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ADDITIONAL DELAY

April 23, 1980

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Anchorage, Alaska

Prepared For: The Joint Gas Pipeline Committee
Alaska State Legislature

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REPORT TO: THE JOINT GAS PIPELINE COMMITTEE

ALASKA STATE LEGISLATURE

THE ALASKA GAS PIPELINE: FAILURE TO
RESOLVE FUNDAMENTAL LEGAL PROBLEMS
PORTENDS MUCH ADDITIONAL DELAY

I. Introduction

This report focuses on the legal restrictions placed on development of the Alaska Natural Gas Pipeline and the impact these restrictions are having on the interrelationships among the pipeline sponsors, the North Slope producers, and the Department of Energy. The report goes on to examine the impact of these legal restrictions on the gasline's future and highlights the most troublesome hurdles still to be overcome. By doing so, we hope the report can be useful for long-range planning and strategy purposes.

By analyzing the historical problems imposed by existing law on the pipeline, we hope to provide insights into the three most important questions facing the Alaska Legislature regarding the gas pipeline:

1. Is the pipeline sure to be built, and if so, when might construction begin in Alaska?
2. Will the Legislature be requested to approve financial participation of some sort in the pipeline, and if so, when will this request be presented to the Legislature and what sort of financing might be proposed? Should Alaska initiate a financing proposal?
3. What role will the State of Alaska be asked to play in the development of the line, and what role may be most beneficial to the State?

An analysis of the law governing the pipeline and the politics for changing that law cannot by itself answer the three questions above. Clearly, the economics of the pipeline (which this report does not attempt to resolve) will probably be the dispositive factor in the pipeline's development. However, an analysis of the fundamental legal problems plaguing the pipeline can put a semblance of order into the largely contradictory reports about the pipeline's status that are being generated from the various private parties and governmental entities involved in its development.

II. Executive Summary

The Alaska Natural Gas Pipeline Project faces extremely serious problems, despite the unwarranted (in our judgment) optimism generated by recent meetings between producers, sponsors and the federal government. While the ongoing negotiations may soon produce a cost-sharing arrangement for the research and design phase of the project, they will not resolve — in fact, they will barely reach — the cornerstone issues.

The worst problems plaguing the pipeline are fundamentally unworkable legal strictures, divergent business interests, and domestic and international policy and political considerations. These institutional barriers are not susceptible to quick, substantial breakthroughs; rather, they must be solved via a long, treacherous reformation process. The sheer volume of domestically-controlled energy that the Line will deliver makes eventual development a high probability (but not a certainty), but the construction commencement date and the institutional structure under which it will be financed, managed and operated remain uncertain.

The current negotiating and financing situation may be best described by means of an illustrative example:

Two strong-willed and independent corporate presidents meet at their country club. Paired in a foursome, they soon realize that they share a corporate objective, yet neither corporation can reach it alone. They kick around the idea of a merger, and by the end of the day, leave the club extremely intrigued by the idea.

Will the companies merge, and if so, when?

Yes, if:

- Their accountants inspect each other's books and find no problems.
- They agree on a price/stock swap, etc.
- They can agree on a corporate structure and mechanism for control of each other.
- The two presidents can find a way to satisfactorily coexist with shared responsibilities and if they can avoid personal conflicts during the difficult negotiation period, and not blow the negotiations apart.
- The federal government approves the merger or facilitates it. And,
- The stockholders and boards of directors of both companies go along with the merger.

In terms of the pipeline, Northwest and the North Slope producers are barely past their day on the golf course; and it has taken 2 1/2 years to get that far. Unlike the imaginary corporate merger described above, it is highly probable that eventually the gasline will be built. When, how, and by whom is very much an open question, however.

A. Changes in Existing Law

Our analysis of existing law indicates it is a virtual certainty that Congress must pass amendatory legislation in order for the gas pipeline to be built. Not only must legislation be enacted allowing North Slope producer ownership participation in the Northwest consortium, but many of the demands made by the producers since negotiations began require Congressional (or FERC) approval. Finally, a high probability exists that some renegotiation of the U.S.-Canada Agreement will be necessary. The most serious impediments to the project are the policies and decisions contained in the basic Alaska Gas Pipeline law — the President's Decision of 1977.

The President's Decision chose the least financially capable or technologically expert applicant to construct and operate the Alaska Gas Pipeline. It then went on to eliminate the three best sources of financial help for Alcan: the North Slope gas producers, consumers (via completion guarantee) and the federal government. The Decision also deterred the major natural gas transmission companies that had previously demonstrated an interest in North Slope natural gas from financial participation. Incredibly, the financial straightjacket in which the Administration enveloped the Alaska Pipeline was not foisted on the President by Congress, the Federal Power Commission, or existing law. It was almost exclusively generated by the Executive Branch. In some instances, Northwest (then "Alcan"), in its drive to gain the certificate by distinguishing itself from the competing applicants, helped to devise the restrictions which may smother its efforts to construct and operate the Alaska Gas Pipeline.

B. Current Negotiations

The negotiations between North Slope producers, Northwest and the Department of Energy have made limited progress. To date, the parties have been unable to reach even preliminary agreement on the tough issues that divide them. At best, they have made progress on a matter that is, while on the critical path to pipeline construction, still somewhat superficial: a research and design phase, financed and managed, at least in part, by the North Slope producers. This Phase I would purportedly produce a credible cost estimate and lead to serious and conclusive financing negotiations. The research and design phase is to be contained in the first section of a "Letter of Intent" between the producers, sponsors, and DOE that would also include the preliminary elements of a financing plan as Phase II.

At its very best, Phase II of the Letter of Intent will be an extremely fragile basis for project success. It will be riddled with conditions wherein the signers can withdraw from the agreement at any time should statutory and regulatory concessions not be made to the satisfaction of the parties. More importantly, should cost estimates generated subsequent to the research and design phase be unacceptable to any of the parties, they would be allowed to withdraw for that reason, too. A critical analysis of the "financing plan" in the Letter of Intent might conclude it will be no more than a nonbinding agreement to agree.

During the negotiation period, two highly controversial proposals — a federally guaranteed cost overrun pool and an all-Federal pipeline (the "FedLine") — have been floated by a DOE financial consultant. While both of these proposals have met with strenuous objections and little overt support, they are quite likely to resurface again and again in the future. It is entirely possible that one or the other could be adopted in some form. The federal cost overrun protection proposal has its most serious opposition in Congress and with the Canadian Government. The "FedLine" would be strongly opposed by the domestic energy industry, as well as many political leaders and would probably be the worst alternative for the interests of the State of Alaska.

C. Congress

The future of the Alaska Gas Pipeline will ultimately be in the hands of the United States Congress. We anticipate that a package of amendatory legislative provisions will be presented to Congress no sooner than the middle of 1981, and perhaps many months later if the proposed changes are substantial or if the financing negotiations between the involved parties are not nearly complete. Ultimately, Congress should act to facilitate development of the pipeline rather than block it, but Congressional consideration will probably cause a significant delay if it must consider amendments that go beyond simply permitting North Slope producer equity. We anticipate that final Congressional action could occur no earlier than the end of 1981, and could well not occur until the end of 1982.

Congress would probably accept North Slope producer equity in the project, but might be hesitant to permit all-out producer control. There is apparent consensus that gas pipeline amendments should be dealt with in one shot, rather than on a piecemeal basis. Consequently, the producers and sponsors will have to be well into financial and management negotiations and key FERC decisions will have to be rendered before comprehensive proposals can be given to Congress.

The non-negotiable conditions are several: Congressman Dingell and the House Commerce Committee will thwart any efforts to authorize consumer non-completion guarantees of any sort. In fact, there is no meaningful support in either House for significantly disadvantaging consumers in any pipeline law changes. Congressman Dingell and a very strong faction in the House will also ensure that should the Northwest Pipeline proposal be abandoned, no gas pipeline route change effecting delivery to the West Coast will ever be authorized.

On the Senate side, Senator Jackson closely adheres to the position that, absent a complete restructuring of the pipeline project, no direct or indirect federal subsidy will be provided for the pipeline. Jackson specifically includes cost overrun pool protection in his prohibitions. Should pipeline financing be opened for reconsideration, Jackson will advocate a facsimile of the FedLine concept floated by DOE. Although Jackson would be a formidable advocate of this position, overall Congressional support is probably lacking for experimenting with such a novel idea on a project of this magnitude.

There is a universal fear that once Congress is presented with the opportunity to reconsider the gas pipeline, all issues will be open for debate and that a protracted amendatory process may be initiated. Under these circumstances, there would certainly be proposals for lifting the pipeline certificate from Northwest. There are likely to be measures dealing with more peripheral issues such as vertical integration of the oil industry and "buy American" requirements for pipe and equipment purchases. If major issues are opened for reassessment, there will be little or no chance that the abbreviated amendatory procedure provided in ANGTA (sixty days for amendment via joint resolution) can be utilized.

With Congress so staunchly against consumer guarantees and perhaps nearly as strongly opposed to federal cost overrun protection, the alternatives for revising pipeline financing remain few. A modified FedLine or some creative pooled private financing approach may be necessary to supply the capital necessary to build the line.

D. Canada

A benchmark decision is fast approaching in Canada regarding the future of the Alaska Gas Pipeline. Authorization for pre-building the Western Leg of the Line must be granted by approximately June 1, or a year's completion delay (to November 1981) will be assured, since mountain construction must be conducted in July and August. The Canadians are leaning toward approval of the pre-build decision, if the U.S. Government and the producers and sponsors can provide Canada with sufficient financial assurances that our side of the pipeline will be financed. While the Canadians may desire to approve pre-build, they cannot do so before receiving a credible Phase II (of the Letter of Intent) financing plan.

We believe that the Canadians will approve the Western Leg pre-build, but will not be able to do so in time to forestall a one-year delay of Western Leg completion. Moreover, we believe the Canadians will use the Eastern Leg decision as their lever to continue to impose pressure on the United States to speed pro-development decisions. The National Energy Board will also likely approve some additional gas exports through pre-build facilities in the near future to help finance those facilities.

In the long term, Canadian attitudes toward the gas pipeline are far less certain. Should the U.S. be forced to provide guarantees, thus violating the U.S.-Canada Agreement requirement that the line be privately financed, renegotiation will be required in the face of strong opposition to doing so. The Canadian Government will be very reluctant to provide similar guarantees on their side of the line, and can effectively veto the U.S. decision to guarantee financing. There is much support in Canada for an energy policy that husbands resources and opposes exports to the U.S. Failure of the U.S. to develop the gas pipeline in an expeditious manner could force the Canadians to abandon their interest in the project and look for other development proposals. Finally, first signs of marketability problems for higher priced Canadian gas have recently surfaced. If indications of long-term marketability problems arise, they would deter the financing prospects for the entire gasline.

E. Alaska Construction Schedule

There are two broad areas that determine when full scale construction of the Alaska Gas Pipeline may begin in Alaska: established engineering-related considerations and resolution of institutional problems. By analyzing these areas, we can determine the earliest possible construction commencement date, and can also estimate the most probable commencement date. Because delay potential is open-ended, it is impossible to determine the latest construction commencement date, since it is conceivable the pipeline might never be built or at least be subjected to indefinite delays.

Actual construction in Alaska (not civil engineering, but building of the line) can commence after six steps have taken place: 1) the research and design phase; 2) Congressional approval of legislative changes; 3) FERC approval of regulatory matters; 4) a period subsequent to FERC and Congressional approval where all follow-up regulatory matters are concluded, permits granted, etc.; 5) all final business negotiations are concluded and financing is arranged; and 6) a civil engineering phase of no longer than six months. Should these six phases occur in the shortest estimated time for each and a high degree of concurrent activity between the phases takes place, commencement of construction in Alaska could begin in the early part of 1983. The September 1977 President's Decision anticipated construction commencement in January 1980. Therefore, under the most optimistic assumptions, gas pipeline construction commencement has slipped three years in the two and one-half years since the President's Decision was announced. A more realistic estimate — which takes into account less optimistic construction schedule assumptions — suggests Alaska leg construction commencement no sooner than 1984, and possibly 1985. Neither the 1983 optimistic estimate, nor the more realistic estimate of 1984-1985 includes provisions for institutional delays (political, regulatory, etc.). We believe some institutional delays are highly probable, so a mid 1984-1985 estimate is, in our opinion, the most realistic Alaska construction commencement date.

We have examined three scenarios (best case, middle case, and worst case) for resolving the political, regulatory and financing problems that still must be confronted. We anticipate that some delay of pipeline construction will inure from these institutional difficulties. At present, the condition of long-term finance markets, particularly long-term bond markets, would make financing impossible. While the date at which the gas pipeline must go to market is at least a few years away, we must voice some concern that the money markets may not be normalized by then or may be incapable of providing the vast sums needed for the gas pipeline at an acceptable interest rate. Our best and middle case scenarios result in construction commencement during the same time frame permitted by engineering prerequisites (1983-1985). However, the worst case scenario results in an indefinite delay or permanent abandonment of the project. We are quite concerned that the project, by 1982-83, will be a \$30-\$40 billion undertaking (1982 dollars), including interest during construction, and that such sums will severely tax

private money markets. Moreover, the cost to build the Alaska gas line will be over twice the cost of the oil pipeline (in comparative dollars) to transport about one-third of the Btus. The gas line has inherently inferior economics to the oil line and as delays mount up and inflation takes its toll, the project's economic viability and the marketability of North Slope natural gas could come into question.

F. Alaska's Role

Assuming that the State of Alaska and its citizenry generally favor construction of the gas pipeline, the issue presented is: what, if anything, should Alaska provide to foster development of the gas pipeline in a manner satisfactory to the best interests of Alaska. In some instances, the prerequisites needed to develop the line cannot be seriously affected by the State (i.e., changes in federal law), but in some others Alaska's role may be pivotal.

The most critical needs of the gas pipeline are financial. First, participation of any sort by the State of Alaska in gas pipeline financing will reassure lenders that a reasonable tax and regulatory environment will exist during the life of the pipeline. Without such assurances, it may be impossible to privately raise the debt necessary to finance the line. Whether the State is willing to risk its funds and probably reduce its regulatory and taxation options is a decision that must be made.

The pipeline, of course, needs far more than lender assurances: it needs substantial equity and debt investment. The sheer magnitude of the dollars involved eliminates most sources from being able to make significant contributions. Alaska is one of the few large sources of debt and equity capital available, should it choose to invest. While the suggestion of substantial equity and debt investment in the pipeline may be anathema to many Alaskans and state leaders, an equally unpleasant prospect is potential abandonment of the gas pipeline project. While we are not stating that the project will not be developed without the investment of the State of Alaska, such a circumstance is not outside the realm of possibility.

The final area of financial need is cost overrun protection. This is probably the least practical avenue for Alaska financial participation.

How important is State investment in the future of the gas pipeline? This is a pivotal question, and the answer seems to swing from one extreme to the other. Over the last year, there have been periods when Alaskan participation seemed almost irrelevant to producers, sponsors, and DOE. Yet it is easy to postulate that circumstances may change to the extent that Alaskan participation may make the difference between a financeable project and one that is possible only under federal auspices. Moreover, should the project not be financeable under the structure now perceived, serious consideration of a FedLine is likely. A FedLine would probably be the worst possible structure for State interests. If it is necessary to develop the pipeline as a FedLine, in part due to financial recalcitrance on the part of

Alaska, the State can expect federal regulatory backlash, including the possibility of lower wellhead values and reduced tax revenues. Further, a FedLine would entail a far greater dependence on Washington, D.C. for any natural gas or gas liquids approval decisions, and a general loss of Alaskan control over its resources.

As to timing, the State will not have to make a final "invest or not invest" decision on the pipeline until 1982 or 1983. Until that time, no firm financial package is likely to be devised and available for commitment. On the other hand, if the State is to take an aggressive posture, State-sponsored financing initiatives — contingent on affirmative actions by the producers, sponsors, Congress and FERC — could be considered and adopted during the 1981 session of the Legislature.

The prospective delay of gas pipeline development has some benefits for the State. It gives the State a greater opportunity to formulate strategy, and to take the actions necessary to effect the most beneficial outcomes to State interests that are possible. Additionally, the time may be spent improving the prospects for developing a petrochemical industry based on North Slope natural gas liquids feedstock. In all probability, the more active a role the State takes in shaping or reshaping the gas pipeline project, the more likely its chances are to realize construction of the gas pipeline in a framework best suited to Alaskan interests, and to create the type of petrochemical industry that Alaska currently desires.

III. History of Alaska Gas Pipeline Law

The Alaska Gas Pipeline is governed by a series of laws and regulations enacted and promulgated over the last several years, some of which have severely limited the pipeline's financing options and may have made development of the line — under these restrictions — impossible.

