THE ALASKA HIGHWAY GAS PIPELINE: A LOOK AT THE CURRENT IMPASSE

A REPORT TO THE ALASKA STATE LEGISLATURE

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JUNEAU, ALASKA

JANUARY 12, 1979

PREFACE

During the 1978 legislative session the legislature and administration in the State of Alaska were approached by the sponsors of the Alaska Highway Gas Transportation System with the request that the state participate in the equity financing of that project. It was expected that this proposal would be an important issue before the legislature during the 1979 session.

In order to assist the legislature in evaluating this project and establishing policies with respect to it, the Legislative Affairs Agency contracted with the University of Alaska's Institute of Social and Economic Research for the preparation of several analytic reports. The first of these, detailing the financial, economic, and political environment in which the gas industries operate, was published by the agency in November of 1978. The second study, presented here, looks more directly at the Alaska Highway Project, examining in detail the events that led up to the current impasse, and the options available for the state if it wishes to influence events in the future.

A third and final report, in addition to integrating the results of the first two studies, will examine various methods by under which the project might be structured to go forward. This final report will be submitted to the agency in March of 1979, and will be made available to the public shortly thereafter.

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Juneau, Alaska
January 1979

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INTRODUCTION: CRITICAL PATH VS. CRUCIAL ISSUES

In August 1978, when the Legislative Affairs Agency and the University of Alaska defined the scope of the present study, the Agency and the authors both felt a need to explore the "critical path" of events upon which construction of the proposed gasline depended. Our intent was to present a clear picture of how the myriad of decisions on detailed routing, engineering design, gas pricing, sales, rates of return, conditioning costs, tariffs, sponsorship, and so forth, all fit into the grand scheme of getting the Alaska gasline project organized, designed, financed, built, and into operation, and within that context to examine how and when State decisions on financing and royalty gas sales could or would have to be made.

During the 1978 legislative session, the pressure was on the State to act --- and act soon. The prevailing view within Alaska was that the eyes of the nation were turned northward, and that the State was in the spotlight to make the next move.

Under this assumption the Alaska Department of Natural Resources called for bids from potential purchasers of the State's royalty gas. The Governor and Legislature also responded promptly to the pipeline sponsors' request that the State establish a financing authority to issue tax exempt revenue bonds for the pipeline. But since no one really knew how much royalty gas was for sale, nor when it would be available (if ever), the solicitation evoked no serious bids; the financing authority proposal receded into obscurity with no serious attempt by the pipeline sponsors to obtain the necessary tax exemption from the 95th Congress.

After the 1978 Legislature adjourned, it became clear that further State action on gas sales and a decision on whether or not to participate in equity financing were not of critical importance -- at least not immediately. Instead attention turned to the President's energy program, with the future of the Alaska gasline ostensibly hanging on favorable Congressional action in setting a "wellhead price" and authorizing "rolled-in" charges to consumers. Action came in October with passage of the National Energy Act. Since that time, Northwest Pipeline Company (the project leader), the Federal Energy Regulatory Commission (FERC), North Slope gas producers, and Canadian interests have been passing the buck back and forth, dickering about incentive rates of return, Canadian exports to enable pre-building, the meaning of the pricing provisions in the new energy legislation, and conditioning costs.

But even these issues are not of critical importance. While it may be fashionable to focus on one or more of them and to blame FERC, Northwest, the producers, Canada or somebody else for holding up the project, each issue is only a manifestation of more fundamental problems. And while conflict over, say, the incentive rate of return may seem to be resolved at some point, something else will inevitably arise to cause trouble until the fundamental problems are dealt with.

At an early stage of investigation, the authors discovered that neither the pipeline sponsors nor the Federal Energy Regulatory Commission (FERC) had mapped out the critical path of the project for themselves. Northwest Alaskan had only a calendar of mileposts it hoped to achieve, while FERC had a meticulously detailed chart of its own internal procedures with repect to the pipeline, related at some points to required actions of other federal agencies. Neither party, however, incorporated into its diagrams the crucial prerequisites for financing of the project, nor the order in which they needed to be accomplished. This lack may not be a problem; however, a critical path chart is not only unnecessary at this time, but would probably be misleading. What is holding up the project is not the scheduling and resolution of a host of individual events -- incentive rates of return (IROR),[1] conditioning costs, gas sales contracts, etc. -- but a resolution of the basic question of <u>who</u> will bear <u>what</u> risks, and in return for what benefits?

Emphasis on specific events has tended to draw attention away from the more basic questions of risk allocation. Moreover, it will be impossible to determine how particular events must interrelate -- even to determine which events are part of the system -- until these broader issues are faced. Once the problems are in fact resolved, (assuming the resolution is sound) the scheduling of reports, permits, engineering designs, procurement, mobilization and the like, are no longer critical policy problems. The sponsors' engineers, construction managers, lawyers and contractors, together with an army of federal and state bureaucrats can work things out.

A good illustration of the difficulty of dealing with risk allocation in a piecemeal, sequential fashion is the current

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1. The President's 1977 <u>Decision</u> on the Alaska natural gas transportation system required the use of a variable or "incentive" rate of return to pipeline equity, which would reward the owners for controlling construction costs and penalize them for overruns. FERC is currently trying to put specific numbers (the "centerpoint" and "marginal" rate of return) into the IROR formula.

IROR dilemma. On the one hand, the governments of Canada and Alberta, the Foothills group (the Canadian sponsors of the pipeline), and even Northwest all maintain that they will not know whether their own equity participation makes sense until firm figures are set for equity rates of return. On the other hand, FERC maintains that specific figures cannot be inserted into the rate of return forumla until it is clear just how much risk the sponsors will bear. Hence, there is a stalemate; and a stalemate in which neither side is necessarily being unreasonable.

The crucial issues cannot be resolved sequentially. There is no critical path of such events that can work. The most important parts will all fall into place at one time --- or not at all. While this concept is difficult to accommodate within the rigid strictures confining most governmental actions, it is the conventional way of operating in the private sector --- at least for solving basic problems of project scope, organization and financing.

This point was recognized by Congress in the Alaska Natural Gas Transportation Act of 1976 (ANGTA), which preceded and directed Presidential selection of a transportation system for Alaska natural gas. That Act made special allowance for the executive branch to study and deliberate over the best means for moving Alaska gas, unhampered by the adversarial method of "adjudication" that is customary in public utility regulation -- a system that evolved to ensure accountability and to protect the public interest, but which inevitably causes confusion and delay where projects are large or the issues complex. While Congress provided an opportunity for continuing a flexible mode of deliberation and decision, even after the President selected a general system concept and a party to build it, the executive has thus far failed to make much use of this opportunity. The Federal Inspector called for in ANGTA has not been appointed, and FERC is making only limited use of the waiver of "ex parte" restrictions (which otherwise forbid the Commission and its staff any contact with interested parties outside of a public adversary proceeding), choosing instead to "negotiate" with the sponsors through a traditional semi-formal rulemaking process.

This paper will explore not only the fundamental question of risk allocation but also why both the federal government and the pipeline sponsors have failed to face up to the issue. Within this context we will lay out a variety of possible strategies for state action.

TROUBLING CHARACTERISTICS OF THE ALASKA GASLINE PROJECT

Almost everyone knows that the Alaska Highway gas pipeline venture is floundering: government officials, businessmen, bankers, and the press are expressing more frequent and deeper doubts about whether the project will be completed on schedule -- or ever. The problems and conflicts now confronting the pipeline project have grown out of three troubling characteristics: (1) its marginal economics, (2) the accompanying uncertainties and risks, and (3) the need for an explicit allocation of those risks.

1. Marginal Economics. A recent report completed for the federal Department of Energy [2] and submitted to the legislature in conjunction with the author's first report sets out the reasons why the Alaska Highway gas pipeline is a marginal venture at best from a business standpoint, and is subject to substantial risks of an ordinary commercial sort. It would still be a marginal venture if it did not face any catastrophic risks such as non-completion or enormous cost overruns. The precariousness of the gasline's economics contrasts sharply with that of the TAPS oil pipeline which, because of

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2. Arlon R. Tussing and Connie C. Barlow, Marketing and Financing Supplemental Gas: The Outlook for, and Federal Policy Regarding, Synthetic Gas, LNG, and Alaska Natural Gas. (A report to the federal Department of Energy). Anchorage: Institute of Social and Economic Research (1978).

the great margin between the cost and market value of the oil, has remained viable even in the face of huge cost overruns and a reduced throughput caused by the Congressional prohibition on exports.

