Presentation to

Legislative Budget & Audit Committee
Senate Resources Committee
Interim Hearings on
ALASKA NATURAL GAS PIPELINE ISSUES

September 1, 2004

Merrill Lynch

Global Markets & Investment Banking Group

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Financing an Ownership Interest in a Gas Pipeline: Options Available to Alaska

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- Began career as Legislative Assistant in Washington, D.C. to U.S. Congressman Jim Weaver of Oregon
- 20 years in fixed income (taxable and tax-exempt bond financing and debt management) area of investment banking, including:
  - Four years in municipal utility finance (New York) – primarily multibillion dollar power plant projects
  - Five years on taxable bond capital markets underwriting desk (New York) – covered Southern U.S. including gas pipelines such as Texas Eastern and SONAT and producers such as Shell, Anadarko and EOG
  - Three years running leveraged and structured finance group (Hong Kong) – including major government owned enterprises such as Qatar General Petroleum Corporation, Singapore Telecom, Korea Electric Power Company and Guangdong Province's Water Supply Pipeline Company
  - Twelve years as municipal investment banker (Seattle) – senior managed clients have included AIDEA, AEA, Municipality of Anchorage, Wyoming Pipeline Authority, Ports of Seattle and Portland, Sound Transit, Bonneville Power Administration
- Consultant to Alaska DOR, DNR, Department of Law on financing alternatives for a gas pipeline, should the State wish to pursue it
- Graduated Harvard College, A.B. Economics *magna cum laude* (1979) and Harvard Business School (1983)

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Financing an Ownership Interest in a Gas Pipeline: Options Available to Alaska

Summary of Testimony

- Alaska is a Petro-State with stranded gas. Forget comparisons to other U.S. states. Look at "Petro-States" like Qatar or Indonesia.
- Government stranded gas owners sometimes take a measured amount of risk to jump start desirable projects.
- Buying 100% of the gas at a fixed price and either (i) committing to ship-or-pay contracts for 100% (on someone else's pipeline) or (ii) financing 100% of pipeline would be one option—but it involves a lot of risk that would have to be carefully managed.
- Committing to financing an amount of pipeline capacity that corresponds to the State's working interest in the gas seems manageable from a credit and economic perspective.
- There are lots of different ownership structures and different kinds of bonds that can be used. Big differences revolve around tax-exemption and ability to shield the State from risk.
- There are many ways to limit worst possible losses from such an investment, while preserving the fiscal upside.

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Lower 48—Few Examples

- No State in the Lower 48 has sold billions of dollars of debt to buy/build an international gas pipeline
- But U.S. States have not shied away from big infrastructure projects when necessary:
  - Wyoming Natural Gas Pipeline Authority--$1 billion bond authorization to increase gas transmission out of the Rockies (ML is lead manager for this program, and its Executive Director will testify next)
  - New York State started Long Island Power Authority to run electric operations in Long Island when LILCO was going bankrupt (about $8 billion of debt)
  - California Department of Water Resources has spent $5 billion to transmit water from the wet north to the desert south
- At the end of the day no other state remotely resembles Alaska

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Stranded Gas of Petro-States: Growing List of Examples

- Every nation or province that has oil and gas extracts taxes and royalties. Typically a producer pays for 100% of the capital to extract the resource and the Petro-State puts in zero capital.

- Other than in the U.S. and other countries with big domestic pipeline systems, gas becomes stranded because of the enormous fixed, inflexible cost of building an international pipeline or LNG facilities. Producers are reluctant to take **all** of the risk when they only own **part** of the gas (i.e., gross production less royalty and tax).

- Petro-States end up investing capital in the pipeline or LNG because otherwise they get zero value for their resource.