The first important statutory treatment of the Alaska Gas Pipeline may be found in Section 302 of the Trans-Alaska Pipeline Authorization Act, enacted November 16, 1973. 1/ The Act requires the Secretary of Interior to investigate the feasibility of one or more gas pipelines from the North Slope of Alaska through Canada to deliver gas to the U.S. market. It requires the Secretary to submit a final report to Congress. The report was submitted in its entirety on December 15, 1975, and consisted of numerous sections prepared by various executive branch agencies covering all of the key pipeline issues, including financing. The significance of this provision is that it laid the foundation for extracting the gas pipeline decisionmaking process from the Federal Power Commission. Moreover, it provided the avenue for the entire Executive Branch to participate in the decisionmaking process, thus adding a plethora of policy issues to the basic applicant selection and route decision. These issues were above and beyond the two paramount concerns in the FPC's selection process: financial and technological capability of the applicant.

In 1974, the two groups competing for an FPC certificate of public convenience and necessity authorizing construction of the Alaska Gas Pipeline filed their applications with the agency. In March 1974, Alaskan Arctic Gas Pipeline filed, and in September an application was received from El Paso. Throughout 1974, 1975 and 1976, the two applicants submitted voluminous testimony and exhibits before FPC Administrative Law Judge Nahum Litt in support of their applications. In July 1976, Northwest Pipeline Corporation applied to the FPC for certification of a transportation system for Alaskan gas.

By far, the most significant pipeline event of 1976 was enactment of the Alaska Natural Gas Transportation Act, on October 22. 2/ Of the principal statutory and regulatory strictures covering the gas pipeline, this one is probably the least to blame for today's problems and perhaps has been the most helpful in expediting the almost universally desired goal of delivering Alaska natural gas to the Lower 48 in a timely fashion.

1/ P.L. 93-153; 43 U.S.C. §§ 1651-1655

2/ P.L. 94-586; 15 U.S.C. § 719 note.

ANGTA is a dual purpose statute: First, it helped select an applicant to build the pipeline; and second, it provided for expedited construction and initial operation. It is the first statute to declare that delivery of Alaska natural gas to U.S. markets is "in the national interest". Section 2(3). The statute provides for suspension of the existing FPC proceedings, a recommendation to be made by FPC to the President of a preferred applicant and route, a subsequent recommendation by the President to Congress of an applicant and route (to be accompanied by a "Presidential Decision and Report", including terms and conditions covering the pipeline), and an expedited process for Congressional approval or disapproval of the President's Decision. It is particularly significant in light of today's pipeline development problems that ANGTA:

1. Does not preclude North Slope producers from equity ownership in the pipeline. In fact, ANGTA does not even require that the pipeline be privately financed (although the House Report does anticipate private financing and refers to the pipeline as "the largest private construction project ever undertaken"). 3/

At Section 7(c) of the Act, it states that:

Unless the President finds and states in his Report submitted pursuant to this Section that he reasonably anticipates that the system designated by him 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.

2. Does not impose any limitations on the eventual decision regarding the gas pipeline tariff, including the use of consumers as guarantors, in order to make debt acquisition easier.

3. Contains an expedited waiver provision to circumvent existing law. The importance of this provision is that it may be used in the future to achieve speedy amendment of the President's Decision (which is now existing law) should such amendment be necessary. This provision, found at Section 8(g), would allow the President's Decision to be amended within sixty calendar days of continuous session of Congress if approved by enactment of a joint resolution.

3/ House Report 94-1658, p. 22.

If there is fault to be found in ANGTA, it is at two places. By its nature, this statute allowed almost every government interest and policy to enter into the decisionmaking process regarding a successful applicant and route. By doing so, it reduced the importance of financial strength and pipeline construction expertise as determinants for applicant selection and laid the groundwork for selection of Northwest (at that time known as Alcan), despite its apparent financial and technological inferiority to Arctic Gas and El Paso. 4/ For solid anti-monopoly policy reasons, ANGTA also included, at Section 13(a), a provision guaranteeing equal access to the Alaska Natural Gas Transportation System for all persons, regardless of their "degree of ownership or lack thereof" in the system. This provision has acted as some disincentive to gas shippers to participate in the project during its early stages since their future access is assured.

1977: The Decision Year

With ANGTA in effect, 1977 was the year of favorable decisions for the pipeline. First, the FPC in May, then the Canadian National Energy Board on July 4, followed by the President on September 22, and finally the Congress on November 2. Looking back on 1977, it was also a disastrous year for the gas pipeline since virtually all of the fundamental legal/regulatory problems which now obstruct pipeline development were created, approved and enacted into law during this year. Moreover, it is sobering to realize how little true progress has been made in the last 2 1/2 years toward solving the problems generated in 1977. This rate of progress does little to cause optimism for early commencement of pipeline construction.

In February, FPC Administrative Law Judge Litt issued his decision to the Commissioners covering the suspended certification proceedings. His 600-page opinion recommended to the Commission that the Arctic Gas Project be approved as distinctly superior to the second-ranked El Paso project. Judge Litt did state that El Paso had provided adequate justification to receive a certificate should the Commission choose to award it to them. More notably, Judge Litt found that the Alcan record was so deficient as to make selection of that project impossible, regardless of its

4/ It can easily be argued, however, that ANGTA did nothing to change the choice of the applicant in that FPC had really chosen Alcan once the dust of the Canadian National Energy Board decision had settled. The FPC recommendation stated: "We recommend that an overland route through Canada be selected, if such a route is made available by the Government of Canada on acceptable terms and conditions." Two FPC Commissioners recommended Alcan. The other two recommended Arctic Gas "conditioned upon timely affirmative decisions by the Government of Canada to make the route available". Otherwise, those two Commissioners stated that Alcan would be approved. When the NEB, on July 4, 1977, rejected the Arctic Gas route, the result was to create, in essence, a 4-0 FPC recommendation of Alcan.

theoretical merits: "No finding from this record supports even the possibility that a grant of authority to Alcan can be made." (Litt Decision). 5/

On May 2, 1977, FPC recommended an overland route through Canada, but deadlocked 2-2 as to whether Alcan or Arctic Gas should be the chosen applicant. The proponents of Arctic conditioned their support on a favorable decision from Canada, which was not to be forthcoming. On May 9, 1977, Justice Thomas Berger, head of the Canadian Government's Royal Commission of Inquiry, issued his final report, concluding that no pipeline should be built across the Northern Yukon (as proposed by Arctic Gas) and that construction of such a pipeline would also run into extraordinary delays to permit settlement of Yukon Native claims. Justice Berger was far kinder to the Alcan route selection.

On July 4, 1977, the National Energy Board recommended approval of the Canadian portion of the Alcan system pursuant to certain conditions. This sounded the death knell for the Arctic Gas proposal and set the stage for the September 22 Decision issued by the President.

Before turning to the President's Decision, some reference should be made to the treaties and agreements negotiated during this period between the United States and Canada pertaining to the gas pipeline. On August 3, 1977, the Senate ratified a treaty initialed in January 1977 between the U.S. and Canada concerning "transit pipelines". More importantly, an "Agreement on Principles Applicable to a Northern Natural Gas Pipeline" was struck between the two nations in mid-1977 6/ and was made a part of the President's Decision and the subsequent consideration by Congress. This Agreement is particularly significant because its provisions are such that any major restructuring of the Alaska gas pipeline in the future will almost certainly require a renegotiation of the U.S./Canada Agreement. The renegotiation of international agreements is always a sensitive, time-consuming matter and imposes substantial uncertainty and potential for delaying construction of the Alaska Gas Pipeline.

In its own right, this Agreement imposes almost as many legal restrictions and potential future legal problems as any of the other critical statutes and regulations. We have excerpted several segments of the Agreement in an effort to indicate the potential problems for renegotiation should meaningful restructuring of the gas pipeline project occur:

1. ¶4(a). It is understood that the construction of the pipeline will be privately financed. Both governments recognize that the companies owning the pipeline in each country will have to demonstrate to the satisfaction of the United States or the Canadian Government, as

5/ For a more detailed description of the Litt Decision, with particular emphasis on the financing issue and Alaska participation, see the Birch, Horton, Bittner & Monroe report to the Joint Gas Pipeline Committee, dated February 13, 1979. See pages 82-96.

6/ It was signed by both governments on September 20, 1977.

applicable, that protection against risks of noncompletion and interruption are on a basis acceptable to that Government before proof of financing is established and construction allowed to begin." 7/

2. "Annex I of the Agreement. The pipeline constructed in Alaska by Alcan will commence at the discharge side of the Prudhoe Bay gas plant facility." In the event the conditioning plant is added to the pipeline from a regulatory and operational standpoint, some negotiation with the Canadians of this provision may be required.

3. "§4(b). The return on equity investment in the pipeline will be based on a variable rate of return for each company owning a segment of the pipeline, designed to provide incentives to avoid cost overruns and to minimize costs consistent with sound pipeline management." Should a "Fedline" be built in the U.S. without a variable rate of return, or federal guarantees be imposed with the rate of return dropped to a set level, the variable rate of return provision of this treaty will have to be renegotiated.

The President's Decision and Report

If any single document can be blamed for the protracted delays that the Alaska gas pipeline has already experienced and for the seriousness of the difficulties facing the pipeline in the future, that document is the President's Decision and Report to Congress. The three most critical financing obstacles — preclusion of federal financial participation, preclusion of North Slope producer equity ownership, and preclusion of consumers as non-completion guarantors — all spring from the Decision. Additionally, many of the lesser problems obstructing the line today, i.e., selection of an industry maverick not accepted by Wall Street or the major oil companies to sponsor the project, an incentive rate of return system that does not deal with the question of investment tax credit treatment, discouragement of early participation by El Paso and Arctic Gas consortium members, creation of a restrictive cost recovery system, uncertain conditioning cost policy, acquiescence in the "project financing" approach proposal of Alcan, and others, are either created or ignored by the Decision and Report.

7/ This provision has been abetted by the Northern Pipeline Act, enacted in Canada, at Condition 12, which requires that no construction may commence in Canada before financing has been obtained for the pipeline, protection has been obtained against risks of non-completion of the pipeline, and risks of interruption of construction have also been eliminated. The Canadian Government interprets this provision to require that firm financial assurances be received by Canada that the entire pipeline will be built — U.S. segments included — before allowing Canadian construction to commence.

The significance of the President's Decision and Report stems from its legal stature: Upon approval by Congress, it became the law of the land, equivalent to any federal statute enacted by Congress via conventional legislative process. The Decision is the "statute" and the Report should be considered as legislative history, as are the reports filed by House and Senate committees with the legislation approving the Decision and Report. The "Alaska Natural Gas Transportation System — Approval Joint Resolution" was passed by Congress on November 2, 1977, backed up by a two-committee House Report (H.R. 95-739, Part I from the House Interior Committee, and Part II from the House Commerce Committee) and Senate Report 95-567 from the Senate Energy Committee. In order to amend any terms and conditions contained in the President's Decision, an act of Congress (either through the normal process or through the streamlined joint resolution process found at Section 8(g) of ANGTA) is required.

The Decision is divided into several sections, including designation of the successful applicant, a description of the route and facilities, terms and conditions covering the project, pricing of the gas, and the Agreement On Principles with the Government of Canada. We have analyzed the President's Decision in light of the problems now facing gas pipeline development and those that must be resolved in the future. The problems are broken down in separate categories below, and quotes from the Decision and Report are extracted. We have also attempted to assess the level of commitment in the Decision to certain key provisions (i.e., are they truly fundamental to the Decision or might there be some flexibility in adjusting them?)

1. Private Financing/No Federal Financial Support —

The commitment to private financing of the pipeline with no federal financial help whatsoever is perhaps the most fundamental aspect of the Decision. From the Decision's Preface (entitled "Overview" at page xiii), the principle is clearly established: "The Alcan Project will be one of the largest — if not the largest — privately financed international ventures of all time. The minimal risk of non-completion will be borne by the private financial market. There will be no federal debt guarantees." More significantly, the "Finance" section of the Decision (page 36) states that "The successful applicant shall provide for private financing of the project, and shall make the final arrangement for all debt and equity financing prior to the initiation of construction."

As stated earlier, the U.S.-Canada Agreement On Principles, reprinted in the Decision, states at Section 4.a: "It is understood that the construction of the pipeline will be privately financed."

The most explicit treatment in the Decision and Report may be found in the section entitled "Federal Government Financial Assistance", page 121 of the Report. This section not only states that federal financial assistance is unnecessary, but states that it is considered undesirable for a list of reasons, including: serious questions of equity resulting from risk transference to taxpayers who will not receive gas supplies from the gas pipeline; lack of incentives for efficient management of the project; placing the government in conflicting roles as guarantor and regulator; and "providing unnecessary federal assistance to this project would set a precedent with respect to other large energy projects that is misleading and counterproductive." 8/

This Section ends at page 127 of the Report with a heading of "Presidential Finding that the Alcan System Can Be Privately Financed" and a final sentence that reads as follows: "Federal financing assistance is also found to be neither necessary nor desirable, and any such approach is herewith explicitly rejected." (emphasis added).

2. Exclusion of Alaska Natural Gas Producers from Equity Ownership --

Section 1 of the Decision designated Alcan (Northwest) to construct and operate that portion of the system within the State of Alaska. Alcan is required to be a "publicly held corporation or general or limited partnership, open to ownership participation by all persons without discrimination, except producers of Alaska natural gas." (emphasis added). Decision at page 5.

While the language of the Decision is clear on this point, examination of other federal agency documents filed during the period prior to issuance of the decision shows that there was already an emerging conflict with respect to anti-trust policy and the financial realities of the project. The original position adopted by the Department of Justice was that producers of "substantial amounts of natural gas should not be permitted to own any portion of or participate in any manner in the selected Alaska natural gas transportation system." (emphasis added). This position was set forward in the Department's comments on competitive aspects of the ANGTS submitted to the President and to Congress on July 14, 1977.

However, on August 9, 1977, the DOJ submitted a letter to the President indicating that "producers could be involved in the guarantee of a portion of the project debt". Justice indicated that this change in position had come about after "consultation with other members of the Alaska Natural Gas Task Force", and learning "that gas producer participation in the financing of the selected project may be essential to the

8/ As described later in this report, this precedent may be more threatening to the oil and gas industry than to the President.

success of the project". Members of the Task Force who influenced Justice on the issue were, of course, from the Treasury Department, where project financeability had been a matter of great concern for some time. Thus, the antecedents of the current debate on producer participation in financing can be found very early on in the pipeline approval process (for a more complete discussion of this issue, as well as federal attitudes toward state financial participation, see: Alaska Gas Pipeline Perspectives: History, Current Perceptions and Potential Federal Influence Related to State Financial Participation, Birch, Horton, Bittner & Monroe, February 15, 1979).

Ironically, of course, it is now the Department of Justice that is being asked to provide a legal justification for the government permitting producer equity participation, despite its previous position and despite the language of the President's Decision. While the Department of Justice is fortunate to have some very fine legal minds in its employ, we doubt that anyone will be able to devise a rationale for permitting producer equity participation, or project control, that will not run afoul of the language in the Decision which was specifically and clearly directed at stopping such participation. It is our firm conviction that the producers cannot legally be equity owners in Northwest without Congressional approval of legislation amending the President's Decision. And, even should Justice develop a "theory" to allow producer participation beyond unsupported debt guarantees, we believe the theory could and would be successfully challenged in federal court. The implications of this problem for project timing are discussed more fully below.

If any doubt remained regarding the prospective financial role for the producers, it was erased in extensive debate before the House Commerce Committee during the approval process of the President's Decision. Representative John Dingell, Chairman of the Energy and Power Subcommittee, discussed the point with DOE Secretary Schlesinger, who was speaking for the Administration. Schlesinger stated that it was the Administration's intention to follow the recommendations of the Department of Justice regarding producer ownership. 9/ Moreover, pursuant to Representative Dingell's request, Secretary Schlesinger submitted for the record the following definitive statement: 10/

9/ The Department of Justice report to Congress stated the following: "We have recommended . . . that ownership interest or participation in any form in the transportation system by producers of significant amounts of natural gas or their subsidiaries or affiliates should be prohibited."

10/ See House Report 95-79, "Natural Gas Pipeline from Alaska", at page 236. The report covers the Joint Hearings on the President's Decision held on September 22 and 23, and October 14, 1977.

Producer Participation in the Alcan Project

The terms and conditions in the President's Decision preclude any participation in the Alcan project by producers of significant amounts of Alaskan gas, other than by loan guarantees that terminate when the project tariff becomes effective. That condition applies to the United States companies, Alcan Pipeline Co., Northern Border Pipeline Co., and Pacific Gas & Electric Co.

