State Financial Participation in an Alaska Natural Gas Pipeline

- **The History**
- **The Project**
- **The Options**
- **The Costs**
- **The Risks of State Participation**

Prepared by the Alaska Department of Revenue
January 31, 2002

PETRIE PARKMAN & CO.

CH2M HILL

Executive Summary

The purpose of this report is to examine whether the State of Alaska should financially participate in a pipeline to transport natural gas from Alaska's North Slope to domestic or foreign markets.

The legal and fiscal issues today are not much different than the gas pipeline concerns Alaskans have grappled with over the past 30 years. During that time, the state and private groups commissioned several reports both favoring and dissuading state financial participation. Although the issues have not changed much, certainly the legal, regulatory, market and fiscal situation today is much different than that of decades ago.

Today, proponents of state involvement cite three main reasons for the state to participate in ownership or financing of an Alaska Gas Pipeline project:

- It would be a good investment with a healthy rate of return and minimal risk.
- Alaska should control its own financial destiny and development of its resources.
- State involvement would enhance the project's feasibility—that is, the pipeline would stand a better chance of getting built sooner if the state was a financial partner.

The answers, however, are much less clear than the questions.

A Good Investment

The state is in a precarious financial position as it starts 2002. Its ability to provide essential services will be tested as the Constitutional Budget Reserve Fund runs out of money. The Department of Revenue projects that the reserve fund, which has helped cover state spending for all but two years since 1991, will hit empty by Labor Day 2004. Alaska may be resource rich but we are cash poor—unless you count the Permanent Fund. Other than taking money out of the Permanent Fund to invest in a gasline, the state is in no position to write a check for any significant investment in a gas pipeline project, regardless how good the investment.

The Alaska Permanent Fund

There are several options for using the Permanent Fund for state investment in the project:

- Spend money from the Earnings Reserve Account to buy in as a gasline partner. This means going into the business of owning and operating a natural gas pipeline. This could be done by a legislative appropriation to another state agency or new state corporation to make an equity investment in the pipeline. However, withdrawing too much from the Earnings Reserve Account could jeopardize its future ability to pay for inflation proofing of the fund's principal and dividends.

- The legislature could change state law to authorize a direct investment by the Permanent Fund in the gasline business. A statute change would be required because the Permanent Fund's investment authority does not cover going into the gasline business.

- Or the Permanent Fund, as part of its regular asset allocation and investment mix, could decide to buy shares in a public traded corporation or buy bonds issued by the corporation or corporations that own the pipeline. These investments, however, would give the state no more control over the project than any other minority shareholder, and any return would depend on the corporation's performance and stock or bond value. Any such investment would—by constraint of the Prudent Expert Rule for Permanent Fund investments—be limited to a small percentage of a pipeline corporation's stock or debt.

Taking on State Debt

The state and its municipalities are looking at how to pay for several billion dollars of school construction and repairs, and deferred maintenance to public facilities. The state, which has not issued any general obligation bonds in nearly 20 years, will go to market in the next year if legislators agree with the governor's proposal for school bonds. Taking on new debt for schools and other needs most likely will consume all of the state's available debt capacity, unless Permanent Fund earnings are diverted from the dividend program to pay debt service.

Any over-ambitious reliance on debt to finance a state investment in the gasline could jeopardize Alaska's credit rating, which could have a domino effect as it raises the cost of borrowing for the state and municipalities.

Rate of Return

The Federal Energy Regulatory Commission in the United States and the National Energy Board in Canada would regulate the rate of return on any interstate pipeline, and we expect that return would not differ significantly from what the state—or the Permanent Fund—could earn in other investments with similar risks.

Risks to the State

State investment as a partner in the project could put the state at financial risk if there are construction overruns, delays in completion of the project, unbudgeted calls for additional capital, or volatile natural gas market conditions. Unlike large corporations, the state does not maintain reserves for such risks, and it would be a difficult policy call to tell the public that key government services might be cut back to make money available for gasline expenses.

State Control

Proponents who advocate state financial participation in the project for reasons of control raise two points: (1) Alaska should take a stronger hand in managing its resource development, and (2) a belief that North Slope oil producers took advantage of the state by inflating tariffs on the Trans-Alaska Pipeline System, thereby reducing their oil tax and royalty payments to the state.

