Canada's Folly:

Government Purchase of Trans Mountain Pipeline Risks an Increase in National Budget Deficit by 36%, Ensures a 637% Gain by Kinder Morgan

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Note: All currency figures in this report are expressed in Canadian dollars, except where otherwise noted.

Executive Summary

The government of Canada has decided to purchase the incomplete Trans Mountain pipeline system from Houston-based Kinder Morgan[1] in hopes of ensuring that this particular piece of Canada's oil industry infrastructure is completed. The Canadian government is buying the unfinished pipeline at a high price and will likely resell it for far less than it will pay to complete it. As a fiscal matter, the Canadian government will lose. As a financial matter, Kinder Morgan Inc. will gain.

The Institute for Energy Economics and Financial Analysis estimates that this transaction and the cost of further planning and construction will require a $6.5 billion[2] unplanned expenditure to Canada's budget during FY 2019. It will increase Canada's projected deficit of $18.1 billion by 36%, to $24.6 billion. The transaction risks an increase in Canada's annual deficit in FY 2020, too, reversing a deficit reduction trend that supports Canada's strong recovery, sound fiscal position and excellent credit rating.

- Kinder Morgan Inc. and its Canadian subsidiary, Kinder Morgan Canada Limited, will share $3.89 billion from the sale of the pipeline to the Canadian government. IEEFA estimates that the return on outlay will total 637%.
- Kinder Morgan's EBITDA for 2017 was $9.21 billion.[3] If its operations in 2018 were to achieve the same profit, the resulting $2.6 billion in profits would amount to an approximately 29% increase over 2017. Kinder Morgan Canada, which had an adjusted EBITDA of $388 million in 2017,[4] would add $1.2 billion, or approximately 309%, to its 2018 profit picture.

To date, both Kinder Morgan and the Canadian government have made only limited disclosures regarding the transaction. The August closing date leaves time open for further review: the Canadian government can and should publicly release the documents necessary to facilitate a better understanding of the transaction and the many questions it raises.

[1] The Share Purchase Agreement ("Kinder Morgan Cochin ULC as Vendor and Her Majesty in Right of Canada, as Purchaser and Kinder Morgan Canada Limited and Kinder Morgan, Inc. as Guarantors, Share Purchase Agreement", May 29, 2018, hereafter referred to as the "Share Purchase Agreement") lists Kinder Morgan Cochin ULC as the Vendor. Kinder Morgan, Inc. and Kinder Morgan Canada Limited are listed as the guarantors and identified as the corporate entities that will secure substantial benefit from the transaction. They are listed separately in this report when doing so clarifies critical aspects of the transaction. We refer to Kinder Morgan, Inc. as KMI and Kinder Morgan Canada Limited (KML) when appropriate**.** Throughout the paper, for the sake of readability, we refer to "Kinder Morgan" to denote the entire enterprise. The Share Purchase Agreement lists nine other Kinder Morgan-related financial entities along with Kinder Morgan Cochin ULC.

[2] All currency references are in Canadian dollars except where otherwise noted. The valuations assigned to the total transaction, expenditures to date and proportionate share of profits for KMI and KML are taken from formal SEC filings by the respective companies and press statements and have been converted at a US$1 to C$1.32 exchange rate. Budget values are taken from formal budget documents listed on the web site of the Finance Ministry.

[3] Form 10-K Kinder Morgan, Inc.-KMI. February 9, 2018, p. 45. The 10K lists profits in U.S. dollars ($6.98 billion, or C$9.21 billion).

[4] Ibid., p. 48.

Background

On May 29, Kinder Morgan Inc.,[5] Kinder Morgan Canada Limited,[6] and the Canadian government[7] issued separate statements confirming that the government of Canada would buy Kinder Morgan's Trans Mountain pipeline project for $4.5[8] billion.[9] The Share Purchase Agreement[10] confers ownership of the pipeline to a Crown Corporation, commits the Canadian government to resume planning and construction activities,[11] and obliges all parties to search for a new third-party owner other than the Canadian government (and presumably any of its subsidiaries or Crown Corporations).