Gas delivered through the Alaska Highway system would cost Lower 48 customers more than twice today's prices for fuel oil, and although oil prices are almost certain to keep rising, there is no assurance that Alaska natural gas will be saleable in competition with other fuels over the project's entire economic life. "Rolled-in" pricing of the gas at the wholesale and retail levels would reduce the marketability risk, but cannot totally eliminate it.[3] A "full cost of service" tariff coupled with rolled-in prices at wholesale theoretically would protect the pipeline and its investors from this risk by shifting the problem "downstream" to local gas distributors.[4] But even these devices beg the question: What would happen to the pipeline's finances if distributors could not or would not pay their bills, or if

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3. For an explanation of "rolled-in" and other pricing rules, see Tussing and Barlow, An Introduction to the Gas Industry (a report to the Alaska Legislature). Juneau: Legislative Affairs Agency (1978), pp. I-66; and Marketing (cited above), pp. II-61-89.

4. "Full cost of service" and related tariff concepts are explained in Tussing and Barlow, Introduction (cited above) pp. I-100, and Marketing (cited above), pp. II-34-36.

state utility commissions ordered them not to do so?

2. Uncertainties, Scale, and Resulting Risks. Catastrophies such as TAPS-like cost overruns, engineering or regulatory problems that would prevent completion of the project after actual construction had begun, or a prolonged interruption of gas production are not very likely, but they are clearly possible. The gasline project is so large that its failure would be devastating to the pipeline sponsors, the gas producers (if they were to sink capital into conditioning and other facilities in the field), the lending institutions, the economy of Canada, and the political fortunes of the Canadian government. The exposure of these parties is magnified not only by the huge investment required, but also by the span of time over which favorable conditions must continue --- several more years for project organization, followed by 3 or 4 years of construction and another 20-25 years of gas production, line operation and successful marketing.

3. The Need for an Explicit Allocation of Risks. Thus, investors in the Alaska Highway project face two kinds of risk: (a) the chance that the cost of Alaska gas will exceed its market value, even if there are no unpleasant surprises connected with the construction or operation of

the pipeline itself, and (b) the possibility of such surprises. The project can not be financed unless there is a creditworthy party or group of parties both large enough <u>and willing</u> to bear both kinds of risk.

Traditionally, large transportation projects have been "conventionally" financed, that is, in a way that the sponsors are assumed to bear all risks. "Project financing" as proposed for the Alaska gasline, however, is a relatively new technique in which the sponsors risk only their invested equity capital.[5] The sponsors will <u>not</u> be liable for debt service; all together, their net worth is not large enough to meet this responsibility even if they were willing to do so. Lenders, on the other hand, cannot afford to take <u>any</u> risks when the stakes are so great. They must therefore be assured that some other creditworthy party will assume responsibility for scheduled payments of debt and interest in the event of project non-completion or a shortfall in revenues during some 25 years of operations. The transfer of these risks onto such parties must, therefore, be tight, complete, and explicit --- especially for a project such as this in which any lender is asked to commit a substantial

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5. For an explanation of the project financing technique, see Tussing and Barlow <u>Marketing</u> (cited above) pp. II-29-46.

fraction of its total resources. This need for an explicit and satisfactory allocation of risks from the lenders' standpoint has not yet been satisfied, and the pipeline project will continue to flounder until its sponsors and the federal government address the problem directly.

PURPOSES OF THE PIPELINE AND THE PROSPECTS FOR PROJECT SUCCESS

The paramount reason the various parties have not decided who is to bear the pipeline's risks is the lack of agreement among them, and particularly within the United States federal government, about the purposes of the project:

> Is the pipeline an ordinary business venture (albeit a very large one) designed to move the reasonably certain volumes of gas deliverable from the Prudhoe Bay field at costs competitive with alternative fuels, while giving its sponsors a public utility-type return on their investment?
>
> Or is it, rather, a national or bi-national strategic enterprise, to (a) insure United States and Canadian economies against an interruption of Eastern Hemisphere oil imports even if the private commercial benefits of so doing are insufficient . . . (b) to open up the Arctic and provide spare capacity for future gas discoveries which, while now only speculative, may be many times larger than the known reserves at Prudhoe Bay . . . and (c) to tie together, materially and symbolically, the energy security and economic welfare of the United States and Canada?

In the 1975-76 debate before FERC's predecessor, the

Federal Power Commission (FPC), over the route of the Alaska natural gas transportation system, all parties tacitly assumed that the system ultimately chosen would be commercially viable <u>and</u> serve strategic purposes (though those purposes were defined differently by the competing applicants). The President's September 1977 decision and Congressional approval of that decision pointedly declined to face up to whether the pipeline should go ahead as an essential national project even if it could not be justified (or financed) on the basis of straightforward business calculations. In part, the Alcan system was chosen by the President and approved by Congress because it was the only one of the three proposals whose sponsors argued that they would <u>not</u> need any sort of government financial assistance.

This expectation may or may not have been realistic two years ago, when most energy experts in industry and government believed that the shortage of natural gas in the United States would continue to grow relentlessly, and that the only practical alternatives to increasingly expensive and insecure foreign oil would be Alaska gas, synthetic gas, and equally expensive but insecure imported LNG. It was, at worst, a widely shared expectation, given the assumptions that prevailed at that time. In the last few months, however, the economic outlook for the Alaska gas pipeline -- along with other supplemental gas projects -- has clearly and radically changed:

-- Instead of a growing gas shortage, the United States is facing at least a short-term surplus, while both Canada and Mexico are wrestling with the domestic politics of managing gigantic gas resources almost unimaginable two or three years ago.

-- It is becoming apparent that the demand for gas not only has tangible limits imposed by the cost of alternative fuels (chiefly oil), but that demand may indeed be approaching those limits, at least in some U. S. transmission and distribution systems, and even with the existing system of rolled-in pricing.

-- There is far less conviction among energy experts than there was only a year ago that there will be a world shortage of crude oil in the 1980's. Despite the current Iranian crisis, which permitted OPEC to raise prices sharply for 1979, many analysts now doubt that the real price of oil (and with it, the market value of gas) will continue to escalate.

-- Because of the current supply bulge, and because gas demand has not been growing at the rates projected in the past, Alaska gas may not be economically competitive or needed at least until several years after the planned completion date of the pipeline.

-- The prospect for an early connection of gas supplies from Canada's Western Arctic has been diminishing, because slower growth in demand and new discoveries in the Western Provinces have pushed back Canada's own need for frontier gas well into the next century.

-- With the now recognized magnitude of North Slope gas conditioning costs, the interest of the Prudhoe Bay gas producers in gas sales has weakened, particularly if they would be required to invest billions of dollars in conditioning and other facilities in the field.

One implication of these changes is inescapable: the Alaska Highway gas pipeline can <u>not</u> now be financed and operated as an ordinary commercial venture, even if it might have been so financed and operated under the assumptions that prevailed from 1974 through 1977. This assertion can remain even mildly controversial today only because the sponsors of the pipeline project, the President and the Secretary of Energy feel compelled to give lip service to the assurances about private financibility they made in 1976 and 1977, as if everything were still the same.

ORIGINS OF THE CURRENT IMPASSE

Two and three years ago the notion that a transportation system for Alaska natural gas could meet conventional market and cost-benefit tests was not terribly controversial. But it was also generally believed that financing such a system would require extraordinary measures to shift construction and operating risks to consumers, the federal government, or both. The two original applicants, Arctic Gas and El Paso, held that in addition to rolled-in pricing, the project would need an "all events full cost of service tariff,"[6] whereby consumers would pay all of the system's costs whether gas could be delivered or not, and federal loan guarantees.

