fund Midstream costs result in increased State funding commitments?
- Will TC's exit erode the State's borrowing capacity?
- Will the State's credit rating be adversely affected by TC's exit?
- Will the long-term impact of the TC buyout be viewed as credit positive?

State Commitments Not Increased with TC Exit

Will the State's direct funding of Midstream costs result in increased State commitments?

Under the arrangement with TC, the State is already committed to pay the costs associated with the Midstream components:

- If the Project fails to complete Pre-FEED: State obligated to reimburse TC, with interest
- If the Project fails to complete FEED: Under the expected terms of the Firm Transportation Services Agreement (FTSA) with TC, the State would be obligated to reimburse TC, with interest
- If the Project fails to complete construction: Under the expected terms of the FTSA with TC, the State would be obligated to reimburse TC, with interest

⇨ **State assumes Midstream development and construction risks**

- If the Project achieves operations: Under the expected terms of the FTSA with TC, the State would be obligated to pay TC fixed capacity reservation charge, including repayment of TC capital through annual depreciation charge, and pass-through of Midstream costs, regardless of throughput volumes

⇨ **State assumes Midstream cost-overrun and throughput risks**

State Borrowing Capacity Effectively the Same with or without TC

Will TC's exit erode the State's borrowing capacity?

TC's exit will not create incremental State debt obligations; the State is already obligated to pay the Midstream costs.

- Under the PA and the anticipated terms of the FTSA, the State's payment obligations to TC require payments to TC to be "supported with the full faith and credit of the State" or a dedicated funding source acceptable to TC
- TC would be relying on the State's credit for reimbursement of its funding of Midstream costs
- FirstSouthwest has noted that the credit ratings agencies will, in all likelihood, consider the State's long-term fixed payment obligations to TC under the FTSA as analogous to a State debt obligation for purposes of analyzing State debt capacity

Example: Credit Rating Agency Treatment of "Take-or-Pay" PPAs

"Take-or-pay" power purchase agreements (PPAs) are similar to FTSAs as they typically obligate the buyer to make capacity charge payments regardless of output. Such agreements are scrutinized by credit rating agencies.

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RATING METHODOLOGY Regulated Electric and Gas Utilities

" […] by paying the capacity charge, the utility is effectively providing the funds to service the debt associated with the power station.
[…]
When the accounting treatment of a PPA is a debt or lease equivalent (such that it is reported on the balance sheet, or disclosed as an operating lease and thus included in our adjusted debt calculation), we generally do not make adjustments to remove the PPA from the balance sheet. However, in relevant circumstances we consider making adjustments that impute a debt equivalent to PPAs that are off-balance sheet for accounting purposes."

"PPAs are recognized qualitatively to be a future use of cash whether or not they are treated as debt-like obligations in financial ratios."

- In prior financings, credit rating agencies have taken into account FTSA-like contracts of much lower value when assessing the credit of local governments
- The rating agencies would almost certainly scrutinize the FTSA payment commitments when assessing the State's credit. Such scrutiny would be heightened due to the FTSA "full faith and credit" or "dedicated fund reserve" requirement

State Credit Rating not Adversely Affected by TC Exit

Will the State's credit rating be adversely affected by TC's exit?

FirstSouthwest advises that a decision to terminate the TC's participation will not, in and of itself, result in a downgrade of the State's credit rating:

- No incremental commitments by the State
- As the State's overall costs related to the Project are projected to be reduced without TC (B&V estimates a reduction of up to $400 million per year), the termination should be viewed by the credit ratings agencies as a net positive for the State
- With or without TC, the State should anticipate a reduction in the State's credit rating during the construction period (when no gas sale revenues are being generated) absent a significant increase in revenue generated from existing sources
- Credit rating should recover once gas sale revenues become established
- TC's exit, by itself, should not result in a credit downgrade during the construction period that is greater than any downgrade if TC remained in AKLNG. The State's credit could instead be improved by the lower costs to the State as a result of TC's exit

Financial Risks to the State of Maintaining TC Funding

- Failure to reach Project FID:
  - The State would be obligated to pay TC's prior Midstream development costs and TC's internal costs, plus interest
  - A potentially substantial appropriation would need to be authorized quickly
- The State's reimbursement obligation could arise at a time of adverse credit impact on the State:
  - Lender community would be aware that the Project would not reach FID
  - the gasline Project revenues would no longer be expected to materialize
  - Consequently, the credit of the State would likely deteriorate
- **Therefore, the State could be forced, in a short timeframe, to repay TC for prior Midstream development costs in adverse credit conditions**

At what cost is the State expected to finance its share of Midstream costs?

How does such cost compare with the cost of the financing provided by TC?