The principal Canadian company related to the Alcan project is Foothills (Yukon) Ltd. It is owned by Westcoast Transmission Company and Alberta Gas Trunklines, Ltd., which are pipeline companies which operate respectively in the Provinces of British Columbia and Alberta. It is anticipated that Trans-Canada Pipeline Ltd. and Alberta Natural Gas Co., two other Canadian pipelines, will acquire interest in Foothills (Yukon) or subsidiaries thereof. To the knowledge of the Department of Energy, United States or Canadian oil or natural gas producers have no equity or debt interest in Foothills (Yukon) or any subsidiaries thereof. It is not contemplated that the producers will acquire such interests. (emphasis added).

3. Consumer Guarantees Prohibited —

In the Overview, at page xii, the Decision states that "Consumers will not be required to bear any portion of the risks of non-completion." More significantly, at pages 37-38, the Decision holds that:

3. Neither the successful applicant nor any purchaser of Alaska gas for transportation through the system of the successful applicant shall be allowed to make use of any tariff by which, or any other agreement by which the purchaser or ultimate consumer of Prudhoe Bay natural gas is compelled to pay a fee, surcharge, or other payment in relation to the Alaska Natural Gas Transportation System, at any time prior to the completion and commissioning of operation of the system.

In the Report, the Administration discusses the position of rival applicants who stated that consumer guarantees through some form of "all events" tariff with non-completion features were necessary. The Report rejects this conclusion and agrees with Alcan's financial advisors who stated that the project could be financed with a more traditional tariff, i.e., "without consumer non-completion guarantees or federal financial assistance." (Page 120). The Decision also rejects the various novel regulatory schemes geared to shifting the project's risks from the private sector to consumers as neither necessary nor desirable.

The holding has caused a double restriction on the financeability of the pipeline. Not only are consumers lost as a source of financial support to aid both the raising of debt capital and the generation of equity, but this provision also served as a substantial financial participation deterrent to the various transmission companies who showed an active interest in Prudhoe natural gas by virtue of their participation in either the Arctic Gas or El Paso consortia. These companies were logical sources of financing for Alcan under normal circumstances. However, they had been burned by their investment of time and money in losing applications already. The above-quoted provision provided a disincentive for these companies to invest in the early developmental stages of Alcan because none of their expenses could be applied to their existing rate base if the project never reached completion. Moreover, they were already guaranteed access to the pipeline by ANGTA, so their desire to be twice-bloodied in the pursuit of North Slope gas was understandably slight.

4. Conditioning Costs/Conditioning Plant —

The Decision and Report does not clearly determine whether the conditioning plant is part of the Alaska Natural Gas Transportation System. By inference, however, it can be concluded that the conditioning plant is not part of the system. The U.S.-Canada treaty reprinted in the Decision describes the "pipeline" as commencing "at the discharge side of the Prudhoe field gas plant facilities". (page 67).

The only other treatment of the conditioning costs/plant question is found in the Report at page 95, where it states that "The transporters (i.e., the project sponsors) will probably be required to bear a portion of the 'conditioning' or processing costs of the gas."

The Decision and Report's treatment of conditioning leaves a great deal of leeway for FERC to decide the issue in a manner satisfactory to both producers and sponsors. So far, FERC has not been able to satisfy these parties, and speculation remains that a mechanism to pass at least some of the conditioning costs through to consumers will eventually be devised. Clearly, the conditioning costs question is not fundamental to the

President's Decision, although clear explication of it, as well as a better determination as to the status of the conditioning plant itself, might have served to avoid some of the delay potential that this yet unresolved issue still holds.

5. Miscellaneous Issues —

The Decision states that FERC may not issue a certificate for the project if the direct capital cost estimates contained in the final financing plan submitted to FERC "unreasonably exceed" a comparable estimate filed by Alcan on March 8, 1977 (page 36). While the term "unreasonably exceed" is not defined, there is some possibility that final cost estimates may be several times larger than the March 8, 1977 estimate, thus precluding FERC from issuing a certificate without an amendment to the President's Decision.

The Report also discusses Alcan's financial plan and its proposal that required capital be raised and secured by means of "project financing", as distinguished from the more traditional balance sheet financing used in the gas pipeline industry. While neither the Report nor the Decision bind Alcan to "project financing", there does appear to be tacit acquiescence to the Alcan proposal. The use of "project financing" may deter debt investment, since such a non-recourse financing approach would allow lenders to seize only the assets of the pipeline and not those of the equity owners in the event of project failure.

Both the Decision and the U.S.-Canada Agreement On Principles require the use of a variable (or incentive) rate of return on equity approach in an effort to reduce the cost of project completion. There are many who believe that utilizing a basically untested, novel rate of return approach in a project of this magnitude makes little sense and will tend to discourage investors. It is not clear to what extent the sponsors' inability to attract sufficient equity and debt investment over the last 2 1/2 years can be attributed to the use of IROR. The variable return, as established by FERC, may cause yet another difficulty: the "center rate" of return (17.5%) may, if reached, result in a political backlash if delivered Alaska gas is significantly more costly than other gas and, in particular, if major oil companies are among the benefactors from the high price. This could lead to Congressional pressure for a reduction of the rate of return and to the extent such a threat is perceived, it will serve to frighten off potential investors. This theory has many supporters, including Senator Mike Gravel.

Significantly, the President's Decision and Report does not address the issue of investment tax credit. By leaving the applicability of ITC to gas pipeline investment a mystery, additional uncertainty has been applied to the project to no positive purpose. The issue of ITC remains unresolved today.

6. Completion Schedule --

It is interesting to note that the President's Decision, issued merely 2 1/2 years ago, contemplates construction commencement in Alaska on January 1, 1980, and even with the potential for delay included, the Report estimates commencement of full operations no later than January 1, 1984. With commencement of construction in Alaska still at least three years away (by our estimates), it can be stated that in the 2 1/2 years since the President's Decision was issued, the project has slipped more than 2 1/2 years.

7. Summation of the President's Decision --

The President's Decision chose the applicant least financially capable or technologically expert to construct and operate the Alaska Natural Gas Pipeline. It then went on to eliminate the three best sources of financial help for Alcan: The North Slope gas producers, consumers (via completion guarantee), and the federal government. The Decision also deterred the major natural gas transmission companies that had previously demonstrated an interest in North Slope natural gas from financial participation. Incredibly, the financial straightjacket in which the Administration enveloped the Alaska pipeline was not foisted upon the President by Congress, the Federal Power Commission or existing law. It was almost exclusively generated by the Executive Branch. And, in some instances, Alcan, in its zeal to gain the certificate by distinguishing itself from the competing applicants, helped devise the restrictions which may smother its efforts to construct and operate the Alaska Gas Pipeline.

Decision Approval

House and Senate hearings were held regarding the President's Decision in which most of the major interested parties testified. It is noteworthy that the leaders of both approving Committees, Senator Jackson in the Senate and Representative Dingell in the House, are still in charge of gas pipeline matters. Both are known to have long memories regarding promises made to them by Administrations or various private witnesses and they can be expected to hold DOE officials, Carter Administration officials, and Northwest spokesmen to prior promises. Neither is likely to be fooled by testimony that is not well-founded. In addition, their top staff assistants, who presided during the approval stage, remain today and can be expected to play major roles in any proposed revisions to the President's Decision or restructuring of the pipeline.

The House Report, covering joint hearings held by the Commerce and Interior Committees, 11/ contains some noteworthy data for Alaskan interests. For example:

1. The Department of Energy submitted a response to a question from Representative Dingell regarding the government's expectations regarding North Slope natural gas liquids. The DOE response (page 235) assumes no processing in Alaska, although it is by no means a binding answer. The response:

Disposition of Natural Gas Liquids

Natural gas liquids (NGLs) currently being produced in association with the oil from the Prudhoe Bay field are being reinjected along with the gas back into the producing horizons. When the gas processing plant is built and operating, the pentanes and heavier liquids which are produced can be shipped through the oil pipeline. Their vapor pressure is sufficiently low at the flowing temperature of the oil line (about 140° F) to allow shipment without difficulty. The ethane could remain in the gas for shipment through the gas pipeline.

Some of the propane may be shipped through the gas pipeline. The rest will be used as field fuel or gas processing plant fuel, or it will be reinjected. Most of the available butane could be shipped through the oil pipeline. That which remains could also be used as field or processing plant fuel, or it could be reinjected.

Final disposition of the NGLs awaits conclusion of gas sales contracts and detailed design of the gas processing plant itself.

11/ H.R. 95-79.

2. The financial experts from the Department of Treasury stated that the Alcan pipeline can be financed privately, assuming equitable participation of the producers of the gas and of the State of Alaska. Treasury specifically states that "The State of Alaska could use a portion of its revenues from the sale of Alaskan oil to assist in the financing of this project. Originally, the State offered to assist in the financing of the El Paso project by guaranteeing \$900 million of project debt. Similar State of Alaska support for the Alcan project is considered advantageous and is encouraged." 12/ Page 122.

3. As stated earlier in the memorandum, the approval hearings clearly keep the producers out of any equity control in the pipeline. On page 442, in a letter to Representative Dingell, the Department of Energy did outline some conditions under which the producers could exercise limited control if they guaranteed debt. For example, their participation could be conditioned on "adherence by the pipeline companies to certain contracting procedures, reporting requirements, advance capital arrangements, levels of contingency financing, or other such reasonable conditions that would provide producers with oversight of construction".

The Joint Resolution approving the President's Decision made no changes in it. The legislative history, however, does shed some light on the meaning of the Congressional approval and helps define some unclear issues in a manner that is useful today.

The House Report, Part II, gives the best indication of the concerns of Congress regarding the President's Decision and is also indicative of some of the attitudes we can anticipate from these same members of Congress should a restructuring of the pipeline be necessary. The most prominent issue in the mind of the House of Representatives and to a lesser extent, the Senate, is the protection of consumers from unreasonable and unnecessary charges. This is obvious from the House Committee's analysis of the President's Decision. It probably augurs ill for any future efforts to use consumers as guarantors of gas pipeline financing, to use consumers as a source of pre-delivery payments, and perhaps also to use consumers to ensure plan sponsors (and producers if they participate) that research and design costs will be reimbursed, regardless of whether the pipeline is built. In essence, it may be postulated that of the three major financial sources ousted by the President's Decision, Congress will make sure that at least one — the consumer — does not become eligible to help finance the line. 13/

12/ The Birch, Horton, Bittner & Monroe report to the Committee on February 13, 1979, details the history of federal perceptions of Alaska's role in financing the gas line.

13/ Not only is the House of Representatives a champion of the consumer, but it is generally conceded that consumer groups have effective representation and sympathy at FERC. While we and most gas pipeline analysts feel that FERC will not play the dominant role in the future of the gas pipeline, it is entirely possible that FERC will balk at some of the anti-consumer demands that may be made in a sponsor-producer Letter of

The House Report goes a step beyond the President's Decision in that it not only agrees that consumers shall not pay any charge prior to completion, but it objects to the risk of service interruption that is transferred to U.S. consumers by the Agreement with Canada (page 24).

The House Committee also reaffirms the President's requirement that the Alcan project be financed without any participation or guarantees by the Federal government. It further states that "The Committee views the matter of private financing as a critical feature of the President's Decision, and accordingly, it intends to stay well-informed regarding the progress of the financing of the Alcan system." (page 31).

Before leaving the House Report, the Minority views bear notice since they directly discuss the sentiment of the Alaska Legislature toward gas pipeline financing. In voicing skepticism as to the ability of the pipeline to be privately financed, the Minority cites the anti-financing testimony of Arco (i.e., that its legal obligations to preferred stockholders, pursuant to its corporate charter, prohibit carrying any more debt than is now obligated), Sohio (its debt obligations are so high that guarantee of a substantial loan might cause its credit structure to collapse), and Exxon (in its judgment it would be imprudent to guarantee gas pipeline loans because of the unpredictable nature of government regulation of the line). The Report then stated:

Officials of the State of Alaska have also testified that they doubt that the Legislature of their state can be persuaded to obligate Alaskan taxpayers to guarantee the financing of the pipeline. Their reasoning seems to follow the same logic as the producing companies: without any participation in the project through control of construction decisions, the prospect of massive cost overruns, absent participation in the management of the finished gas line and with no assurances about prices and tariffs, they simply conclude that the risks are too great to obligate their taxpayers.

13/ cont'd.

Intent. The potential for FERC objection to such demands lends an additional element of potential delay and may perhaps be a serious obstacle to pipeline development.

All six of the Minority Congressmen signing the Report are still on the full Committee, including Samuel Devine, the ranking Republican on the full committee and Clarence Brown (Ohio), the ranking Republican on the Energy & Power Subcommittee.

1978 and the Natural Gas Policy Act

1978 can be characterized as a year of organization and frustration for Alaska Gas Pipeline sponsors, capped by a favorable decision by the U.S. Congress in the Natural Gas Policy Act covering pricing of North Slope gas. It was also a year marked by the beginning of the incentive rate of return battle at FERC and the Carter Administration's failure to name a federal inspector for the pipeline.

In March 1978, the Northwest Alaskan Pipeline Company and five other companies ^{14/} formed a partnership named "The Alaskan Northwest Natural Gas Transportation Company" for the purpose of planning, financing, constructing, owning and operating the Alaska segment of the gas pipeline. Of the partners, Northwest became and still is the operating partner.

Throughout the year, Northwest sought new members to add financing strength and technological capabilities to the partnership. Its efforts were unsuccessful, despite various incentives offered for early membership.

On May 8, 1978, the Federal Energy Regulatory Commission issued its first proposed incentive rate of return plan. This triggered an immediate response from the project sponsors, who termed the proposal completely infeasible, thus beginning a long up-and-down battle that apparently culminated on August 29, 1979, when FERC reaffirmed its June 8, 1979 final order approving an incentive rate of return establishing a center rate of 17.5% for the Alaskan segment.

The foremost event in the pipeline's 1978 legal history was the enactment on November 9 of the Natural Gas Policy Act, P.L. 95-621. This legislation was one of the most heavily lobbied bills in U.S. Congressional history, although the key Alaska Gas Pipeline decisions were determined early on. It is generally conceded that the pricing decisions for the Alaska line were favorable, and gave sponsors and producers an incentive to actively move forward on development.

^{14/} Northern Natural Gas Co., Panhandle Eastern Pipeline Co., United Gas Pipeline Co., Pacific Gas & Electric Co., and Pacific Interstate Transmission Co.

The sequence went like this: In March, House and Senate Conferees agreed that Prudhoe gas would be considered "old gas", priced at \$1.45 per mcf as of April 1977, with adjustments for inflation (were the gas delivered today, the inflation adjusted wellhead price would exceed \$1.80); in June, the Conferees agreed on rolled in pricing for the gas.

The Senate Report, 15/ issued on August 18, contains language that is enormously significant to the future of the Alaska Gas Pipeline, since it reflects the continuing views of Senator Henry Jackson with respect to financing the Alaska gas pipeline. The language relates to Section 208 of the Act, entitled "Alaska Natural Gas", and is reproduced verbatim:

The Conference agreement requires rolled in pricing for any portion of the first sale acquisition cost which is not required to be incrementally priced, and transportation costs, for gas produced from the Prudhoe Bay Unit and transported through the natural gas transportation system approved under the Alaska Natural Gas Transportation Act of 1976.

The Conferees agree to provide rolled in pricing for natural gas transported through the Alaska Natural Gas Transportation System and for the cost of transportation because they believe 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 (emphasis added).

The "no more federal subsidy" posture of Senator Jackson was reflected once again in a letter to the Secretary of Energy that he and Senator Stevens co-signed on February 19, 1980, opposing the double cost overrun pool concept that DOE was negotiating with North Slope producers. It is the bottom line restriction Jackson imposes on the gas pipeline, absent complete project restructuring. It is his equivalent to Representative Dingell's staunch advocacy of consumer protection regarding pipeline guarantees. We see little prospect for a change in position by either of these two key members of Congress, absent complete project restructuring.

The Natural Gas Policy Act also gives the Federal Energy Regulatory Commission discretion to increase the maximum lawful price for gas to compensate for conditioning and processing costs at Prudhoe Bay. At Section 110(a) of the Act, it states that the first sale of natural gas shall not be considered to exceed the maximum lawful price if such first sale

15/ Senate Report 95-1126, page 103.

exceeds the maximum lawful price to the extent necessary to recover "(2) any costs of compressing, gathering, processing, treating, liquefying, or transporting such natural gas, or other similar costs, borne by the seller and allowed for, by rule or order, by the Commission."

1979: FERC Actions and the Beginning of DOE Financing Negotiations

To a large extent, 1979 was dominated by the question of federal financial assistance for the Alaska Gas Pipeline. In January, DOE Secretary Schlesinger testified before the Joint Economic Committee of the U.S. Congress. During a question and answer phase, he stated that Congress should not reject out-of-hand the possibility of loan guarantees for the pipeline. He stated that loan guarantees in the neighborhood of \$2-3 billion might be considered. However, subsequent to Secretary Schlesinger's testimony, a host of statements were issued from DOE denying a reversal of the Administration position on private financing.

