ALASKA NATURAL GAS TRANSPORTATION PROJECTS
OFFICE OF THE FEDERAL COORDINATOR

Federal loan guarantee helps pipeline finances

A federal loan guarantee authorized for the Alaska gas pipeline is intended to help smooth the path forward for what could be the world's most expensive private project ever.

The guarantee joins other measures in federal law designed to ease the project ahead and lower its capital costs. The other measures include putting a key regulator on a timetable to act, accelerating the pipeline depreciation for tax savings, restricting court challenges of the project, and allowing tax credits for a massive gas treatment plant at Prudhoe Bay.

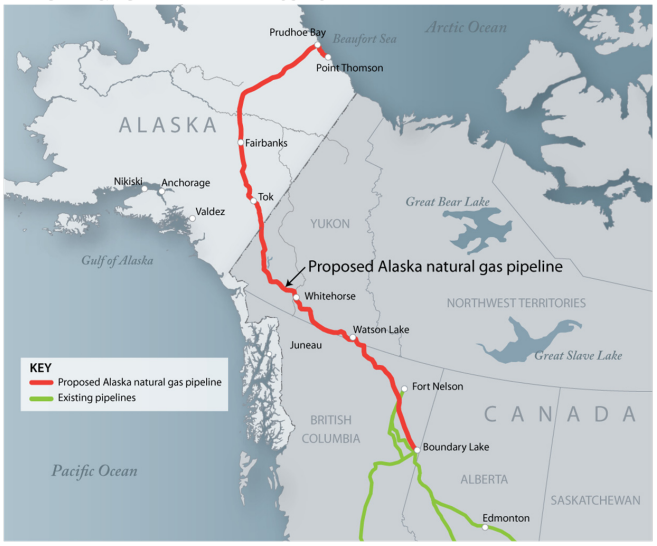
The loan guarantee is gargantuan. Congress authorized $18 billion in 2004 and linked its value to inflation, lifting the guarantee's size to about $21 billion today.

If the pipeline proceeds, the guarantee is intended to lower the cost of construction debt, which in turn would lower the cost of shipping gas through the pipeline. The effects would be to:

- Raise the prospects that the project gets built, is financially sound and has more financing opportunities.
- Strengthen the profit potential of North Slope gas producers and the amount of state royalty and production tax revenue.
- Arguably encourage U.S. industry and consumers to switch to natural gas fuels because Alaska gas would bolster the nation's long-term supply.

In 2004, when the $18 billion figure was born, the amount was considered adequate to back the entire amount a pipeline builder would borrow for construction. That no longer is the case. The pipeline's estimated cost has escalated, and now the guarantee might cover just two-thirds of the debt.

ALASKA GAS PIPELINE PROJECT



That's not the only problematic event since 2004. The global financial crisis caused the banking industry and capital markets to unravel like a bad alibi. This has altered how companies that need to borrow a fortune get cash from banks and investors.

Indeed, backers of an Alaska pipeline would need a fortune. The project now is estimated to cost between $32 billion and $41 billion. That means the builders might need to borrow roughly $25 billion to $30 billion. (The pipeline owners would put up the remainder of the money themselves as their equity stake, just as a home buyer fronts the down payment and borrows the rest of the purchase price.)

Still, with a federal guarantee, shouldn't borrowing funds be a relative snap?

It's not that easy.

The loan guarantee works only after a chain of other events also happens. Not the least of these events: The pipeline builders would need to pay a fee to cover the risk of a loan default, or Congress would need to appropriate money to cover the fee, or a combination of the two.

In addition, even with the guarantee, no one will lend money for the project unless it has locked up big gas shippers with gold-plated credit records, and secured scores of government permits needed for construction and operation.

Another challenge as mentioned already: the $18 billion loan guarantee no longer is enough to cover all of the pipeline project's debt.

What Congress did

Interest in building a gas pipeline from the North Slope revived in the early 2000s when gas prices suddenly soared.