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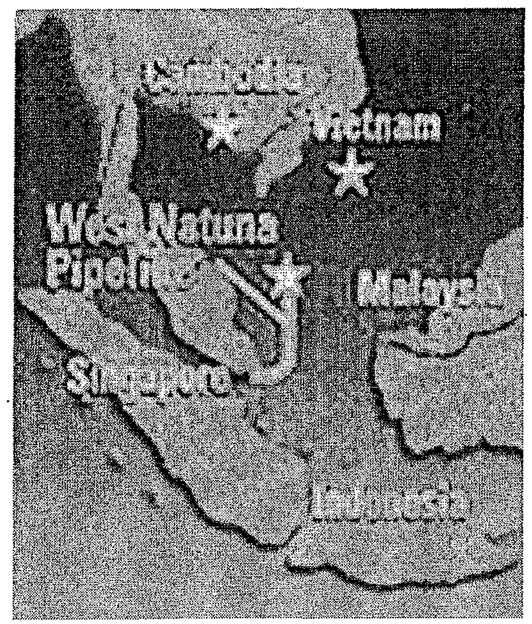
West Natuna Pipeline from Indonesia to Singapore: Indonesia's Investment Reportedly $400 million

- Pertamina (Indonesia's oil company) leased blocks of West Natuna to Conoco, Gulf Indonesia and Premier.
- The three production-sharing contractors, acting as the West Natuna Group, partnered with Pertamina (Indonesian state oil company) to build 656 km West Natuna Transportation System, with ultimate capacity of 1 BCFD
- The total pipeline cost was reported to be $1.2-$1.5 billion. Reportedly, the Government of Indonesia's investment was $400 million relating to PGN (state gas company) construction of pipeline infrastructure from Grisik to Singapore.



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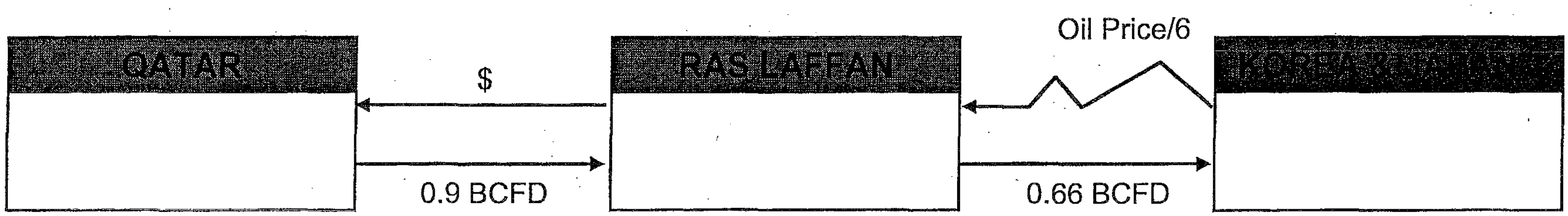
Ras Laffan LNG Project is 66.5% owned by State of Qatar/26.5% by ExxonMobil--Qatar equity investment about $500mm



QATAR royalties of about $0.87/mcf

2004 Project Cash Break Even (i.e., zero R.O.E.) of approx. $1.95/mcf or $12.65/bbl on 0.66 BCFD (source: S&P 7-Jan-04)

Must take 0.66 BCFD (rest sold spot or other contracts); Also has condensate sales.

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What Risk Can the State of Alaska Take: How Deep are Your Pockets & How Big is the Risk?

- **How deep are your pockets?**
  - The total State unrestricted revenues are about $2 billion per year
  - Rating agencies project "total available for appropriation" of $3.5 billion in 2010
  - Alaska's pockets get deeper if gas successfully commercialized
- **How big is the risk?** That depends on how big of a share you take of the whole enterprise and for any particular share:
  - How much financing risk you lay off on other participants through non-recourse debt
  - How much construction risk is laid off through pre-engineering, fixed price contracts, insurance, completion guarantees, etc.
  - How much commodity price risk you lay off on other participants through hedging, fixed price sales contracts, variable gas purchase contracts, etc.

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Very Large Degree of Risk, State Takes it All, Without Risk Mitigation

- Pretend producers would sell gas to State for $1 (fixed price) at North Slope. You sign a 20 year Gas Purchase Agreement with them

- Pretend a well-reputed pipeline company will build a pipeline, with $2 tariff. You sign a 20 year Ship-or-Pay Contract

- Pretend you know for sure that over the next two decades there will be: 15 years when the price in Chicago will be $6, 5 years when the price will be $1.50. You just don't know in advance which years are going to be the ugly years. You don't hedge and all your contracts are for spot Chicago prices

- Two bad years in a row (i.e., at $1.50 per MCF) loses you $4.4 billion.

