GENERAL ACCOUNTING OFFICE WASHINGTON DC ENERGY AND N-ETC F/G 5/3 COSTS AND FINANCIAL RISKS OF CERTAIN LIQUEFIED NATURAL GAS IMPO-ETC(U) OCT 81 UNCLASSIFIED GAO/EMD-82-12
The Honorable John D. Dingell
Chairman, Subcommittee on Oversight
and Investigations
Committee on Energy and Commerce
House of Representatives

Dear Mr. Chairman:

Subject: Costs and Financial Risks of Certain Liquefied
Natural Gas Import Projects to U.S. Taxpayers
and Gas Consumers (EMD-82-12)

In your July 27, 1981, letter and during subsequent
discussions, you asked several questions regarding two projects
developed in order to import liquefied natural gas (LNG) from
Algeria. These projects are known as the El Paso and Trunkline
projects. The El Paso project began operations in 1978 but was
suspended in April 1980 because of a gas price dispute involving
the Algerian and U.S. Governments. The Trunkline project has
not yet begun service. Specifically, you asked for information
regarding any U.S. subsidies, Government loans, and tax credits
available to the owners and operators of LNG facilities. You
also asked what costs have been passed on to gas consumers since
the flow of LNG in the El Paso project was halted as a result of
the price dispute. This letter and the enclosures respond to
your questions. The following paragraphs summarize our findings.
Details are developed in subsequent sections.

Both the Export-Import Bank and the Maritime Administration
provided financial assistance for LNG projects. However, their
involvement was not directly related to the U.S. importation of
Algerian natural gas. The Export-Import Bank provided loans and
loan guarantees to Sonatrach, the Algerian national oil and gas
compny, to facilitate Sonatrach's use of U.S. contractors and
equipment in the construction of LNG facilities and thereby
promote American exports. The Maritime Administration, in line
with its mandate to encourage the growth and maintenance of the
U.S. merchant marine and shipbuilding industry, provided the U.S.
shipbuilders and shipowners with construction subsidies and loan
guarantees to ensure the construction of ships in the United
States.

U.S. owners of LNG facilities and ships are not entitled to
any special energy tax credits. They qualify, however, for the
standard investment tax credit available to anyone who invests

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(001700) 1
Based on discussions with officials from each of the companies involved, we estimate about $161 million of investment credit has been or will be claimed, subject to audit by the Internal Revenue Service. However, about $38 to $46 million of this may be recaptured by the United States Government because, as a result of the El Paso project's suspension, the six U.S.-built El Paso ships may not be in service for the period of time required to qualify for the investment credit.

Costs generally cannot be passed on to gas consumers until a project begins service. Because the Trunkline project has not yet begun operations, none of its costs has been passed on. The El Paso project was in service from March 1978 to April 1980, when the last LNG shipments arrived from Algeria. Costs attributable to this project continue to be passed on. From the time the gas would have been fully delivered had it been sent out at normal rates, through July 1981, gas consumers have been billed about $158.8 million. The Federal Energy Regulatory Commission (FERC), however, is currently investigating whether billings reflect the proper interpretation of authorized LNG rate schedules.

We obtained our information from reviews of agency documents and discussions with agency and company officials. To determine gas costs passed on to gas consumers, we spoke with officials at FERC, the El Paso Company and its three LNG customers, and the Trunkline LNG Company. We also reviewed company documents submitted to FERC. To identify costs and risks to U.S. taxpayers, we examined documents from the Export-Import Bank, the Maritime Administration, and the Internal Revenue Service, and spoke with officials at those agencies. We used estimates of the investment tax credits provided by each of the companies involved including those identified above, as well as the estimates of the three partners who own the LNG tankers which Trunkline will use. We did not verify their tax credit estimates.

THE EL PASO AND TRUNKLINE PROJECTS

Each LNG project is unique; nevertheless, these projects tend to have certain common features. Each major project normally includes dedicated facilities including gas gathering, processing, and exporting facilities in the producing country; specialized LNG tankers; and receiving terminals and regasification facilities in the importing country. Project costs run into the billions of dollars. Because these large expenditures must be financed in advance, long-term contracts of 20 to 25 years are normally signed by the parties involved.

