TRANSCANADA AKLNG PARTICIPATION DECISION PRIMER

OFFICE OF THE GOVENOR

THE STATE of ALASKA

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1.0 Executive Summary

Background: In June 2014, the State of Alaska (SOA) and TransCanada Alaska Midstream LP (TransCanada) entered into a key agreement authorizing TransCanada to pay the upfront capital costs and hold the State's 25 percent share of ownership relative to the midstream components of the Alaska LNG (AKLNG) Project. These midstream components are the Gas Treatment Plant (GTP) and pipeline portions of the overall project.

The agreement, called the Precedent Agreement (PA), was based on terms of a Memorandum of Understanding (MOU) between the State and TransCanada signed in December 2013. While the Alaska Legislature was not a party to this agreement, it reviewed and debated the terms of the MOU during the 2014 legislative session. Under the PA, TransCanada pays upfront capital costs related to the State's share of the AKLNG midstream with the agreement that the State will repay all of TransCanada's costs with interest whether or not the AKLNG project is completed.

A critical component of the original MOU as well as the PA is that the State is authorized to take back its equity share of the AKLNG midstream components by exercising off-ramps designed in the agreement.

Decision at hand: Per the terms of the PA, the State is now faced with a December 31, 2015 deadline to make a decision on whether to take back TransCanada's share and have direct equity participation in the AKLNG midstream. To do so would require termination of the PA. Under the PA's terms, by December 31, the State is obligated to either enter into a Firm Transportation Services Agreement (FTSA) with TransCanada or terminate the PA. Alternatively, if agreeable to TransCanada, the State can negotiate to extend the date for entering into an FTSA beyond December 2015.

Recommendation: The State administration recommends termination of the TransCanada relationship by December 2015 and replacing it with the State's direct participation in the AKLNG midstream. The State administration expects this path to allow the State to better manage the obligation the State has for AKLNG midstream costs whether or not the project proceeds, increase the overall economics of the project to the State, and allow the State to have more direct voting rights on key AKLNG issues in return for its investment.

2.0 Introduction

The SOA is faced with the strategically important decision of whether to terminate the existing PA, which grants TransCanada a portion of SOA's equity and decision making responsibilities in the AKLNG Project. The decision hinges on the SOA's desire to either increase its direct participation in the Project and gain its full equity and voting rights equal to its share of gas or limit the upfront financial exposure for the SOA while giving up more control.

The State has two main options:

1. Terminate the PA by December 31, 2015 and reimburse TransCanada for its costs incurred to date (plus approximately 7% interest) – SOA increases overall equity and voting rights to 25%, which equals the SOA's share of gas;

2. Execute an FTSA with TransCanada by December 31, 2015; TransCanada would continue to incur costs on behalf of the SOA unless there is a termination at a later date, at which point the SOA will have to reimburse TransCanada's costs (plus approximately 7% interest)[1]

Note that option 2, executing an FTSA with TransCanada by December 31, 2015, would be premature and very risky from the State's perspective. The original December 2015 deadline to execute an FTSA was premised on an expectation that various project enabling agreements would be finalized to facilitate the State entering into any long-term transportation agreement and the associated guaranteed payments to TransCanada. If the SOA decides to continue the relationship with TransCanada, an extension of the deadline to execute an FTSA will need to be negotiated with TransCanada, assuming TransCanada is willing to consider that.

It is the recommendation of the administration to proceed with termination of the PA and to reimburse TransCanada for its costs incurred to date. As discussed in this primer, the administration believes that this is the best decision for the SOA, as regaining full voting rights will ensure the SOA is able to achieve the optimal value from the Project while enabling the SOA to actively manage risks.

