# ANS (ALASKA NORTH SLOPE) LESSEES, 4/20/05

Joint Work Session 4-20-05
Sen. Res. & L.B. & A

# FIVE COMMON MISCONCEPTIONS ABOUT PRODUCER "CONTROL" OF ANS GAS AND ITS RELATION TO THE PIPELINE

TESTIMONY BEFORE THE
ALASKA LEGISLATIVE BUDGET
AND AUDIT COMMITTEE

APRIL 20, 2005

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# INTRODUCTION

My name is Mark Cotham and I am appearing today with my law partner, Mark Harwell. We are attorneys with the Houston law firm of Cotham, Harwell & Evans. Our firm has been engaged by the Alaska Gasline Port Authority (the "Port Authority") to testify on issues surrounding the obligations of leaseholders of gas properties.

We have been practicing oil and gas law for a combined over forty-three years. Biographical information about us and our firm is attached to these remarks. Our firm specializes in representing royalty owners in development and marketing disputes with oil and gas producers. The circumstances surrounding Alaska's stranded gas reserves and the history of attempts to have a gas pipeline built to them are unique. However, the obligations that producers have to develop and market natural gas are established and familiar in the lower forty-eight states.

We have been asked by the Port Authority to review with you the legal duties and obligations that the Alaska North Slope ("ANS") producers have to develop and market this stranded gas. Reviewing the Alaska natural gas discourse, I have been struck by the absence of much, if any, public discussion about the producers' duties. There has, and rightly so, been a lot of discussion about the Federal Government's loan guarantee and why it was important in getting the pipeline built. The producers have likewise been very outspoken about concessions as far as royalty and the taxes that they have said "must" be made by the State.

It is a *misconception*, however, to believe that the oil companies enter discussions about Alaska's gas reserves without their own specific duties. In fact, the authors of Alaska's leases have provided clear duties and responsibilities for which the ANS producers *are* accountable. Furthermore, the State is in an excellent position, if it so chooses, to require the ANS producers to promptly and diligently market that gas.

While I am here today in my capacity as counsel for the Port Authority, it is important for me to emphasize that the viewpoints I am going to share are *not*, from an oil and gas law perspective, contentious or an attempt to advocate debatable legal propositions. The body of law that we'll be discussing today is settled and scholars agree, to an extent uncommon in most areas of the law, on what is required.

In order to insist upon the performance that is due to the people of Alaska, it is important to have a firm grasp on what is due from the oil companies under their leases and the law generally. Unfortunately, that subject has sometimes been the subject of misconceptions.

The five misconceptions that I would like to address with you today are:

- *MISCONCEPTION NUMBER 1*: The oil companies "own" the ANS gas.
- *MISCONCEPTION NUMBER 2*: The oil companies have complete legal control over *if* and *when* the ANS gas is marketed.
- *MISCONCEPTION NUMBER 3*: The oil companies can choose how much profit they want and not market the ANS gas until their profit goals, through State concessions or otherwise, are met.
- *MISCONCEPTION NUMBER 4*: The oil companies, by virtue of owning the ANS leases, have the legal right to dictate the location, ownership and structure of the pipeline.
- *MISCONCEPTION NUMBER 5*: The State is in a relatively weak negotiating position with the oil companies.

I hope by reviewing these issues that I can help to bring the discussion away from the false issue of what Alaska "has" to do by way of concessions to get the producers to agree to market Alaska's stranded gas. And, instead, assist the discussions to focus on which pipeline proposal offers the most benefit to the Alaskan people. This is *the* critical inquiry for good stewardship of Alaska's resources.

Because this is a discussion about the legal duties that the ANS producers have to the State, it is necessarily based on the myriad of cases and treatises that have addressed these oil and gas law issues. For the most part, these are collected in the end notes to avoid the discussion becoming bogged down in legal detail.

## Terminology and Background

Because there are a variety of terms used to describe relations in an oil and gas lease context, it is helpful to address this subject first. The **lessor** here is obviously the State of Alaska. It owns the minerals. In return for a **royalty** (and a competitive bid bonus payment), the State has leased the subject ANS acreage to **lessees.**

The lessees are oil companies. The interests they own, which bear the costs of drilling and operating, are known as **working interests**. This is to be distinguished from a **royalty interest** which bears none of the costs of drilling or producing oil or gas. The **operator** is a working interest owner who assumes managerial duties on behalf of all of the working interest owners. Almost always, the operator owns the largest share of the working interest.