Closing on the Share Purchase Agreement is expected in August. The Canadian government will provide $4.5 billion in cash[12] at closing to Kinder Morgan[13] under the terms of the deal and will enter into a separate credit facility with the Royal Bank of Canada[14] to finance the resumption of planning and construction activities. Kinder Morgan expects to clear $2.64 billion[15] on its financial statements during 2018[16] and Kinder Morgan Canada Limited $1.25 billion.[17]

Kinder Morgan Canada Limited has identified $1.1 billion in Trans Mountain project expenditures to date.[18] IEEFA estimates, however, that the true outlay for Kinder Morgan Inc. and its Canadian subsidiary has been approximately $610 million, a

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5 Kinder Morgan. "Trans Mountain Pipeline System and Expansion Project to Be Sold for C$4.5 Billion." May 29, 2018.
6 Ibid.
7 Department of Finance Canada: https://www.fin.gc.ca/n18/18-038-eng.asp and https://www.fin.gc.ca/n18/data/18-038_1-eng.asp
8 One analyst estimates the government is overpaying. See also page 15 of the recent KML explanation that includes discussion of a Canadian government study showing a price of $3.85.
9 Department of Finance Canada**:** https://www.fin.gc.ca/n18/18-038-eng.asp
10 See footnote 1.
11 On April 8, 2018, Kinder Morgan Inc. provided notice that it would be suspending activities on the pipeline due a political conflict with the government of British Colombia.
12 United States Securities and Exchange Commission, Schedule 14A, Kinder Morgan Canada Limited. p. 24.
13 Form 8-K Kinder Morgan Canada Ltd, Article 2.3, p 25. June 1, 2018.
14 Form 8-K Kinder Morgan Canada Ltd, Article 1.1, Definitions, 39, "Covered Credit Agreement," p. 7. June 1, 2018.
15 Kinder Morgan's securities filings and press statements describe the transaction as a C$4.5 billion sale. It states that the company's share of profits from its 70% interest is US$2 billion. IEEFA has converted this to C$2.64 billion to achieve consistency in presentation within this report.
16 Kinder Morgan. "Trans Mountain Pipeline System and Expansion Project to Be Sold for C$4.5 Billion." May 29, 2018; and Form 8-K Kinder Morgan Canada Ltd. June 1, 2018.
17 Kinder Morgan. "Trans Mountain Pipeline System and Expansion Project to Be Sold for C$4.5 Billion." May 29, 2018. According to KML, the company will receive $1.25 billion from its 30% interest in the project.
18 Kinder Morgan Canada Limited. "Kinder Morgan Canada Limited Suspends Non-Essential Spending on Trans Mountain Expansion Project." April 8, 2018. See also United States Securities and Exchange Commission, Schedule 14A, Kinder Morgan Canada Limited. p. 17; and *Reuters*, "How Kinder Morgan won a billion-dollar bailout on Canada pipeline." May 30, 2018. The $1.1 billion needs to be more specifically detailed to identify the actual cost items and the sources of revenue to the Trans Mountain project that are attributable to KMI and KML and other funders. Kinder Morgan's public filings give the appearance that the company spent $1.1 billion. For the purpose of calculating the company's actual return on investment this is a misleading figure. The actual company outlay must take into account third-party sources of revenue. The $1.1 billion requires independent review.

number that could shrink once reviewed by an independent auditor.[19]

The Canadian government is taking the extraordinary step of buying and owning the pipeline project in order to preserve jobs associated with the project and to bolster the export prospects of oil sands producers. The pipeline would increase the capacity to export oil from the West Coast from 300,000 barrels per day to 890,000 barrels per day.[20]

The Canadian government does not see itself as the long-term owner of the Trans Mountain pipeline system. Indeed, the government is promising the following indemnifications:

- Payment to a new project proponent for any additional costs incurred by the project due to adverse actions taken by any Canadian municipality.
- Payment to a new project proponent for future costs and a reasonable return if the proponent abandons the project due to adverse judicial rulings or if it cannot meet a completion deadline.
- Repurchase of the pipeline (that is, a second Canadian government purchase) if the new project proponent fails to complete it.