Natural gas has had two historic price ranges. In the first, from the 1920s to the mid-1970s, the average annual wellhead price never topped $0.30 per thousand cubic feet. The second phase started in the late 1970s when federal price controls began phasing out. Prices grew rapidly then got stuck at roughly $2 for almost 20 years.

But in the last part of the 1990s, gas prices burst ahead amid concerns that the nation's conventional gas production had peaked and could be headed for decline. The price doubled between 1998 and 2001. Prices continued rising for seven more years.

The higher price blew through the barrier that had stymied the Alaska pipeline project for over two decades: The high cost of transporting the gas. Getting North Slope natural gas to Lower 48 markets suddenly seemed possible financially.

In the early 2000s, an Alaska pipeline project was estimated to cost about $22 billion, with a transportation tariff for shipping the gas at $2 to $2.50 per thousand cubic feet, or mcf. The project revived because market prices by then had reached about $3.50 or $4 per mcf. With those numbers, the pipeline could turn an adequate profit and the North Slope producers could make money, too.

Still, the pipeline would be a massive undertaking that would be tricky to finance because of its huge cost and because it would flood the market with fresh gas. At the time, Alaska's 4.5 billion cubic feet a day of gas would have boosted the U.S. supply by about 7 percent.

Believing that more domestic gas would be good for the country, Congress stepped in with a set of laws designed to spur the Alaska gas project.

The loan guarantee appears in the Alaska Natural Gas Pipeline Act of 2004. That law declared that the nation needs Alaska's gas to help meet growing demand. In support of the project, the law also set an accelerated schedule for permitting the pipeline and limited the timing and venue of legal challenges to the project.

The law set the loan guarantee ceiling at $18 billion. That provision, plus the tax benefits for the pipeline and gas treatment plant, apply only to projects delivering Alaska gas to the Lower 48. Where did that figure come from? It was about 80 percent of the $22 billion estimated project cost. And it was expected the pipeline builders would borrow up to 80 percent of the construction cost — or up to $18 billion. The project now is expected to cost $32 billion to $41 billion, meaning borrowings could reach $30 billion. (The state's Alaska Gasline Inducement Act requires pipeline developer TransCanada to use lower-cost debt rather than higher-priced equity for at least 70 percent of the project cost.)

As written, funds covered by the loan guarantee may be applied to the construction expense, interest owed during construction, escalation and contingencies.

Although the law empowered the U.S. secretary of Energy to issue the guarantee, it did not *require* the secretary to guarantee the debt, and even more important, it did not *appropriate funding* to cover the guarantee.

Issuing an actual guarantee and funding it are just two of a series of actions needed before the debt guarantee can help the pipeline project. The pipeline builders also must:

- Secure long-term gas-shipping contracts from creditworthy shippers.
- Line up the debt that the guarantee would back.
- Obtain all the government permits the multibillion-dollar project requires.
- Negotiate state of Alaska tax terms on gas production and the pipeline.

How the loan guarantee would work

The process of getting a loan guarantee would go something like this:

Step one. Companies wanting to build the pipeline must arrange for financing before applying for a guarantee. That financing likely will be contingent on getting a loan guarantee.

Step two. With contingent financing in hand, the companies will apply to the secretary of Energy for the guarantee. Department staff will vet the applicant. That process resembles what homebuyers endure to obtain mortgages: a credit check, a look at their income, a review of their job security, etc. For a pipeline project, those steps will include studying the quality of the applicant's contracts with gas shippers to be confident the pipeline owner will enjoy enough cash flow to repay its debt.

The staff will make a recommendation to their boss, the Energy secretary. If the secretary grants the guarantee, the scene shifts to the federal Office of Management and Budget and the Treasury Department.

Step three. A 1990 law gives the OMB a say in the guarantee. Congress enacted the Federal Credit Reform Act that year to provide a more realistic picture of how much federal loans and loan guarantees actually cost the government due to non-payments and defaults.

The law requires the OMB to determine the "credit subsidy cost" of the guarantee — an estimate of how much the treasury might be forced to pay if the loan goes bad and the guarantee kicks in. This cost gets built into the federal budget if the guarantee goes through.

How getting a federal loan guarantee would work*

Step one: Pipeline builder arranges for loan.