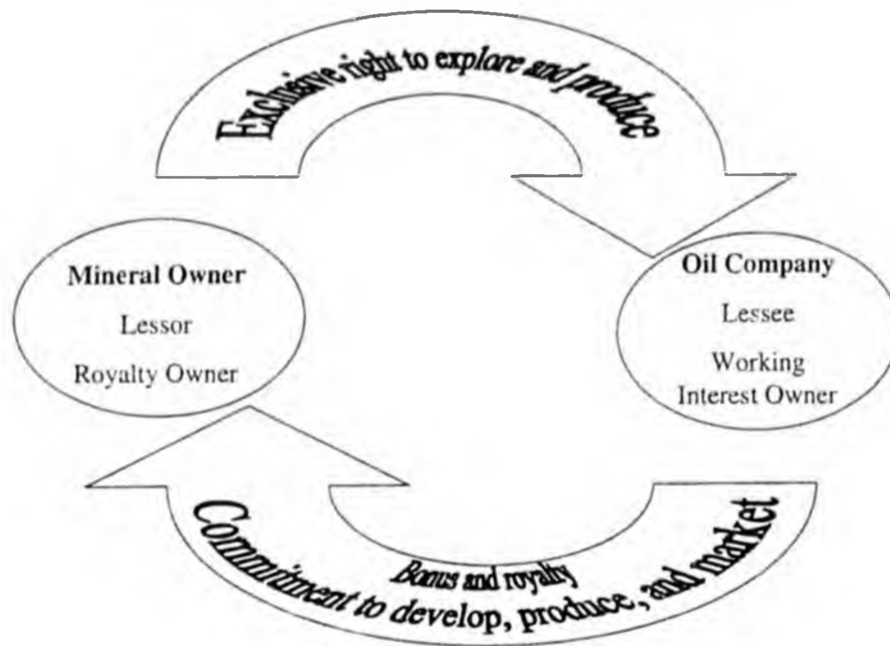
Throughout this report, the phrase **producers** is often used. This is meant to generically encompass the operator and all of the other working interest owners who each assume the same basic obligations. In this regard, it is worth nothing that while lessees' duties are almost universally phrased in terms of the "*operator's*" duties, the same duties extend to all of the producers who are subject to the same forms of lease.

A **unit** is a collection of leases, or parts of leases, that are combined to more efficiently explore and develop the combined acreage. The Prudhoe Bay Unit is an example of a unit. Units are subject to approval by the Department of Natural Resources as well as the Alaska Oil and Gas Conservation Commission. Inside of the oil and gas units are **participating areas** which include that portion of the leases in a unit that cover a known or estimated accumulation of oil and gas and to which production is allocated by a unit agreement.

**Development plans** are periodic plans submitted by producers in which they are required to address "long range proposed development activities for the unit, including plans to delineate all underlying oil or gas reservoirs, bring the reservoirs into production, and maintain and enhance production once established" and the "details of the proposed operations for at least one year following submission of the plan." These plans are reviewed by the Commissioner of the Department of Natural Resources who must approve them.

Graphically, the basic rights and responsibilities that exist between the State as lessor and the ANS oil companies as lessees appear as follows:

**What is conveyed by an oil and gas lease?**



*MISCONCEPTION NUMBER 1*: **The oil companies "own" the ANS gas.**

**Reality:** **The oil companies have the right to develop and market gas; however, that right has corresponding responsibilities. *If* the producers do not meet their responsibilities, 100% of their rights to the ANS gas can be cancelled.**

There have been many references in discussions about the gas pipeline to the fact that the producers own or control the gas. The one I particularly like and sympathize with was former Chairman Ogan's question last Fall, "How [does] one get past the [reality] that the guys with the gas make the rules."[1] While I understand the sentiment, the fact is that the producers *do not own*, or for that matter entirely control the ANS gas, as a matter of law.

One normal incident of ownership is that an owner can decide to use or not use the property that they own.[2] For instance, an owner can decide to develop his or her property or not. Another incident of ownership is that an owner can choose to sell or not sell their property.[3] Unless the State changes ownership, through for example exercising its condemnation powers, an owner's legal use of and decision to sell all or none of that property is *solely* up to the owner.

The producers do *not*, however, have a legal choice about whether or not to develop, produce and market the ANS gas reserves. Instead, under the oil and gas leases that we'll discuss momentarily, the producers are *expressly* required to reasonably develop and produce the ANS gas.[4] Further, they must, in accordance with the common interpretation of oil and gas leases, market the ANS gas with reasonable diligence.[5] Finally, and this is very important, *if* the producers breach their leases, they are subject to having their interests forfeited.[6] That is expressly provided in the ANS producers' leases and will be discussed later in detail.

