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AK LNG: Pros and cons of a state-led project

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Contents

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Point of departure

Over the past few months, the State of Alaska has proposed that the Alaska Gasline Development Corporation (AGDC) take the lead role in developing the Alaska LNG (AK LNG) project. Broadly speaking, a state-led project could mean:

Option 1. AK LNG becomes a state-owned, tolling project.

Option 2. Same as Option 1, but the state tries to lower cost of supply.

Option 3. AK LNG becomes a state-owned, merchant project.

What are the pros and cons of each structure? What are the core principles that should guide the state's efforts? And what questions should the Legislature be focusing on?

Option 1. AK LNG becomes a state-owned, tolling project

Project structure. In this case, AGDC owns the hardware: the gas treatment plant (GTP), the pipeline, and the liquefaction and marine facilities in Nikiski. AGDC will sign long-term contracts with the producers, and maybe others, whereby the companies will pay AGDC a tariff to use the facilities. Should the state take its royalty in kind or its production tax as gas, the state (DNR/DOR) could become a shipper as well. AGDC will use these commitments to attract investors and/or secure third-party finance.

Assessment. This structure changes the capital call for the producers: ExxonMobil, BP and ConocoPhillips would spend money to further develop Prudhoe Bay and Point Thomson but they would not spend billions to build the infrastructure. Instead, they would sign long-term contracts to use the capacity. For them, the capital call for this project has fallen considerably.

This structure also removes some complexity and reduces risk for the producers. It might no longer be necessary, for instance, to negotiate a payment-in-lieu-of-tax (PILT) for property since the state will own most of the infrastructure that would be subject to property tax. It might not even be necessary to negotiate "fiscal stabilization," since the capital that the producers would put at risk would fall sharply.

But this structure does not, in itself, lower the cost of supply—if AK LNG is uneconomic, this structure is unlikely to make a major difference, unless the state were exempt from federal income taxes, a prospect which is yet unknown, or benefited from other tax exemptions (AGDC is exempt from property tax to state and local jurisdictions, although some revenue sharing would still need to happen). This structure also raises project risk to the state by shifting the burden of execution from the producers to the state.

Option 2. Same as Option 1, but the state tries to lower cost of supply

Project structure. In this case, AK LNG moves to a structure similar to Option 1, but now the state takes on a more aggressive role in reducing the cost of supply. In effect, the state deploys non-engineering ways to lower costs—for instance, the state could reduce the rate of return used to calculate the tariffs for the GTP, the pipeline and the liquefaction facility. Lower returns would lower tariffs and thus lower the price at which the producers can sell gas to the market and still make an acceptable return. Lower returns, however, would also reduce the profits that the state can expect to make from AK LNG.

The state can also deploy its taxing power to impact project economics. Property tax, for example, is a major component of total project costs, and the state was already in discussions with the producers to come up with a mutually acceptable structure that both delivers a fair tax to the state as well as supports the project's development. In a state-owned project, AGDC would be exempt from paying property tax, which would impact the cost of supply—although the impact on communities would still need to be addressed and factored into the cost.

Assessment. It is hard to evaluate this possibility in the abstract. Sovereigns routinely offer concessions to support economic and industrial development; on their own, concessions tells us little about their advisability. It all comes down to specifics: what concessions, why, for how long, and so on.

Even so, there is one risk: that the state assumes, alone, the task of making AK LNG competitive. In other words, if there is a gap between the market price and the cost of supply, the state tries to close the gap by offering more and more concessions. This problem is particularly acute if the state sees AK LNG as a "must have," and is thus willing to take on too much risk or offer too many concessions to advance a project that is uneconomic. In this scenario, it is imperative to screen every concession and understand why it is being offered; it is similarly important to extract concessions from other parties so that the state is not, alone, trying to reduce the cost of supply.

Option 3. AK LNG becomes a state-owned, merchant project

Project structure. In this case, the state owns all the infrastructure, as in Options 1 and 2, but instead of merely providing treatment, transport and liquefaction services in exchange for a tariff, the state buys gas at the wellhead from the producers and then re-sells it further downstream (for example, as LNG at Nikiski).

Assessment. Broadly speaking, the merits of this approach depend on specifics: at what price is the state buying gas and at what price is it selling it? These details are unknown, but one could envision two scenarios: either the two transactions are linked or they are not.

In a linked transaction, the state might buy gas from a producer at a price equal to Henry Hub and then sell it as LNG for a price also linked to Henry Hub plus a margin (say $7/MMBtu). In this case, the question is whether the margin covers the costs and return on the infrastructure. But it is not clear that the state provides any value—if the transaction makes sense, the buyer and seller would deal directly with each other, and one of them would pay the state a tariff for using the infrastructure (as in Options 1 and 2). The only value would come from adjusting the margin—but the state can do this without owning the gas (i.e. Option 2).

Alternatively, the state might buy and sell gas at prices that are not linked—for example, the state might buy gas at a Henry Hub price but sell LNG at an oil-linked formula. In this case, the risks for the state rise exponentially—as do, the theoretical returns if prices move in a way that favors the state. Such a deal, however, would not only require extensive due diligence; it would also require a very high risk tolerance.