Both are emotional issues, and both require an unemotional review.

First, whether the state should take an active role in managing the development and marketing of its oil and gas resources is a public policy call. If people believe that is the overriding issue in this project, then it might justify the financial risks to the state. However, advocates of this position should carefully weigh the risks against the potential benefits. Could state participation in the gasline make it happen any sooner? Would state participation dissuade corporations from putting up their own billions—private money that Alaska needs. And is it the role of government to build and operate for-profit ventures? We believe the state could best control the development of its resources by regulating their extraction and use, and

could best profit from its resources by levying reasonable taxes on the companies that profit from their development.

Second, whether the state received less revenue because of the oil pipeline tariff structure—as some have alleged over the years—is immaterial to the gasline. The Federal Energy Regulatory Commission would regulate the gasline tariffs, and the state would have full access to those proceedings—regardless whether it had a so-called "seat at the table" as an active partner in the business. The state would not gain any more control over the gasline tariff as a business partner than simply participating in the federal regulatory proceedings as the State of Alaska.

And, assuming the state was not the sole owner or majority owner of the gasline, its seat at the table would most certainly be a minority seat with little or no ability to influence any major corporate decisions. The state would have more authority with its own statutes and regulations to influence project management decisions than as a minority business partner.

It is also important to note that even if the state had a seat at the table as a partner operating the gasline, the state could not use any information from the table in tax or regulatory proceedings on the project, nor could it use any of the proprietary information to compete with its other partners for natural gas sales. Confidential information set out on the table would have to remain at the table.

Helping the Project

The two biggest hurdles to building a project to carry natural gas from Alaska's North Slope to market are: (1) the risk of construction cost overruns, and 2) the risk that in periods of low market prices either the pipeline operators or the shippers would suffer a loss. State participation as a business partner would do nothing to lessen either risk and, in fact, some might argue that state involvement in building and operating the line could add to the cost.

Although people talk more and more about running government like a business, the truth is government is not a business. It has rules and regulations and procedures and public access laws that could present formidable problems should government sign on as a partner with a private business venture. Nor surprisingly, none of the oil and gas and pipeline industry

representatives interviewed for this report saw much, if any, benefit to having the state sit on the board of directors of a gasline venture. Many listed such state laws as open meetings, public records and procurement codes—not to mention the entire process of public policy decisions—as key reasons not to take on the state as a partner. Speed and decisiveness are essential to running a multibillion-dollar construction job and company, and, unfortunately, it's highly possible that state involvement would detract, not add, to the operation.

But the largest risk to any partner in the gasline venture is that there could be periods when the market price for gas is not high enough to cover the cost of moving the gas to market and still leave an economic wellhead value for the producers. There is no guarantee that year in and year out, over the entire life of the project, the market will be such that profits will flow to everyone involved in the gasline. Someone—the gas producers or the pipeline owners, if they are different than the producers—would have to take the risk that some of the gas sometimes could move to market at a loss.

If the producers build and operate the line to move their own gas, they would take the risk. If pipeline companies build the line, they and the producers could negotiate which of them shares how much of the risk. Either way, state participation in the project would do nothing to eliminate that risk.

For example, the gas flow at 4 billion cubic feet per day would be worth $14 million a day at $3.50 per million Btu. Perhaps two-thirds or more of that $3.50 would go toward the tariff—the cost of moving the gas to market. If the market price were to drop below that cost, the financial loss could be significant to anyone sharing in the risk. A market price just 10 cents below the cost of moving 4 Bcf per day to market would add up to a $400,000-a-day loss for whoever is contractually bound to the price risk.

Finally, the oil and gas and pipeline companies on the list of potential sponsors simply do not need the state's money to build the project. Their own finances are strong enough that they could either just write a check or raise the money they need from commercial financing sources or by issuing corporate bonds.

It appears state financial participation would do nothing to move along the project, unless the state could find a way under federal law to issue tax-exempt debt to own and/or finance the

project. The lower cost of tax-exempt debt could help tip the project toward economic feasibility, and that could be a proper role for the state to take in assisting in the development of its natural resources. Even with the lower interest rate on tax-exempt debt, however, it is still possible that the companies might choose to issue their own taxable debt in order to take advantage of the federal tax benefits of owning and depreciating the line.

As it says in the cover letter to this report, there are no easy answers.