The El Paso project

This project called for the delivery of the equivalent of about 1 billion cubic feet of gas per day for 25 years using nine El Paso ships to transport the LNG from Algeria to two U.S. terminals. Three of the ships were built in France and six in the United States. (Three of the U.S.-built ships, however, never became operational because of technical problems.) Each ship is owned by a separate El Paso subsidiary. The two terminals are owned by El Paso's three customers. Columbia LNG Corporation and Consolidated System LNG Company jointly own a terminal and facilities at Cove Point, Maryland; Southern Energy Company owns those at Elba Island, Georgia. When the project was in operation, each of these three companies regasified the LNG and sold the gas to its respective affiliated buyer—Columbia Gas Transmission Corporation, Consolidated Gas Supply Corporation, and Southern Natural Gas Company. These companies in turn distributed the gas (directly or by exchange) through their pipeline systems to their customers.

Early in 1979 Sonatrach demanded an increase in the base price of LNG deliveries. El Paso and its LNG customers participated in the renegotiation of the agreement with Sonatrach. Although the Economic Regulatory Administration of the Department of Energy approved a contract amendment negotiated with Sonatrach, the amendment was not approved by the Algerian Government which wanted a higher price. Deliveries from Sonatrach to El Paso were, therefore, suspended on April 1, 1980. The last shiploads of LNG arrived at Cove Point on April 10, 1980, and at Elba Island on April 9.

To resolve the price impasse, representatives of the U.S. and Algerian Governments held numerous meetings, but failed to produce a settlement. In February 1981, after the last of these meetings was suspended indefinitely, El Paso determined that prospects for project resumption were remote. It decided to abandon the project and write down its investment in LNG facilities to a realizable value. Southern, Consolidated, and Columbia, however, are continuing to negotiate directly with Algeria to resume LNG shipments.

The Trunkline project

The Trunkline project has not yet begun operations, but may begin startup in late 1981. Trunkline LNG Company, a subsidiary of Panhandle Eastern Corporation, is authorized to buy the equivalent of about 460 million cubic feet of gas a day from Sonatrach over a 20-year period and will use five ships, two American and three Algerian, to transport the LNG to a terminal in the Lake

Charles area of southern Louisiana. The American ships are owned by Lachmar, a partnership formed by subsidiaries of Panhandle Eastern (40 percent), General Dynamic Corporation (40 percent), and Moore McCormack Resources, Inc. (20 percent). Trunkline LNG will regasify the LNG and deliver the gas to its affiliate, Trunkline Gas Company, which will transport this gas through its extensive pipeline system to its customers.

On August 7, 1981, Trunkline LNG informed Sonatrach it was ready to receive LNG and begin startup procedures. However, Trunkline officials report that Sonatrach claims that major repairs on a gas transmission line are not complete and that the first LNG delivery cannot be made until November at the earliest. In the past, however, Sonatrach has raised questions about the contract price and volume; Trunkline officials, therefore, are uncertain whether Sonatrach's position on price will affect the startup of operations.

THE EXPORT-IMPORT BANK

The Export-Import Bank of the United States is an independent Federal agency established to assist American exporters by providing loans, loan guarantees, and export credit insurance to foreign borrowers who buy U.S. goods and services. The Bank supports its operations through interest and/or fees on these loans, guarantees, and insurance. It does not receive appropriated funds. Since receiving an initial capitalization of $1 billion in 1945, the Bank has paid dividends to the Treasury totaling more than that amount and has produced retained earnings of about $2.2 billion.

The purpose of Bank assistance for Algerian LNG projects is to promote the use of U.S. contractors and equipment in the construction of LNG facilities. This support is not directly related to the U.S. importation of LNG. Through June 30, 1981, the Bank had authorized Sonatrach $515 million in loans and $194 million in loan guarantees (net of cancellations). These loans and guarantees support three projects, known as LNG I, II, and III. The obligations are backed by the "full faith and credit" of the Algerian Government. Bank officials said Sonatrach has not defaulted on any of these loans or loan guarantees. In their view, it is highly improbable that Algeria would default on a loan, even if political relations were strained or severed. They expressed no doubt that Algeria will repay its loans, in full and on schedule.