While most of the private intervenors and governmental witnesses before the FPC agreed that some such measures would be necessary and acceptable, they did not agree on which ones. Consumer advocates and some state utility commissions vehemently opposed all-events tariffs, while Treasury Department officials were worried about the precedent that governmental backstopping of the project would establish. Treasury's concern is reflected in a July 1977

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6. For a discussion of "all events" tariffs, see Tussing and Barlow, Introduction (cited above), pp. I-100, and Marketing (cited above), pp. II-34-36.

interagency report to the President, Financing an Alaska Natural Gas Transportation System:

> One serious concern is that Federal financial assistance will create subsidies which may cause an underpricing of gas and a misallocation of scarce energy and economic resources. Another serious concern is that assistance by the government in this instance will set a precedent which will make it difficult to find willing parties to support other large energy projects without government assistance. Such a precedent could have long term adverse consequences for the national economy.
>
> Even if Federal assistance were ultimately found necessary to finance the project, it should not be provided in lieu of risk bearing by other parties. Direct beneficiaries of the project [Alaska and the gas producers] should remain obligated to bear the project risks to the largest extent feasible, and any taxpayer risk should be residual and subordinate.[7] [insertion added; emphasis in original].

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7. Report to the President: Financing an Alaska Natural Gas Transportation System. Washington: U. S. Department of the Treasury (Lead Agency) (July 1, 1977).

Members of Congress also were concerned whether any Alaska gas transportation system could be built without backstopping from the federal government. Observing the enormous overruns on the Trans Alaska oil pipeline, they feared that self-serving and unrealistic cost estimates by project sponsors, accepted by gullible government officials, would lead the FPC to certify one of the three proposed pipeline projects on the theory that it could be financed wholly by private capital --- only to have the sponsors come back a couple of years and several billions of dollars later appealing for the government to rescue a vital national effort on which thousands of jobs, and a large part of the nation's energy supply, now depended.

Congress deliberately and specifically addressed this concern in the Alaska Natural Gas Transportation Act of 1976, which required the President to submit:

> ". . . a financial analysis of the transportation system designated for approval. Unless the President finds and states in his report . . . that he reasonably anticipates that the system he selects can be privately financed, constructed and operated, his report shall also be accompanied by his recommendation concerning the use of existing

Federal financing authority or the need for new Federal financing authority.[8]

Members of Congress, to be blunt, wanted the President to assure them that they were not being gulled or sandbagged, and to let them know whether loan guarantees or subsidies were likely to be needed, <u>before</u> they voted to approve any Presidentially recommended gas transportation project. While they obviously would have preferred to find that a transportation system could be built without consumer or government guarantees of any kind, there is no evidence that either the executive branch or Congress had prejudged the issue in 1976.

A third contestant, the Alcan Pipeline group, filed an application in May 1976; Alcan asked neither for an all-events tariff nor for government backstopping; there were good reasons to believe that the Alcan proposal was less risky than its rivals. In its original form, at least, the Alaska Highway project would involve the smallest capital outlay among the three proposals. It would be built along-side an existing pipeline and highway, using conventional technology and conventional construction methods. The Canadian applicants had experience in building gas pipelines

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8. P. L. 94-586, Section 7(c).

through rugged mountains, muskeg, and permafrost --- building them on time and within budget. And the project was relatively immune from controversy over Native claims, environmental impacts, or safety.

In essence, the Alcan group distinguished itself from the other two applicants by its willingness to explore ways for reducing the uncertainties and risks, rather than simply loading those risks onto consumers and the government. A good illustration is Alcan's scheme to reduce the non-completion and cost overrun risks through collection of an additional pool of capital before construction even begins. Nevertheless, while Alcan was able to <u>reduce</u> many of the risks inherent in the rival proposals, unless the risks are effectively <u>eliminated</u> somebody still has to be willing to bear them.

Arctic and El Paso took a more forthright but politically difficult position in centering arguments on effective <u>risk allocation</u> through government and consumer involvement. On the other hand, Alcan took the politically attractive but impractical approach in centering its pleas on <u>risk reduction</u>, in hopes of eliminating the need for consumer or government support. Unfortunately, this latter approach moved well beyond promising simply to try harder than the other applicants to finance the line privately; instead the applicants gave at least the impression of an absolute "we can!" Today it is apparent that a strategy midway between the two extremes is the only realistic approach --- on both a practical and political level. Such a strategy would first entail a thorough attempt to reduce risks, in order to make government or consumer participation politically palatable; then efforts are needed to find ways to apportion remaining risks effectively and fairly among all "beneficiaries" of the project, including the federal government and consumers, but not just the federal government and consumers.

"HE WHO RIDES THE TIGER . . ."[9]

The Alcan sponsors had made the President an offer that was very difficult to refuse. He took their optimistic claims at face value, accommodated the Treasury Department's fears, and gave Congress the assurances it hoped to hear. In his Decision and Report, President Carter stated:

> The Alcan sponsors and financial advisors have stated the Alcan project can be privately financed. The financial analysis above supports this conclusion. Therefore, it is reasonable to anticipate that the Alcan project can be financed in the private sector.
>
> Novel regulatory schemes to shift this project's risks from the private sector to consumers are found to be neither necessary nor desirable. Federal financing assistance is also found to be neither necessary or desirable, and any such approach is herewith explicitly rejected.[10] [emphasis added]

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9. "... dare not dismount." (But what if he's been knocked senseless by the brush?)

10. Executive Office of the President, Decision and Report to Congress on the Alaska Natural Gas Transportation System. Washington: (September 1977). pp. 127.

Thus the project sponsors and the Administration hooked Congress --- and themselves. Their failure to address the financing question openly and realistically from the beginning has sowed seeds of suspicion that could well prove fatal to the project, or at least to its present sponsors, when and if they finally decide to ask for federal help. Moreover, the optimism of Northwest and the President that loan guarantees or unconventional tariff designs _would not be needed_ has seemingly been turned into a Congressional dogma that such assistance absolutely _shall not be given_.

The members of Congress who deliberated on and drafted the Alaska Natural Gas Transportation Act were fearful that something would be put over on them; later they were skeptical of the President's finding and took great pains to state their concerns and intentions. The report of the Senate Energy Committee approving the Presidential decision is worth quoting at length:

> While the Committee has reservations about the ability of the Alcan project sponsors to secure the necessary private financing, we are recommending approval of the President's Decision based upon the unqualified assertions

made by the administration and Alcan officials.

It is essential for the project's sponsors to proceed with their financing arrangements as promptly as possible. The State of Alaska, the producers, and most of all the project sponsors should bear in mind that the door to the Federal Treasury has not been left open to them. We have taken the administration's and the sponsors' assurances at face value and are placing our reliance upon them.

The Committee cautions the Administration and the sponsors against taking a back door approach to Federal financing. We are, of course, aware of the possibility that the Federal Energy Regulatory Commission may be tempted to devise a new type of tariff, or a special type of wellhead price policy, that would in essence be a "back door" or indirect approach with the same practical effect as direct Federal participation in project financing. We intend to monitor the project's progress closely and caution that financial "gimmicks" involving consumer risk-taking via the Federal Treasury or via special tariffs will

> not be tolerated by the Congress. [emphasis added] [11]

Congressional spokesmen reiterated this attitude once more in the Fall of 1978. The Conference Report accompanying the Natural Gas Policy Act stated that the conferees:

> . . . agreed [reluctantly, we must add] to provide rolled-in pricing for natural gas transported through the Alaska Natural Gas Transportation System and for the cost of transportation because they believed that private financing of the pipeline would not be available otherwise. Rolled-in pricing is the only Federal subsidy, of any type, direct or indirect, to be provided for the pipeline. [12] [insertion and emphasis added]

In short, the Alcan sponsors, in order to get their project chosen, offered the FPC and the President the optimistic financing forecasts they wanted to hear; the

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11. U. S. Senate, Committee on Energy and Natural Resources, To Approve the Presidential Decision on an Alaska Natural Gas Transportation System. Washington: (October 1977) pp. 13.