The conditioning cost issue came to the forefront on February 2, when FERC issued a notice of proposed rulemaking covering the treatment of production-related costs for natural gas sold and transported through the pipeline. On August 24, FERC issued Order No. 45, in which it found that natural gas producers in Alaska should be responsible for "conditioning" the gas for transport to the proposed Alaskan pipeline system. FERC opined that the conditioning costs should come out of the wellhead price received by the producers, with the exception of costs incurred for removal of carbon dioxide to levels below three percent of total volume transported, should FERC require such reduction (Northwest is seeking a 1% CO₂ content in the line). A request for rehearing was made, but prior to FERC's ruling on the rehearing petition (a denial was anticipated), the Secretary of the Department of Energy asked the Commission to postpone its final decision while gas pipeline financing negotiations were ongoing. FERC has acceded to the Secretary's request, and the conditioning cost decision will remain unresolved indefinitely. The question of allocating gas plant capital and operating costs is clearly an item of negotiation between the government, the producers, and the pipeline sponsors.

The risk of abandonment of the entire pipeline project came to the forefront twice. In March, Northwest filed a report with FERC (the Commission staff disputed Northwest's high-risk conclusion), in which it stated that the risk of abandonment of the project was 35%. Later in the year, a General Accounting Office report to the United States Congress ^{16/} recommended that if Congress were requested to consider federal involvement in the line, it should evaluate all feasible alternatives, including abandonment of the pipeline project, before approving any federal financial involvement. GAO indicated that if new conventional gas sources or gas conservation were sufficient to meet demand in a cost-efficient manner, the pipeline should not be built.

^{16/} Dated 10/26/79, entitled "Issues Relating to the Proposed Alaska Highway Gas Pipeline Project".

The federal government's administrative mechanisms for regulating the pipeline finally fell into place in 1979. President Carter's Limited Reorganization Plan for the gas pipeline, which established the Executive Policy Board governing the gasline, was approved by Congress on May 29, and John Rhett was confirmed by the U.S. Senate as the Federal Inspector in early July.

President Carter reiterated his determination to support the Alaska Gas Pipeline in July. The President's somewhat extravagant statement referred to the gas line not just as a prospect, but as a fait accompli. Specifically, Carter said "One major project will be the new pipeline to be built from Alaska, through Canada, to bring natural gas to the Lower 48 states. By 1985, Alaskan and Canadian natural gas can displace almost 700,000 barrels of imported oil per day." This unequivocal Presidential position, coupled with the return to power of Canadian Prime Minister Pierre Trudeau, who is clearly on record as a firm supporter of the pipeline and who had negotiated the pipeline agreements with President Carter, spells a strong executive commitment in both countries toward realization of the pipeline at an early date.

On August 6, FERC issued a final technical decision that met with great controversy in Alaska, choosing a 48-inch diameter, 1260 psig pipeline with the conditioning plant to be located at Prudhoe Bay. Exactly one month later, FERC issued its final order on the incentive rate of return for equity investors, an order that is very favorable to Northwest's position on the issue. The order rejected FERC staff opinions suggesting that a lower rate of return was appropriate, and renewed hope that the project might yet be privately financeable.

Finally, on October 26, the Department of Energy received a financing plan from Exxon which initiated the most recent series of DOE/producer/sponsor negotiations. (see next section). The Exxon proposal suggested that North Slope producers might purchase up to a 40% equity interest in the Alaska segment of the pipeline and supply up to 40% of the debt, under a series of conditions that can only be described as extremely favorable to producer interests.

Prologue to the Negotiations

The gas pipeline history described above set the stage for the high level pipeline financing negotiations now in progress. The major positions and interests of the parties are as follows:

1. The Department of Energy considers the gas pipeline a top priority, reflected by the active participation of Secretary Duncan and Assistant Secretary John Sawhill in the negotiations. Additionally, DOE hired New York financial lawyer Martin Lipton as a full-time consultant

with orders to "put the deal together". DOE recognizes that the Alaska Gas Pipeline is the surest new domestic energy source that can be generated through at least the mid-1980's and perhaps in the whole decade.

2. The President has made it clear that he wishes to have the pipeline project moving forward well before the 1980 election, so the line can be cited as evidence of a successful national energy policy. The Administration may, however, have to settle for some form of agreement that at least appears to have the pipeline moving forward, such as the Letter of Intent from the producers that consultant Lipton has been advocating.

3. DOE has concentrated its efforts on reaching a negotiated agreement that can be implemented without the approval of Congress, since reopening the pipeline issue in Congress means potential delay and political disadvantage. In the event the Administration felt that Congressional approval was unavoidable, its fallback plan was to present Congress with a finalized pipeline financing program that needed only an amendment to the President's Decision on one or two relatively non-controversial issues. It was felt that if Congress perceived that it was the last and only obstacle to pipeline development, a fairly rapid and favorable response could be generated.

4. Entering the negotiations, Alaska Gas Pipeline law was clear. First, there was no way the Administration could finesse the question of producer equity, regardless of how much the Department of Justice bent over backward to render a favorable opinion on its antitrust concerns. Second, FERC was about to issue a final rule on the conditioning costs question, a ruling that probably would be detrimental to successful negotiations. Third, the negotiators did not have flexibility regarding the consumer guarantee option, since Congress has indicated no willingness to back off its position of consumer protection. Finally, the Administration and company negotiators may have felt that Congress would be more amenable to federal guarantees than in fact is the case.

5. In order for the negotiations to be successful, they had to result in the provision of adequate financial assurances to the Canadian government that the U.S. portion would be built. Without these assurances, neither the Northern Pipeline Agency nor the Canadian Cabinet could permit pre-building of the pipeline's northern section. This requirement limited the negotiators' ability to merely solve the initial problem of finding design money, and bound them to also deal with long-term financing considerations.

6. The DOE-inspired negotiations began because Northwest and its partners could not generate adequate funds to develop the pipeline by themselves, even with the recent favorable incentive rate of return decision from FERC. Northwest and its partners were, however, absolutely

unwilling to give up control of the project to the North Slope producers. On this latter point, the law, if not the financial realities, was on Northwest's side.

7. The North Slope producers had \$50 billion worth of gas in the Prudhoe field, with escalating reinjection costs and associated gas losses. They were cash-rich, due to huge 1979 profits generated largely via OPEC crude oil price increases. Despite these factors, they were understandably unwilling to write a blank check on their balance sheets for project development and cost overruns, and were resistant to making a substantial investment without retaining control over that investment. Finally, the North Slope producers were particularly concerned with the conditioning costs issue and their ability to pass conditioning costs onto the consumer, rather than have them subtracted from wellhead price. As we noted in our report to the Committee of April 27, 1979, this latter issue has national implications for the producers. Allowance of conditioning costs over and above NGPA ceilings in Alaska would arguably establish or support precedent for such a procedure in gas fields elsewhere in the United States.

8. Finally, potential debt investors, such as large insurance companies and financial institutions, did not play active roles in the negotiations but were clearly factors to be reckoned with. To be successful, any negotiations had to allay their fears of non-completion or interruption of debt service payments.

IV. Current Negotiations

The negotiations that commenced with the Exxon proposal to DOE 17/ on October 26, divide into three segments. The initial segment covers the period from the first Exxon proposal, reaction to it by the various parties, and the resulting negotiations in November and December, 1979. The second segment, during January and February, 1980, saw the first signs of progress, followed by alternate proposals put forward by DOE and others, some backtracking, and a high level of frustration. Finally, the current phase is one in which the first direct producer-sponsor negotiations have occurred (March 18) and thus, the possibility exists that some initial agreement will be reached.

Initial Segment

The original Exxon proposal ran counter to much existing law and would have, if implemented, necessitated substantial concessions from Congress and FERC. The proposal was heavily advantageous to the North Slope producers on every significant issue associated with producer participation. While the proposal was an initial negotiating posture, rather than a final offer, many of the points that ran afoul of existing law will likely be included in a final agreement, thus still necessitating favorable Congressional and FERC action.

From the standpoint of the gas pipeline's future, the potential for delay, the potential for abandonment of the project, and the level of concessions that may be required from Congress and FERC, the document is of great interest. The changes in existing law and regulations it would have required are:

1. Congressional revocation of the prohibition on producer equity.
2. Probable Congressional revision of producer participation restrictions to allow producers to own debt, rather than simply guarantee debt.
3. Revision of the limitations on producer controls and management of the project during construction, and probably on producer involvement subsequent to completion.

17/ The Exxon proposal did not, of course, come out of thin air. Prior to its submission, negotiations had been conducted between Exxon and top DOE officials involved in the gas pipeline which inspired its submission. In fact, Exxon's statement attached to the proposal stated that DOE had "requested" the proposal. Much speculation existed that DOE had effectively co-authored the Exxon proposal and that therefore, the government's imprimatur was on it.

4. FERC reversal of its final order on conditioning costs, so that conditioning costs would be allocated, at least equally, to the transportation system sponsors, rather than virtually all to the producers.

5. FERC reversal of its decision to keep conditioning plant costs out of the gas pipeline tariff mechanism (current Exxon sales contracts provide that purchasers shall bear these costs. These provisions are directly contrary to existing FERC policy).

6. IRS issuance of a favorable tax ruling to accommodate producer participation and resolve the investment tax credit issue to the producers' satisfaction.

7. FERC approval of an adjustment in the sponsors' Partnership Agreement so that the profit discounts for late participants will not apply. FERC would also have to approve a change in the Partnership Agreement that would provide "for a 2/3 vote on significant issues", in essence giving the producers a veto over any sponsor decision on important issues.

8. Probable renegotiation of the U.S.-Canada Agreement On Principles to include the conditioning plant as part of the Alaska Natural Gas Transportation System.

9. FERC approval of producer participation in system ownership (provided such approval is not mandated by Congressional action under Numbers 1 or 2 above).

10. The legal requirements imposed on the Northern Pipeline Agency (receipt of firm financial assurances that the U.S. segment of the pipeline will be built prior to authorizing prebuild in Canada) would have to be very liberally construed by them or the requirement would have to be amended. This problem will likely have to be faced in some form later this year.

The Exxon proposal does not obligate Exxon to purchase any project debt; rather it states that if, in the opinion of producers, the cost estimates, design and engineering work done over the following year or two are "acceptable", then Exxon would "at that time agree to purchase its share of 40% of project debt". Exxon also conditions its equity and debt commitments on favorable FERC rulings and on the other producers assuming their proportionate share and other financially capable lenders accepting 60% of the debt requirement. Exxon stated that its commitment was subject to its debt and equity terms being "equal to those obtained by other lenders, sponsors and/or producers".

It should be quite obvious from the above that the Exxon proposal posed huge statutory and regulatory problems. Yet, Administration officials sympathetic to the Exxon proposal held on to the belief that there was some chance that they could implement it or a reasonable facsimile without needing the approval of Congress. ^{18/} They also assumed — and presumably still do — that the Federal Energy Regulatory Commission would accede to many of the demands made in this proposal. The first possible stumbling block was postponed when Secretary Duncan prevailed on FERC to delay its final decision on conditioning costs while negotiations continued.

There is some irony to be found in Exxon's statement accompanying the proposal. As we stated earlier in this report, the President's Decision chose the least financially and technologically capable of the three applicants. In advocating its proposal, Exxon stated that it provides the project with the first significant immediate financial contribution and offer of participation and that it would supply the considerable Arctic experience it had gained in designing and constructing the TAPS line.

Once the Exxon proposal was on the table, DOE attempted to bind the producers and sponsors into at least a general commitment to a financing plan, via the use of a "Letter of Intent". As expected, Northwest immediately objected to the Exxon proposal for a variety of reasons, including its loss of control over the project. Northwest was forthcoming at this point concerning the need for cost overrun pool participation, both from the producers and the State of Alaska, as an alternative to the Exxon-type proposal.

The evolution of the "Letter of Intent" concept provides an interesting insight into the pipeline negotiations. The idea was originated by Martin Lipton, and strongly advocated during his tenure. It is still the document that the various parties are working toward. What has changed dramatically is the projected date for initialling the Letter of Intent. DOE first hoped to have it signed by mid-December.

In a December 7 memorandum to all ANGTA parties, Lipton outlined his plan. The Lipton concept included a section on "Final Design", which would include the financial commitment of producers and sponsors to upwards of \$500 million in design costs so that a reliable total project cost estimate might be generated. This segment has come to be known as "Phase I".

^{18/} It would appear that at least some of the DOE negotiators either ignored or misunderstood existing law and the political realities involved in significantly changing it. This error became particularly obvious when Senators Jackson and Stevens strenuously objected to the negotiation of a double cost overrun pool in their February 19 letter to Secretary Duncan.

The second segment of the proposal and letter would describe the "Financing Plan". In this phase, Lipton conceded that sponsors and producers had dramatically different financing plan concepts and that both would be included in the letter with a provision he described as evidencing "recognition that the parties do not agree with respect to financing and agree to work with each other and DOE to evolve a financing plan." Moreover, the financing segment of the letter would also include recognition that "if agreement on financing plan cannot be reached, the project must be restructured and new legislation may be necessary." 19/

The Lipton memorandum also states that the Letter of Intent should include a section entitled "Recital of Steps to be Taken to Reach Definitive Contract". What is troublesome about this segment of the proposed letter is that it assumes many statutory and regulatory concessions will be made. Impliedly, failure of any of these concessions to materialize would be grounds for voiding the Letter of Intent. For example, the conditions include "satisfactory treatment of conditioning plant", "satisfactory arrangements for the Canadian segment", "all necessary DOE, FERC, DOJ, Federal Inspector, Alaska, Canada, etc. approvals", and the satisfactory creation of a financing plan and partnership agreement. Additionally, should cost estimates generated be unacceptable to any of the parties, they would apparently be allowed to withdraw for that reason, too. Lipton envisioned that DOE would actively participate in the negotiations and the drafting of the letter, and that the letter would be signed by DOE, the sponsors, and the producers. It is still DOE's hope to gain tripartite signatures to a similar letter of intent.

Given the provisions of existing law and regulations, and the apparent unwillingness of Congress to provide a legislative "quick fix" form of federal guarantee, the Letter of Intent -- as conceived in early December and as it is still perceived today -- seems to be an extremely fragile basis for project success. In our judgment, the prospect of further delay, renegotiation, or even complete restructuring of the project will remain, even after the Letter is signed. In fact, the "problems and solutions" discussed in the December Lipton memorandum indicate that the major problems initiated by the President's Decision and Congressional approval, and exacerbated by subsequent FERC decisions, remain as threatening as ever and remain essentially unsolved. The major problem areas the memorandum cites which would need Congressional amendment or positive Administrative decisions include: conditioning costs, producer equity, rolled in pricing for conditioning, perfect tracking and minimum tariff bill decisions (from FERC), and acquisition of a sufficient cost overrun pool so that no federal or consumer completion guarantees are necessary.

19/ It is difficult for us to imagine that Northern Pipeline Agency Commissioner Mitchell Sharp could accept such "recognitions" as adequate assurance that project financing would be available. Clearly, denial of pre-build authority would be a blow to the project and raise the spectre of overall project abandonment. And, in a mid-March letter to Secretary Duncan, Commissioner Sharp stated that Canada will not approve the southern Canadian part of the pipeline until financing for the entire project has been arranged.

Middle Segment

Neither Northwest nor the producers made any major concessions during January and little progress was apparent. ^{20/} As consultant Lipton neared the end of his full-time tenure (he resigned February 14), he publicly floated two fairly dramatic proposals for restructuring the pipeline, apparently in an attempt to move the negotiations off dead center. Neither proposal has been publicly endorsed by Secretary Duncan.

The first proposal called for an all-federal pipeline (the "FedLine") in the event that no agreement could be reached between the various parties. The second called for a double cost overrun pool providing federal guarantees of completion, with the pipeline remaining privately owned. Both proposals would entail indepth Congressional consideration and almost certainly significantly delay the commencement of pipeline construction.

The "FedLine" proposal was aimed directly at John McMillian. It was contained in a January 30 memorandum to Secretary Duncan, accusing McMillian of refusing to negotiate with the North Slope producers. Lipton stated that if McMillian would not negotiate, then a totally different approach to the project would be needed, such as an all federal line. As Lipton conceived it, the FedLine would be financed by government bonds and would probably be constructed by the producers. Northwest would not participate. The pipeline would be owned and run by the federal government and might reduce consumer costs for North Slope gas delivered to the Lower 48. While this position was not publicly advocated by anyone at DOE other than Lipton, its concept has some support from Senator Jackson.