Indicative Low Market Price Case			
Revenue	4BCFD x 365 x $1.50 =	$2,190	
Gas Purchase	4BCFD x 365 x $1.00 =	($1,460)	
Tariff	4BCFD x 365 x $2.00 =	($2,920)	
Annual Loss		($2,190)	
			x 2 yrs
Total Two Year Loss		($4,380)	

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A Smaller Scale Investment

- State Royalty Interest in gas produced on North Slope is now approximately 1/8th. Equitable argument for putting up 1/8th of the capital, if deal won't happen otherwise. If the project costs $24 billion, 1/8th is $3 billion.

- You could take your royalty as Royalty-in-Value or Royalty-in Kind. We'll discuss later that RIK makes issuing tax-exempt bonds easier.

- If you put up $3 billion (which gains you market access for 500 million cf/d of State gas):
  - a lot (maybe 80%) could be in Revenue Bonds (of a new State Agency or AKRR), where the State is not on the hook
  - 20% remaining ($600 million) as State-supported reimbursable debt (this means experts forecast that project revenues will almost always carry the debt, but the State is directly on the hook, in some fashion if things go awry for a long period)

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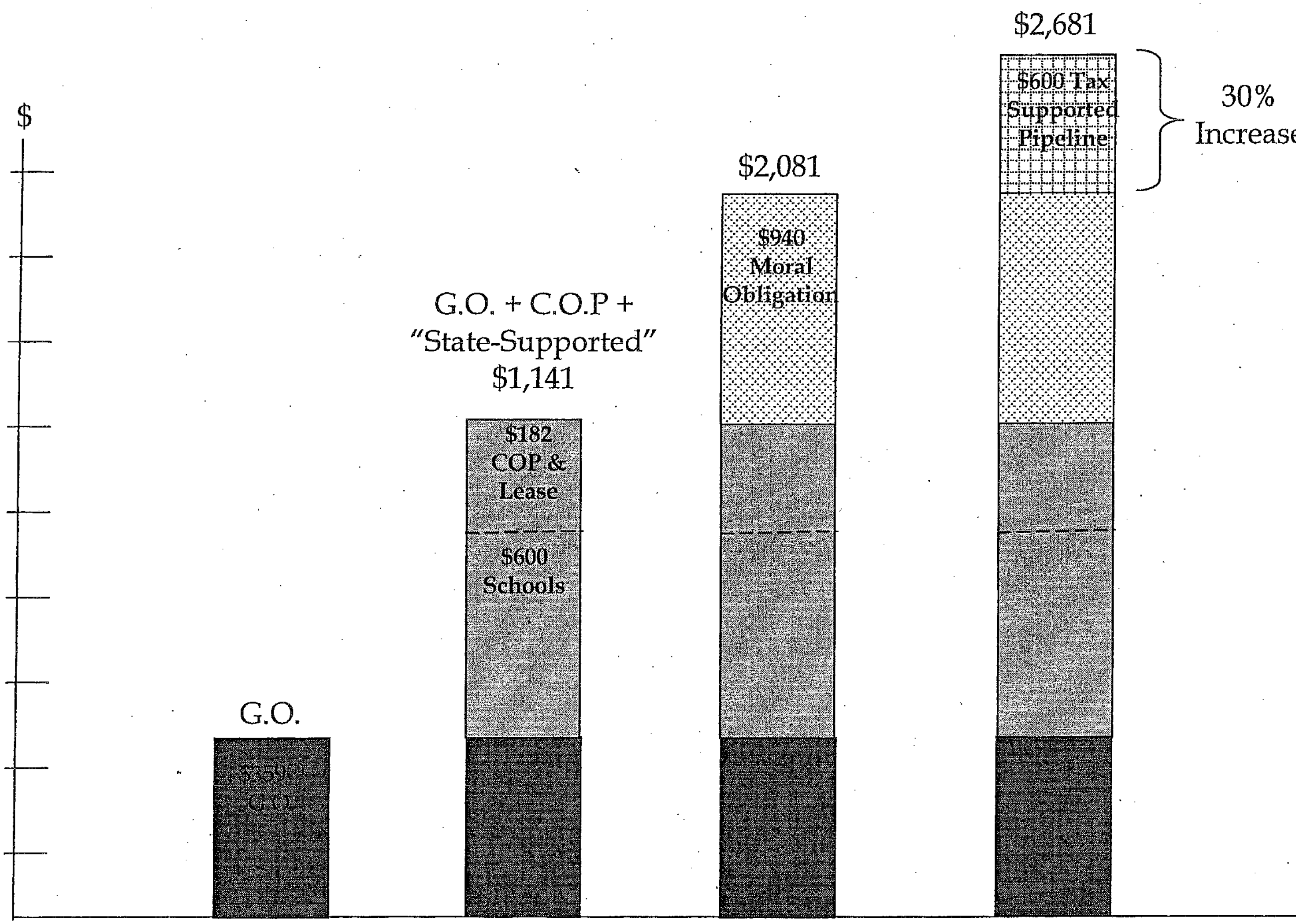
$600 Million Extra Tax Supported Debt—Your Pockets Seem Deep Enough