12. U. S. House of Representatives, Conference Report to Accompany H.R. 5289. Washington: (October 10, 1978) pp. 103.

President, in order to get his choice approved, told Congress what it wanted to hear. Both parties may well have been sincere (if naive) in their confidence about the basic soundness of the project. Federal backstopping, they seemed to believe, would be necessary (if at all) only to deal with extraordinary catastrophic risks, and not with uncertainty about the national "need" for high-cost supplemental gas. In any event, Northwest seemingly accepted an obligation to exhaust all possible efforts to put the project together <u>without</u> loan guarantees, price supports, subsidies, or innovative tariff provisions, before any of these measures could even be considered again. In our judgment, however, this charade has now become a waste of time, effort and money, and the longer it goes on the more it will erode the sponsors' credibility and that of the project concept itself.

The best and most powerful defense today against charges of incompetence or deception would be for industry and government spokesmen to acknowledge the changed energy outlook, particularly the changed supply and demand outlook for natural gas. Yet, this defense has been politically unavailable to the Administration over the last year. To acknowledge the change in outlook would have undercut the case for the President's energy program, whose major premises were a coming world energy crunch, and particularly the notion that the shortage of natural gas was the nation's most acute energy problem.

Northwest was in no better position than the Administration to call attention to the end of the natural gas "crisis," both because of its close political and personal ties to the White House, and because its management believed that pricing provisions in the President's legislation were absolutely crucial to progress on the pipeline project.

Passage of the President's energy program did not set the gasline sponsors and the Energy Department free to address the problems of the pipeline project openly and realistically, however. The fact that they had oversold the energy legislation to Congress as an answer to those problems became another compelling reason for reticence. The new natural gas law would not in fact have been enacted without the votes of a substantial number of members who supported it because -- and only because -- they thought that the legislation would clear the way for gas sales contracts and, ultimately, for the financing and construction of the Alaska gasline.

The theory was that a Congressionally determined wellhead price and Congressional sanction of rolled-in pricing would cut through the delays and legal uncertainties that are inherent in traditional FERC price proceedings under the old Natural Gas Act. Passage of the new law, gasline supporters believed, would remove the uncertainty that was keeping gas producers from signing sales contracts with potential shippers. Signed sales contracts would pave the way for transportation contracts, which would allow the pipeline sponsors to start lining up commitments for equity and debt financing. At the very worst, Northwest and the Administration believed passage of the Natural Gas Policy Act of 1978 would bring a quick test of whether or not the sponsors' financing plan would work without federal backstopping.

In this belief, both parties were probably sincere but quite wrong. The wait for passage of the President's energy program actually <u>delayed</u> this determination by at least a year, and the legislation has in fact created entirely new difficulties for the project. First, passage of the law does <u>not</u> set the wellhead price or define the terms of sale, either at the wellhead or to final consumers. It only marks the beginning of a rulemaking process by FERC that will be followed by challenges in the courts (a process that could just as well have begun as soon as Congress ratified the President's decision in favor of the Alcan system).

Moreover, the Natural Gas Policy Act has given the gas producers and the State of Alaska hopes of receiving a wellhead price ($1.45 plus inflation) that is considerably higher than the figures most commonly considered before the energy bill was proposed. It is true that the price provided by the Act is only a ceiling price. But even if that price would make Alaska gas unmarketable when conditioning and transportation costs are added, the producers and the State now have encouragement from Congress to hold out for an unrealistically high price.

Finally, it is not clear that the end-use pricing provisions of the 1978 energy legislation will help rather than hurt the gasline project. The law does provide Alaska gas with "rolled-in" treatment for its wellhead price and pipeline tariffs, as against "incremental pricing" for most other sources of high-cost gas. Yet the actual implementation by FERC and DOE of incremental pricing for any component of gas supply and of the Powerplant and Industrial Fuels Act (another part of the President's program, which prohibits the use of gas in new industrial boilers) could worsen the project's marketing outlook, by greatly shrinking the industrial and electric utility markets for natural gas --- and despite recent professions to the contrary by Administration spokesmen, that was the explicit purpose of these measures when they were proposed to Congress.

In any event, passage last October of the President's bill does <u>not</u> lead directly to negotiation of gas sales contracts essential for further progress in putting together the project's financing. Moreover, passage of the bill alone does not ensure that events will follow in a way that provides Northwest with an opportunity to go through all the motions which the sponsors may believe are required in order to keep faith with the President, Congress, and the public. There will yet be months of skirmishing among the interested parties before FERC and the federal courts over the meaning and implication of the new legislation. Gas producers and gas purchasers are not likely to sign definitive sales contracts until these debates are concluded. It is by no means clear that they will do so even then, <u>unless the questions of the gasline's basic economics and the allocation of risk also have been resolved</u>.

Since passage of the energy legislation last October, the authors have noticed a spreading suspicion (now hardening into conviction) in the gas industry, Congress, and even within DOE itself, that the Department is determined to reject every other major gas project application until construction of the Alaska pipeline is assured. If a strategy does indeed exist to kill off LNG projects, Mexican import opportunities, and imports of Canadian gas by anyone except the Alaska project sponsors, that strategy is again based upon the illusion that the Alaska gasline can be made financeable without a substantial federal commitment. At best such a policy will be as ineffective as its predecessors. More likely it will be counterproductive: The belief (right or wrong) that the Administration is using these tactics to help the project, and particularly the suspicion it is doing so to repay a political debt, is creating enemies for the pipeline where they did not exist before and is undermining credibility that will be indispensable to DOE and the President when and if they finally decide to confront the real problems of pipeline finance.

With such a background, it is little wonder that neither the federal administration nor the pipeline sponsors have been eager to raise the issue of federal backstopping. Both parties are damned if they do and damned if they don't: the project is essentially stalled, but if the sponsors now admit that the line might not be built without government help, many members of Congress will believe (as indeed they may already believe) that Northwest and the President deliberately and systematically misled them about the need for federal support. As one relatively sympathetic senior legislator told the authors, "We knew there could be financing problems when we approved the President's choice. I asked [a Northwest official] what would happen if they couldn't raise the money in the market; all we got was [a former western governor who was lobbying for the project]'s assurance that everything had been taken care of. Now, I don't know what we could do for them if we wanted to . . . if only they had leveled with us from the start!"

There is an ominous similarity here to the TAPS debate, during which the oil companies, the federal administration and the State of Alaska assured Congress that North Slope crude oil would all be absorbed on the West Coast of the United States, and that none of them remotely contemplated shipping oil to Japan. A less dogmatic and confident posture -- together with a straightforward explanation of the circumstances in which exports of Alaska oil might be in the national interest -- would not have defeated the oil pipeline. But even today, there are members of Congress who adamantly oppose exports of Alaska oil largely because they were "lied to" in 1973. In the TAPS case, the pipeline sponsors at least got the construction permits they were seeking; with the gasline today, widespread resentment in Congress could kill the project.

In the final report of the present series, we shall review possible strategies for dealing with both the ordinary commercial risks of the project and the extraordinary risks it faces because of its great size. At the moment, however, we do not see any surefire (not to mention comfortable) way out of the sponsors' political dilemma --- how to acknowledge that the project is stalled, and how to identify correctly the problems that have to be solved to get it moving again.

STRENGTHS AND MERITS OF THE ALASKA HIGHWAY PROJECT

It is only fair to temper the preceding pessimism with a review of the strengths and merits of the Alaska Highway project. It still represents the largest single addition to the supply of clean energy that could be brought on stream from proved domestic resources with proved technology. There is probably no other group of domestic energy supply projects of a similar magnitude that involve lower levels of safety and environmental risk, or at least involve less <u>controversy</u> over environmental and safety impacts. The Alaska Highway gas pipeline project is the only major U. S. energy project, to our knowledge, which owes its approval in part to endorsements from the Sierra Club, Friends of the Earth, and the Wilderness Society. The pipeline itself remains uncontroversial (except with regard to its method of financing and the credibility of its sponsors); it is still without real enemies (except for corporate sponsors of rival projects and their financial advisors) though this may be changing. Almost every sectional and sectoral interest in North America has indicated it can at least live with the proposed system.