The double cost overrun pool proposal may be the more realistic of the two proposals, because it would entail fewer changes in the basic structure of the project, and therefore, could theoretically be implemented more quickly. As Lipton perceives it, the producers would put up the majority of a \$5.5 billion cost overrun pool, assuming an \$11 billion project, and the government would then guarantee a second overrun pool of \$10 billion. The producers and sponsors may be able to accept this concept, provided that other conditions they demand are met. However, to date, the proposal has not been endorsed by Secretary Duncan or President Carter, and has been staunchly opposed by Senators Jackson and Stevens. Thus, it appears that producer/sponsor acceptance of the concept is a secondary consideration at this point. Finally, Canadian approval of such a no longer privately financed line would be necessary (see Section III for details).

^{20/} While Northwest had been recalcitrant regarding some aspects of the negotiations, they were by no means solely to blame for the delay and frustration attendant upon the negotiations. The negotiations in December and January progressed on certain issues contained in the original Exxon proposal, but the negotiation process broke down in early February when Exxon apparently backtracked and returned to its original October 26 position.

Unfortunately, Lipton's double cost overrun pool pays little heed to existing law. It assumes that the "Alaska segment of the pipeline and the conditioning plant would be treated as a single project." 21/ To effect this, a major FERC decision and perhaps renegotiation of the Agreement with Canada would be essential. Lipton states that the proposal would require legislation, but that in practical effect, it still results in a privately financed project. We do not concur with his opinion and the Stevens-Jackson letter supports our conclusion.

Senators Jackson and Stevens wrote a joint letter to Secretary Duncan on February 19, expressing their "grave concern" with the double cost overrun pool proposal. Citing the President's Decision and Congressional approval of it, the Senators stated: "We do not believe it is appropriate for the parties to negotiate from the basis of a position fundamentally contrary to the 1977 Decision". The letter goes on to state that the terms and conditions of the Decision prohibit natural gas producers from participating in the ownership of the system as equity investors and from having voting power in the project and a role in management. It cites the Lipton proposal as contrary to each of these prohibitions. It also takes issue with the private finance question and states: "We have also repeated the warning to all concerned that the door to the federal treasury is closed as far as this project is concerned" and cites the quotation from the Senate report on the NGPA regarding federal subsidies as authority.

Just prior to the Jackson-Stevens letter, the producers sought an informal signal from both the Carter Administration and Capitol Hill that pursuing the idea of a double cost overrun pool would not be fruitless, i.e., that such a federal completion guarantee was at least a negotiable concept to the Administration and Congress. We know of no affirmative response from the Administration.

Current Segment

On March 18, the gas pipeline reached something of a landmark in that, for the first time, producers and sponsors met face to face in the office of the Secretary of Energy in an effort to agree on a research and design agreement and a financing plan. Immediately prior to the meeting, the producers had evidenced a willingness to help finance the design phase and leave subsequent issues until firm cost estimates generated from Phase I were available. For their part, the sponsors indicated a willingness to discuss the essential question of control and management of the project, but seemed unwilling to accept a letter of intent covering only Phase I research and design work.

21/ February 11, 1980 Lipton memorandum to Secretary Duncan, entitled "Advantages of the Double Cost Overrun Pool Financing Plan for ANGTS".

Negotiations have continued through April. A Phase I cost-sharing arrangement for the research and design work may soon be agreed upon, but the tough, long-term issues on which the parties seem intransigent remain essentially untouched.

V. Congress: Negotiable and Non-Negotiable Conditions

Overview

It is virtually certain that the Alaska Gas Pipeline will need legislative action to be constructed. At the very least, Congressional approval of producer equity will be required. 22/

Ultimately, we anticipate that Congress will facilitate development of the Alaska Gas Pipeline, rather than block it. However, Congressional review will delay the commencement of construction and the length of the delay will relate directly to the extent of the restructuring job presented to Congress, as well as the date Congress begins to consider gas pipeline amendatory legislation.

1980 Action

In 1980, it is very unlikely that Congress will be presented with legislative proposals to amend Alaska Gas Pipeline law. Indeed, there is a slight possibility that Congress will not even hold hearings on the gas pipeline this year. Whether hearings will be held is dependent upon the success or failure of the current negotiations between the producers, sponsors and DOE, coupled with the timing of those negotiations.

At present, no hearings on the Alaska Gas Pipeline are scheduled by the Senate Energy and Natural Resources Committee or the two House Committees with jurisdiction over the gas line: the House Interior and Insular Affairs Committee and the House Interstate and Foreign Commerce Committee. This circumstance can change quickly, however. The Senate Energy Committee maintains a very active interest in the progress of the gas pipeline and will probably hold hearings this year if the producer-sponsor negotiations break off before the last busy weeks of the 96th Congress. It is also possible that the Senate Energy Committee will hold oversight hearings on a gas pipeline financial plan, if such a plan is agreed to by the parties. Whether the Committee will hold oversight hearings on the financial plan depends on its calendar, as well as the number of available days left in the session.

On the House side, the Interior Committee held general update hearings on October 15 and 16, 1979, and committed itself to holding

22/ There is always the remote possibility that the Justice Department will approve producer equity without amendment of the President's Decision, convince Congress that its approval is legally sustainable, and can defeat court challenges, such as stockholder derivative suits, to its opinion. We not only believe that this prospect is extremely remote, but presume that lenders and potential investors will strongly prefer Congressional resolution of this issue, rather than chance court challenges that may upset the project at various junctures.

further hearings in the spring of 1980. Those hearings were targeted for early April, but were cancelled pending outcome of the current negotiations. This Committee expects to hold hearings on the gas line this year, assuming something definitive occurs before the last few days of the session. The House Commerce Committee may hold hearings this year, but its plans remain unclear and it too awaits some outcome from the negotiations.

The Players

The three committees that have been instrumental in shaping Alaska Gas Pipeline law will also determine its future. The leadership and staffs of these committees have remained very much intact since the consideration and enactment of ANGTA. Moreover, the predominant legislators are on the record for and against certain policies. This supports our belief that legislative history and prior commitments made personally to the leadership will play an unusually potent role in future legislative decisionmaking.

In analyzing each of the jurisdictional committees below, we have attempted to highlight the apparently non-negotiable positions of the leadership, and also point out the areas where compromise seems more feasible.

1. Senate Energy Committee --

This committee is chaired by Senator Henry Jackson, who will dominate its decisionmaking vis-a-vis the Alaska Gas Pipeline. While Senator Stevens sits on the committee now, there is a strong possibility that he will have returned to the Senate Commerce Committee by the time gas line legislation reaches the committee.

Senator Jackson should be considered a strong advocate of construction and operation of the Alaska Gas Pipeline, and has been so for many years. He and the Committee appear willing to accept an equity role for North Slope producers if all other conditions are satisfactory. Neither is willing to accept changes on a piecemeal basis, however. The changes in existing law the Administration in power proposes will have to be submitted to the Energy Committee in a package in order to gain approval.

By requiring a full complement of changes at once, the Committee is probably imposing a significant, albeit reasonable, delay of legislative action. Some aspects of the final financing, regulatory and legal structures may not be ascertainable until the research and design phase of this project has produced a credible cost estimate (This phase should take about 18 months, beginning around mid-1980, if all goes well. Possibly it can be accelerated to 12 months) and FERC has adjudicated the key regulatory questions before it. Presumably, a complete legislative package will not reach the committee

before the latter part of 1981 or the beginning of 1982. Under the optimal conditions (60 calendar days of continuous session for enactment of a joint resolution of approval), Congress cannot be expected to approve amendatory legislation before January 1, 1982. Quite obviously, approval could easily take until the latter part of 1982.

Senator Jackson is taking an apparently non-negotiable position regarding band-aid federal financial assistance proposals, such as consultant Lipton's double cost overrun pool. Jackson firmly believes that this project should be a privately financed project and that rolled in pricing for Alaska natural gas "is the only federal subsidy, of any type, direct or indirect, to be provided for the pipeline". (Senate Report on the Natural Gas Policy Act, page 103; S. Rep. 95-1126). If private financing cannot be obtained, Senator Jackson advocates that the next-best approach would be an all federal line, owned by the federal government, built by the Army Corps of Engineers or a private contractor, and operated by the federal government. Such a Fedline might deliver North Slope gas to the Lower 48 at the lowest possible consumer price. The Fedline proposal is similar to legislative initiatives that Senator Jackson has supported in the past for federal energy companies, such as a federal oil and gas exploration corporation (FOGCO). Senator Jackson may be on the extreme end of the Senate Energy Committee regarding an all federal line, if private financing cannot be acquired. However, Senator Jackson's ability to convince his committee that a Fedline is the best alternative should not be underestimated.

2. House Interior and Commerce Committees —

The Interior Committee should be willing to entertain most reasonable suggestions for bringing the project to fruition. Two members of the committee are particularly conversant with the gas pipeline, Representative Harold Runnels (D-N.Mex.), Chairman of the reviewing subcommittee, and Congressman Don Young. The full Committee is chaired by Representative Udall, who has not taken a particularly rigid position regarding the pipeline. Neither he nor his Committee appears likely to make any non-negotiable demands regarding gas pipeline restructuring, except perhaps opposition to consumer non-completion guarantees.

The House Commerce Committee is another story. Beginning in 1981, it will be chaired by Representative John Dingell. He much resembles Senator Jackson in political muscle, philosophical commitment to certain conditions regarding the gas pipeline, and — fortunately — in commitment to seeing the gas pipeline built. Dingell appears willing to accept North Slope producer equity. While he and his committee are committed to making the pipeline a privately financed project, they would probably be more willing than Senate Energy to accept federal financial participation in a manner less inclusive than an all Fedline.

Congressman Dingell draws the line between negotiable and non-negotiable conditions in two places: He will not accept any consumer guarantees of non-completion, nor will he likely agree to any restructuring of the pipeline that dramatically increases consumer cost to the benefit of producers and sponsors (for example, he would likely find a FERC decision loading all conditioning costs on consumers unacceptable and would fight it legislatively). 23/

While Senator Jackson has been a long-standing supporter of the Alaska Gas Pipeline, Congressman Dingell, in contrast, was not originally a fervent advocate. He has recently, however, become strongly committed to the project. Dingell's Energy and Power Subcommittee is populated with members from eastern and midwestern states with limited domestic energy production and much need for Alaskan gas. Dingell can expect particularly strong support on the gas pipeline from the ranking Republican on his subcommittee, Clarence Brown of Ohio. The recent proposals to shake up the House of Representatives' jurisdiction over energy matters, including the gas pipeline, were defeated and Representative Dingell and his committee have succeeded in adding to their energy jurisdiction (the committee was given jurisdiction over national energy policy), rather than losing power.

Congressional Outlook

While it is difficult to predict Congressional actions on a subject as complicated and controversial as the Alaska Gas Pipeline, there are certain conclusions that can be drawn from the established positions of the principal operatives, the interviews we have conducted with Committee staff, and the history of the pipeline. The conclusions which we feel are least speculative are these:

1. The expedited procedure for amending the President's Decision found at Section 8(g) of ANGTA, involving approval of a joint resolution within sixty days of continuous session, will only come into play if the restructuring process is minor, noncontroversial, or agreed to by all parties ahead of time. The most fundamental change the expedited procedure could reasonably be used to cover appears to be permitting North Slope producers' equity. Even in that instance, the joint resolution approach will be available only if there are few, if any, other regulatory or legislative changes needed for the commencement of the project. The tough issues (such as federal participation) are ones that each Committee desires to consider at length within the framework of the entire project. All parties fear that Congressional consideration of almost any significant issue will open up the entire pipeline to reconsideration and possibly cause substantial delays.

23/ Any efforts to revive plans for an All-Alaska - West Coast gas delivery system would almost certainly be crushed by Dingell and the midwest coalition in the House.

2. Congress would probably accept North Slope producer equity in the project, but might be hesitant to permit all-out producer control.

3. Consumer non-completion guarantees have no support and are therefore not a financing option.

4. There is currently no interest in reconsidering the route decision.

5. There would be some sentiment for lifting the certificate from Northwest, if the line cannot be privately financed but of course, this would involve selecting an alternate sponsor. It is probable that Congress would not have the inclination to make such a time-consuming change unless it was absolutely necessary for project realization.

6. There is little chance of Congressional approval of pipeline law amendments before the end of 1981. The process could be dragged out until the end of 1982, or perhaps into the ensuing Congress.

7. Congressional consideration of the Alaska Gas Pipeline is fraught with the possibility that explosive peripheral issues could cause almost interminable delay. Three such issues are eminently apparent: protection of the U.S. steel industry via "buy-American" legislation; vertical integration of the oil industry; and, in the event of a Republican Administration (particularly if headed by Governor Reagan), the party's philosophical opposition to federal government involvement in traditionally private areas of the economy (i.e., oil and gas pipelines).

The steel industry problem is very real and could severely threaten the pipeline as early as the first-quarter of 1981. Bidding for the supply of pipe, valves, etc. for the Eastern Leg may open then. The Agreement On Principles between the U.S. and Canada requires, at Section 7, that goods for the pipeline be supplied on generally competitive terms and that the respective governments can require renegotiation of contracts or the reopening of bids if the certificate holder chooses a higher bidder (provided such higher bidder does not have higher capabilities justifying the higher cost). The Canadian steel industry (in particular, Stelco and Ipsco) is probably capable of supplying at least the Eastern Leg at prices below those available from the U.S. industry. Should either Stelco or Ipsco bid on the Eastern Leg, they may well instigate a crisis. If they produce the lowest successful bid and are selected, the steel industry in the United States, abetted by the "Steel Caucus" in both the House and Senate and the United Steelworkers Union, will actively work to derail the gas pipeline and/or require that any amendatory legislation include a "buy-American" clause. If, on the other hand, the Canadians are low bidders but are rejected, then the Canadian government may be forced to lodge a protest 24/

24/ The Canadians can pressure the U.S. quite effectively by threatening to reject Eastern Leg pre-build, reduce gas exports, or hike export gas prices.

with our government and require the United States to have the contracts renegotiated or rebid. In either event, the gas pipeline project will certainly be set back, as will U.S.-Canada relations. It is hoped that the spectre of such a result will deter the Canadian companies from bidding on the steel supply contract. A slightly less onerous result will occur if another foreign country's steel industry, such as Japan, underbids U.S. manufacturers and is chosen. This, too, would likely delay the project.

With regard to vertical integration, there are probably 35 Senators and 125 Congressmen who will vote for vertical or horizontal divestiture of the oil companies at almost any time. The major oil companies are not now in the interstate gas transmission business. Should Exxon enter a new segment of the energy business, it is sure to generate boisterous opposition in Congress, and that opposition can well delay action on pipeline amendments.

Finally, if government guarantees are proposed, we can anticipate probable White House opposition should Governor Reagan or any Republican be elected. Despite the fact that all of the Republican candidates advocate increased domestic energy production, they and their party not only oppose active government financial participation in private industry, but also fear the precedent it would set for federal oil and gas exploration companies, and similar quasi-governmental corporations that would compete with private industry. White House opposition would probably delay, and possibly defeat gas pipeline amendments.

Should Congress face the more fundamental and difficult pipeline issues — federal participation and the extent of it, lifting the pipeline certificate from Northwest and John McMillian, Congressional revision of FERC decisions unacceptable to the pipeline investors or debt holders, and others — it is difficult to project the outcome. We would guess, however, that based on today's Congress, an all Fedline proposal would be very difficult to enact. During the legislative review process, a large number of logistical problems would probably become apparent, the shadow of other quasi-private corporations such as Amtrak and the U.S. Postal Service would work against its adoption, and the idea of trying such an experiment on the largest international energy project ever undertaken would frighten away many legislators.

Whether Congress would accept the role of cost overrun guarantor is a close question. Without doubt, the overwhelming sentiment on Capitol Hill is that the gas pipeline should be built and that it is in the national interest. Most legislators would agree that it may be appropriate for the country to pay some premium for such a large new domestic supply. If the decision comes down to no gas pipeline without guarantees or a gas pipeline with them, our guess is that guarantees would be forthcoming. We have found near-unanimous agreement that if federal guarantees are provided, the rate of return for equity participants will be reduced significantly.

Finally, there have been some suggestions that should Congress reassess the entire project, it would seek to remove Northwest Pipeline and John McMillian as the certificate holder. We have found no strong sentiment one way or the other on Capitol Hill regarding this subject, and believe that few legislators or staffs have seriously considered it.

VI. Canadian Law, Pre-Build and Future Choices

Background

The decision of the Canadian National Energy Board on July 4, 1977 regarding the Alaska Natural Gas Pipeline established certain fundamental policy conditions for constructing a gas pipeline system, which have been translated into statutes and regulations in Canada. In general, Canadian policy has been beneficial to the United States, with the exceptions discussed below.

First, the NEB decision favored continued Canadian gas exports to the United States and rejected proposals that existing gas export agreements be cancelled. NEB based this decision largely on its conclusion that existing gas production in western Canada (primarily Alberta) exceeded current and projected demand to a sufficient extent that such exports were justified.

