

## **EQUITY PARTICIPATION IN THE ALASKA GAS PROJECT**

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**What is the rationale for proposing equity participation and risk sharing for the State of Alaska in the Alaska Gas Project?**

**Quite simply, this is the only option:**

- **to improve project economics, and**
- **ensure an attractive Alaska government take at the same time.**

### **DISCUSSION**

**Why equity participation and risk sharing?**

The fundamental problem that Alaska faces in monetizing its gas compared to most other jurisdictions in the world is that the government take on the project consists primarily of US federal income tax. The US federal take is more than the Alaska take and cannot be changed. Furthermore, if Alaska would provide fiscal incentives, the US federal income tax is automatically higher, because the tax deductions are less. Therefore, Alaska's ability to influence the project economics through government take incentives is limited.

This limited ability can be illustrated by a simple calculation. The current State estimate of the Status Quo would provide the State (at \$ 3.50 prt MMBtu in Chicago) with \$ 43 billion while the US Federal government earns \$ 57 billion<sup>1</sup>. The estimated IRR of the project is 14.8%. If Alaska would set the entire Alaska take at zero (no royalties, no severance taxes, no property taxes and no State corporate income tax) the Federal take would go up to \$ 71 billion and the estimated project IRR would improve to 17.3%.

In other words, even if Alaska would be willing to forego its entire take, it could only improve the IRR of the project by two and a half percentage points. Therefore, this is not a viable way for Alaska to make the project more attractive.

Therefore Alaska needs to consider an alternative way to improve project economics. The equity participation and risk sharing proposal put forward by the State of Alaska achieves this objective. It is a way to improve project economics without affecting the Alaska take and without increasing the Federal take.

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<sup>1</sup> This number includes some Canadian federal income tax and some Canadian provincial and US State taxes. Figures are calculated on a "gas only" basis with the PVM model.

Under the October 1 proposal made to the Sponsors, the State improves the estimated project IRR to 16.5% by making FT commitments on Alaska's royalty and tax gas, while the Alaska take improves slightly to \$ 44 billion (including the pipeline investment earnings) and the Federal take remains about \$ 57 billion. In other words, the State improves project economics by co-investing rather than by reducing State take.

Furthermore, by sharing in the project risks, the State makes it possible for the Sponsors to accept a lower IRR, because risks are lower.

### **Why is there a need to improve project economics?**

Why not simply stick with the Status Quo?

The decision to go forward or not with the major construction phase of the project will be made on the "project sanction date". This is 4 or 5 years from now. Whether the project will go forward depends on the alternative investment opportunities of the Sponsors at that time and the prevailing economic conditions. Therefore, at this time we can only speculate how the project may stack up in the "queue" of alternative investment opportunities and what the economic prevailing conditions will be on project sanction date.

However, what is certain, is that the probability that the project will go forward is higher if the risk-reward balance of the project is more favourable. The equity participation and risk sharing proposal of the State puts the project higher in the "queue" compared to the Status Quo economics. This makes it more likely that the project will go forward.

Based on an international comparison it was concluded that the risk-reward balance of the project was relatively unattractive based on Status Quo economics. The above mentioned IRR of 14.8% nominal is based on rather favourable assumptions, such as:

- All the gas can be sold in Alberta without discount to AECO prices
- Steel prices would return to levels of 2001
- AECO netbacks would improve considerably after about 2026 due to lower transport tariffs
- The pipeline would be full for 30 years and all yet to be found gas would be found by the Sponsors and could be developed on the basis of low costs per Mcf.
- Financing can be done on the basis of current low financing costs.

Based on less favourable assumptions the IRR could be 11-12% nominal.

Based on the same stress price of \$ 3.50 per MMBtu in Chicago, a comparative review was done of other projects in the world. It does not appear that major oil companies are currently executing major integrated upstream-midstream projects with a low rate of return of 11-14% nominal, with the possible exception of Norway. Norway provides unusually low after tax financing costs.

In addition, the Alaska Gas Project would be high risk. Cost overruns could lower the profitability of the project considerably. The project is the largest "single decision" project in the world, requiring a commitment of all the capital up front. The project has the highest overall transport costs to the Lower 48 market. This market is also the most volatile in the world.

In summary, it is clear that the Alaska Gas Project is a low IRR - high risk project based on the Status Quo. Therefore the Alaska strategy to improve project economics, through equity participation and risk sharing, in order to put the project higher in the "queue", is entirely justified.

### **But why improving project economics under current high gas prices?**

Under gas price forecasts of \$ 5 per MMBtu in Chicago or more, the Alaska Gas Project seems very attractive. Why is it necessary to improve the fiscal package under these circumstances?

Based on \$ 5 per MMBtu in Chicago, and corresponding gas prices in European and East Asian markets, several thousand Tcf of stranded gas reserves can potentially be produced in the world under IRR's that are similar to or better than the Alaska Gas Project.

The vast majority of these actual and potential projects are smaller and easier to launch by a wider variety of companies. Continued high gas prices in the next few years will create favourable entry conditions in the US market to a wider variety of competitors. The probability that the Alaska Gas Project would be "nibbled to death" by smaller gas export projects to the Lower 48 United States therefore increases with a higher gas price in the next few years.

The favourable conditions at this time are a threat to the Alaska Gas Project, not a benefit. It creates conditions which make it more risky to launch a long term project.

Alaska already went through this cycle.

Ten years ago LNG exports to East Asia from Alaska seemed viable and economic. In fact, the Stranded Gas Development Act was created in order to capitalize on this opportunity. Today, gas prices are higher and gas markets are stronger in East Asia than were predicted 10 years ago. Yet, LNG exports to East Asia from Alaska are no longer realistic. The main reason for this failure was that the Alaska LNG project was too large, too costly and too long term to fit in the evolving East Asian market. The LNG project could not compete with other supplies to this market.

The same could happen with the Alaska Gas Pipeline project with respect to the gas market of the Lower 48 United States.

**What is the best strategy to secure maximum benefits from the Alaska Gas Pipeline project?**

There will be no benefits to Alaska unless the pipeline gets built.

Therefore, it is imperative for Alaska to ensure that the Alaska Gas Pipeline project is placed in the best possible economic position. This ensures the highest probability that the Alaska Gas Project will be built.

The equity participation and risk sharing proposal of the State of Alaska achieves this objective. Yet, at the same time the most attractive overall government take is being achieved, compared to jurisdictions which compete for the same market on a long distance basis.

The best strategy is to continue the policies that the State has implemented so far, which are:

- Create a Stranded Gas Contract proposal with a high degree of fiscal stability
- Provide terms that improve the project IRR and lower project risks while maintaining an attractive Alaska take,
- Provide for a strong work commitment by international standards
- Orchestrate continued US Federal pressure on the Sponsors to launch the project
- Do whatever possible to unblock possible obstacles in Canada
- Rely on the need of all three Sponsors to maintain their Reserve/Production ratios and the important role that Alaska will play in this framework.

Where the Sponsors are prepared to improve the production tax, through an attractive PPT, the overall strategy can be further improved by providing fiscal stability on oil.