The Alcan system was chosen by the U. S. and Canadian governments over its rivals in a remarkable cooperative effort involving many agencies of both governments, which cut through the conventional adversary processes to arrive at a compromise substantially different from the system proposed by any single applicant. While one might question individual decisions of the Canadian sponsors and governmental authorities, Canada has been and remains totally loyal to the project, and the private and governmental parties in Canada generally have lived up to their commitments.

Northwest and Foothills were in part chosen to build the system because of their foresight in recognizing changing market conditions in Canada, because of a far greater sensitivity compared to their rivals about environmental concerns and Native claims, and because of their flexibility --- their willingness to change design and organizational strategy to meet the two governments' changing perceptions of the transportation system's purposes.

As a practical matter, the Alaska Highway pipeline (at least its distinguishing features) is the <u>only</u> transportation system for North Slope natural gas that is likely to be built in the near future --- if any is to be built at all.

Of the four proposals before the FPC and Canada's

National Energy Board (NEB) in 1976, the Alaska Highway system remains the only one that would have the remotest chance of success today. If this project appears uneconomic or risky now, it is far less so than the Arctic Gas, El Paso, or Maple Leaf schemes would have been. The relative advantages of the Alcan project over its rivals have grown since the President's decision, as the lack of Canadian markets for frontier gas, the West Coast energy surplus, and the difficulties in siting a major LNG terminal in California have become more obvious.

Now that the project seems to be stalled, it is fashionable to deride the amateurism, financial weakness, and opportunism of the sponsors, and Northwest in particular. While these charges may not be entirely unjustified, we cannot regard the Alcan group's sins or handicaps as graver than the inflexibility, arrogance, and political unrealism of their former rivals, El Paso and Arctic Gas.

Because of the web of mutual obligations binding the Administration to the present pipeline sponsors, moreover, it is fruitless to think of giving the project new momentum and direction by making Northwest Pipeline Company the scapegoat for the impasse, and displacing the company from its leadership position, at least so long as Jimmy Carter is President of the United States. Nevertheless, Congress may be so moved. And after all the effort that went into the project's birth, it seems remarkable that the project may now be allowed to die of attrition and frustration simply because the sponsors are too politically embarassed to admit they need help, and because the federal government refuses to face up to the question of <u>why</u> it wants a pipeline for Alaska gas <u>now</u>, and what responsibilities it is willing to accept if the project can not stand alone as an ordinary commercial venture.

Two years ago, in claiming that wholly private financing was possible, the President and Northwest may truly have believed what they were saying; they may even have had a plausible case for doing so. Today their failure to confront what has now become obvious can not be judged so leniently. However difficult it may be to acknowledge changed circumstances and however grim the prospects in Congress, facing up to the impasse can not be as damaging to the project as continued drift and evasion. Understanding of the problem is so widespread -- if not fully articulated at least intuitive -- that no matter when the charade breaks down, no one really ought to shoulder the blame. Who can be blamed for failing to foresee the recent Mexican and

Canadian discoveries? Who can be blamed for misjudging consumer demand and failing to see the now evident market value limitations of natural gas? Almost everybody is to blame; therefore nobody is.

AN HISTORICAL PARALLEL

Putting the problem in perspective, there is nothing inherently evil if one tries to do the optimum, fails, and ends up settling for something less. A close historical parallel occurred more than a quarter century ago. It is the story of the TransCanada gas pipeline, which now extends from the Alberta gas fields to Montreal:

-- TransCanada was plagued with marketing uncertainties because there were no established gas markets in eastern Canada; it was recognized that even under the <u>best</u> possible circumstances a subsidy would be needed for at least several years.

-- Getting the project off the ground required an elaborate arrangement whereby Canadian gas would be exported temporarily into the north central United States, and U. S. gas would temporarily be imported into Eastern Canada. (This arrangement had the dual advantage of creating domestic markets for U. S. gas and Canadian markets for Canadian gas. FERC should note that the FPC dragged its feet for years and almost killed the project despite intense diplomatic efforts by Canada.)

-- Largely because of technological unknowns (constructing a gasline over and through the bedrock barrens and muskeg swamps of the Canadian Shield), lenders could not be found to finance the western Ontario section of the line in the absence of government risk-bearing.

-- The line was built in two stages, with the first part put into operation before construction of the second part was even begun.

-- The choice of route and design for the line was highly politicized and economic concerns were to some extent overridden by nationalistic and sectional issues.

-- For six years the sponsors (actually, several groups of sponsors) and the government worked together to find a way to finance the pipeline without government support. Failing that, an approach was finally negotiated in which government bore enough of the risks to attract required amounts of equity and debt capital.

-- One of the most divisive internal conflicts in Canadian history raged in Parliament on the question of government participation, and what form it should take. In the end, TransCanada won; but the majority party that had put the deal together was so damaged by the struggle that it lost the subsequent election.[13]

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13. U. S. federal officials should note that it was not advocacy of federal aid for TransCanada per se that fatally damaged the St. Laurent government, but its deviousness and heavyhandness in pressing for Parliamentary approval. The whole fascinating story is found in: William Kilbourn, PipeLine. Toronto: Clarke, Irwin and Company, Ltd. (1970).

THE NEED FOR COOPERATION AND REASONABLENESS

Before an Alaska natural gas transportation system can be organized, financed, and constructed, active cooperation of one sort or another is needed from a financially strong enough group of gas transmission company sponsors, and from the same or another group of creditworthy gas transmission companies willing to buy the gas and contract to ship it; from financial institutions willing to lend short-, medium-, and long-term debt capital; and from federal regulatory bodies in the United States and Canada. The project requires, in addition, at least a sympathetic accommodation from the State of Alaska, and perhaps from the Western provinces of Canada and regulatory bodies of the major consuming states in the Midwest and California. Above all, of course, the project requires an unwavering federal commitment.

The degree of commitment by various parties to the pipeline project is a subjective matter, and may be judged differently by the parties themselves. It appears, however, that the only parties now unconditionally committed to the project, and making wholehearted and serious efforts for its success, are some (but not all) of the Alaskan Northwest partners, the Foothills group, and the government of Canada. The United States government (through the decision of the President and Congressional approval, and FERC's conditional certification), the State of Alaska, and the remaining members of the Northwest partnership nominally support the project, but in each case with some confusion, ambivalence or reservations. None of them, in any case, regards itself <u>responsible</u> for the success or failure of the venture, and each is waiting upon the actions of others.

Other parties whose cooperation is necessary to the project (such as the gas producers, several potential gas purchasers, and the big lenders) would like to see this project or a similar one succeed, but they are in essence just waiting to see what happens, without making any efforts or taking on risks to move it along. Finally, there are a few parties -- most of them U. S. or Canadian gas transmission companies and their financial advisors -- whose cooperation may eventually be necessary to the project as gas purchasers and shippers, but who will support it if and <u>only if</u> its completion is assured; in the meanwhile, they favor rival projects or a reorganization of the present project under different leadership. These parties would not be displeased to see the venture fail, and might well use whatever opportunity comes along to obstruct it.

The economics of the project are so fragile, the risks so large, and the number of crucial actors and actions so diverse, that the project can not possibly succeed in the face of active opposition, unrealistic or unreasonable demands, or even poor judgment or clumsy management by the sponsors, the producers, FERC or other units of the Federal Energy Department, Canadian interests, or Alaska. Thus, several parties each have the power <u>to kill</u> the pipeline project, at least as it is now planned, organized and scheduled. The State of Alaska is clearly one of these parties: there is no doubt the State could impose sufficiently onerous tax and regulatory burdens to make any pipeline unprofitable. Considerably lesser burdens or even their serious consideration by the legislature could be enough to frighten off lenders. In addition, entirely plausible pronouncements or actions of the Department of Natural Resources or the Oil and Gas Conservation Commission could create sufficient doubt about gas deliverability to keep a pipeline from being financed.