The government of Canada has agreed also to maintain a $1 billion project reserve in order to comply with insurance requirements.[21]

Fiscal and Financial Implications of the Transaction

The Trans Mountain Transaction Risks an Increase in Canada's Federal Budget Deficit

IEEFA estimates that transaction costs could increase the FY 2019 deficit by $6.5 billion, or 36%.

The Canadian Department of Finance puts the government fiscal deficit for FY 2018, which ended on March 31, at $19.4 billion, down from $21.6 billion in FY 2017.[22] The government projects a FY 2019 deficit of $18.1 billion and declining deficits through

[19] When the company closes the $4.5 billion transaction outlined in the Share Purchase Agreement it is claiming a $3.89 billion gain on investment. IEEFA assumes a cost adjustment to the $4.5 billion transaction of $610 million. IEEFA derives a 637% return, a profit of $3.89 billion on an outlay of approximately $610 million. IEEFA believes that the profit potential could be even higher as companies with pipeline contracts may have to absorb certain construction costs. It appears that the project may have benefited from $1.1 billion in total expenditures, but the actual outlay from Kinder Morgan is far less. Kinder Morgan's actual outlay needs to be confirmed by an independent review.
[20] Trans Mountain. "5 Ways Alberta Will Benefit from the Trans Mountain Expansion Project." July 7, 2016.
[21] Share Purchase Agreement, p. 99.
[22] The Canadian Department of Finance estimates that the deficit at the end of March is $16.1 billion prior to end of year adjustments. The Department estimates that its $16.1 billion deficit is roughly in line with the $19.4 billion projected in the out years of Canada's fiscal plan.

2022.[23] IEEFA estimates that the Trans Mountain transaction and the cost of further planning and construction will require a $6.5 billion unplanned expenditure to Canada's budget during FY 2019. This would increase the existing deficit by 36%, from $18.1 billion to $24.6 billion. How the Canadian government pays for the plan and accounts for it in its official financial documents remains to be seen. Until such clarifications are received, the expenditures for the transactions are at risk of adding to the annual deficit.[24]

The Canadian government will also incur a second, separate liability under its Covered Credit Agreement with the Royal Bank of Canada for the resumption of planning and construction of the pipeline. It is estimated that the project will be completed by December 2020 and that overall costs will range from $7.4 billion and perhaps higher, as the company sees potential for a 10% increase, or $8.2 billion.[25] If project activity is resumed in August 2018, IEEFA estimates an additional FY 2019 deficit risk of $1.8-$2 billion.

While IEEFA estimates that the $6.5 billion during FY 2019 would increase the existing deficit by 36%, the impact of costs related to the transaction will extend well into the future. Ongoing costs could increase Canada's annual deficit, reversing a trend that has supported its strong economic recovery, sound fiscal position and excellent credit rating.[26]

Long-Term Cost Increases for Canadian Taxpayers Are Uncapped

The Canadian government is taking open-ended responsibility to absorb all costs and ensure profits for any potential new owner of the pipeline. It has made a series of promises to cover cost overruns caused by future political interference, adverse judicial rulings and unmet construction deadlines. The government's promise extends not only to project costs; it includes a guarantee for a reasonable rate of return.[27]

This promise covers what appears to be costs associated with three distinct phases: 1) the sale of the pipeline from Kinder Morgan to the Canadian government, which is covered in the Share Purchase Agreement; 2) the period of federal ownership during which the government will incur costs paid out on a Covered Credit Agreement with the Royal Bank of Canada; and 3) the transfer or sale of the pipeline from the Canadian government to a new, third-party owner during or after construction of the pipeline.

