

SENATE FINANCE COMMITTEE
February 21, 2014
5:04 p.m.

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CALL TO ORDER

Co-Chair Meyer called the Senate Finance Committee meeting to order at 5:04 p.m.

MEMBERS PRESENT

Senator Kevin Meyer, Co-Chair
Senator Anna Fairclough, Vice-Chair
Senator Click Bishop
Senator Mike Dunleavy
Senator Donny Olson

MEMBERS ABSENT

Co-Chair Kelly
Senator Hoffman

ALSO PRESENT

Deepa Poduval, Principal Consultant, Natural Gas and Power Fuels Group, Black & Veatch Management Consulting; Janak Mayer, Partner, Enalytica; Nikos Tsafos, Partner, Enalytica;

SUMMARY

Fiscal Analysis by Black and Veatch Management Consulting:
The Heads of Agreement and the Memorandum of Understanding

Presentation by Enalytica: Legislative Consultants
Presentation on Costs of Momentum Delay

^Fiscal Analysis by Black and Veatch Management Consulting:
The Heads of Agreement and the Memorandum of Understanding

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DEEPA PODUVAL, PRINCIPAL CONSULTANT, NATURAL GAS AND POWER
FUELS GROUP, BLACK & VEATCH MANAGEMENT CONSULTING,

continued to speak to the PowerPoint presentation, "Building a World of Difference: TransCanada Participation in AK LNG Project." (Copy on file).

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Ms. Poduval turned to Slide 16, which listed the values TransCanada brought to the Alaska LNG project; the committee had been going through this exercise by asking 4 questions: What was the economic impact to the state from TC, could the state go it alone, is TC a good partner, and does it bear any financial risk. (Slide 6) She shared that she would be picking up the conversation at question 3: "Is TC a good partner?"

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Co-Chair Meyer noted the committee's attendance.

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Ms. Poduval continued to address Slide 16, "Is TransCanada a good partner for the state of Alaska in the AKLNG project?" She made the distinction that the state was not evaluating different financing options for the pipeline; TransCanada was not acting solely as a bank in the transaction to reduce the state's upfront capital cost in exchange for annualized payments from the state over a period of time. She asserted that TransCanada was a very experienced pipeline builder, owner, and operator, with particularly qualified to do business in Alaska because of their high-level experience with Northern pipelines. She related that although the Alaska project would be very challenging given the location and environmental conditions, TransCanada would bring its northern experience to benefit the project. She pointed out that TransCanada had a long history of interest in developing an Alaska pipeline and had been the only company to submit a completed application in the Alaska Gasline Inducement Act (AGIA) process. She discussed the orange box on the slide, "Facilitates expansion." She stated that TransCanada as an independent third party would help to facilitate expansion and access by expanding the pipeline and transport more volume, because it would increase the volume of their business and grow their revenues.

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Ms. Poduval continued. She related that having TransCanada as a partner would help retain the momentum of the project. She cited the body of work and experience that TransCanada had having already studied the pipeline route while studying AGIA. She stated that it was not a certainty that the state would lose time on the project without TransCanada, but that it was a likelihood. She noted that relationships were already in place because of the discussions that had supported the Heads Of Agreement (HOA) and Memorandum Of Understanding (MOU) between the producers and TransCanada. She said that if the state wanted to bring another party into the project it would take time and when the two terms were examined on which could be approved upon, the debt/equity structure and the expected return on equity, TransCanada had offered a 75 percent debt and 25 percent equity capital structure, with a 5 percent cost of debt and 12 percent return on equity in today's market.

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Senator Dunleavy requested that the numbers be repeated.

Ms. Poduval replied 75 percent debt and 25 percent equity; a 12 percent return on equity, and 5 percent cost of debt. She pointed out that in the pipeline world those were good numbers.