Cost to the State of TC Financing

Under the TC financing arrangement, the State will pay to TC the cost of capital as follows:

- If the PA is terminated:
  - TC's costs reimbursed with interest at rate of 7.1%
  - higher rate applies if payment is not made within the required period under the PA
- If the Project proceeds to operations:
  - the State would pay a return on TC's rate base calculated on the basis of deemed weighted average cost of debt and cost of equity
  - cost of debt and return on equity adjusted for changes in the yield on 30-year Treasury bonds over time
  - debt to equity ratio: different during the construction and operating periods
    - 70:30 through the second anniversary of the in-service date and in respect of expansions and maintenance capital additions
    - 75:25 after the second anniversary of the in-service date on capital other than capital additions for expansions and maintenance

Sample TC Deemed Weighted Average Cost of Capital under the PA*

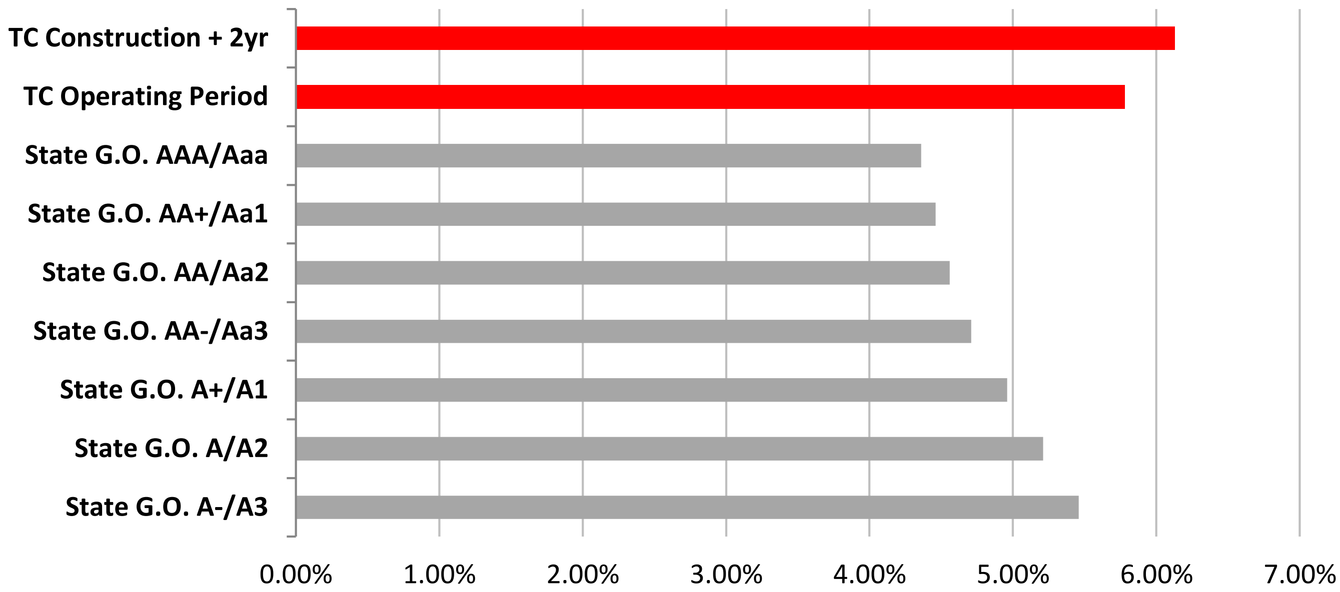
	Dec 12th, 2013	Sep – Oct 2015
30-Year Treasury Yield	3.91%	~2.95%
TC WACC through 2nd Year from ISD	7.10%	~6.15%
TC WACC after 2nd Year from ISD	6.75%	~5.80%

*Actual cost of capital could be higher or lower at the time of financings.

TC Cost of Capital vs. State Debt Interest Rate

The interest rate on State debt would depend on the credit rating. The table below compares:

- TC weighted average cost of capital under the PA, calculated as of Sept 11, 2015
- Interest rates on taxable State G.O. debt, estimated by FirstSouthwest as of Sept 11, 2015



- Under all scenarios of State credit rating downgrade down to A-/A3, the State cost of debt remains below the TC cost of capital
- Note that, following a rating downgrade during the construction period, the State credit rating and cost of capital will likely recover once the Project is operational; TC cost of capital is fixed at FID for the term of the FTSA

How will the State fund its share of Midstream project costs?

Total State Funding Requirements

Shown below are the estimated funding requirements for the State's share of the project going forward*

- Includes both the Midstream components and the LNG plant
- In other words, these are the State funding requirements without TC

Pre-FEED	FEED	Construction
2014-2016	2016-2018	2019-2026
~144 million	**~675 million**	**~13 billion**

* Including payment of the TC Termination Amount and excluding prior pre-FEED appropriations and projected AGDC or agency costs.

State Funding Options

The State will have the following options to pay the TC Termination Amount and finance its share of the Project during the remainder of Pre-FEED, FEED and the construction period*:

- The Legislature could appropriate from existing State funds, e.g., the Constitutional Budget Reserve Fund (CBRF), Earnings Reserve Fund
- The Legislature could authorize the issuance of State debt
- The Legislature could authorize pursuit of project financing
- The Legislature could authorize the pursuit of funding from other sources: LNG buyers and other potential equity investors

* These are the same funding options for the LNG Plant if TC remained in the Project.