The determination by Canada that there was, at least over the short run, a surplus of natural gas available for sale in U.S. markets is integral to the pipeline and its economics. The emerging short-term Canadian surplus was foreseen by pipeline sponsors, and early construction of facilities to allow export of this surplus (which would eventually be repaid to Canada with Alaska gas) was included as a key selling point in the Alcan proposal, since such early exports would provide relatively large cash flows and relatively low capital costs early in the project's life.

From the Canadian standpoint, of course, such early gas deliveries (via what has come to be called the "pre-build" segments of the project) entailed some economic and political risk. Both varieties of risk centered on the possibility that the Alaska segment of the line could not be financed. In the event that Canada authorized short-term surplus exports and the Alaska line failed to be completed, Canada would at least theoretically be short of natural gas for its domestic requirements in years to come. While the possibility of a Canadian gas shortage due to exports might be somewhat speculative, the political fallout in Canada from a collapse of the American side of the project is less so. Clearly, the thrust of economic nationalism in Canada favors development of Canadian resources for Canadian benefit; export of Alberta gas, followed by the failure of the U.S. to replace that gas could be expected to generate substantial political difficulties in Canada, leading to charges that the government had "sold out" or been "suckered" by the Americans.

As a consequence of these perceived economic and political risks, Canada entered the negotiations with the United States with the firm objective of holding the pre-build segments of the project as "bait" to encourage the U.S. to formulate a sound and viable project, especially from a financial standpoint. From the first U.S.-Canadian negotiations on the pipeline, insistence on a sound U.S. financial plan has been the centerpiece of

Canadian policy on the pre-build segments. This policy has been quite consistent (and a major potential source of trouble for the pipeline, as discussed below) until recently. As will be discussed subsequently, it now appears that Canada is willing to soften its position with respect to the status of U.S. financing, at least to the extent of authorizing the Western Leg exports, which constitute only a relatively small part of the total pre-build portion of the project.

On April 12, 1978, the Northern Pipeline Act became law in Canada. The Act established the Northern Pipeline Agency and initiated the Canadian government's effort to "facilitate the planning and construction of a pipeline for the transmission of natural gas from Alaska and Northern Canada and to give effect to an Agreement between Canada and the United States of America on principles applicable to such a pipeline and to amend certain acts in relation thereto." 25/ The Act is an expedition/facilitation statute, somewhat analogous to the Alaska Natural Gas Transportation Act. It contains both statutory provisions and a series of conditions. These "conditions" are analogous to federal regulations in the United States and therefore, can be amended without an act of Parliament.

The Act creates the Northern Pipeline Agency as a ministerial level agency of the Government of Canada. It states that the Minister shall "oversee and survey all aspects of the planning and construction of, and procurement for, the pipeline; and in order to carry out the obligations of Canada contained in the Agreement, consult with the appropriate authorities of the United States on any matter arising under the Agreement." Section 9(d) and (e).

The Act issues certificates of public convenience and necessity to the Canadian companies involved in building the gas line, but retains NEB authority to rescind, amend or add to the terms of those certificates. It is noteworthy that the certificate granted to the companies by the Act is one to carry Alaska natural gas and no other.

The Act deals with "Native Claims" in summary fashion. At Section 23.1, it states the following:

Notwithstanding this Act, any Native claim, right, title or interest that the Native people of Canada may have had prior to the coming into force of this Act, in and to the land on which the pipeline will be situated continues to exist until a settlement in respect to any such claim, right, title or interest is effected.

25/ Preface to Northern Pipeline Act, Vol. 3, No. 4, Canada Gazette Part II, Chapter 20, 26-27 Elizabeth II.

It is significant to note that the Trans-Alaska Oil Pipeline might not yet be built if the claims of the Alaska Natives had not been settled by the Alaska Native Claims Settlement Act. The claims of the Yukon Natives have, as yet, not been settled and remain a difficult and potentially explosive issue to resolve. The Yukon Native claims are perhaps not as intricate or substantial as the Alaska Native claims were, but they remain a source of possibly significant delay. To date, negotiations between Yukon Indian groups (chiefly the Council of Yukon Indians) and the government have yielded very little in the way of results. These negotiations were not assisted by the six-month Tory interregnum between Prime Minister Trudeau's Liberal governments.

The Northern Pipeline Act goes on to restate the Agreement on Principles with the United States, including the provision at Section 4(a) that the companies owning the pipeline will have to demonstrate to the Canadian government that "protections against risks of non-completion and interruption are on a basis acceptable to that government before proof of financing is established and construction allowed to begin." This is the legal test that the U.S. sponsors and government will have to meet in order to enable the NPA and Cabinet to authorize pre-build construction.

This policy is embellished by the conditions attached to the Northern Pipeline Act under the heading of "Financing" at ¶ 12. This paragraph states inter alia that: "The companies shall, before the commencement of construction, . . . (b) establish to the satisfaction of the Minister and the Board that . . . (i) financing has been obtained for the pipeline, and (ii) protection has been obtained against risks of non-completion of the pipeline and interruption of construction on a basis acceptable to the Minister and the Board." Technically, the "condition" applies only to the Canadian segment of the pipeline, while Section 4(a) applies to the U.S. position. From a practical political standpoint, the U.S. side will likely be held to the same standard of financial certainty as is the Canadian. It is very probable that an agreement solely to finance and manage the research and design phase of the Alaska portion of the pipeline cannot satisfy ¶ 12(b)(i).

Administrative and Regulatory Actions

Canadian-U.S. ties regarding the gas pipeline were strengthened dramatically in March of 1979, when Prime Minister Trudeau and President Carter issued a joint communique in which Trudeau stated that he received strong assurances from President Carter that the Alaska Gas Pipeline would be completed, allowing delivery of Canadian and Alaskan gas to American markets. This announcement followed by one week a pronouncement from the National Energy Board that Canada would have two trillion cubic feet of currently excess natural gas to sell the United States during the next eight years. These "pre-build" gas sales would help finance the southern leg of the proposed pipeline.

During the last half of 1979, the Canadian government, principally via the Northern Pipeline Agency, continued to press the U.S. and Northwest for adequate assurances that the Alaska segment could and would be built. Simultaneously, the National Energy Board was also wrestling with policy regarding the export of Canadian gas through the Eastern and Western legs of the pipeline, and the attendant authorizations for new facilities necessary for such exports.

On December 6, 1979, the NEB approved 3.75 trillion cubic feet of natural gas exports over a seven-year period for the pre-built Western Leg of the line. This export volume was immediately attacked, both in the U.S. and by Canadian producers as inadequate to support the projected Western Leg segment, and NEB reconsideration was requested.

The NEB decision has added some urgency to DOE attempts to obtain a Letter of Intent from the pipeline sponsors and North Slope producers. It is DOE's judgment that such a letter (including at least a tentative plan in the form of the Phase II portion) would make the NEB more sympathetic to approving additional exports. NEB hearings on reconsideration began March 18 and a decision is expected by May 1, 1980. The additional volume being sought is .5 trillion cubic feet, and while most participants on the U.S. side anticipate NEB approval of the additional exports, it should be kept in mind that this decision affects only the Western Leg of the project. Action on the Eastern Leg exports and facilities is still pending, leaving the largest section of the pre-build still unresolved (and hence, the largest financial benefit to the project sponsors in terms of cash flow and additions to the project's basic financial structure). In general, if Canada is to hold some portion of the project "hostage" until the U.S. financial situation clarifies, it is likely to be the Eastern Leg export volumes and associated facilities. Since the Eastern Leg is not scheduled for completion until 1981, the Canadian decision to use this portion of the "pre-build" as a pressure point gives the U.S. somewhat more time to get its side of the project in order.

Recent events suggest that Canada is still very supportive of the project as a whole and is desirous of seeing it move ahead. Specifically, at the March 11, 1980 NEB hearings on project financing, the Board issued "findings" ^{26/} favoring looping of existing facilities, rather than new construction, for export of the gas. ^{27/} Second, proposed language has been floated by NEB and NPA to amend Condition 12 of the Northern Pipeline Act to allow approval of facilities, even if final U.S. financial approvals are not in hand (this amendment of Condition 12 is discussed more fully below).

^{26/} The NEB announcement was in the nature of "findings" and authorized nothing. It was the first phase of a two-stage hearing process geared to adjusting the December 6 Decision. The first phase findings, on financing, were issued on March 11. The second phase, with hearings beginning March 18, deals with the additional gas exports on pre-build facilities over the next seven years. It will also consider whether some gas already authorized for export may be shifted from non-pre-build facilities on the Eastern Leg.

^{27/} The authority to construct said facilities lies with the Northern Pipeline Agency, and not the NEB. NEB has the authority to authorize exports and facilities, yet it does not have authority to issue permits to construct

Despite these signs of Canadian cooperation, concern over financing on the U.S. side remains high. In mid-March, Northern Pipeline Agency Commissioner Mitchell Sharp wrote to Energy Secretary Duncan demanding a financial plan for the Alaska portion of the pipeline by May 1980, and threatening that if such a plan is not produced, Canada will not pre-build the southern parts of the line. Sharp also warned in his letter that construction delays were intolerable since they would hurt several Canadian industries and create substantial economic losses in Canada. As discussed previously, we believe Sharp's comments are directed primarily at the Eastern Leg of the project, and that the Western Leg is still likely to move ahead, barring some major disaster on the U.S. side.

The outcome of the pre-build issue will hinge not only on the success of financing negotiations in the United States, but also on the relationship between the NEB and the Northern Pipeline Agency. Both must agree that the conditions precedent for pre-build have been satisfied in order for the go-ahead to be given. Additionally, the Canadian Cabinet must give its approval of the project.

In order to construct the loops and other related facilities necessary to transport this gas, the Northern Pipeline Agency will have to be convinced that proper financial assurances exist that the rest of the Alaska Highway Pipeline will be built. Without that assurance and hence, without the necessary facilities, the NEB decision on pre-build exports will be void, unless and until new applications are filed with NEB to export that gas on facilities other than those associated with pre-build.

Pre-Build Decision Schedule

At present, the Western Leg of pre-build is scheduled to be completed in Canada on November 1, 1980. In order for this deadline not to be delayed for one year, Foothills must be granted authority to construct by June 1. The June 1 date is tied to construction requirements in the mountains of British Columbia. Foothills states that it must construct in this region during July and August, or it must wait until next July to do so.

In order for the Canadian Government to authorize construction 28/ by Foothills on schedule, it must receive no later than mid-May, the following:

1. Final NEB findings on the level of exports that can be justified.
2. NEB's final findings on financing the pre-build.

27/ cont'd.

facilities to be used for pre-build sections of the Alaska Gas Pipeline. Only the Northern Pipeline Agency can issue such certificates.

28/ See n. 26. supra.

3. A favorable decision from the Northern Pipeline Agency regarding the financial assurances and other completion assurances provided by the U.S. Government and Northwest Pipeline regarding the U.S. sections of the line.

In order for the Northern Pipeline Agency to conclude that it has received adequate assurances that the U.S. segment of the pipeline will be built, it must receive a credible financial plan. This plan is far more than the contemplated Phase I Letter of Intent, which will only include the research and design phase and finances for it. Phase II is now contemplated to contain a description of the financial commitments made by the sponsors and producers, although it will have a great many caveats, escape clauses, and conditions to be met. The true test of Phase II will be whether it is so flimsy that Canadian Cabinet members or members of the public and press who oppose pre-build can expose Phase II as no more than a vague "agreement to agree".

There is one more document that will be presented to the Northern Pipeline Agency and the Canadian Cabinet that may help provide the financial assurances necessary. Almost unquestionably, President Carter will provide the Canadians with a statement of his deep commitment to the pipeline, of his certainty that the pipeline will be completed, the high level of support and effort his Administration will continue to give the pipeline, and he will probably include his estimate of when the pipeline will be completed. Our guess is that the President will estimate 1986, give or take a year. The value of such a Presidential declaration on the pipeline is also open to varying degrees of interpretation.

At the earliest, the NEB decisions on Western Leg export and finance, coupled with the Northern Pipeline Agency decision on financial assurances, will be presented to the Cabinet by about May 20. This would leave the Cabinet a very short time (at most, 3-5 weeks, assuming Foothills could still go ahead if approval slipped a couple of weeks from the June 1 deadline) to act, and act favorably, so that pre-build can advance on schedule.

Before leaving the timing issue, we should mention that the year's delay effected, even if all goes well on the financial assurances question. First, Pacific Gas Transmission's U.S. side of the Western Leg is somewhat behind schedule in getting its approvals from FERC. A several month delay may result. Second, the Canadian Cabinet may not be willing to act immediately on the pre-build package presented to it in late May. The Canadian Government may still be embroiled in negotiations which are about to begin between Alberta and the Federal Government regarding control over and pricing of Alberta gas and oil. Alberta controls most of its natural resource policies, but Ottawa controls inter provincial wellhead prices. The very difficult negotiations soon to be entered center around Alberta's desire to hike its wellhead price to world oil price levels (hence raising prices to her sister provinces) and Ottawa's desire to increase its share of Alberta's petroleum revenues (at least ostensibly, to redistribute some of the oil wealth

to poorer areas of Canada). Such negotiations may put the gas pipeline temporarily on hold and in fact, under certain scenarios, the gas pipeline decision may be used to impose Ottawa-favored conditions on Alberta (who benefits both from export of pre-build gas and from pipeline construction).

Probable Western Leg Pre-Build Outcome

If the United States cannot devise at least a semblance of a financing plan to present to the Canadian government covering the U.S. segments of the gas pipeline, there is little possibility that pre-build will be approved. If, however, a firm Phase II financial agreement is reached and presented to the Canadians, there is virtually no possibility that pre-build will be rejected.

Unfortunately (from the standpoint of making solid predictions), it is most likely that the United States will submit to the Northern Pipeline Agency a two-phase Letter of Intent, with Phase II consisting of a fairly vague financing plan with many issues still to be resolved, many regulatory and legislative conditions included, and the ability for the parties to withdraw easily from the agreement. Along with such an agreement, it is expected that a strongly worded Presidential commitment to the pipeline will be supplied. This leaves the Northern Pipeline Agency and the Canadian Cabinet with discretion to go either way on its Western Leg pre-build decision.

In assessing the probable decision that the Northern Pipeline Agency will reach, it should be remembered that the agency was created to expedite, facilitate and generally bring the Alaska Gas Pipeline into existence. It has a natural tendency to boost the line, rather than delay it. Therefore, if the Northern Pipeline Agency is faced with a close question, it may be willing to determine that the pre-build condition has been met. A hint of NPA leaning may be found in a recent report stating that the Northern Pipeline Agency (and/or NEB) will soon submit a proposed amendment to Condition 12 of its statute. If this amendment is approved by the Cabinet, it would be the controlling language, along with Section 4(a) of the Agreement On Principles, regarding the sufficient financial assurances decision. At present, Condition 12 requires the Northern Pipeline Agency to be convinced that "financing has been obtained for the pipeline". (emphasis added). NPA's amendment would change the language so that NPA could be satisfied if it is assured that "financing can be obtained or is assured" (emphasis added) for the pipeline. Obviously, the latter requirement is far easier to meet.

It is our estimate that given a discretionary decision, the Northern Pipeline Agency and the Cabinet are far more likely to approve pre-build than to disapprove for several reasons. For one, Foothills and the Canadian Government have a great deal at stake and have made substantial investments in pre-build. Second, a major portion of the 1.8 trillion cubic feet authorized by NEB to be exported through the pre-build facilities (of the total approved exports of 3.75 trillion cubic feet) is gas owned by 700 small

producers, and by Petro-Canada, the national oil company. Third, many Canadian industries are geared up for pre-build, as is a significant portion of the work force. Fourth, the Alberta gas surplus does exist and export of the gas will produce substantial revenues. Finally, rejection of pre-build would be viewed as a serious blow to the viability of the entire project and could have a serious negative political impact on the Trudeau Government, a long-time pipeline supporter.

With regard to timing of the western pre-build decision, it is our estimate that the June 1 date will be very difficult to meet. We are led to this conclusion because: (1) it is entirely possible — in fact probable — that a credible financing plan cannot be readied by the U.S. producers and sponsors by mid-May; (2) the U.S. Western Leg problem may still remain; and (3) the Canadian Cabinet could well be mired in the Alberta/Ottawa controversy. As a result of a few months' delay in the approval date for pre-build, deliveries through the Western Leg will not commence until the latter part of 1981.

It is not known whether a year's delay in the development of the Western Leg will lead to a delay in construction commencement of the Alaska segment of the line. While it does not appear that a direct impact will be felt on Alaska commencement, it is possible that some indirect or residual impacts could ripple through the entire project. In any event, it is likely that the U.S. side of the project has potential for significant delay to outweigh any detrimental impacts arising from a one-year delay on the Canadian Western Leg.