Interest rates on the loans range from 6 to 9 percent. Long-term U.S. Treasury bonds issued at about the time of loan authorizations were generally within 1 percentage point of the loans. Repayment schedules range from 4 to 9 years but do not begin until 6 months after project completion and after other participating private lenders are paid. This feature is designed to encourage financing by private banks.
Bank credit for Algerian LNG production is based on the value of U.S. exports. As previously mentioned, it does not depend on the U.S. importation of Algerian gas. Production from LNG I was dedicated to the El Paso project, but LNG II and III were never explicitly dedicated to either the El Paso or Trunkline projects. The expectation that the gas would be shipped to the United States was a consideration in granting the loans, but according to Bank documents, was not an overriding factor.

In 1973 the estimated cost of U.S. goods required for the liquefaction plant and related facilities at Arzew, LNG I, was $349.8 million. The Bank authorized a direct loan for $157.41 million and guaranteed another loan for a net of $146.39 million. The Bank also guaranteed a net loan of $47.75 million in local currency to cover costs incurred in-country. According to Bank officials, this latter guarantee was included in the loan package to make it more competitive, since this feature is frequently offered by other countries. In 1975, also related to LNG I, the Bank authorized a $37.5-million loan to help construct a processing plant in the gas field at Hassi R'Mel. U.S. exports for this facility were estimated at $119.2 million. Cost overruns on the liquefaction plant resulted in an additional loan in 1977 of $67 million against a U.S.-export value of $167.5 million.

In evaluating the loan for the second liquefaction plant at Arzew, LNG II, bank officials were aware of a potential connection with the Trunkline project. However, they concluded that Sonatrach had more than enough contracts even without Trunkline to sell the expected plant production. In 1978 the Bank authorized a loan of $240 million against the U.S.-export value of $320 million.

A third liquefaction plant planned for Arzew, LNG III, also received a loan commitment, but Algeria later canceled this plant. Although most of the loan was also canceled, $13.02 million is still available to be applied to U.S. contractor expenses for work already completed. Enclosure I provides details on the status of the outstanding loans and loan guarantees for LNG I, II, and III.

MARITIME ADMINISTRATION

The Merchant Marine Act of 1936, as amended, establishes various programs designed to foster and maintain an American merchant marine adequate to meet the needs of U.S. commerce and national defense. One such program provides construction subsidies and another provides loan guarantees. Both programs were used to finance the construction of the eight U.S.-built ships involved in the El Paso and Trunkline projects. The Maritime Administration has not provided any operating subsidies.

The Construction-differential Subsidy Program provides for paying construction subsidies to American shipbuilders by the U.S. Government. The subsidy itself is the difference between
the estimated cost of having a ship built in a foreign shipyard and having the same ship constructed in a U.S. shipyard. Because foreign costs are often lower, the subsidy is intended to place the construction of U.S.-built ships on a parity with foreign construction costs. On the eight U.S. tankers, the Maritime Administration paid about $211 million in subsidies, as shown in enclosure II.

The Federal Ship Financing Program, established under title XI of the Merchant Marine Act, provides guarantees on obligations to enable the financing and refinancing of American-built vessels that are owned and operated by U.S. citizens. The U.S. Government guarantees prompt payment in full of interest and principal in the event that the shipowners default on such payments. Funds secured by title XI guarantees are obtained in the private sector. According to the Maritime Administration, the program enables owners of eligible vessels to obtain long-term financing on favorable terms and conditions and at interest rates comparable to those available to large and financially strong corporations. The interest rate on the guaranteed obligation must be within the range of rates prevailing in the private market and must be determined to be fair and reasonable. As shown in enclosure II, the Maritime Administration has guaranteed about $672 million of obligations on the eight U.S. LNG ships, at average interest rates ranging from 8.3 to 9.8 percent. Amounts guaranteed were generally about 75 percent of the actual cost to the owners. As of June 30, 1981, $624 million was still outstanding.