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Drilling Down to Details on a 1/8th Investment Example

- Pretend State wishes to co-invest for 1/8th of the Gas Pipeline.
- We will talk about how the overall deal could be structured with the producers
- We will talk about how we might finance as much as possible without having State be on the hook (i.e., Project Revenue Bonds)
- We will talk about the type of securities that would typically be issued by the State
- We will talk about what makes a deal tax-exempt vs. taxable
- We will do some simple examples to show how big the risks are at each extreme of the price spectrum

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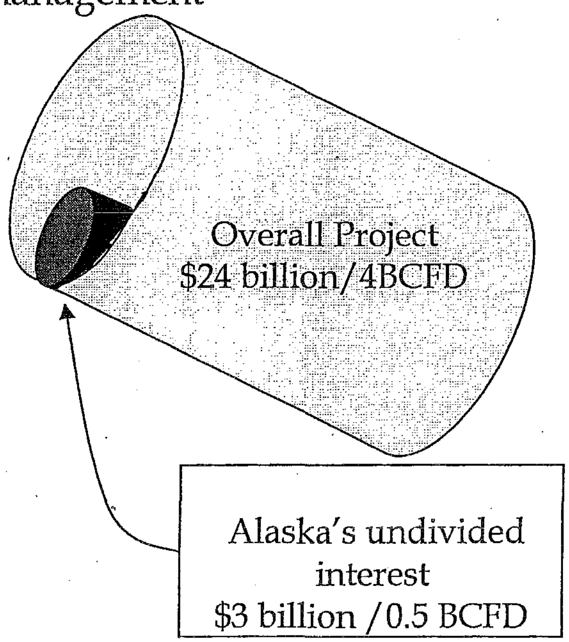
Two Possible Business Structures

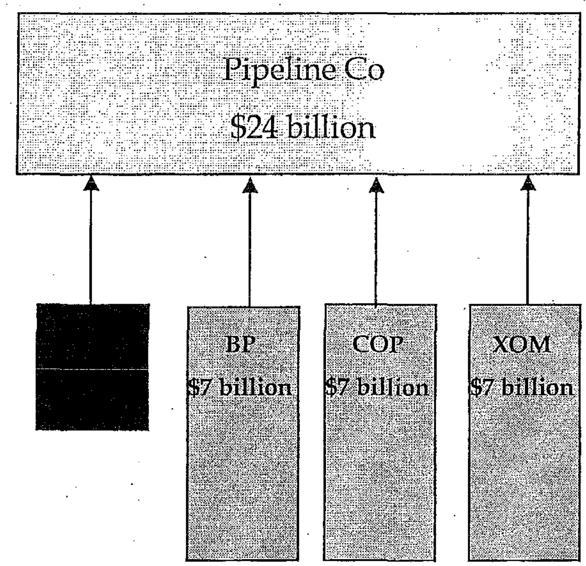
Undivided Interest: Alaska Pipeline Agency