Now, what difference does all of this make? First, appreciating the limits on the producers' rights in ANS gas is necessary to understanding why the producers' decisions *are* the State's business. After all, if the producers really *owned* the gas, in a traditional sense, then how they use it would, as a matter of respect for property rights, *not* be the State's business. Second, because the producers' rights in this gas are conditioned upon them being diligent in their development, production and marketing, the State has every legal right to insist upon this as a means to further its interests as a royalty owner.

A good analogy to illustrate this difference between absolute ownership and more limited legal rights is a comparison of someone who owns their own business, say a hamburger stand, versus someone who owns say a McDonald's franchise. By comparing the attributes of these two different circumstances you get a good understanding of the difference between ownership of the ANS gas on the one hand and the far more limited rights that the producers possess here. Comparing these two circumstances, you find:

| **Single Owner Hamburger Stand** | **McDonald's franchise** |
|---|---|
| The owner holds 100%. | Many incidents of ownership, all *subject* to a franchise agreement. |
| Owner runs it however he or she pleases. | Must run it according to standards established in a franchise agreement. |
| No matter how it is run, the owner will remain *the owner.* | Failure to meet the franchise agreement standards will lead to *forfeiture* of the franchise. |

As I hope throughout this testimony to illustrate, the ANS producers cannot fairly be portrayed as an owner in the same sense as our single hamburger stand owner. Instead, their rights are far more analogous to a McDonald's franchise. The ANS producers, like a franchise, have to meet standards and failing that the producers can totally lose their rights.

So, in summary on this point, the State, as mineral owner, has not fully conveyed its mineral interests. To the contrary, it has conveyed only the right to explore and produce, subject to requirements, including the possibility of forfeiture in the event of breach of the leases. In legal parlance, this more limited interest is generally known as a "fee simple determinable."[7]

With an appreciation of the fact that the ANS producers are not true owners of the gas, we can now turn to what extent the producers nonetheless can legally "control" *if* and *when* the ANS gas is produced and marketed.

***MISCONCEPTION NUMBER 2*: The oil companies have complete legal control over *if* and *when* the ANS gas is produced and marketed.**

REALITY: **The oil companies are subject to very specific duties to develop and market the ANS gas. The duties that the oil companies have include:**

**(1) the duty to reasonably develop this acreage; and**

**(2) the duty to market the gas with reasonable prudence and diligence.**

**The violation of these duties would entail extraordinary financial consequences.**

The duties to which I am referring are, as the end notes make clear, *very* well established in the American common law. In circumstances, such as the case here, where Alaskan courts have not addressed an issue, Alaska's rules of decision indicate that it will follow this law.[8]

While the duties to develop, produce and market are complementary, they are worth discussing separately since they have different origins and may have different remedies.

The ANS producers' development and production duties are expressly recognized in the leases and unit agreements. The standard modern form State of Alaska lease,[9] provides in pertinent part:

13. **DILIGENCE AND PREVENTION OF WASTE.**

(a) The lessee *shall exercise reasonable diligence* in drilling, producing, and operating wells on the leased area unless consent to suspend operations temporarily is granted by the state.

(b) Upon discovery of oil or gas on the leased area in quantities that would appear to a reasonable and prudent operator to be sufficient to recover ordinary costs of

> drilling, completing, and producing an additional well in the same geologic structure at another location with a *reasonable profit to the operator*, the lessee must drill those wells as a *reasonable and prudent operator* would drill, having due regard for the interest of the state as well as the interest of the lessee.
>
> (c) The lessee shall perform all operations under this lease in a good and workmanlike manner in accordance with the methods and practices set out in the approved plan of operations and plan of development...

(Emphasis supplied.) Our review of other earlier State leases suggests each have functionally equivalent requirements.[10] Furthermore, even in the absence of express requirements, courts have implied a duty to diligently develop.[11]

In contrast to these development obligations, the Alaskan leases that we have reviewed do not provide for any *express* obligations to *market* production. This is not at all uncommon for oil and gas leases. In such circumstances, courts and commentators have long recognized that an *implied* duty to market exists.[12]

The duty to market obviously lies at the heart of the parties' purpose since without it the lessor (the State here) does not receive any royalty. As the New Mexico Supreme Court explained in *Darr v. Eldridge*,[13]:

> Obviously production without disposition of the product is futile. Thus the courts have developed the implied covenant 'to make diligent efforts to market the production in order that the lessor may realize on his royalty interest.'