Maritime Administration officials said that none of the companies have defaulted on their loans, nor do they expect any defaults. Construction on three of the six El Paso ships, those built by Avondale Shipyards, Inc., was suspended in July 1979 when cracks were discovered in the insulation in one of the vessels following gas trials. The insurance underwriters, El Paso, the Maritime Administration, and the shipbuilders reached a $300-million settlement which, according to both El Paso and Maritime Administration officials, should assure servicing of the U.S. Government Guaranteed Bonds. El Paso officials said they plan to continue payments on the remaining ships also despite their abandoning of the LNG project. The company is now seeking to dispose or make other use of all its LNG ships.

Despite El Paso's abandoning of the project and the technical problems on three of the ships, the Maritime Administration will not recoup the construction subsidies paid. However, if the ships are used in the future, they may retain the same use restrictions the Maritime Administration originally required.

TAX CREDITS AND OTHER BENEFITS

Owners of LNG facilities and ships do not qualify for any special energy tax credits. However, U.S. owners of domestic
LNG facilities and ships generally qualify for the standard investment tax credit available to anyone who invests in qualifying property. This LNG property must be depreciable and tangible and have a useful life of at least 3 years. The regular credit allowable is 10 percent of the eligible investment. Subject to certain limits, the credit is deducted from the tax as shown on the tax return.

Normally, the tax credit can be claimed for the year in which the property is placed in service. However, if the property has a normal construction period of 2 or more years and meets other criteria, expenditures for the construction-work-in-progress can be treated as qualified investment before service actually begins. Generally, owners of the LNG facilities and ships believe they have met these criteria. If the property is disposed of before the end of the 7-year period, however, the U.S. Government recaptures some or all of the credit claimed.

Based on discussions with officials from each of the companies involved, we identified $160.7 million of estimated investment tax credits associated with the El Paso and Trunkline LNG import projects. Because of certain "carryover" provisions of the tax regulations and because the Trunkline project has not yet begun service, not all the amounts have yet been claimed. These portions of the totals are, therefore, only estimates. The full amounts are still subject to audit by the Internal Revenue Service. Details are provided in enclosure III.

It is important to note, however, that the El Paso Company's portion of the total, $46.6 million, represents the investment credit on its six U.S.-built ships. Because of the company's decision to withdraw from the LNG project and to write down its investment, company officials expect that all or most of the $46.6 million will be recaptured by the U.S. Government. They indicate that perhaps about $8 million (one-third of the credit on the three ships that were in service) may not be subject to recapture, since the tax regulations allow one-third of the credit if the property has a useful life of at least 3 but less than 5 years.

Although not through a tax credit, owners of LNG vessels may qualify for certain benefits which allow them to defer a portion of their Federal income tax. Amendments passed in 1970 to the Merchant Marine Act of 1936 created the Capital Construction Fund, administered by the Maritime Administration, to encourage the modernization and expansion of the U.S. Merchant Marine. This fund allows participants to defer the Federal income tax on the operating income generated by the ships by depositing such income into the fund. The income is available to repay the principal portion of the mortgage on the ship. When it is used in this manner the tax basis of the ship is reduced. Thus, the Government recoups the tax deferral on the deposits through a reduction in future depreciation allowances. According to a Maritime Administration official, the program in essence acts as an interest-free
loan whereby the taxes deferred are ultimately collected. The cost to the Government is the time value of the deferral from the deposit until recoupment through the depreciation mechanism. The three El Paso subsidiaries whose ships were operational and one of the Lachmar partners, Moore McCormack Resources, have entered into these types of agreements with the Maritime Administration to pay the principal on their respective ships.

Two other tax implications should be noted. First, when El Paso decided to abandon its LNG project, it wrote down its assets to what it considered their net realizable value. El Paso's 1980 financial statements show that, before taxes, its total write down was $547.5 million. However, the net write-down was $365.4 million, because the company expected tax benefits of over $182 million.