Future Problems: Marketability, U.S. Agreement Renegotiation and Billing Commencement

While not statutorily related to the pre-build issue, recent Canadian actions with respect to export prices have economic and political implications for both the pre-build and trunk-line portions of the project. In January, the Canadian Government raised the border export price of its gas from \$3.45 to \$4.47 per million Btus, bringing an angry response from the U.S. Department of Energy. And, on February 20, the Department of Energy rejected plans of three U.S. companies (one of them, Northern Natural Gas Co., a partner in Northwest) to buy the higher priced Canadian gas. The immediate effect has been a slight cooling of U.S.-Canadian energy relations and a March 24 visit by U.S. Energy Secretary Duncan to Canada for consultations with Energy, Mines and Resources Minister Mark Lalonde.

The Canadian price hike, and the U.S. refusal to pay, points up a central gas pipeline issue that has received only limited attention of late, but may re-emerge as a very serious impediment to pipeline construction. That issue is marketability of North Slope gas. At present, there seems to be only limited demand for Canadian gas at \$4.47 per million Btus, both because there are apparently adequate gas supplies in the Lower 48 markets and because of the gas' high price. As construction estimates for the Alaska

Gas Pipeline escalate, the possibility increases that delivered North Slope gas will be far more costly than other available gas. At present, the various entities involved in the pipeline appear convinced that North Slope gas will be marketable, but a long delay in the line or a substantial change in the line's cost (to the extent these are two distinct alternatives) could reverse that thinking. The problem could be exacerbated should gas supplies in the Lower 48 continue to be plentiful and should large new reserves come on line quickly (not altogether unlikely, since most gas industry analysts suggest that relatively large volumes of gas remain undeveloped in the continental U.S. as a consequence of nearly 25 years of federal price control policy). Recent discoveries in the Overthrust Belt, tight gas, and OCS developments could further threaten the marketability of Alaska gas.

While the marketability issue is not new, the change in Canadian prices and the reluctance of the U.S. to pay these prices indicate the vulnerability of the project to construction cost increases and extrinsic natural gas supply conditions, either of which could adversely — and perhaps fatally — affect project economics. Marketability of North Slope gas can also be affected by U.S. policy decisions. For example, FERC has just proposed a gas pricing rule promulgated under the 1978 Natural Gas Policy Act, which will require large industrial users to bear a disproportionate share of price increases for new natural gas supplies, as opposed to household and light commercial users. This rule takes effect on May 9, provided that it is not overridden by Congressional veto. These large industrial users (traditionally having both greater sensitivity and flexibility regarding price increases than do residential or light commercial users) are already avoiding new gas purchases in favor of alternative fuel sources. If the FERC rule is left standing, it seems likely that this will further reduce the available market for North Slope gas, dilute the impact of rolled-in pricing and create added marketability problems for the Alaska gas.

Additional U.S.-Canada Stumbling Blocks

One of the basic tenets of the Agreement On Principles between the United States and Canada is that "it is understood that the construction of the Pipeline will be privately financed." Section 4(a). If the United States breaches that agreement by providing financial guarantees for the U.S. side of the line, the repercussions will be pronounced in Canada. In theory, the entire gas pipeline, both the U.S. and Canadian sides, will be financed out of the same general capital pool controlled by the major North American financial institutions. Should the United States guarantee its side of the line, then the U.S. side will be lower risk and should attract debt and equity at the expense of Canadian financing.

This circumstance would probably compel a move from the Canadian Government, either toward guaranteeing its segment of the gas line or toward refusal to renegotiate the Agreement with the U.S. to provide for a U.S. guarantee. There is substantial sentiment in Canada that is opposed to any Canadian Government guarantees of the gas line, particularly since the construction and resultant financing problem is in the Alaska segment of the

line and not in Canada. The Canadian Government will be quite reluctant to pledge its credit for the benefit of the U.S. and the U.S. consortium. 29/

Needless to say, failure of the Canadian Government to renegotiate the Agreement to permit U.S. participation will bring the pipeline project to a halt. Canada's veto power over U.S. participation is an extremely serious threat to the pipeline and poses a strong argument for pursuing every avenue or creative approach toward privately financing the U.S. segment.

A second problem facing Canadian lenders, Canadian energy officials, and the Foothills consortium revolves around the pipeline's billing commencement date. Both the President's Decision (at Section IV, ¶3) and FERC (Order 31) have precluded any charges to purchasers or ultimate consumers prior to completion and commencement of operation of the Alaska Gas Pipeline System. The concern in Canada is that they will complete the Canadian segment of the gas line up to the Alaska border and that the U.S. segment will not be ready to provide deliveries. It would appear that the Canadians would, under these circumstances, be unable to pass debt service or other charges on to U.S. consumers until the Alaska leg is completed and therefore, the Canadians are, to an unnerving degree, dependent upon Northwest Alaska's ability to perform on time. This is not a position the Canadians relish, nor one the Canadian lenders may be willing to accept. Unfortunately, this consumer safeguard appears to be a fundamental precept of the U.S. Alaska Gas Pipeline law that Congress probably will not be willing to change. The billing commencement date problem is serious and is quite likely to be brought to the forefront by reluctant lenders, once the project reaches the stage of advanced financial negotiations.

29/ The problem of Canada using its discretion and choosing not to finance its part of the line may not crop up if Canada has no discretion, i.e., should the Canadian side of the line also become so expensive or problematic that lenders will be equally unwilling to invest adequate sums in it without government guarantees. It is generally conceded that the Canadian side of the line can easily be financed at present. It is not out of the realm of possibility that this situation could change.

VII. Commencement of Construction in Alaska

It is impossible to precisely identify the time when full-scale construction of the Alaska leg of the Natural Gas Pipeline will begin. Throughout this report, we have emphasized the substantial potential for delay and even the outside chance of abandonment, so no "latest" construction commencement date may be ascertained. On the other hand, it is possible to identify with some degree of reliability the earliest possible instate construction date. We can do so because certain pre-conditions must be met before construction can begin and these are well-accepted time frames for each of these prerequisites.

In this section of the report, our analysis assumes that no "institutional" (i.e., political, regulatory, or other such problems, as distinct from engineering difficulties or labor problems) roadblocks occur between now and construction commencement. In the succeeding section of the report, we discuss three possible scenarios for the pipeline's future, two of which assume that some problems, not related to construction or engineering pre-conditions, arise. If the reader believes that certain delays of this latter ilk will arise, then the reader can generally apply the amount of non-construction delay to the pre-construction schedule below and determine when construction of the Alaska segment will begin.

There are five principal requirements that must occur prior to actual pipeline construction in Alaska. In sequence, they are: (1) The Letter of Intent must be signed, commencing the research and design phase of the pipeline and allowing the Canadians to approve at least the western pre-build; (2) The research and design phase must be completed, yielding a meaningful cost estimate for the project and producing enough factual certainties so that final producer-sponsor negotiations can be completed, contingent financing arranged, and enabling the participants (with the Department of Energy) to formulate a legislative package for submission to Congress; and then garner legislative approval; (3) All Canadian and U.S. regulatory approvals must be acquired, including resolution of any legal challenges to pipeline construction and satisfactory settlements arranged with the Council of Yukon Indians; (4) Subsequent to acquisition of final governmental approvals, final financial commitments must be put in place, equity sold and any cost overrun protection (if necessary) arranged; and (5) The civil engineering phase of construction must be completed so that the actual building of the line with its substantial manpower and equipment needs can begin on an assured technical basis.

The chart below lists these various prerequisites, describes the time requirements of each, and the manner in which they interrelate with both prior and subsequent conditions. On the right side of the chart are two time estimates for each phase, one which is most optimistic (shortest) and another which reflects the most pessimistic (longest). These time estimates have been extracted from various government publications, testimony received by Congress, and statements from the interested parties. In some instances, these estimates are based on interviews conducted with regulatory officials or are our own estimates, based on historic agency practices (including expedited scheduling).

<u>Condition</u>	<u>Duration of This Phase</u>	<u>Optimistic Completion Date For This Phase</u>	<u>Pessimistic Completion Date For This Phase</u>
1) Approval of Letter of Intent by DOE/Sponsors/Producers. Said approval will allow commencement of the research and design phase of the pipeline. We have used only the optimistic 7/1/80 date in order to comply with our policy of excluding negotiation/regulatory/political/legal delays in this pre-construction chart.	Present to 7/1/80	7/1/80	7/1/80
2) The research and design phase will commence upon signature of the Letter of Intent and all its conditions will be included in the Letter of Intent. Producers have estimated this phase to take 18-24 months, while DOE feels it can be accelerated to 12 months. It appears to be in the interest of all parties to complete this phase in the shortest possible time. However, the duration of this phase is partly dependent on the outcome of frost heave experiments and that outcome will be unknown until the experiments are actually conducted.	12-24 mos.	7/1/81	7/1/82

<u>Condition</u>	<u>Duration of This Phase</u>	<u>Optimistic Completion Date For This Phase</u>	<u>Pessimistic Completion Date For This Phase</u>
3) Final negotiations between producers/sponsors/DOE will commence on completion of R&D phase (thus giving the parties a believable cost estimate from which to bargain). A package of amendments will be provided to Congress. This phase also includes enactment of those amendments under the abbreviated joint resolution procedure.	6 months	1/1/82	1/1/83
4) Subsequent to Congressional approval of amendments, applications to FERC must be filed formalizing the provisions of amendments and all other FERC approvals must be garnered to memorialize the final agreements reached in negotiations between the parties during the prior phase. Any changes in U.S.-Canada treaties or Canadian Government approvals must also be commenced during this phase. We have abbreviated this phase to 6 months on the assumption that much of the preliminary work can be done on a contingent basis during the prior phase.	6 months	7/1/82	7/1/83

<u>Condition</u>	<u>Duration of This Phase</u>	<u>Optimistic Completion Date For This Phase</u>	<u>Pessimistic Completion Date For This Phase</u>
5) Final binding financial commitments must be obtained, equity and debt sold. Again, we assume that much of this work can be done during the prior phase or phases on a contingent basis. Therefore, we are optimistically projecting <u>no added time</u> for this phase. (We are also optimistically suggesting that the long-term bond market, now in disarray and effectively nonexistent, will not only be functional but will provide sufficiently reduced interest rates so that the project is financeable.)	0-6 months	7/1/82	1/1/84
6) Civil engineering must be conducted on site in Alaska prior to full-scale building. Some of the civil engineering will be completed during the prior phases, but a substantial portion cannot be undertaken until the project has been financed.	6-12 mos.	1/1/83	1/1/85 be

As stated before in this report, the September 1977 President's Decision anticipates construction commencement in January 1980. Therefore, under the most optimistic assumptions, gas pipeline construction commencement has slipped three years in the two and one-half years since the President's Decision was announced. A more realistic estimate — which takes into account less optimistic construction schedule assumptions — suggests Alaska Leg construction commencement no sooner than 1984. Neither of these estimates includes provision for institutional delays (political, regulatory, etc.). We believe some institutional delay is highly probable, so a 1984-1985 estimate is the earliest likely commencement date for construction in Alaska. There appears to be universal consensus that it will take 3-4 years to build the Alaska Natural Gas Pipeline, so initial deliveries could occur no sooner than 1986, but more realistically, should be anticipated in 1988-1989.

VIII. Possible Scenarios

Engineering considerations are only a small part of the guessing game involving the gas pipeline's future. The regulatory and financial environment will be at least as telling regarding realization of the pipeline.

Throughout this report, we have focused on legal and other regulatory problems facing the gas pipeline. We have not, however, interrelated these problems with each other, nor presented likely scenarios for future resolution of these entwined difficulties. In this section, we present three fact patterns covering the legal, regulatory, financial and political hurdles the pipeline must overcome to become reality. We have done so on a best case — average case — worst case basis. In each situation, we have focused on the most likely alternatives and the most likely difficulties. Many of the problem areas cited earlier in the report are not included in these scenarios because we wanted to focus on only the most prominent obstacles and solutions. These lesser potential trouble spots can, of course, have further negative effects on the timing of pipeline construction.

We have also noted several exogenous variables which have been held constant throughout the analysis, primarily because of their highly uncertain nature. The most important variables include the state of U.S. and international financial markets, political attitudes within the U.S. energy industry, and Canadian energy development and policy. Any of these factors could have great effects on the timing and outlook for the pipeline, depending on future conditions. However, our estimate of the impact of these variables on the project is limited to the brief remarks below.

Best Case

Under this scenario, the current negotiations will yield a signed Letter of Intent by July 1, 1980, covering research and design during the next 1-2 years and a general framework for financing and managing the pipeline thereafter. The research and design would produce favorable results regarding frost heave problems and not uncover significant under-estimates of project costs. By mid-1982, all of the parties would be convinced that \$11 billion (1978 dollars) would cover construction of the Alaska Leg, including the conditioning plant, and that there was virtually no possibility that overruns could exceed \$5.5 billion. If the project's sponsors can add several other substantial domestic shippers to their consortium based on the reliable cost estimates and producer participation, federal financial support could be avoided. Amendatory legislation would be submitted to Congress in the second half of 1981. This legislation will be presented as the final step prior to project commencement; it will request only producer equity (offset by assurances that no anti-competitive practices will exist) and a few seemingly insignificant technical and non-technical changes.

Congress could act favorably by the end of 1981, and FERC could hand down all the key decisions necessary to satisfy the North Slope producers and lenders by the same time. If this were to take place, the first half of 1982 could be a period characterized by the final mop-up of loose ends at FERC and other government agencies involved in pipeline approval, renegotiation (if necessary) of any of our U.S.-Canada agreements covering the pipeline, and completion of financing arrangements.

With financing completed, the civil side of project construction could commence by the middle of 1982, and full-scale pipeline building in Alaska by early 1983.

Middle Case

Based on the history of the Alaska Gas Pipeline, one must conclude that some significant difficulties remain ahead. To date, almost every deadline has been missed, progress has been spotty at best, and the fundamental difficulties initiated by the President's Decision and other legal-regulatory requirements have not been resolved. Therefore, we believe this "middle case" is more realistic than the "best case" and might be the most probable of all three cases.

In this case, the Letter of Intent would be signed by mid-1980 ^{30/} but could contain the seeds of future problems. The Letter of Intent will be conditioned upon satisfactory regulatory determinations primarily from FERC, and satisfactory action by the U.S. Congress to resolve the statutory difficulties discussed previously in this report. Most importantly, each of the parties will be able to withdraw from the agreement if they determine that the Alaska Gas Pipeline is not a good investment based on final cost estimates.

Once the R&D phase is completed, the final negotiations between the parties will be difficult, if not hostile. The fundamental questions of control, levels of equity and debt participation, and overrun protection will be hard to resolve. We anticipate that this progress will take a substantial amount of time and even if they are successful, there is still a good chance that government guarantees will be needed.

Once the financial negotiations are completed, Congress will be presented with legislation to significantly restructure the pipeline, not only to allow the producers equity and an appreciable amount of control. Congress may face a federal guarantees question and perhaps some issues previously delegated to FERC. We suggest that FERC decisions rendered in 1980-1981 could be unsatisfactory to at least some of the parties and that Congress may have to involve itself in some of these decisions. In short, Congress

^{30/} This is by no means a certainty. The Phase II negotiations could drag on through the year, yet never break off. Once the pre-build decision deadline is passed, no back-up deadline (other than artificial, moveable ones set by the parties) in 1980 exists.

may completely reconsider the gas pipeline, although it may end up amending Alaska gasline law as modestly as possible so construction delays are not exacerbated. Whether Congress will take the opportunity to completely restructure the line or make the minimum changes necessary will depend on the surrounding political circumstances, the actions of the President, the manner in which Congress is approached by the sponsors and producers, and domestic gas availability. Finally, should Congress approve financial guarantees, it will probably make renegotiation of the U.S.-Canada Agreement very challenging, if not impossible, and may necessitate a set of complicated FERC proceedings to readjust downward the rate of return.

If some, but not all, of the problems enumerated in this case do arise, the Alaska construction commencement cannot be expedited before mid-1984 or 1985, at the earliest.

Worst Case

This scenario could be crafted in several different forms, but each of them would include an irrevocable breakdown of financing negotiations between producers and sponsors under the tenets of existing law. Alternatively, a clear message from lenders that they will not finance the line under existing law, regardless of what the producers and sponsors agree to, could serve as a basis for this "worst case". It is irrelevant whether the reasons for the negotiation breakdowns would be producer unwillingness to accept John McMillian and Northwest, Northwest's unwillingness to accept producer control, or any other reason.

Should the negotiations break down, Congress will attempt to completely restructure the pipeline. It could entail selection of a new certificate holder, initiation of new regulatory proceedings at FERC (perhaps in abbreviated form), redesign of the tariff and return mechanisms, and many other possibilities. The time delay potential during and after Congressional action is almost boundless.