3.0 TransCanada Precedent Agreement

The SOA entered into the PA with TransCanada in 2014 as a result of the decision to shift efforts from the Alaska Gasline Inducement Act (AGIA) project (also known as the Alaska Pipeline Project (APP)) to the AKLNG Project. TransCanada was the State's licensee under AGIA and had rights to the work product developed under those efforts. While TransCanada's work on AGIA and APP allowed smooth transition into pre-FEED for the AKLNG Project and the use of AGIA work products in the development of the AKLNG Project, the agreement with TransCanada was designed to provide the State (and TransCanada) with several off-ramps as the AKLNG Project moved through its different development stages. The State now believes that it is time to exercise an off ramp before December 31, 2015, and terminate its relationship with TransCanada.

[1] The State also has a third option: exercise its option to acquire 40% of the equity of the TransCanada entity that will own the 25% of the AKLNG midstream. This option is not discussed in this primer but in general it has many of the same pros and cons associated with option 2 above, but to a somewhat lesser degree. (*e.g.*, not full voting rights and some limitation on the upfront financial exposure).

4.0 Why is Termination of the TC Relationship in the State's Best Interests?

First, it is important to understand a fundamental element of the structure of the SOA's current relationship with TransCanada. Under the current agreement, TransCanada pays the upfront costs related to the AKLNG midstream and the State has a contractual obligation to repay all of TransCanada's internal and project related costs with interest whether or not the Project is completed. The decision is not, whether or not, to pay TransCanada; the decision is whether to pay TransCanada a lower amount now or pay them a much larger amount later. Either way the State will owe payment to TC for holding our portion of the equity in the AKLNG midstream. This fact holds true whether or not the Project goes forward. In other words, the State ultimately bears all the development cost and risk associated with its equity ownership of the Project, regardless of TransCanada's participation.

ALIGNMENT & VOTING RIGHTS: Terminating the PA allows the State to better align its voting interest in the Project with its ownership percentage of gas. Currently, the SOA is estimated to receive 25% of the gas from Project; however, with TransCanada's equity participation in the midstream portion of the Project, the SOA only retains 25% equity in the LNG plant. As a result, the SOA's equity participation in the entire project, which determines the weight of voting rights, is only ~12.5% (LNG plant is expected to be approximately 50% of total cost). It should be noted that each of the Producers have alignment between their share of equity and gas in the project and hence the State is the only party currently without this alignment.

Under the current arrangement, TransCanada serves as the SOA's midstream participant in the joint venture agreement and holds the SOA's 25% equity share in the Project midstream. As a result, TransCanada makes decisions that are motivated by creating value for its shareholders, which are sometimes but not always aligned with the long-term interests of the State's shareholders, our citizens. To maintain independence in its control of the midstream segment, TransCanada is expected to require separate voting rights from those of the State for the midstream segment and equal voting rights with respect to AGDC with respect to matters that affect both the midstream and the LNG plant. By removing TransCanada, the SOA would gain voting rights equal to its gas share and have more direct influence over key decisions such as Project budget and schedule for the midstream portion. Importantly, the State would have more direct and timely access to information related to the AKLNG Project midstream

ECONOMIC BENEFIT: In addition to the misalignment of equity interest and share of gas in the project, the SOA may also be positioned to lose value in the Project by having TransCanada as an equity participant. The financial participation of TransCanada comes at a borrowing cost of ~7%. The SOA's borrowing costs have historically been lower than TransCanada's ~7% weighted cost of capital and the Department of Revenue (DOR) has opined that, in the future, the SOA's borrowing costs are expected to be lower than TransCanada's for the AKLNG Project. According to Black &

Veatch's report released on September 30, based on DOR's view of the SOA's ability to borrow funds at a lower cost, the SOA could realize up to $400 million of additional annual net cash flows from the Project (depending on the actual final borrowing costs[2]) by financing the midstream portion of the Project itself. Even if the State experiences a credit downgrade and has a higher cost of capital, it is still expected to achieve higher annual net cash flows without TransCanada.

In other words, once the Project is in operation, the SOA would make a tariff payment to TransCanada that could exceed, by several hundred million dollars per year, the costs that it would otherwise owe to lenders at a lesser rate through direct state ownership. This incremental cost would also create additional risk of needing Legislative appropriations for the State to cover instances in which revenue from its gas sales is insufficient to cover its tariff costs to TransCanada (which will include, in addition to bank financing costs, a component to compensate TransCanada for their equity investment). As described by Black & Veatch's report, with TransCanada, the cost level that the State's revenues need to cover are expected to be as much as $1/MMBtu higher than without TransCanada.