Step two: Pipeline builder applies to secretary of Energy for the guarantee. The guarantee granted after applicant passes vetting by Energy staff.

Step three: Federal OMB, with help from Treasury Department, calculates a cash value of the guarantee – called a "credit subsidy cost." Calculation based on probabilities of default and recovery of federal money through collateral.

Step four: Somebody fronts the credit subsidy cost – the pipeline builder or possibly Congress.

Step five: Energy Department staff and pipeline builder negotiate specific terms of the guarantee itself.

* Some of these steps must happen in sequence, some can occur concurrently.

Here's a simplified example of how the OMB, with assistance from the Treasury Department, might determine that credit risk fee:

Let's say you get a $1,000 government loan, repayable in two years. The OMB might say there's a 4 percent probability that you will default. It also might estimate that if you do default, the government will eat 50 percent of the loss and it will get the other half out of your assets or collateral. So the OMB will decide the credit risk fee is $20, computed by multiplying your $1,000 loan by 4 percent (chance of default) and by 50 percent again (portion of the loss the government will eat).

For the pipeline project, it's unclear how big the credit risk fee might be. OMB could calculate a figure of a few hundred million dollars or more.

Step four. Somebody needs to pay the credit risk fee.

Congress could write this check, though this appropriation might be a hard sell politically.

Another option would be for the pipeline builders to front the credit risk fee. But this would add a cost to what already would be the most expensive project the companies have ever undertaken.

Step five. The Energy Department staff and the pipeline builder must agree to terms. The federal agency will try to minimize the risk that the treasury will pay out anything.

These terms will define what constitutes a default, what financial ratios the applicant must meet, how the loan guarantee will be paid and under what conditions.

Some of these five steps must happen in sequence, some can occur concurrently.

Still, a key takeaway is this: Securing the loan guarantee could take a while.

How the guarantee would help

The loan guarantee would help the pipeline in two key ways.

First, it would greatly lower the odds that the pipeline project would be a financial loser for the lenders. This could make it easier to muster the mix of lenders from the banking and bonding worlds needed to provide tens of billions for the project.

Second, the guarantee would give North Slope producers incentive to ship their gas through the pipeline and find more gas.

Here's how that second point would work.

The guarantee would lower the interest rate on debt incurred to build the pipeline.

A lower rate means a lower annual interest payment.

Lower interest payments mean lower tariffs for shipping gas through the pipeline.

Lower tariffs raise how much the gas is worth as oil companies produce it. This "wellhead value" is a simple calculation: Market price minus transportation cost. For example, if the market value is $6 per thousand cubic feet, and it costs $4.50 to clean, chill, compress and pipe that gas to market, the wellhead value is $1.50 per mcf. The transportation cost would include shipping through the Alaska pipeline as well as any connector pipes on the way to market.

What's unclear at this point is how much the lower interest rate would benefit tariffs, wellhead values, producer profits, etc. This benefit will depend on the amount borrowed, the debt repayment terms, the size of the interest rate break and other factors. These are unknown at this point.

However, last year the joint venture proposing an Alaska pipeline made preliminary estimates of the interest rate break. The Alaska Pipeline Project of TransCanada and ExxonMobil estimated in its open season documents that the guarantee could lower their interest rates by 2.25 percentage points.

Applied to $18 billion in borrowings, that interest rate break would amount to billions of dollars in savings over time.

As it is, even after a guarantee is affixed to the debt, TransCanada/ExxonMobil estimates its annual interest cost at over $2 billion in the first full year it operates the pipeline to Alberta. That's over one-third of the estimated total annual pipeline cost.

For more information, please visit our website: www.arcticgas.gov

Contact information:
Bill White, Researcher/Writer for the OFC
(907) 271-5246
bwhite@arcticgas.gov

General Questions:
info@arcticgas.gov

Locations:
OFC Washington, DC
1717 H St. NW, Suite 801, Washington, DC 20006
(202) 478-9750

OFC Alaska
188 W. Northern Lights Blvd., Suite 600, Anchorage, AK 99503
(907) 271-5209