Metaphorical "Pipe within a Pipe" = "Tenants-in-Common" = "Undivided Interest"

A very common version of public/private project management



LLC (Limited Liability Corporation): Alaska Gas Pipeline Finance Corporation



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What Makes Bonds Tax-Exempt Under Federal Law—A Rough Layman's Summary

- At a bare minimum, to issue tax-exempt bonds the Issuer has to be a government entity. A governmental entity would need to own the pipe and use the pipe for gas the State owns (RIK gas). That is, under ordinary circumstances, you couldn't finance 100% of the pipeline tax-exempt and then have the three producers be the sole shippers under long-term ship-or-pay contracts

- The IRS looks deeply into the business arrangements to see if somehow the entity that "uses the project" and "pays for the debt service" is a private party, in which case the bonds are taxable unless certain restrictive conditions are met. Gas pipelines, like a lot of other utility property ("output facilities") have special "output rules" by which the IRS lets you know how much "private use" is too much

- **Long-term fixed volume gas sales contracts (over three years) with a non-government party violate those rules**

- There is another provision that makes an otherwise tax-exempt financing ineligible, a federal guarantee on the debt

- These restrictions would not apply if the State is able to use the special tax law provisions that apply to the Alaska Railroad Corporation—a good thing to explore with attorneys (and I am not an attorney)

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Kinds of Bonds Available Under Alaska Laws

	15 Yr. Rate Today	Pros	Cons
G.O. Bonds	4.25% Tax-exempt	➢Cheapest financing ➢Currently rated Aa2/AA	➢Full-faith & credit ➢Need a vote of people ➢Is it a capital improvement under the Constitution? Under review by State Bond Counsel
Appropriation or C.O.P	4.40% Tax-exempt	➢Very flexible tool ➢A little more expensive ➢Currently Aa3/AA-	➢Huge black mark on State's credit if don't appropriate
Revenue Bonds	5.25% Tax-exempt	➢No recourse to State	➢Higher cost because would be rated lower than the State, possibly as low as BBB (still investment grade, though)
Revenue Bonds with Moral Obligation	~4.60% Tax-exempt	➢Typical State Agency issue (like Bond Bank) ➢Lower cost than pure revenue bonds (gets A2/A ratings because of State Moral Ob) ➢Typically not calculated in rating agency ratios if underlying project solid	➢Huge black mark on State's credit if don't appropriate, as with C.O.P. ➢Rated two "notches" worse than State C.O.P.
Revenue Bonds with Federal Guarantee	5% Taxable	➢Riskless to investors, so cheap!	➢Must be taxable (No tax-exempt muni bonds allowed with Federal Guarantee)

Financing an Ownership Interest in a Gas Pipeline: Options Available to Alaska

Assumptions for Numerical Examples

- 4.1 BCFD delivered Chicago at 1080 Btu/cf
- Total Project to Chicago = $24 Billion (inflated plus capitalized interest). To AECO would be less.
- State Share = 1/8th or $3 billion
- Finance 80% with Revenue Bonds= $2.4 billion
  - Of that $2.4 billion, $2.25 billion could be Federal Guaranteed (being our share of $18 billion max as was provided in last version of Energy Bill)
  - So another $150mm would be non-Guaranteed Tax-Exempt Revenue Bonds
- The balance of 20%=$600mm might be:
  - General Obligation Bonds (subject to various restrictions), or
  - Appropriation debt similar to C.O.P.'s