Second, according to officials from each of the LNG importing companies, most domestic facilities, including marine terminals, LNG storage tanks, regasification units, and transmission lines to deliver the gas, were financed through a combination of equity and commercially financed debt. Southern Energy, however, was able to finance $85 million of its $160 million cost of terminal and regasification facilities through revenue bonds issued by the Savannah Port Authority and exempt from Federal, State, and local taxes. For this type of issue, the cost to the borrower is less. According to a study by the Office of Technology Assessment, these bonds were marketed at a price of 99.75 percent of par and with a coupon rate between 5.7 and 6.75 percent, depending on the maturity. At the time of the prospectus, taxable Aaa bonds were yielding around 9.5 percent, considerably more than the Savannah Port Authority bonds. 1/

**GAS COSTS PASSED ON TO CONSUMERS**

FERC has jurisdiction over the transportation and sale of natural gas in interstate and foreign commerce. By law every natural gas company must file a schedule of rates and charges for transactions that fall within its jurisdiction. Columbia LNG, Consolidated System LNG, Southern Energy, and Trunkline LNG all have filed rate schedules which FERC has accepted. These rate schedules, among other items, determine the kinds of LNG costs which can be passed on to the companies' respective customers.

The El Paso project

Rate schedules accepted by FERC for the three El Paso customers call for these companies to recover all costs including

both return and depreciation related to their equity investment as long as gas is flowing to their customers. Officials from each of the LNG importing companies stated that their customers would, in turn, be able to pass these costs on to their customers and ultimately the gas consumers. If, however, the companies cannot deliver gas for a period longer than 1 day, "minimum bill" provisions of their rate schedules do not allow them to recoup this return on and depreciation of their equity investment.

When the Algerian Government demanded an LNG price increase higher than El Paso and its customers were willing or authorized to pay, Sonatrach suspended deliveries. The last LNG shipment arrived in the United States on April 10, 1980. In the case of Columbia LNG and Consolidated System LNG, rather than continuing deliveries at normal rates until the stored LNG was depleted, both companies continued to send out minimal amounts of gas to their customers until December 10, 1980, that is, for 10 months after the LNG disruption. The companies indicated their intent was to prevent the facilities from warming up and to retain, as long as possible, the capability of accepting resumed deliveries on short notice. Until December 10, they billed for all expenses including operation and maintenance expenses, taxes, expenses of debt repayment, and a return on and depreciation of their equity investment. After December 10, when they invoked the "minimum bill" provisions, they continued to bill for their expenses but could not bill for a return on and depreciation of their equity investment.

The Attorney General of Ohio and others, however, have asked FERC to rule that the "minimum bill" provision should have been activated on April 23, 1980, the date that all of the stored LNG would have been delivered if deliveries had continued at the same rate as the preceding month. If FERC determines the company billings were not in accordance with the approved rate schedules, it can order refunds on the amounts charged above what the "minimum bill" would have allowed.

From April 23, 1980, through July 31, 1981, Columbia LNG and Consolidated System LNG billed their customers (i.e., their affiliated pipeline companies) about $109.5 million, $43.2 million and $66.3 million, respectively. According to company documents submitted to FERC, the amounts charged over what "minimum bill" would have allowed if activated April 23, 1980, total $41.7 million -- $14.9 million for Columbia LNG and $26.8 million for Consolidated System LNG.

In addition to this uncertainty on ultimate costs to the consumer, on October 31, 1980, Columbia LNG and Consolidated System LNG filed a petition with FERC to permit them to capitalize an amount equivalent to the return on equity lost while the minimum bills were in effect and to recover it if LNG ships are resumed. FERC has not yet acted on the petition.
The situation for Southern Energy is different. Southern is continuing to send out small amounts of gas and has not yet invoked its "minimum bill" provisions. It has, therefore, continued to bill its customer, Southern Natural Gas, for all of its expenses, including a return on and depreciation of its equity investment. According to FERC staff, Southern would have had to place its "minimum bill" into effect on April 24 if it had delivered its remaining LNG supplies at the average daily design delivery rate. According to Southern Energy's estimates, total billings from April 24, 1980, through July 31, 1981, were $49.3 million. Based on the data provided by company officials, the amount charged above what the "minimum bill" would have allowed, if invoked on April 24, 1980, is about $14.0 million. Because Southern is faced with the same cut-off of Algerian LNG supplies as Columbia and Consolidated, FERC is also investigating Southern's "minimum bill" interpretation.