An accumulation of individually reasonable demands could also have a seriously adverse impact on pipeline economics. The State cannot expect to bargain for and get all the benefits Alaskans now anticipate from pipeline construction and operation. Demands for a high wellhead price (and thus high royalty and production tax revenues), high taxes on pipeline property and income, liberal tariff terms for gas taken out of the line in Alaska, the ability to sell gas for out-of-state consumption now and to retrieve it later for use within the state, extraction of gas liquids for industrial use in Alaska, local hire, and exceptional measures to protect the environment or to protect and aid impacted communities, not only are competitive with one another but, also, if too many demands are pressed too far the project cannot succeed.

The same considerations apply to other parties with an influence on the gasline venture: the producers with respect to the wellhead price and responsibility for gas conditioning; the project sponsors and governments in Canada with respect to the return on Canadian equity, "Canadian content" (purchases from Canadian suppliers), provisions for a future connection to the Canadian Arctic, levies to cope with socioeconomic impacts in the Yukon, and federal and provincial taxes; and the United States federal government with respect to final consumer pricing rules, environmental and safety protection, provision for low-cost future expansion at the expense of higher costs now, and affirmative action for Alaska Natives, other minorities and women. In short, the Alaska Highway gas pipeline can not be regarded as a Christmas tree with loads of goodies for everyone in its neighborhood (as the oil line was treated). As a privately or even publicly financed business venture it can succeed (if at all) only if all the affected parties are reasonable in their expectations and demands.

Right now, the expectations of the various parties, including the State of Alaska, are cumulatively far from reasonable, as are some of the individual commitments already made --- for example, the $1.45 plus inflation wellhead price offered by the U. S. Congress, and a 16.0 to 27.2 percent range on return to Canadian equity granted by the NEB. If there were yet any chance the project could succeed as a self-sustaining business venture, burdens such as these would surely scuttle it. Open-ended consumer or governmental subsidies and guarantees, on the other hand, could make these or virtually any other exaction by any of the parties attainable. But if such backstopping measures are in fact necessary to make the pipeline viable and finance-able, any price for the gas substantially above the cost actually needed to deliver it, and any return to equity above the market rate on very low-risk investments would be an unnecessary, unreasonable, and unfair imposition on U. S. consumers or taxpayers.

WHO IS CAPABLE OF BEARING THE ULTIMATE RISKS?

The question of who bears the ultimate risks is the real crux of the pipeline's problems. Because of the federal government's reluctance to define the national purposes of the pipeline and to face its own leadership and financial responsibilities, the Treasury Department, the President, and (taking a cue from them) Northwest Pipeline Company identified the State of Alaska and the gas producers as major "beneficiaries," who should take on or share the pipeline's construction and operating risks.

For several reasons, neither the State nor the producers could serve as effective guarantors of last resort for pipeline financing even if they wished to do so:

> -- Neither the producers nor the State controls wellhead or end user prices, the rates of return on U. S. and Canadian equity, federal and Canadian taxes or any of a dozen other crucial economic parameters. Thus, credible financial guarantees by the State and the producers would only signal to all other parties that they are free to extract as much from the project as each of them individually viewed as fair and reasonable. Alaska and the gas producers could therefore end up subsidizing everybody else to the extent of

their backstopping commitment. This tendency could go full circle and leave the project just as risky as it was before.

-- No prudent person will take on a contingent business liability, that is, cosign a loan, without collateral or other recourse against the primary borrower in case of default. The President's decision selecting the Alcan system incorporated a Justice Department recommendation that the gas producers be forbidden to hold any <u>equity</u> interest in the pipeline. By denying the producers the opportunity to protect themselves by taking over the pipeline if they had to bail it out, the President totally eroded any chance that might have otherwise existed for producer <u>debt</u> guarantees.

The creditworthiness of the State and the major North Slope producers (perhaps excluding Exxon) depends overwhemingly on their income from oil production at Prudhoe Bay. While the present cash flow of the producers and the State seems relatively secure, some of the very dangers against which the big lenders want their gasline debt to be protected -- for example, unforeseen production problems at Prudhoe Bay or a collapse of world oil prices -- also could jeopardize the value of their North Slope oil properites and hence their ability to make good on any guarantee. Thus, the "Big Three" institutional lenders -- the Prudential, Metropolitan and Equitable Insurance Companies -- are likely to look with some skepticism on loan "guarantees" that <u>compound</u> rather than offset their present commitments to the North Slope petroleum economy.

Most important of all with respect to State assumption of risk may be the fact that no State financial guarantee would be truly credible to the major lenders of long-term debt, essentially the Big Three companies and the smaller institutional lenders who take their lead from the Three. These institutions are convinced (justifiably we believe) that if construction, operation, or marketing difficulties forced the State to make good on any deficiency in pipeline revenues pursuant to a loan guarantee, Alaska would try to recoup those losses by means of higher taxes on oil and gas production, or on a profitably operating TAPS oil line. The North Slope producers as owners of the Alyeska pipeline are already among the largest borrowers from these same financing institutions. The Big Three, therefore, will not regard any backstopping by the State of Alaska as a true assumption of risk, but rather as a shift of risk from the gas pipeline bonds these companies are now being asked to buy to the oil company pipeline bonds the same companies already hold.

In our view, among all the beneficiaries, only the federal government is large enough, and only the federal government can capture enough of the non-marketable benefits of the project, to be able and motivated to provide the essential financial guarantees. The forms these guarantees might take will be examined in the final report of this series.

CONCLUSIONS AND IMPLICATIONS FOR STATE ACTION

The preceding pages developed the following points:

(1) Some very substantial problems currently block progress in putting together a pipeline package that private investors (equity as well as debt) will find attractive. These problems center on the need to apportion the risks and benefits explicitly among all involved parties --- the project sponsors, the gas producers, the gas purchasers, the State of Alaska, the Canadian government, large institutional lenders, the U. S. federal government, and final consumers --- in a way that all will find acceptable. This task becomes even more difficult when one considers that while the project may make strategic sense, from a strict business standpoint it is clearly marginal at best.

(2) Of all the involved parties, the only ones financially capable of bearing a substantial part of these burdens are consumers and the U. S. government, and possibly Canada or one of the three major producers (Exxon). Of these, only the first two have any reason at all for taking on such risks, and those reasons are weakening. And yet, the President's Decision approving the Alaska Highway pipeline application and subsequent actions by Congress expressly prohibit substantial government or consumer risk-bearing.

(3) Both the present project sponsors (really only Northwest since the others joined the partnership after Northwest had made promises to the President and Congress) and the current federal administration stand to lose not only face but much more if and when the above points are acknowledged. Northwest may be charged by Congress with deliberate deception, and is a handy scapegoat for demands that the sponsorship be moved into other hands. Likewise, the Carter Administration could come under similar Congressional attack, while the federal government as a whole stands to set what it considers a dangerous precedent if it does acquiesce to substantial government or consumer risk-bearing. Hence, there is a tremendous incentive for both the current sponsor and the administration to avoid confronting the issue, waiting perhaps for divine intervention. Added to this is the fact that neither party is really in a position to set the other one up as the maligning force and then prompt a showdown; President Carter and the chairman of the principal sponsor (John McMillian) owe each other profound political debts. In effect, both parties are in a box: they can each jockey for position within that box (as they are doing now) but they cannot step outside its bounds.

What does all this mean for the State of Alaska? On the surface it looks as if the State can avoid for at least another year confronting the difficult policy questions: (1) does the State want to contribute risk capital to assist the project? and (2) what should be done about the royalty gas? After all, until the fundamental risks are explicitly apportioned, it is impossible to make prudent judgments, either on the soundness of financial involvement or on how critical State financing or royalty decisions are to the project's success. Moreover, unless Northwest or FERC is excessively naive about the State's comprehension of these points, neither of these parties will be putting much pressure (at least directly) on the State to reach decisions during the 1979 legislative session.

Before the royalty gas and financing questions are brushed aside and set on next year's agenda, let us first examine what the outcome may be when the federal administration, and ultimately Congress, finally confront the necessity for substantial consumer and government risk-bearing.