It is also possible that the breakdown will occur, not because the parties cannot agree, but because of marketability or other economic flaws. In this case, there is a distinct possibility that the entire pipeline project will be abandoned, perhaps to be revived several years from now, or maybe never to be revived at all.

The type of delay this "worst case" scenario could impose is difficult to project since it would, in part, be based on when financial negotiations fall apart. If they fall apart in the 1980 round of negotiations, then the upcoming 97th Congress will probably seriously attempt to pass a Fedline bill or completely restructure the pipeline. If it does so expeditiously and money markets are not impossible to deal with, a delay could be reasonably modest — perhaps only two years (to 1985).

More importantly, if the negotiations break down, a great deal of pressure will be put on the Canadian Government to extract itself from the Alaska Gas Pipeline project. The Canadians are decidedly against building a purely export system, and if the Alaska Leg of the project appears doubtful, we can expect very serious problems from north of the border. Foothills has already threatened to back out of the project and would very possibly make good on its threat if negotiations here break down. If the negotiations disintegrate, protracted reconsideration in Congress could by its very nature threaten the project's economics. In the chart below, we have taken the current estimates of gas pipeline costs, updated them to current dollars and projected them to future dollars. The magnitude of the sums involved exclude most sources of possible finance and begin to challenge the value of the asset they would transport. It is obvious that a \$30-\$40 billion project presents a financing nightmare, particularly when the lead company has assets as relatively small as Northwest's. Moreover, Northwest's partners also have limited assets. (See chart below). By way of comparison, the assets of a gas pipeline industry giant, Tenneco, is also listed.

CHART 1

Estimated Costs of Construction

	<u>1978 Dollars</u>	<u>1980 Dollars</u> ^{2/}	<u>1982 Dollars</u> ^{3/}
Field Gathering	\$4.0	\$4.7	\$5.5
Conditioning	3.5	4.0	4.7
Alaskan Segment	7.5	8.9	10.5
Canadian Segment	6.0	7.1	8.4
Lower 48 Segments	2.0	2.4	2.8
	<hr/>	<hr/>	<hr/>
TOTAL	\$23.0 Billion ^{1/}	\$27.1 Billion ^{1/}	\$31.9 Billion ^{1/}

^{1/} Does not include interest during construction, which would add about \$2 billion. Interest under the 1980 and 1982 assumptions would be greater than \$2 billion, but we cannot estimate the increase.

^{2/} Based on GNP Deflator (1980 dollars 18% higher than 1978 dollars).

^{3/} Applying 1978-1980 GNP Deflator rise to 1980-1982 period.

CHART II

U.S. Members of the Alaskan Northwest Natural Gas Pipeline

Company

Gross Revenues (1979)
\$ Million

Northwest Energy Co.	998
Pacific Gas & Electric	3626
Pacific Lighting Co.	2224
Northern Natural Gas Co.	2262
United Energy Resources	2692
Panhandle Eastern Pipeline Co.	1418
American Natural Resources	2337
<hr/>	
Tenneco (for comparative purposes)	11209

Source: Washington Analysis Corporation

Oil Pipeline Comparison

A parallel to the oil pipeline is appropriate here. The oil line cost approximately \$8 billion to build. At completion, it was transporting an asset that, at that time, would have been worth \$50 billion (10 billion barrels times an average wellhead price of \$5 per barrel in 1977). If the gas pipeline costs approximately \$32 billion in 1982 dollars (which is one federal estimate), it will be transporting an asset worth perhaps \$60 billion in 1982 dollars (26 trillion cubic feet times approximately \$2.28 per mcf). ^{31/} Hence, the oil line was available to transport assets worth 6.25 times its completion cost in 1977, even with the spectacular cost overruns encountered during construction. By comparison, the gas line, even if it meets current estimates, will be available to transport assets worth less than twice its cost. While this example is used only for a very rough comparison, we believe it is useful to show the magnitude of the risks facing pipeline sponsors and developers. When the value of the gas assets is discounted over the 30-year projected life of the field, the economics of the project can, under many sets of assumptions, become prohibitively expensive.

Exogenous Variables

The first variable is the current state of U.S. financial markets. Not only are interest rates at unprecedented levels, but the long-term bond market which the gas pipeline must utilize is nonexistent. Once interest rates have peaked, the issue is how far down they will plummet and at what speed. Consequently, the future of the long-term bond market and the money market's ability to finance projects such as the Alaska Gas Pipeline by 1982 or soon thereafter is unknown. If the bond market and interest rates do not return to normal, federal debt guarantees may become an absolute necessity. Conceivably, a Fedline may be required regardless of how well the producers and sponsors resolve their differences. In our analysis, we have assumed that the money markets will be normalized by the time the gas pipeline is ready to be financed.

Second is the intense desire of the domestic energy industry to keep government involvement in their industry at a minimum. We believe that the threat of federal financing for a gas pipeline, or an all Fedline, may elicit unprecedented action from the oil and gas industry, pipeline companies, shippers and local distribution companies. Such unprecedented action could be in the form of a broad-based cost overrun pool devised, without running afoul of antitrust laws, with the intention of risk-spreading throughout all the companies involved in the gas pipeline. We have not factored this consideration into our scenarios, but feel that should a Fedline prospect be seriously considered by Congress, this type of response may be forthcoming from industry.

^{31/} The gas reservoir contains 26 TCF, of which 20 TCF would reach market. On a Btu basis, it contains about 1/3 the Btu's of the oil reservoir.

Finally, Canadian energy policy and the magnitude of Canadian gas reserves could well be a substantial determinant of the Alaska Gas Pipeline's future. From a policy standpoint, there is a division between the factions in favor of exporting surplus natural gas to the United States primarily for the betterment of the Canadian balance of payments picture, versus those who believe in husbanding energy resources and keeping the maximum amount of low cost (Alberta) natural gas accessible to as large a portion of Canada's population as possible for as long as possible. The former faction successfully pushed pre-build and the pro-export decisions made by NEB. If the United States is incapable of developing its segment of the Alaska Natural Gas Pipeline, it will deal a blow to the pro-export forces and may turn Canadian energy policy toward isolationism.

Additionally, there are two gas pipeline proposals extant in Canada that could conceivably — though not likely — supplant the Alaska Gas Pipeline if it continues to flounder. The first proposal is called the "Polar Gas Project", headed by TransCanada Pipelines, the project manager. This consortium includes PanArctic Oil, Ltd. (controlled by PetroCanada), PetroCanada itself, Ontario Energy Corporation (owned by the Ontario Government), Pacific Lighting Gas Development Company, and Tenneco Oil of Canada (subsidiary of Tenneco in the United States). The proposal entails a Y-shaped pipeline encompassing the Beaufort Sea/Mackenzie Delta on the west arm of the Y, with the east arm stretching to Melville Island. The junction of the Y is at Great Bear Lake, where a single line moves southward to join the existing TransCanada Pipe System in Northern Ontario above Lake Superior. This project has been formally announced, and some very preliminary applications and communications have been made to the National Energy Board. It is now in an engineering and environmental studies phase. Should the Alaska Gas Pipeline falter, this project could give Canada access to the substantial amount of gas believed to exist in the Mackenzie Delta/Beaufort Sea region. One must recall that one of the principal economic benefits to Canada from the Alaska Gas Pipeline is access to this region via the proposed Dempster Lateral — a benefit arguably available under the Polar Proposal. Finally, the original Foothills Maple Leaf Proposal may be revived if the Alaska Project fails to move forward and Foothills chooses to turn its attention to other projects. The Maple Leaf Project was considered uneconomic when proposed years ago, but additional discoveries in the Beaufort area may have changed that. Maple Leaf could have serious Native claims problems, but the extent of these difficulties is currently unclear.

IX. Alaska's Role

The previous eight sections of this Report describe existing law in the United States and Canada covering the gas pipeline, the problems existent in developing the pipeline, and the prospects for resolving those problems. The remaining piece of the puzzle is the role that the State of Alaska will play — if any — in the future of the gas pipeline and the time frame in which Alaska must decide what its actions will be. These questions have become even more difficult to resolve because so much of the regulatory, legal and economic umbrella under which the pipeline resides is currently (or will be) in flux. Moreover, the actions the State of Alaska takes regarding the pipeline's future may have little impact on it, or in the alternative, may be dispositive as to when the pipeline is built, or possibly, whether it will be built.

Our analysis assumes that the State Government and the Alaska citizenry generally favor construction of the Alaska Gas Pipeline. This support is based on the following: 1) immediate economic benefits arising from a \$10 billion construction project instate; 2) the value the pipeline gives to the State's Prudhoe Bay royalty gas and the State tax revenues that will be realized from the producers' North Slope gas and the pipeline itself; 3) the opportunity the gas pipeline will present for the transportation of other gas found instate that might otherwise be uneconomic; and 4) the opportunity to develop a petrochemical industry in the State of Alaska using North Slope natural gas liquids.

If Alaska wants the gas pipeline, it must balance the risks and rewards attached to options for investment in the line. Obviously, State investment in the pipeline may translate into reduced State ability to strictly regulate pipeline operations or to tax pipeline facilities. Some forms of State participation may impose other limitations or may entail substantial financial risks. State investments in the line could impact upon the State's credit rating, ability to finance other projects, or otherwise provide the goods and services requested by Alaskans.

We do not presume to suggest any final investment decisions. We do, however, point out that there is a multitude of problems facing the pipeline, and many of these problems are extremely serious fundamental problems, financial and otherwise. There is a serious need for positive action, leadership, creativity, and in some instances, compromise from all parties with a major stake in the pipeline's future. The manner in which these problems are resolved over the next 1-2 years will not just determine the nature and ownership of a gas pipeline, but will determine whether the gas pipeline project is long delayed (or abandoned) and whether it is built under a framework that produces the least or greatest benefit to the State of Alaska.

The Pipeline's Critical Needs

In order to be financed and built in the near future, the Alaska Gas Pipeline proponents must fulfill certain needs, some of which the State of Alaska can help provide and others over which it is powerless. Clearly, the State cannot create a federal regulatory environment nor the necessary changes in federal statutes to facilitate development. However, the State can contribute in an area where few others can so meaningfully respond: the financial arena.

The gas pipeline has so far been shunned by substantial lenders. Without question, the pipeline will never be built in the private sector without the reassurances that lenders must receive in order to prudently purchase the unprecedented amount of debt required by the gas line. Lenders will be reassured of the pipeline's viability if the State of Alaska agrees to participate in some as-yet-unspecified manner in gas line financing. The lenders believe that state participation would create a commonality of interest between the State and other investors so that rational (in the lenders' opinion) regulatory and tax decisions will be made by Alaska during the pipeline's existence. Only Alaska has the ability to render this type of assurance to potential lenders.

The pipeline needs far more than lender assurances: it needs sizeable equity and debt transfusions. The sheer magnitude of the dollars involved -- probably \$30-\$40 billion -- eliminates most private sources from being able to make a proportionately significant investment. The choices are limited to North Slope producers, a few natural gas transmission companies (unfortunately, Northwest and its partners are not among them; the current participants in the North Slope consortium are not large enough to provide sufficient investment capital) and the major financial institutions in the U.S. and Canada, and the institutions appear only a prospect for the debt side. The only two other large sources of capital are the federal government and the State of Alaska. The former cannot, in all practicality, do more than guarantee completion in one of a few ways (absent the possibility of a Fedline). This leaves the State of Alaska as the remaining candidate for significant equity and/or debt investment. While this prospect may be anathema to many Alaskans, including state leaders, at least equally unpleasant is the thought that the gas pipeline project could conceivably be shelved or abandoned without direct Alaskan financial participation. 32/

The third area of financial need is cost overrun protection. This is probably the least practical avenue for Alaskan financial participation, and fortunately, it may be the least essential. State government systems are not geared to such open-ended financial commitments, nor is there significant

32/ We are not suggesting that failure of Alaska to invest in the line will be critical, only that it is not outside the realm of possibility.

precedent for providing it. There are probably undiscovered legal constraints under the Alaska State Statutes, too. In any event, should the research and design phase of the pipeline produce a reliable cost estimate, the need for overrun protection above and beyond the amount that the producers and sponsors have already discussed (\$5.5 billion) may not be required by debt holders.

How important is State investment in the future of the gas pipeline? This is a pivotal question, with an answer that seems to swing from one extreme to the other. At first, Northwest implored the State to make equity and debt investments, claiming that such investments were essential to develop the pipeline. In more recent times, inclusion of the North Slope producers has seemingly diminished the need for State investment to the point where the Department of Energy and the producers have taken an almost indifferent posture toward Alaskan participation. The final answer to the question will come sometime after the research and design phase has produced a believable cost estimate, and the parties actually attempt to raise the money to build the pipeline.

At present, the pipeline cannot be financed, and its costs are escalating dramatically. Federal involvement (a guarantee) may cause substantial domestic and bilateral political problems and diminish statewide benefits from the gas line (i.e., via reduced wellhead values, etc.). Should the pipeline eventually be built as a Fedline, the drawback to the State of Alaska would be enormous. Among the more prominent disadvantages would be a lower wellhead, lower tax revenues, a far greater dependence on Washington, D.C. for any natural gas or gas liquids approvals or decisions, and a general loss of Alaskan control over its resources. Preclusion of the Fedline alternative should be factored into any risk-reward investment analysis made by the State.

Alternatives

Alaska, or any state in its circumstances, would probably be most comfortable if it could rely on the private parties developing the gas pipeline to reach an agreement and produce a workable corporate structure to interface with the state, all without needing major regulatory or statutory changes to bring the project to fruition. Under those circumstances, there would be predictability regarding structure and some certainty as to outcome. It is possible that the Alaska Gas Pipeline negotiations will succeed and the project will ripen into a committed definable consortium that can be relied on to finance and construct the line within a traditional framework and with little change in the law. Unfortunately, our analysis leads us to conclude that this latter outcome is unlikely.

In our opinion, the troubled condition of the Alaska gas pipeline project makes it more incumbent than ever on the State of Alaska to take an active — perhaps even a leadership — role in the development of the gas pipeline. To date, Northwest and its partners have proven incapable of developing the gas pipeline and really offer little hope of reversing that record by themselves. Injection of the North Slope producers has provided a ray of hope,

but has brought inherent conflict with Northwest and many long-range problems. Department of Energy efforts have been well intended and perhaps slightly successful, but the progress DOE has inspired on the fundamental problems can be measured in inches, not miles.

The remaining benefactor of pipeline development with the wherewithal to incite real progress is the State of Alaska. For the first time, aggressive State participation can be justified on the basis that a realistic possibility exists that the gas pipeline project may be either indefinitely delayed, constructed and operated in a manner least favorable to the State (the FedLine) 33/, or abandoned, without such an aggressive State posture.

At this juncture in the pipeline development process, the State may benefit from generating the perception in the lender community, as well as with the three factions in the ongoing negotiations, that Alaska, under the proper terms and conditions, may become an important participant and help solve some of the current roadblocks. The Governor's Gas Pipeline Task Force could be the vehicle to create this perception if the group, with the participation of the Legislature, is well-staffed, highly visible, and actively participates in the negotiation process. Moreover, initiatives from Alaska, rather than the reactions to other parties' initiatives, would be an extremely positive sign. The format, method of operation, or approach taken by Alaska is open to a wide variety of options that can easily be determined and chosen by its leadership. It is the conversion from a reactive to an initiative mode that may be a useful first step toward stimulating pipeline development on Alaska's terms.

Decisionmaking Timetable

In all likelihood, the State will not have to make a final "invest or not invest" decision on the gas pipeline until 1982 or 1983. Until that time, no firm financial package is likely to be designed and available for commitment.

On the other hand, if the State chooses to take an aggressive posture, such as advancing its own financing proposals (contingent on affirmative actions by the producers, sponsors, Congress and FERC), they could be considered as early as the 1981 State Legislative session.

The delay we forecast in this Report has some benefits for the State of Alaska. It gives the State a greater opportunity to formulate strategy, contingency plans, and to take the actions necessary to effect the most beneficial outcomes per State interests. There may also be some amendments to State law that are needed to facilitate the gas pipeline, and the State may seize the opportunity to participate in amending federal law so that it best serves Alaska.

33/ If it is necessary for the pipeline to be built as a Fedline, there is likely to be a regulatory backlash against the State of Alaska for not participating in a national interest project when the State had such obvious benefits inuring to it. The backlash prospect was discussed in our July 27, 1979 memo to the Committee, and the ability of the federal government to disadvantage Alaska was described in Section III of our February 15, 1979 report to the Committee.

The additional time will also better enable Alaska to ensure development of a petrochemical industry based on North Slope natural gas liquid supplies. This latter undertaking is a complicated one, and will be impacted in many ways by any reshaping of the Alaska Gas Pipeline project. By taking a more active role in developing the gas line, Alaska will better its prospects for creating the type of petrochemical industry it currently desires.