Courts, in cases involving leases similar to the State of Alaska leases, have found the existence of other requirements in leases – such as to "produce" or "develop," further support an implied duty to market. In *Cole Petroleum Co. v. United States Gas & Oil Co.*,[14] for example, the Texas Supreme Court explained:

> Under the ordinary oil and gas lease, the lessee is not required to market the yield of the leased land at any certain time for any certain price. When the lease is silent on the subject, the lessee's duty is to exercise

> ordinary or reasonable care. The assignment before us explicitly fixed the degree of care to be used by the assignee in proceeding to develop the lease to the normal stage of production as such care 'as is reasonably necessary'...Without the exercise of reasonable care to market the gas, there could be no compliance with the assignee's obligations to proceed with the development reasonable and necessary to bring the lease to a normal stage of production.

Similarly, other courts have reasoned that without the exercise of reasonable care in the marketing of gas, there could be no compliance with a lessee's obligations to proceed with reasonable development.[15]

The standard against which a producer's marketing efforts must be measured has been summarized by Professor Kramer[16] as follows:

> [M]odern courts, in reviewing the lessee's marketing efforts, have generally applied the reasonably prudent operator standard. Absent an express agreement altering the marketing duty, neither the lessee nor the lessor determine the duties owed under the marketing covenant. Instead, the decision turns on the facts, circumstances, and practical considerations presented in each case. Therefore, the lessee in any given case is compared to a hypothetical reaso. ble person engaged in oil and gas operations. Under such an objective standard, the lessee cannot justify his wrongful act or omission on the grounds that his course of action was reasonable based on circumstances peculiar to himself. Rather, the lessee's marketing activities are compared to those that would have been carried on by a reasonably prudent operator under similar circumstances. Where it is found that the lessee failed to meet this standard of conduct he will be liable for breach of the implied marketing covenant.

Ultimately therefore, the duties to develop and market turn on what a "reasonably prudent operator" would do in the same circumstances.[17] In this case, the relevant circumstances would certainly include the fact that the reserves are

enormous, certain to exist (indeed gas is being produced daily), and the existence of a market.

Several cases address whether or not an operator was "reasonably prudent" in securing or failing to secure pipeline connections for gas. The most prominent and relevant case in this regard is *Cole Petroleum Co. v. United States Gas & Oil Co.*[18] There, a lessor alleged that the producer had not used reasonable care to market the gas. The jury found for the lessor and specifically concluded that for over two years the producer had not sold and delivered gas to an available pipeline.[19] The lease terms in *Cole* were very similar to the State leases here and the Texas Supreme Court found they supported an implied covenant to "exercise ordinary or reasonable care" in marketing.[20] The Texas Supreme Court also found that the producer's breach of the marketing covenant supported lease forfeiture where the lease provided as much upon the operator's failure "to fulfill any of the covenants of this agreement."[21] The *Cole* case remains good law and has been repeatedly cited by courts across the land. It is *the* case that is the most on-point to the circumstances presented by the ANS leases.

Other cases have, like the *Cole* case, found that a lack of diligence in securing a pipeline connection or negotiating gas contracts is a breach of the producer's duty to market which renders a producer liable.[22] Even in the cases where the courts have found the implied covenant to market was not breached, they have nevertheless emphasized the diligence that operators showed with respect to trying to secure, and in some cases actually securing, pipeline connections.[23] In each of these cases the courts recognized that the producers' attempts to and actually contracting with a pipeline were central to the issue of whether reasonable diligence in marketing had been shown.

A final factual issue that is key to how a reasonably prudent operator would interact with a pipeline (prospective or nearby) is the recognized need of such pipelines to secure long-term commitments from producers. Case law and legal commentators have repeatedly recognized this fact as an economic reality of the industry.[24]

While Alaska oil and gas law is not well developed concerning the responsibilities of a lessee to a lessor, Alaska *does* have a body of law that is consistent with and complementary to the principles embodied in the other states' oil and gas law. Alaska law recognizes that in *every* contract there is an implied covenant of good faith and fair dealing that neither party will do anything which will injure the right of the other to receive the benefits of the agreement.[25] This

general requirement finds specific application when one party's obligations are subject to a condition precedent. In this case, a condition precedent to the ANS oil companies' duty to produce and sell the ANS gas is the existence of a market for that gas.