Very recently the Carter Administration has been doing its best to undermine all rival high-cost gas projects. The LNG projects systematically are being killed. Even the SNG projects (so essential to the Department of Energy's public rhetoric) are lost in a battle between FERC and DOE's own Economic Regulatory Administration (ERA) --- the ERA being unwilling to authorize government backstopping (even though Congress did give conditional approval to the concept last year) and FERC steadfastly refusing to grant full consumer guarantees. No attempt to resolve this in-house clash at a higher level is apparent. Moreover, the January 10 Washington Post reports that Secretary Schlesinger openly linked DOE's lack of enthusiasm for Mexican gas imports directly to a preference for building a system to move Alaska gas.

Nevertheless, even if the Administration were willing to do everything in its power to destroy all rival projects, that policy would not be enough to salvage the Alaska gasline unless the government were also willing to take on some of the risks it has, to date, refused to contemplate. Added to this problem is the very real possibility that blunt actions to stifle competing sources for the express purpose of making room for Alaska gas may very well stir the ire of Congress and prompt retaliation.

Hence, there is a very real chance that the Alaska Highway project may be scuttled or at best put on the back burner. The government may well decide that the gas is still needed --- but that it is not needed now. Any among a host of reasons can provide the federal government with convenient (and even sound) pretexts for avoiding the unpleasantness of invoking consumer or government guarantees to rescue a huge and ailing project. These include: recognized limitations on consumer demand for increasingly high-cost gas; the prospect of other relatively secure sources (Canada and Mexico); and the prospect of substantial new domestic supplies prompted by higher prices and relaxation of the barriers between inter- and intrastate markets. Now that the traumas of the embargo and price upheaval of 1973-74 are receding into history, the initial extremist slogans (e.g. U. S. energy "independence") are giving way to a more moderate and cosmopolitan approach emphasizing diversity of import sources. The very notion that energy is America's number one problem has lost its force; inflation has become a more fashionable rallying point, and unfortunately with respect to the gasline, a victory on the energy front can only be secured with a substantial loss in the war against inflation.

The other possible outcome is that the federal government may resolve to assume the burdens that no one else is able to carry. However, it is virtually certain that federal backstopping can be made politically palatable <u>only</u> if the other parties who stand to benefit likewise bear their fair share of the burdens. No matter how important the gasline might be to the federal government in a strategic sense, the government cannot be expected to bear all the risks if the producers, sponsors, Canadian interests, and Alaska are going to extract "unearned" economic benefits. This concept was repeatedly stressed throughout the President's Decision and backup documents:

> The risks associated with the construction and operation of the Alcan Project must be assumed by creditworthy parties in order to achieve private financing. There is sufficient credit support capacity among the direct beneficiaries of the project to assure completion of the pipeline without assistance from consumers. Such beneficiaries are the gas transmission companies, gas producers, and the State of Alaska. The benefits to these parties sufficiently outweigh the risks associated with the project so that it is reasonable to expect them to provide support at small additional cost to consumers.[14]

The problem with the above conclusion is that the President's report expected the producers, the State of Alaska, and the gas transmission companies to agree to bear risks that they would be largely unable --- and probably foolish --- to take on. The expectations were unrealistic;

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14. Decision and Report (cited earlier), p. 102.

even so, the President's policy thrust is valid. While the so-called "beneficiaries" of the project cannot be the ultimate and full risk-bearers, there are certainly more moderate approaches for extracting sacrifices sufficient to facilitate financing and which these parties are capable of carrying (and maybe even willing to carry) <u>provided that the federal government and consumers as a whole take on a larger share than they have yet accepted.</u>

Whatever the resolution of the current impasse, it will be objectionable to at least some important factions in Alaska: either the project will die for the foreseeable future, or the State will find itself being "asked" --- not by Northwest but by the federal government --- to assume certain explicit burdens. In the latter case, it will be very clear that federal willingness to provide the necessary backstopping (and thus the future of the project) depends on some state sacrifice, or at least upon sharply reduced expectations of benefits from the gasline. It will no longer just be "very important" for the State to take a particular action (as Northwest advised last year with respect to State financial participation) but it will become "absolutely essential" for the State (and other parties) to do something which is yet undefined.

In summary, Alaskans may decide that construction of the gasline and resulting ability to move gas from Prudhoe Bay are a Good Thing for the state regardless of any other benefits it may produce. The compromises needed to get the system built and into operation, however, may leave precious few ancillary benefits to divide up among Alaska communities and interest groups, and may additionally require the State to bear some financial risk.

ALTERNATIVE POSTURES FOR ALASKA

It is thus apparent that Alaska would be foolish to commit itself now to participate in gasline financing. Nevertheless there are several plausible attitudes the State could take toward this and other pipeline issues during 1979. Possible State postures range from total passivity to an attempt to exert overall leadership in putting the pipeline project together. Between these extremes lies a continuum of more responsible and realistic approaches, which can be divided into three general types: Defensive, Offensive, and Strategic.

The following pages will examine briefly some of the pros and cons of these three postures, and the purposes for which they might be employed.

Posture # 1 - Defensive

The first approach is grounded on a belief that for one reason or another, it is best for the State to avoid any direct responsibility for progress of the pipeline, but that it is nonetheless vital for the State to take some action to protect its interests and to stake out bargaining positions. The driving force to take <u>some</u> action can be either concern that the State might be stuck with the blame of project failure, or recognition of a need to at least keep up with the other parties in asserting its interests and reacting to their proposals.

This description corresponds most closely to the posture that both legislative and executive branches have taken in the past year. The executive has consistently filed testimony on proposed FERC rulemakings. The IROR rulemaking is most notable, but pipeline design was another topic that prompted State reaction. Likewise, the executive and legislature did take action in response to federal and sponsor pressure last spring urging the State to issue $1 billion of tax-exempt revenue bonds to be used as pipeline debt capital, and $500 million of State equity in the form of preferred shares. When the legislature satisfied itself that it faced no serious risks in doing the former, a bill setting up a process to issue such bonds was passed (SB 603), but even then final approval was deferred. Further, about a dozen specific conditions were attached to the bill and it, in effect, became a vehicle for staking out territory and putting the State's interests on record. To respond to the equity request, a committee was appointed by the legislature to study the question (SCR 102).

Looking back on those actions, it is now difficult to think of any other approach the State could have taken that would have been as effective in protecting the State's interests in the face of enormous unknowns, yet at the same time enable the State to pull its weight in the drive to "keep up the momentum" --- which was a very real and legitimate concern last year.

This year, any of four reasons would be sufficient to continue this approach:

(1) It is probably the best back-up position to take if there is no real impetus or consensus for assuming a more active role.

(2) It is probably the best approach if one does not particularly care one way or the other about the project, or if one would rather see it die (for environmental, social, spiteful, or whatever reasons) or postponed (possibly due to field production uncertainties), yet at the same time one does not want to voice those feelings openly.

(3) It is probably the best approach if one feels the situation is hopeless --- that there is no way the problems can be resolved (at least in the near future) and resolved in a way tolerable to the State's interests, and that there is no point in the State spending much energy on the whole thing.

(4) Likewise, the approach makes sense if one believes that while the situation may not be hopeless, the State is in no position or is simply unable to act effectively and with sufficient finesse to do any good, and at the same time keep out of trouble.

Posture # 2 - Offensive

The State could take an approach in which it would be the first to lay its cards on the table, hoping that others would then do the same. It could, for example, make a commitment to follow through on a particular action (say, taking a specific financial position in the pipeline venture) if certain enumerated conditions were to occur first. The State would thereby stake out its own position on the risks it is willing to bear and the benefits it expects in return. A variation on this theme would be for the State to issue an ultimatum, declaring that it will not even consider taking a stand on a particular action until certain conditions are met.

On the one hand this posture could be an effective way to jar things off dead center. But it might have a debilitating effect as well --- what if the demands made by the State prove to be unrealistic and unachievable? One can only conjecture whether laying out demands that may later prove impossible would have a more deleterious effect than doing nothing at all. One likewise can not be sure that the State would escape blame for killing the project when and if the other parties finally abandon the myth of private financing.

A real difficulty in this approach centers on internal Alaskan considerations:

-- How realistic is it to expect that the Governor and sixty legislators could arrive at a consensus on specific preconditions at this time?