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Ms. Poduval addressed Slide 17, "Retaining Momentum On Project Could Be More Valuable Than Securing Better Commercial Terms", which depicted how the state could benefit by trying to improve on the already fairly decent commercial terms. The slide depicted 3 sets of numbers on 3 different panels. The panel on left looked at the debt equity mix, which was the capital structure of the project. The middle data point was the offer by TransCanada with the 75 percent to 25 percent debt to equity ratio. She stated that one thing to keep in mind, was that as equity in the structure was increased, the weighted interest cost also went up. She pointed out that you wanted more debt and less equity in a project because it lowered the overall interest cost. The slide showed that a 5 percent change in the project's capital structure was equivalent to about \$200 million in additional net present value (NPV) to the state. She continued to the second panel which illustrated the return on equity (ROE). She relayed that TransCanada's

offer was on the farthest right row of the panel. She said that if the state tried to improve the numbers by bringing in a third party to bid resulting in the 11 or 10 percent ROE, impact of each percentage decrease would result in approximately \$100 million in additional NPV to the state.

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Ms. Poduval related that if the state found another partner that was as qualified as TransCanada, that wanted and 80/20 debt equity mix and a 10 percent ROE, it would be an improvement of the commercial terms on the table from TransCanada to the tune of approximately \$300 million. . She spoke to the last panel on the right which depicted the cost to the state if the project were delayed. According to the slide, a single year's delay of the project would cost the state \$800 million in NPV. She asserted that any improvement in the commercial terms would be cancelled out by the cost of delaying the project.

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Co-Chair Meyer understood that if the state did not work with TransCanada there would be a delay and it would be costly.

Ms. Poduval replied that if the process to replace TransCanada resulted in a delay in the project, it would come at a significant cost to the state.

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Co-Chair Meyer queried if it was true that any of the oil companies could build a pipeline.

Ms. Poduval responded in the affirmative; however, TransCanada had been studying the project since the inception its license. The state would lose having a third party participating in the project and the incentives that accompanied that third party.

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Senator Dunleavy queried whether the state had in-house expertise to negotiate and construct projects of this type on its own.

Ms. Poduval replied no.

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Senator Dunleavy noted that acquiring the expertise would take time and money.

Ms. Poduval replied yes.

Senator Dunleavy wondered whether acquiring the expertise would be beneficial to the state or would it be better to stick with a partner that already had the expertise.

Ms. Poduval replied that the negotiation experience should be separately weighed from project development and execution experience. She observed that if the state wanted to develop the expertise in-house that this was not the project that the state wanted to "cut its teeth on." She noted that the project was one of the most complex in the world and that the learning curve would be steep.

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Ms. Poduval discussed Slide 18, "Does TransCanada Bear Any Financial Risk?" She related that TransCanada had committed to being involved in the project and had committed to commercial terms as part of the MOU. She said that the commercial terms that they had committed to, with the capital structure and the return on equity and cost of debt, was meaningful. She stated that given the scale of the project, the uncertainties associated with it, and how early it was in the development of the project, the financing was still far off. She said that locking in the capital structure before actual financial agreements were known placed a risk on TransCanada that they might not be able to match in the market what they had committed to using on paper as a cost to the state, which could result in an erosion of their earning from the project, as well as under earning on their ROE.

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Ms. Poduval spoke to Slide 19, "Does TransCanada Bear Any Financial Risk?" The slide depicted the effective return on ROE that TransCanada would earn if their actual capital structure and financing arrangements differed from what they had committed to in the agreement with the state. The

blue line, at the far left was what TransCanada had committed to with the state; a 75 debt, 25 percent equity and 5 percent cost of debt mix. She explained the TransCanada effective ROE under different financing arrangements. She pointed out that as that the ROE eroded the market would not allow TransCanada to borrow 75 percent of what they would need for the project. She furthered that the market could limit the percentage of debt that the state could borrow; if TransCanada had similar constraints at the time it was trying to borrow for the project, and were only able to borrow 70 or 65 percent of the project as debt, their effective ROE dropped.

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Ms. Poduval continued. She relayed that the risks faced by TransCanada were that its financial strength would erode from where it was today. She said that the MOU technically listed 12 percent ROE plus a "rate Tracker", which took away the risk of the general market cost of debt changing. She asserted that from a historic perspective debt was currently cheap. She said that the deal that TransCanada had with the state would not expose the company to the structural market risk of interest rates generally raising; however, TransCanada would be exposed to the weakening of its own financial balance sheet. She said that TransCanada is taking the risk of the effective ROE changing and underrunning relative to their expectations.