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[23] Government of Canada. "Annex 2- Details of Economic and Fiscal Projections." February, 2018.
[24] *Bloomberg News*. "Canada Buys Kinder Trans Mountain Pipeline for $3.5 Billion." May 29, 2018.
[25] Form 10-K Kinder Morgan, Inc.-KMI. February 9, 2018, p. 52.
[26] Canada's credit rating is strong and stable, reflecting solid GDP growth and declining unemployment. The country nevertheless projects annual deficits into the future. It is likely that Canada's strengths will remain stable, but the country faces new challenges: deterioration in U.S. trade relations (NAFTA and tariffs), anticipated slowing of GDP growth post 2019 and rising interest rates. How new expenditures related to the Trans Mountain pipeline play into this mix remains to be seen.
[27] Department of Finance Canada: https://www.fin.gc.ca/n18/data/18-038_1-eng.asp

During the first phase, the Canadian government will pay at closing an estimated $4.5 billion to secure ownership. This payment will cover Kinder Morgan's estimated outlay for the project, which has not yet been confirmed by outside sources, and will provide a benefit to the company and its subsidiaries of $3.89 billion.

Once the Canadian government ownership phase begins, the costs of the project are open and incurred by the Canadian government, subject to the Share Purchase Agreement and any underlying agreements that come with the title. The duration of Canada's ownership period will be driven by the ability of the government to satisfy public oversight requirements[28] and to find a new owner on terms and conditions acceptable to the buyer and seller (the Canadian government). It is unclear how much it will cost to construct the pipeline, but an upper limit of an additional $7.4 billion (on top of the $4.5 billion to be paid by the Canadian government for the project) has been estimated by Kinder Morgan.[29]

The third-phase guarantee covers the anticipated sale or transfer to a new third-party owner. Canada's indemnification promises seem to cover any future agreement. IEEFA concludes that revenue to the Canadian government from any resale of the pipeline to a new owner would be unlikely to cover the Canadian government outlay, since resale of the pipeline would likely be under distressed conditions.

The Canadian government will find itself in a weak position to sell the pipeline because: a) the Canadian government has telegraphed to the market that it is a reluctant owner and seeks to rid itself of its ownership position at the earliest possible exit opportunity; b) the National Energy Board projects that continued growth of oil sands production is contingent on prices rising above US$80 per barrel after 2027.[30]

Opinion is mixed on oil price futures. The U.S. Energy Information Administration sees long-term oil prices rising to US$80 per barrel by 2022 and rising thereafter. The World Bank does not expect oil prices to rise above US$70 per barrel through 2030.[31] Oil sands production remains the most vulnerable oil production region in the world due to its high cost structure.[32] Further, while supportive of the government action, the CEO of Suncor, Canada's second largest oil producer[33], does not see the move improving Canada's oil competitiveness on the global market.[34]

Further still, opinion is mixed on whether oil producers in Canada will actually receive a higher price for oil as a result of the pipeline's completion or if Asian markets will materialize in the way thought by Canadian business and governmental proponents of

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[28] *The Star*. "Purchases, permits and route hearings may stall Trans Mountain pipeline for years, say legal experts." June 15, 2018.
[29] The company estimates that there could be a 10% cost overrun, which would drive the costs up to $8.2 billion. Here we subtract $1.1 billion from that amount as it is already covered by the $4.5 billion.
[30] National Energy Board Canada: https://www.neb-one.gc.ca/nrg/ntgrtd/ftr/2017lsnds/index-eng.html
[31] Word Bank Commodities Forecast. April 24, 2018.
[32] *Global News*. "A 'carbon bubble' is coming, and Canada's oil sands are doomed: study." June 5, 2018.
[33] *Reuters*. "Suncor profit beats, oil production falls." May 1, 2018.
[34] *Global News*. "Trans Mountain deal fails to change Suncor position on Canadian competitiveness." June 6, 2018.

the transaction.[35]

There is every indication that the Canadian government has bought the pipeline at a high price and is likely to resell it for far less than it will pay to build it. The estimated total expense through 2020 is at least $11.6 billion, with additional upward pressure driven by unanticipated construction overruns, unfavorable credit terms and transaction costs associated with the pipeline resale, and potential delays from legally required public input into permit and other processes.[36] The government's indemnification promise also includes a willingness/obligation to repurchase the pipeline in the event that the second owner falters.