Additionally, the State's financial advisor, FirstSouthwest believes that a decision to terminate the PA with TransCanada will not, in and of itself, result in a downgrade of the State's credit rating. The State is already committed to pay the costs of TransCanada's involvement in the Project, so the State assuming TransCanada's costs does not increase the State's commitments. To the contrary, as the State's overall debt costs related to the Project are projected to be reduced in light of lower financing costs, the termination should be viewed by the credit ratings agencies as a net positive for the State. While the State may have to come up with funds on an accelerated basis if the agreement with TransCanada is terminated, FirstSouthwest believes that these funding amounts are well within the SOA's ability to raise funds. FirstSouthwest has noted that under both the TransCanada financing option and a State financing option, the State should anticipate a reduction in the State's credit rating during the construction period for the Project while no gas sale revenues are being generated, with the credit rating beginning to recover once gas sale revenues become established. First Southwest further noted that since the credit ratings agencies will consider the TransCanada financing option as being similar to a State debt obligation in their credit analyses, the magnitude of the credit rating reduction should not be greater if TransCanada is terminated, and could instead be mitigated by State financing as noted above.

5.0 Why Terminate TC now?

There are several reasons why the Administration believes terminating the PA by December 31, 2015 is the preferred path for the SOA rather than negotiating an extension to a later date.

MANAGE FINANCIAL RISK: First, there are significant financial implications to the SOA if the PA is not terminated but the Project does not progress to completion. The benefit from continued

[2] It should be noted that if the State's borrowing costs are higher than generally presumed, then the additional annual cash flow benefit to terminating the PA with TransCanada could be less than indicated here.

TransCanada involvement stems from the potential reduction in State appropriations during the Project's development phase if indeed the project progresses to completion. This benefit, however, will be entirely eroded and will require even larger State appropriations (reflecting payments to TransCanada for interest and their internal costs) if the Project does not progress to completion. This is because under the PA terms, there is no sharing between the State and TransCanada of project development or construction risks; the State bears these risks in their entirety:

- If the Project is terminated prior to the end of Pre-FEED, then the State will need to reimburse TransCanada for its expenditures to date, plus interest, within the time period established in the PA; a higher interest rate applies if the payment is made later;
- If the Project is terminated during or at the conclusion of FEED the State is expected to owe TransCanada its development costs plus interest, although that would have to be agreed as part of the FTSA;
- If the Project is terminated during construction, the State is expected to owe TransCanada its share of the construction costs plus interest, although that would have to be agreed as part of the FTSA. Assuming that is true, then the SOA's cost responsibility would be higher than it would have been without TransCanada.

Accordingly, any financial value of TransCanada's involvement comes only if the project is indeed brought into operation. Should the project fail, then a very substantial, one-time appropriation would likely need to be assembled very quickly to cover all prior development costs and TransCanada's internal costs, plus associated interest. That appropriation would include not only the funds involved in the currently-requested appropriation for reimbursing TransCanada, but also all such amounts subsequently spent. Finally, borrowing costs at such time would reflect the lender community's knowledge that the State's path to a future revenue-generating gasline project had been halted or delayed; that is, they would likely be higher than they are today.

Put differently, if it assumes full and direct ownership in the Project now, the State today enjoys certain inherent risk mitigation opportunities, in the way of low borrowing costs, should the Project not proceed. Not only are interest rates historically low, but lenders also recognize that the State's finances may be importantly boosted in the future from a successful gasline project. In the event of Project failure at least one, and perhaps both, of these mitigating factors may be absent.