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Ms. Poduval discussed slide 20 (same title). She pointed out that the slide showed a similar framework to the previous slide but looked at NPV instead of the return on equity. She pointed out that TransCanada's NPV would decrease when the costs of financing project exceeded what it would recover from the state. She furthered that when moving across each of the lines on the slide, the NPV decreased as what the cost of financing the project exceeded what they would be able to recover from the state.

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Ms. Poduval addressed Slide 21, "Summary On 4 Key Questions." The slide reiterated the 4 core questions and provided answers. The total economic impact to the state from TransCanada would be that total cash flows would be

reduced by \$4 billion and NPV impact would be marginal. As to whether the state could go it alone; TransCanada could reduce the state's investment by \$4 to \$7 billion and the state could hit debt limits going at the project alone. She spoke to whether TransCanada was a good partner, pointing out that the company had experience in Alaska, comes in as a third party with incentive to expand the project, and has helped to keep the momentum going on the project. Finally, committing to the financing arrangements with the state so early in the project exposed TransCanada to risks from eroding the return on equity that they could earn on the project and in lowering their NPV. She concluded that these reasons highlighted why it made sense to have TransCanada involved in the project.

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Vice-Chair Fairclough asked if the state were to go forward alone like a corporation making the same investment, would the rate of return or lost opportunity cost be taken out later in the process and the money returned to shareholders, and would that effect tariff rates or other components of the project.

Ms. Poduval replied in the affirmative. She said that from the producer's perspective the entire project had to earn a certain return. She said that the concept of the project of allotment supported by future earnings was that each of the companies involved had an expectation that the up-front cash flows that were committed to the project would earn healthy returns.

^Presentation by Enalytica: Legislative Consultants Presentation on Costs of Momentum Delay.

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JANAK MAYER, PARTNER, ENALYTICA, spoke to the PowerPoint presentation prepared for Senate Finance Committee, February 21, 2014. Mr. Mayer turned to Slide 2, which offered a brief biography.

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NIKOS TSAFOS, PARTNER, ENALYTICA, addressed Slide 3, which offered a brief biography.

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Mr. Tsafos spoke to Slide 4. He offered 3 large ideas that would form the foundation of the work that would be presented to the committee as discussions on AKLNG continued, those being: competitiveness, project pathway, and project alignment. He relayed that where Alaska sat in the world, where Alaska was in the process and what could be expected over the next 6 years, and the possibility of switching from an in-value to an in-kind world would all be areas under discussion.

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Mr. Tsafos continued to speak to Slide 4. He and related that the message of the map was that Alaska was not alone in the world of oil and gas. He noted that he wanted to discuss several ideas in particular, specifically that it was tempting to look at all the obstacles that one is facing, while comparing how well others were doing. He pointed out that the slide illustrated that each place looked tempting from afar but that each of the competing suppliers had a number of challenges that they would have to overcome before they could get to market. He felt this was important to note because the project was, without a doubt, a very expensive project. He noted the general concern that the project seemed unreal given how expensive it would be. He reassured the committee that just because a project was expensive did not mean that it would not get built.

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Mr. Tsafos discussed Slide 5, which illustrated what the situation looked like in the mid to late 2000s. He said that at the time, things had looked positive, there were a lot of options. He detailed the different proposed projects illustrated on the map and revealed that most of them did not come to fruition. He stated that all of the action had happened in Australia and pointed out that it was not a low cost supplier; the lesson was not to despair because the costs were high. At the end of the day, the only thing that mattered was settling on a price that made the seller and buyer happy. He pointed out that there was more to having a successful project than just having a cheap supply.