Potential Funding Sources: State Funds

The Legislature could appropriate from existing State funds, e.g., the CBRF, Earnings Reserve Fund

- Analysis by the DOR Treasury Division estimates:
  - CBRF could be depleted in 2018 – 2019 (exact timing depends on oil price)
  - Utilizing the CBRF to fund the TC reimbursement and the Midstream Pre-FEED and FEED costs would accelerate CBRF depletion by approximately 3-5 months
- Therefore, the CBRF could be used to fund Pre-FEED and at least a portion of FEED costs, but not construction costs
- CBRF utilizations could be repaid from the proceeds of State debt, project finance debt or other forms of State long-term funding

Potential Funding Sources: State Debt

The Legislature could authorize the issuance of State debt:

- Bondholders would look to the State's credit for repayment (annual appropriations would be required)
- Could be used to finance FEED and construction costs
- Could be used as long-term financing (repayment periods of 20-30 years)
- Timing implications: Authorization to issue GO debt would require voter referendum approval

Potential Funding Sources: Project Finance

The Legislature could authorize the pursuit of project financing:

- Lenders would look primarily to the Project-level cash flows and assets as security for repayment, rather than State funds
- Common form of debt for LNG projects
- Requires the Project commercial structure to be in place:
  - All key project agreements must be executed
  - Commercial structure must be "bankable"
- Requires that FID is reached; not available to fund FEED costs
- May require constitutional amendment to allow the pledging of LNG sales proceeds as lender collateral as the Lenders will demand that funds will be dedicated to repayment, which is currently not permitted by the State's Constitution

As the Project's commercial structure has not yet been agreed, it is premature to evaluate the extent to which project finance could be a viable source of funding

Potential Funding Sources: LNG Buyers and Other Equity Investors

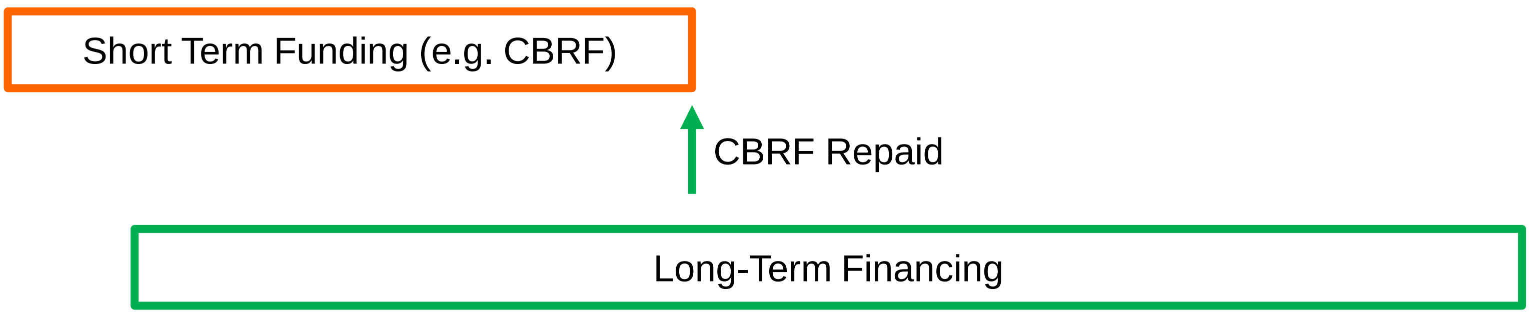
The Legislature could authorize pursuit of investment from LNG buyers or other equity investors:

- Offtakers have often acquired equity in LNG projects
- Approach by the State would need to be made in coordination with marketing plan
- New equity investors could share Project development risk
- Could provide sources of funding in the event a Producer withdraws

At this stage of the Project's development, it is premature to evaluate the extent to which LNG buyers or other equity investors could be viable sources of funding

Example Funding Scenario (For Illustrative Purposes Only)

Pre-FEED	FEED	Construction
2014-2016	2016-2018	2019-2026
~144 million	**~675 million**	**~13 billion**



Proper sequencing of the utilization of available sources of funds would ensure adequate timing to implement the funding plan approved by the Legislature:

- The CBRF could be utilized initially, with CBRF utilizations repaid from the proceeds of State debt or other forms of State long-term funding
- CBRF utilization in the near-term would provide additional time needed for the Legislature to consider proposing a GO debt offering, which would require a voter referendum approval

Conclusion

- TC's exit will require the State to fund the reimbursement of TC's Midstream development costs immediately
- TC's exit will not result in incremental financial commitments by the State
- TC's exit will have no incremental impact on the State's long-term credit rating and borrowing capacity
- TC's exit will not increase the State's cost of financing its share of Midstream costs
- The State has several options to fund its share of Midstream costs

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