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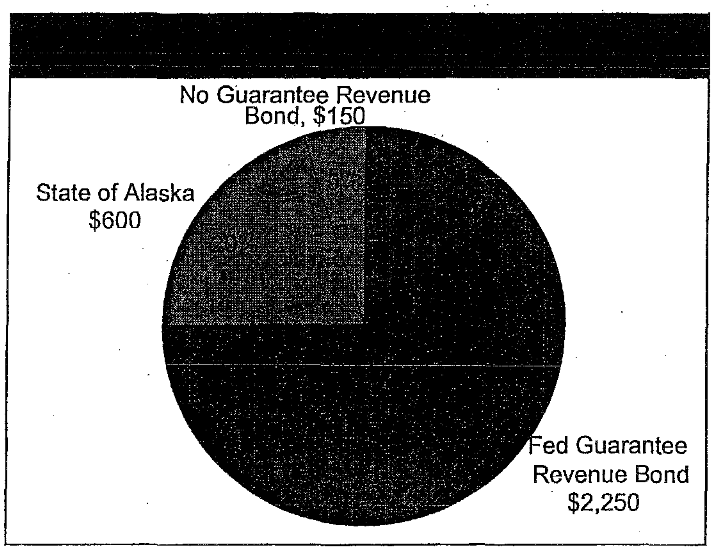
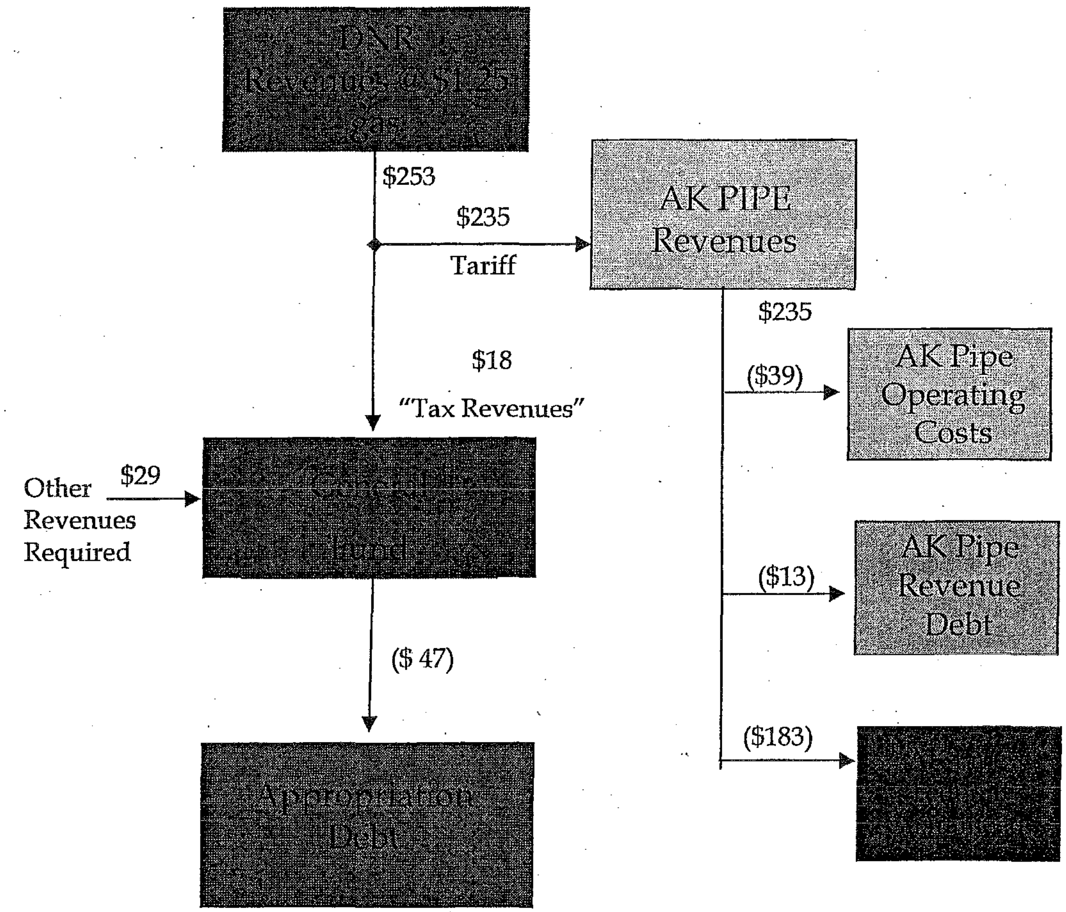
A Bad Year: Excess Money From Selling Gas Doesn't Cover Securities Issued by the State

(in Millions)





Financing an Ownership Interest in a Gas Pipeline: Options Available to Alaska

A Good Year: Excess Money From Selling Gas is Large and Available for Other Programs

(in Millions)