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Mr. Tsafos spoke to Slide 6, which offered an overview on how the Queensland Curtis (QC) LNG project in Australia. He hoped that the slide would make the point that projects evolved. He opined that there was anxiety over how much the state should lock itself into a particular pathway, that the decision that the legislature made in 2014 would predispose future legislatures onto a specific path. The slide looked at three different snap shots at different dates along the project:

FEED (July 2008)

Size

One train: 3-4 mmtpa
Expandable to 12 mmtpa

Upstream

BG owned 9.9% of QGC and 20% of QGC's coal-bed methane in Surat Basin

Liquefaction

T1: BG 70%, QGC 30%

Off-take*

BG Group: 100%

FID (October 2010)

Size

Two trains 8.5 mmtpa

Upstream

All BG except CNOOC 5% and Tokyo Gas 1.25% in parts of Surat Basin

Liquefaction

T1: BG 90%, CNOOC 10%
T2: BG 97.5%, Tokyo Gas 2.5%

Off-take

CNOOC: 3.6 mmtpa*
Tokyo Gas: 1.2 mmtpa*
BG Group: balance

January 2014

Size

Two trains 8.5 mmtpa

Upstream

Gas from AP LNG; Same as FID plus CNOOC 25% in Surat and Bowen Basin

Liquefaction

T1: BG 50%, CNOOC 50%
T2: BG 97.5%, Tokyo Gas 2.5%

T3: CNOOC option for 25%

Off-take

CNOOC: 8.6 mmtpa*

Tokyo Gas: 1.2 mmtpa*

Chubu Electric: ~0.6 mmtpa*

External

Financing

JBIC: 175 mn to Tokyo Gas

US EX-IM: \$1.8 billion

*Off-take is supplemented by BG's global portfolio-not all LNG will come from Australia

He said that the first snapshot was at the front end engineering and design (FEED) stage, which was where the state would like to be in a year and a half to two years. He stressed that Alaska was well before the FEED stage. He relayed that the second column was the final investment decision (FID), which was when the real money would begin to be spent. He continued to the last column, January 2014, and noted that the project was not yet online. He reiterated that this was a project that had yet to ship its first cargo. He pointed out that the size, upstream, liquefaction and off-take all changed from the FEED stage in 2008 to FID in 2010.

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He said that the 2010 column represented what the project looked like when the BG and CNOOC went to their boards for funding. He pointed out that the January 2014 represented what the project looked like today. He relayed that this was a fairly typical evolution with LNG projects. He observed that the current discussion was about the state's equity shares, financing, participation, and off-take. He voiced that it might seem that the state was making long-term commitments, but they were not as rigid as they seemed. He repeated that LNG projects changed, sometimes quite dramatically.

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Ms. Tsafos addressed Slide 7. The slide intended to illustrate where the state was in the process. He offered that at this point the state was trying to get to pre-FEED. He offered that on the marketing level the state was reaching out to buyers to determine interest, MOUs and HOAs

could have been signed for the sale of gas, the focus was the marketing plan. He informed the committee that financing would be under discussion in the early stages. He said that the state would go into the FEED process with the goal of getting the final investment decision by approximately 2018. He furthered that after that discussions would begin about finalizing deals; who would the state sell the gas to and for what volume, price, and term. He stated that at this point discussions about secure financing and the signing of loans and a potential new partner search would occur. He continued to emphasize that the project pathway would be changing and dynamic.

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Mr. Tsafos continued to Slide 8. He communicated that the state had four pathways; the status quo had the state taking gas in-value and no ownership anywhere. The HOA potentially changed the first column on the slide from in-value to in-kind; the upstream remained at zero, but the GDP&Pipe and the LNG both went up to 25 percent, which made the state responsible for that capital expenditure. He added that the state's cash commitments would be principal in interest for any debt taken and the tariff would matter only notionally. The bottom two options on the slide pertained to the MOU and how it changed, which would be discussed at a later date.

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Mr. Mayer turned to Slide 9, which charted the FY15 production tax estimates using income state format from the Department of Revenue sourcebook, Fall 2013, page 106, under SB21. He related that alignment was crucial to moving any massive project like this forward. He said that the question of how the state derived value as the ultimate sovereign resource holder of the North Slope gas had prompted the conversation of alignment as an illustration as to why the state might want to think about ways of being better aligned with producers and the way producers generated value. He thought that it would be a helpful exercise to bring the world of gas back to the world of oil and compare them, highlighting the crucial ways that they are different, and why the question of alignment was critical.