AVOID BACK-IN RIGHTS: A second reason for terminating the PA now is that unlike the PA, the proposed FTSA is expected to include a commitment to give "back-in" rights for TransCanada. The back-in right states that within five years of exercising its termination option, if the State participates in a pipeline project to commercialize North Slope gas that is substantially similar to the AKLNG project, the State would need to offer TransCanada an option to participate in the GTP and pipelines of that project under similar terms. Terminating TC's participation now would give the State a clean off-ramp without needing to offer any back-in rights.

INFLUENCE DESIGN DECISIONS: Finally, certain key project decisions are slated to be made in the next six months. There is a fundamental difference between the State's and the producers' (and potentially TransCanada's) primary decision criteria for these decisions. By terminating the PA with TransCanada, the State would gain voting rights equal to its gas share and have a more direct influence over key decisions related to the midstream such as Project budget, schedule and by-product handling. In addition, terminating the PA with TransCanada is expected to facilitate simpler and more efficient resolution of voting rights in AKLNG governance agreements currently being negotiated.

6.0 What are the Immediate Implications for State of Alaska?

FINANCIAL IMPACT: The most significant impact of terminating the PA with TransCanada will be financial. If the SOA assumes TransCanada's role in the midstream of the Project, then the SOA will also have to assume the upfront cash calls responsibility for a full 25% share of project development and construction costs. If the PA is terminated, the SOA will have to reimburse TransCanada for any direct project payments they've made since January 2014 as well as their related internal management costs and a 7.1% carrying cost. It is estimated that this will total approximately $70 million through the end of 2015. The additional SOA costs to complete the midstream Pre-FEED work in 2016 would be ~$61 million per Alaska Gasline Development Company (AGDC) estimates based on AKLNG pre-FEED cost estimates. If the project moves into final construction, the SOA will be responsible for arranging financing of approximately $13-14.0 billion, or about twice what would have been needed with TransCanada. TransCanada's continued involvement in the project would reduce the SOAs share of direct Midstream financing during development and construction. However, the SOA would still be obligated through the FTSA to ultimately repay TC's capital invested.

TECHNICAL IMPACT: A secondary consequence of terminating the PA would be the need to replace the technical expertise that TransCanada provides to the Project. However, the AKLNG Project partners have worldwide experience and the resources to be able to step into the pipeline lead role and associated technical positions currently staffed by TransCanada employees.

Alaska Gasline Development Company (AGDC) has recently completed development of Pre-FEED and FEED for the Alaska Stand Alone Pipeline (ASAP) project, on time and under budget. The AGDC team is available on an interim basis to support the State's interest in a natural gas pipeline from the North Slope. AGDC's technical staff is familiar with Alaska-specific design and construction issues that are critical for AKLNG project success. AGDC assets include the proposed SOA right-of-way (RoW) for most of the pipeline alignment and the Federal land RoWs are expected to be granted in mid-2016. Additionally, AGDC has taken over TC's role of coordinating the AKLNG Parties in the owners' review and guidance on the Federal Energy Regulatory Commission (FERC) National Environmental Policy Act (NEPA) resource report filing for the Project.

SOURCE OF FINANCING: Lastly, by terminating the PA with TransCanada, the SOA eliminates a source of funding. As discussed previously, this does not pose a challenge to the SOA's ability to finance their portion of the project. However, if one of the producers decides to withdraw from the Project, having TransCanada as a participant could provide more options to fund the withdrawn producer's portion. It should be noted that depending on the timing of any withdrawal by one of the producers, other partners including potential LNG buyers may be willing to step in and invest in the Project.

7.0 Conclusions & Recommendations

The current arrangement with TransCanada was designed to provide the State (and TransCanada) with several off-ramps as the AKLNG Project moved through its different development stages, including an important clean off-ramp for the State in December 2015. The State administration recommends termination of the TransCanada relationship by December 2015 and replacing it with the State's direct participation in the AKLNG midstream. As described in the assessment above, the exercise of this off-ramp is expected to

- create greater alignment and more direct voting rights on key AKLNG issues in return for its investment,
- help the State better manage its obligations for AKLNG midstream costs whether or not the project proceeds, and
- improve the overall economics of the project to the State