The Transaction Will Supply Kinder Morgan With a 637% Return on Its Investment in the Pipeline

The Share Purchase Agreement contains the following language:

> "KML [Kinder Morgan Canada] and KMI [Kinder Morgan Inc.] will derive substantial economic benefit from the transactions contemplated by this Agreement."[37]

Kinder Morgan Canada has identified $1.1 billion in project expenditures to date. IEEFA estimates that the outlay that can be attributed to Kinder Morgan Inc. for the project is approximately $610 million.[38] Between them, Kinder Morgan Inc. and Kinder Morgan Canada will receive $3.89 billion in profit. This amounts to a return on outlay of 637%.

Kinder Morgan Inc.'s profit for 2017 was $9.21 billion.[39] If its operations achieve the same profit in 2018, the $2.64 billion would add almost 30% to its 2018 profit picture. Kinder Morgan Canada had an adjusted profit of $388 million in 2017.[40] The additional $1.2 billion gained from the transaction would increase Kinder Morgan Canada's 2017 profit picture by 309%.

Kinder Morgan's decision in April to halt spending on the pipeline placed the project and the stock value of the company at risk.[41] The company's April statement[42] reflected its frustration with the political climate in Canada and the potential for long-term delays in the project. While expressing its confidence in the long-term economic viability of the project, the company's short-term costs were mounting and showed no signs of abating. Kinder Morgan took the risk of ending the project.[43] It then received an offer

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[35] Oil Change International. "Tar Sands: The Myth of Tidewater Access." March, 2018.

[36] *The Star*. "Purchases, permits and route hearings may stall Trans Mountain pipeline for years, say legal experts." June 15, 2018.

[37] Share Purchase Agreement, Recitals (G), p. 2.

[38] See footnote 19.

[39] Form 10-K Kinder Morgan, Inc.-KMI. February 9, 2018, p. 45.

[40] Ibid., p.48.

[41] *Reuters*. "Investors back Kinder Morgan Canada's Trans Mountain move." April 10, 2018.

[42] Kinder Morgan Canada Limited. "Kinder Morgan Canada Limited Suspends Non-Essential Spending on Trans Mountain Expansion Project." April 8, 2018.

[43] It is unclear if the company took any steps to sell the project to a third party under current conditions.

from the Canadian government that provided a substantial benefit to the company.[44] Absent the political intervention by the Canadian government, the company would likely have written off the investment or a substantial portion of it. The company's stock price would likely have declined.

The economic benefit from the sale affords each company—Kinder Morgan Inc. and Kinder Morgan Canada—an opportunity to improve its financial condition through shareholder payments, debt reduction[45] or new investment.[46] Kinder Morgan stock price has increased by 5% since May 29.

Greater Transparency: Documents Should Be Released, Specific Questions Should Be Answered

The transaction outlined in the Share Purchase Agreement has been developed in a climate of crisis and conflict. The fiscal and financial implications are significant, as the public cost to Canada are considerable and the benefits to Kinder Morgan substantial. As the project moves to closing from the current agreement in principle, time permits public clarification on the terms and conditions of the deal.

The Canadian Government Can and Should Release the Results of Its Background Investigation Into This Project

The Share Purchase Agreement states that the Canadian government has performed its own independent background analysis[47] of Kinder Morgan and the transaction:

> "Purchaser hereby acknowledges and affirms that (a) it has completed its own independent investigation, analysis and evaluation of the Target Entities and the Assets, it has made all such reviews and inspections of the Business, Assets, results of operations, condition (financial or otherwise) and prospects of the Target Entities and Assets as it has deemed necessary or appropriate and acknowledges that it has been provided access to the personnel, properties, premises and records of the Target Entities for such purpose and (b) in making its decision to enter into this Agreement and to consummate the Transaction, it has relied solely on the representations and warranties set forth in this Agreement and Purchaser's own independent investigation, analysis and evaluation."[48]

[44] See Kinder Morgan's recitation of the events leading up to the transaction, p, 12-19.
[45] https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1128353
[46] Oil Change International. "Tar Sands: The Myth of Tidewater Access." March, 2018. See discussion on use of proceeds, p. 10.
[47] Share Purchase Agreement. p. 59.
[48] Ibid., p. 59.