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Mr. Mayer explained that the start was a gross value that was netted back to the well head by subtracting mid-stream costs, starting with oil at \$105 bbl West Coast price. He said that at the well head on the North Slope the price was approximately \$10 less because of the \$6 TAPS tariff as well as \$3.50 for marine transportation and some additional cost around quality backing and the like. He furthered that we then had an approximately \$95 barrel of oil from which would need to be subtracted out \$46 in lease expenditures. He observed that the question of credits had not been included because the focus had been to simply compare oil and gas.

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Mr. Mayer addressed Slide 10, which illustrated that price for Alaskan gas would be less transparent, less consistent by destination, likely to link to Japan Crude Oil Cocktail (JCC), and lower value versus oil. He emphasized that gas prices varied massively between different regions, they varied within regions and even varied within countries. He explained that the price of LNG was dependent entirely on the specific contract that a specific cargo was sold under, some was sold under long term contracts signed when the market was scarce, others when the supply was plentiful, some on spot prices. He reported that, generally, most LNG contracts were linked to crude oil. He remarked that a linkage to oil did not mean that the gas was priced the same, by and large it was priced at a discount. The contracts had a pricing formula that stated that the price of gas would have a certain relationship to oil where the same heat value of gas costs the same amount of the heat content of a barrel of oil. He stated that frequently LNG contracts did not have a steep slope in parity, if we were selling LNG into Japan on a .13 percent slope contract, the state would be getting \$81 bbl equivalent in terms of the heat content of out LNG and not the \$100 of the crude oil price even though the sale was happening under a crude oil liked contract.

Mr. Mayer continued to Slide 11. He relayed that the biggest difference between oil and gas was that the midstream for gas was nearly unrecognizable when compared to oil. He related that the tariffs for the combination of gas treatment and processing, pipeline and liquefaction, would be an order of magnitude higher; gas is significantly more expensive to transport. The tariff would not be

regulated by Federal Energy Regulatory Commission (FERC), FERC would regulate permitting and not rate-setting. He pointed out that whatever tariff was applied to the infrastructure would be highly sensitive to a range of assumptions used in setting the tariff; the capital structure and the initial cost of capital could each have an impact on the tariff paid by the state. The tariff was highly sensitive to capital structure.

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Mr. Mayer turned to Slide 12. He discussed the working of the tax calculation for gas. He said that if the gas were thought of in barrels of oil equivalent, instead of the \$100 bbl price we would be getting \$81 per barrel of oil equivalent for the LNG. He remarked that the entire midstream component would have a \$66 per barrel tariff, a large portion of the total value. He explained that what that meant was that even at high oil prices, netting back to the well head, the \$66 tariff in a \$100 bbl oil world would leave little value left to tax or as royalties. He stated that when \$6 was removed for lease expenditures there was only \$8.82 oil equivalent LNG left to tax. He contended that the debate surrounding what the tax rate should be for a very small number would be an even smaller number. He warned that small changes in the cost of the midstream or in the price could completely take away the states value altogether. He said that if instead of \$100 bbl the price dropped to \$89 bbl there would be no production tax value and only marginal gross value, even for royalties.

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Mr. Mayer spoke to Slide 14. He said that if tariffs rose by 12.2 percent it would wipe out any production tax value and leave only a sliver of value in terms of value of the royalty at the wellhead. He believed that the state should consider what the issues would be with a \$66 tariff on the midstream in order to bring itself into alignment with its partners.

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Mr. Mayer concluded that ensuring a fair market price for the gas received was critical in the gas world in a way that was taken for granted in the oil world. He stressed

that the overwhelming majority of the costs in the project would be in the midstream, which meant that was where the largest portion of the value would accrue. He contended that if the state remained a wellhead taxing, wellhead royalty generating entity, it was cutting itself off from a huge amount of the value in the project. The wellhead value would be insufficient to drive state take. He believed that discussions going forward would lead to understanding why the administration in what they had negotiated so far was looking at the question of participating through equity in a project of taking gas not as a value at the wellhead in terms of royalty or production tax value, but instead as a gas share of gas that would be transported through the state's infrastructure and sold into Asia.

Co-Chair Meyer discussed housekeeping.

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ADJOURNMENT

6:15:50 PM

The meeting was adjourned at 6:15 p.m.