How the state buys gas matters as well. On one extreme, one could imagine an arms-length transaction between the state and a producer. But one could also imagine a sale that is part of a leaseholder's "duty to produce." In this latter case, the state would need (a) to keep prospective buyers interested while the (likely lengthy) negotiations are completed; and (b) to ensure that the state does not put itself in a position where it is obligated to buy gas that it may not be able to resell at a reasonable price. As enalytica noted in the past, the liabilities involved with buying gas can run into the tens of billions (enalytica, "Negotiating firm withdrawal terms: Key issues," November 2015). Combined with a scenario where the state borrows money to build AK LNG, the state could be assuming enormous liabilities to make this project a reality.

Some core principles to remember

State-led project needs credibility boost. A transition to a state-led project raises big questions about execution and governance. Can the state assume the leading role in driving one of the largest infrastructure projects ever? The state needs a plan for how it will do this, and it also needs a clearer delineation of responsibilities among state agencies as well as a clear blueprint for dealing with the producers.

Don't expect to outsource risk. The state cannot expect to take on a leading role, and full control, without assuming more risk—or, more precisely, while assuming that most of the risks will be borne by others (suppliers, contractors, banks, etc.). Nor should the state expect a large number of third-party investors to flock to the project in order to earn sub-par returns. Experience shows that infrastructure funds have limited appetite for liquefaction assets—and there is even less evidence that such investors would be happy with low returns.

State cannot avoid partner veto. The state places a high premium on not allowing any of its partners to hold back the project; for instance, the "AGDC-AK LNG Concept Document" (July 2016) states that its concept is "Very similar to the current structure except that a single party cannot hold up the entire development of the system." This might seem desirable but is, in reality, impractical: no investor would join a venture without having veto rights over major decisions such as whether to build the project (i.e. Final Investment Decision). It is especially unrealistic to expect that the state will not surrender any veto rights to investors who are asked to accept subpar returns and shoulder major risks.

Don't overdo financial engineering. Return is supposed to be a project-level, not a sponsor-level, concept: the return that an investor should expect should match the project's risk. In other words, AK LNG has an inherent risk that leads to an expected return. Moreover, leverage increases risk: if the state borrows to finance AK LNG, it should increase its expected return on equity. The idea that the state should, at the same time, lower its return threshold and increase debt exposure in order to make this project work would go against basic principles of corporate finance.

Focus on risk-return. Options 1 to 3 could easily be thought of as forming a risk-return continuum: Option 1 offers some benefits to the existing structure but may not suffice

to make the project economic. Option 2 allows for more concessions—these could help if they are targeted and in response to specific concerns, and as long as other parties do their part as well. Option 3 seems to offer few benefits over Option 2 but substantially more risk—as such, its merits need to be stated very explicitly. Either way, the state is proposing a big increase in risk and thus, the key questions remain: what returns are acceptable for AK LNG? And how much risk is the state willing to take?

Critical questions

As the Legislature evaluates these proposed changes, here are some possible questions to focus on.

Why state ownership? AK LNG has reached a stumbling block, but it is not obvious why state ownership is the only option available to AK LNG, especially since the primary benefits of the state taking over the project remain unproven. What levers are available to the state to reduce the cost of supply, and how much impact does each have? Is there a path that preserves the merits of the current approach while delivering some of the benefits of state ownership?

What's the organizational plan? The organizational challenges of developing AK LNG are immense and will require a major change in AGDC's capabilities and in cost. What does that look like, how long will it take, and how much does it cost?

What's the project structure? It is not clear, at this point, which path the state is following or why. Is the state looking to be an infrastructure provider? Or will it buy and sell the producers' gas? If the latter, why? What are the pros and cons of each structure from the state's perspective, and which path is being pursued?

What's the plan for securing/confirming tax-exemption? The exemption from federal taxation is a major argument for the state's increased role in AK LNG; what is the timeframe for confirming such status? How will tax exemption affect other aspects of AK LNG (e.g. issuing non-recourse debt)? What happens if that path is not successful?

What's the financing plan? LNG projects typically raise funds from the official sector, banks, and markets (bonds). But these have different costs and carry different risks. How do different financing scenarios impact project returns? What will very high leverage (say 90% or 100%) do to project risk given the amount of debt that would be needed to finance AK LNG?

Who are the target investors? Another critical assumption driving the state's efforts is the idea that third-party infrastructure funds will invest in the project, and will do so for returns that are lower than those of the producers. Liquefaction is generally not an asset that such funds have invested in, which raises the question: what case studies lead the state to believe that such investors will step forward? What returns will they require given the risks of the project?

What's the risk-sharing strategy? Many of the proposed risk mitigation strategies—that lenders will offer money at reasonable trades, that infrastructure investors will accept lower returns, that contractors will assume construction risk at a reasonable price, that future partners will waive their veto rights—are unproven at this stage and many seem implausible. A clearer definition of risk allocation would be most helpful, including the role that the producers will play in advancing this project forward.