The Trunkline project

Since the Trunkline project has not yet begun operations, none of its costs has been passed on to its consumers. If the project never begins, none of the costs can automatically be recovered. In approving the project, the Federal Power Commission specifically stated that if the project were to fail, a determination of cost recovery would be made at the time to take into account the specific circumstances. According to a FERC official, such a review would probably be made under section 4 of the Natural Gas Act and be subject to the test of "prudent costs." Since FERC does not have jurisdiction over ships, however, FERC staff doubt that ship costs could ever be recovered from gas consumers.

Trunkline LNG's rate schedule is different from those of the three El Paso customers. If the project begins operation and deliveries are subsequently reduced below 90 percent of contractual volumes, the "minimum bill" provision of Trunkline's approved gas rates allow Trunkline to receive a pro rata share of its expenses, including return and depreciation related to its equity investment.

At the request of your office, we have not obtained agency comments. As further arranged with your staff, unless you publicly announce the contents of this report earlier, we plan to restrict further distribution for 7 days.

Sincerely yours,

J. Dexter Peach
Director

Enclosures - 3
U.S. EXPORT-IMPORT BANK ASSISTANCE

IN ALGERIAN LNG PROJECTS

(AS OF JUNE 30, 1981)

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<th>Credit number</th>
<th>Date authorized</th>
<th>Estimated export value (millions)</th>
<th>Net amount of authorization (millions)</th>
<th>Amount disbursed (note a) (millions)</th>
<th>Amount outstanding (note a) (millions)</th>
<th>Interest rate (percent)</th>
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<td>(b)</td>
<td>146.39</td>
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<td>~ 4457</td>
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a/ In the case of loan guarantees, these amounts refer to loans from other sources which included the Export-Import Bank has guaranteed.

b/ Included under Loan No. 4455.

NOTE: Totals may not add due to rounding.
### MARITIME ADMINISTRATION ASSISTANCE

<table>
<thead>
<tr>
<th>Name of LNG Ship</th>
<th>Construction differential subsidy paid</th>
<th>Amount of mortgage (thousands)</th>
<th>Amount outstanding June 30, 1981 (thousands)</th>
<th>Average interest rate (percent)</th>
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**NOTE:** Totals may not add due to rounding.
### ESTIMATED INVESTMENT TAX CREDITS

<table>
<thead>
<tr>
<th>Project</th>
<th>Estimated tax credit (millions)</th>
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<tbody>
<tr>
<td><strong>El Paso project:</strong></td>
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<tr>
<td>El Paso subsidiaries (owners of 6 U.S. ships)</td>
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<tr>
<td>Columbia LNG (co-owner of facilities at Cove Point, Maryland)</td>
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<td>Consolidated System LNG (co-owner of facilities at Cove Point, Maryland)</td>
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<td>Southern Energy (owner of facilities at Elba Island, Georgia)</td>
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<tr>
<td><strong>Total</strong></td>
<td>87.0</td>
</tr>
<tr>
<td><strong>Trunkline project:</strong></td>
<td></td>
</tr>
<tr>
<td>Lachmar Partnership (owner of 2 U.S. ships)</td>
<td></td>
</tr>
<tr>
<td>Panhandle Eastern – Pelmar subsidiary</td>
<td>12.9</td>
</tr>
<tr>
<td>General Dynamics – Pantheon subsidiary</td>
<td>10.0</td>
</tr>
<tr>
<td>Moore McCormack – Morgus subsidiary</td>
<td>6.0</td>
</tr>
<tr>
<td>Trunkline LNG (owner of facilities at Lake Charles, La.)</td>
<td>44.8</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>73.7</td>
</tr>
<tr>
<td><strong>Estimated credit for the two projects</strong></td>
<td>160.7</td>
</tr>
</tbody>
</table>

\*a/Because of El Paso's decision to withdraw from the LNG project, company officials expect all or most of the $46.6 million will be recaptured by the U.S. Government. They indicate that perhaps about $8 million (one-third of the credit on the three ships that were in service) may not be recaptured, since tax regulations allow one-third of the credit if the property has a useful life of at least 3 but less than 5 years.