-- What would these preconditions actually mean . . . a bargaining stance from which the State expected to retreat? the package the State believed was reasonably fair to all parties, and achievable? the bottom line from which no retreat would be tolerated?

-- Would other parties understand what the State really intended by its list of preconditions? would they believe what the State said about them?

-- What is the danger the State might give away too much too soon? or be unable to retreat from a position that turned out to be unattainable, because it had developed an implacable in-state constituency?

-- Finally, is it possible for an open government to arrive at a public position and at the same time keep its true strategy and bottom line secret from those with whom it has to bargain?

Before State officials take any more steps in this direction, we suggest that they frankly assess the outcome of last year's legislative action. Creation of a pipeline bonding authority was conditioned on a list of demands, some of which are clearly unreasonable or unattainable in light of present conditions. What effect --- positive or negative --- has setting out these preconditions actually had? What effects will it likely have in the future?

We also advise a reflective look on one of last year's biggest controversies --- the ALPETCO royalty oil contract. While such introspection runs the risk of exhuming old hostilities, it does present some comparisons and contrasts that should not be overlooked.

Before royalty oil bids were even solicited, the State chose to set out a list of conditions, most notable of which was the in-value price floor. The solicitation prompted several responses and the process of negotiation began. Right from the start it was apparent that most, if not all, of the companies had no intention of meeting that pricing mandate. Why had they bothered to bid? Because these private companies expected to find a process of negotiation similar to that in which they were used to dealing; that is, a process in which both parties initially stake out unattainable demands then slowly back down until an agreement is reached. Hence, the initial pronouncements were not taken too seriously.

The Administration, however, had no intention of backing down from its original position. In any event, once that position had been announced, it was very unlikely the legislature or the public would have tolerated any retreat from it, or at least would have severely berated the State's negotiators. This intransigence reflected the fact that the situation was not one in which the State <u>had</u> to find a buyer for its oil, since an inability to do so would only mean a continuation of in-value taking. The State could comfortably afford to wait until some buyer (if ever) was willing to meets its non-negotiable demands.

It took a long time for the bidders to accept this inflexibility --- most of them assumed the State was seeking the best terms it could get for its royalties, <u>compatible with the overriding objective of getting a refinery or chemical plant built</u>. At the eleventh hour, one bidder was finally willing to accept terms that (at least in the view of most industry observers) totally precluded the financing or profitable operation of a petrochemical plant or refinery.

One can defend such an approach as nearly risk-free when royalty sales are the issue. What if it does run the risk that the successful bidder might actually be the most naive or disingenuous of the lot --- and hence the least likely to carry out its plans? What has the State lost? The governor had made it clear from the beginning that he didn't want a refinery or petrochemical plant if it required discounting the royalty oil price or any other sizeable state subsidy. With respect to the gasline, however, an adamant "take it or leave it" posture makes any sense at all only if one's attitude toward the pipeline is the same as the State's position toward ALPETCO; that is, only if one is comfortable with the "... or leave it" alternative of no gasline.

Posture # 3 - Strategic

Posture # 1 was a more or less passive, but sufficiently defensive, attitude. Posture # 2 centered around an aggressive but singular action by the State in the hope of prompting other parties into action. The third approach is less forthright in a visible sense than the second, but effectively it comes much closer to the aggressive leadership role we characterized earlier as one of the poles on the whole continuum of possible State postures.

That extreme itself was dismissed as probably unrealistic because the only possible locus of true leadership (now so apparent in its absence), and a leadership credible to the other parties, is the federal government. The U.S. sponsor is already bogged down by its unfulfilled promises, and has always been under scrutiny by the defeated gas transmission companies that hold critical pieces of consumer markets. Added to that is the sponsor's proved inability to convince the gas producers to even begin serious conversations. In effect, the only party which has the potential credibility or clout to wield leadership is the party that can and must become the ultimate respository of risks other parties are incapable of accepting or prudently cannot take on.

This is not to say that the State cannot serve as a catalyst. That role is the heart of what we call the Strategic Posture because effective action at this point to give the Alaska Highway project new momentum (if indeed any such action is possible) calls for a turning away from the present adversarial, piecemeal approach. This prevailing adversarial stance is exemplified by the fact that the involved parties, often as not, have chosen to "speak" to each other through legal briefs and the public media.

Posture # 3 relies mainly on means other than state proclamations; it is not conducive to establishing a formal Alaska "position". In a large sense, it is impossible to judge what role is fair, right, or even necessary for any party to assume until all are considered together. Likewise, it is probably not conducive to blackmail or bullying on the part of the State --- particularly heavy-handed dealings with the federal government, which must instead be eased into taking on the least attractive role that anybody will have to carry.

The State would continue to appear before FERC and at Congressional hearings, but not in order to stake out territory nor to present detailed legalistic critiques of proposed orders or regulations. The State would, instead, use these proceedings as a forum for setting out the issues in a fashion maybe similar to how they have been described here, and to give others a general understanding of the State's interests and limitations.

Probably the most useful thing anybody could catalyze at this point is an understanding by each party about the real financial and political limitations restraining every other party. Certainly the President misjudged the producers' interests when he claimed private financing was possible and relied on the Treasury Department's wishful fantasies about the gas producer's motivations and restraints. Perhaps the least understood of all parties will prove to be the Canadian government. While it cannot help but gain all sorts of goodies if the pipeline is built, onerous political considerations prohibit the Canadian government from taking on many (if any) risks. The U. S. executive branch has already demonstrated a tremendous insensitivity to these considerations.

The authors wish to make no judgment here whether the State could actually function in this manner, nor are we confident that it would be successful. The present impasse is highly complicated by conflicts of interests, both real and imaginary, and seemingly insurmountable psychological hurdles. Overall, the impasse is characterized more by nuance than forthright and absolute certainties. Indeed, we are not convinced that the State or any other earthly force can plow through it all and sow the seeds that will lead to ultimate resolution of all the critical problems.

Even if the State could do it, the "State" is not a monolithic force. Negotiations could only be handled by the executive, but all major results would need to survive legislative scrutiny as well. How much credibility would the State have in dealing in this fashion? Would the legislature be willing to grant the necessary leash and provide enough support to give the executive sufficient clout in its dealings?

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A final note . . .

Of the three possible approaches for State action during the upcoming year, the authors believe that the governor and the legislature would be most comfortable with Posture # 1 or # 2. Policy makers' political inclinations and philosophical views about the government's appropriate role and its ability to maneuver in a much broader arena, of course, play a large role in the choice of strategy. While such considerations are outside the author's terms of reference for this study, the present report has so far avoided more than passing mention of another question that is crucial, but which <u>is</u> part of our assignment: Are there conceivable ways to put the project together so that each of the involved parties will find its own apportionment of risks and benefits at least tolerable? Might Posture # 3 (which thrusts the State into a behind-the-scenes catalyst role) prove fruitful, or would it just be a waste of time --- in which case, the semi-passive approach of Posture # 1 might make more sense?

The authors plan to explore this question in detail in the final report. Nevertheless, while we hope the complete series of reports will assist the legislature in choice of approach, we cannot offer a definitive answer to the question:

Should the State of Alaska want a gas pipeline, this pipeline, and at this time? Even the sponsors do not know whether they really want to build the thing. The only prudent answer is "<u>maybe</u>, if ..." --- and the "if" really cannot and should not be hammered out at this time or by us.

Only when the State knows what it will get out of the project (tariff conditions, wellhead price, etc) and what it has to give up in return (financing risks, etc.) --- hence, only <u>after</u> the risks and benefits are apportioned among all parties --- can judgment be made. Even then, it will have to include a hard look at alternatives. If the pipeline is not built now, what are the chances it might be reborn and under more or less favorable conditions? What is the effect of an extended period of gas reinjection during oil production? What alternatives (if any) <u>realistically</u> exist for using the gas within Alaska? Only after these points are better known and are weighed against one another can a prudent judgment be made on whether the State wants the gasline and whether it wants it bad enough to accept any givin share of the system's risks and costs.