The Investigation Should Publicly Address and Answer the Following Questions:

- Will the Canadian government release the financial analysis from the Greenhill Company that is identified by Kinder Morgan Canada in its financial filing?[49]
- How did the Canadian government decide to pay $4.5 billion for a project in which the stated total outlay is $1.1 billion and the estimated outlay by Kinder Morgan, Inc. was $600 million and could be less? What type of analysis was conducted to determine that Canadian taxpayers are paying a fair and reasonable price?
- How was the $1.1 billion expenditure figure derived? Is there an allocation of these expenses between the two Kinder Morgan companies and other third-party funding sources?
- How did the Canadian government establish the independent character of the review? Who performed the service and how much were they paid?
- Was a fiscal cost-benefit analysis conducted?
- What is the Canadian government's estimate of its upper limit budget exposure for the Share Purchase Agreement, holding period of ownership and resale of the pipeline?
- Where will the money come from to pay the $4.5 billion at the closing in August?
- Will the Parliament need to approve the unanticipated expenditures? What is the timeline for the approval process?
- Is there a market analysis that assesses the potential for the resale of the pipeline?
- What happens if the Canadian government is unable to find a willing buyer for the pipeline? Does it have a long-term ownership plan?
- What timeframes have been established by the Canadian government to finish the regulatory oversight process and acquire needed review and approvals? [50]
- How much does the Canadian government believe this project will cost if it must retain ownership throughout the life of the construction cycle?
- What are the economic implications of this transaction? Will specific Canadian-based oil companies benefit from this decision? Which ones would those include and how would they benefit?
- What risks does the Canadian government face on this project?
- How much does the Canadian government estimate it will recover from the subsequent resale of the pipeline system?
- Does the Canadian government anticipate entering into any service or other contracts with Kinder Morgan for the Trans Mountain pipeline?
- Did the Canadian government's analysis cover the level of profit that Kinder Morgan Inc. and Kinder Morgan Canada would receive from this transaction? Is there any fiscal or legal opinion that supports the government's case to provide such a substantial taxpayer-funded benefit to Kinder Morgan?

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[49] United States Securities and Exchange Commission, Schedule 14A, Kinder Morgan Canada Limited. p. 15.
[50] *The Star*. "Purchases, permits and route hearings may stall Trans Mountain pipeline for years, say legal experts." June 15, 2018.

- Did Kinder Morgan try to sell the project to a third party, and if so what were the results of that effort?[51]
- Did the investigation conducted by the Canadian government attempt to reconcile Kinder Morgan Canada's February 20, 2018,[52] statement to its shareholders that it would actually benefit from a 10% cost overrun scenario versus its April statement citing "unquantified risks" and an environment that threatened the investment value of the project? [53]
- Can Kinder Morgan rebid for the pipeline in the future?

The Canadian Government Should Release Background Information, Term Sheets and Draft Agreements with the Royal Bank of Canada Regarding its Covered Credit Agreement

- What are the basic terms and conditions of the agreement, such as the upper credit limit, anticipated interest rate and expected maturity date?
- What are the plans for repayment of principal and interest on these notes?

The Government Should Disclose How It Plans to Finance the $1 Billion Resource Reserve Required Under the Share Purchase Agreement

- What combination of resources will be used to satisfy compliance with the terms of any reserve requirements?
- Is there a financial or legal opinion that supports the use of existing resources for this purpose?

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[51] It is an assumption made by Kinder Morgan Canada (see p. 18) that no third party was interested in the project.
[52] Form 10-K Kinder Morgan, Inc.-KMI. February 9, 2018, p. 52.
[53] Kinder Morgan Canada Limited. "Kinder Morgan Canada Limited Suspends Non-Essential Spending on Trans Mountain Expansion Project." April 8, 2018.

About IEEFA

The Institute for Energy Economics and Financial Analysis conducts research and analyses on financial and economic issues related to energy and the environment. The Institute's mission is to accelerate the transition to a diverse, sustainable and profitable energy. http://ieefa.org

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