Alaska law makes clear that *if* a party such as the ANS oil companies take steps to impede the condition from occurring, or even fails to cooperate in helping the condition to occur, then the oil companies can be liable as though the condition had occurred.[26] It is worth emphasizing that the duty imposed under this doctrine is not only to avoid "hindering" a condition, but also to "cooperate" and actually take affirmative steps to cause its occurrence.[27]

One final point should be made with respect to what is and what is *not* required from producers. There is strong authority supporting the position that a producer is not itself required to build a pipeline.[28]

***MISCONCEPTION NUMBER 3*: The oil companies can choose how much profit that they want and delay developing or marketing the ANS gas until their profit goals, through State concessions or otherwise, are met.**

> REALITY: **The terms of the leases and the common law more generally require the oil companies to develop and market the ANS gas if and when they have a "reasonable expectation of profit." That unquestionably *now* exists for ANS gas.**

An important corollary to the "reasonably prudent operator" standard is that such an operator *will* act if and when there is a "reasonable expectation of profit."[29] As the Colorado Court of Appeals in *Whitman Farms v. City of Longmont*,[30] recently explained:

> When, as here, there is a proven field of oil or gas, courts have held that a lessee is required to further develop the lease when there is a reasonable expectation that one or more new wells would generate enough revenue to cover the cost of development and return a reasonable profit. Thus, when a prudent operator would have a reasonable expectation of such economic viability and a lessee is not developing the field, it is proper to conclude that the lessee has breached the covenant of reasonable development and to grant an equitable termination to the lessor.

In light of this description of the law, it is worthwhile to examine the oil company decision-making process that may be associated with any proposed gas pipeline. This Committee last Fall heard testimony from the ANS producers as well as a former ARCO executive describing how oil companies generally approach big projects from a capital budgeting perspective.[31] One aspect of that budgeting process involved oil companies deciding whether capital projects were "discretionary" or "nondiscretionary."[32]

By way of illustration, an oil company divides the items that it considers for inclusion in its capital budget as falling into two basic categories:

| Non-Discretionary | Discretionary |
| --- | --- |
| 1. Mandatory health safety and environmental investments. | 1. Project #1. |
| | 2. Project #2. |
| 2. Projects where concessions will disappear; leases will be lost. | 3. Project #3. |
| | Etc. |

How does this discretionary/non-discretionary distinction relate to the development and marketing obligations these producers have with respect to ANS gas? We know – given that more than thirty years have passed since discovery of the ANS gas reserves *without* a pipeline – that the ANS gas pipeline has been seen as "discretionary." Whereas, for instance, Qatar, Venezuela, Nigeria, etc. have set firm deadlines making their projects "non-discretionary", the oil companies evidently perceive no such urgency in Alaska. I like the analogy I recently heard that the Alaska gas pipeline project has been viewed like a grocery product with no "expiration date" whereas other projects evidently do have expiration dates.

There is, however, good news in that circumstances now exist that should move the development of ANS gas from the discretionary category to the non-discretionary category of projects. The ANS producers now have enormous reserves, a market and therefore a more than reasonable expectation of profit. Graphically, the equation is:

| Extraordinary Reserves | + | Minimal Production Expense | + | Strong Market | = | More Than a Reasonable Expectation of Profit |
| --- | --- | --- | --- | --- | --- | --- |

These combined facts mean that it should no longer be "discretionary" for the oil companies to market the gas – instead they *must* diligently market the gas.

A second aspect of the way that oil companies decide when and where to invest is the distinction between "non-commercial," "commercial" and "competitive" projects. This categorization of projects by oil companies was likewise the subject of testimony before this committee last Fall.[33] "Non-commercial" projects are projects that are *not* calculated to return their costs,

including the costs of capital. "Commercial" projects return their costs, including capital costs plus something. "Competitive" projects, are projects with high enough returns to rank at the top of the oil companies' capital budgets.

Historically, development of the ANS gas has been perceived as either non-commercial, or commercial but *not* competitive. Obviously, the project has *never* been seen as competitive. The law, however, requires that the project be pursued *if* it is *commercial* to the extent of involving "a reasonable expectation of profit."[34] Here, after only relatively minor infrastructure adjustments, the producers would be paid a billion or more dollars a year for thirty years. That level of profit is simply extraordinary.

If the ANS oil companies themselves were being asked to shoulder the burden of building a pipeline, then the risks involved in building that pipeline might have relevance. When, however, other parties are ready, willing and able to construct a pipeline, the profit that the oil companies are looking at is simply "off the charts" and risk free.

In summary on this issue, doing nothing in the face of an available market is not an alternative that the law affords to the oil companies. Warehousing reserves, or as the courts have typically described this behavior, holding leases for "speculative" purposes, is uniformly regarded as unacceptable.[35] "Leases of this kind contemplate exploration and development, and not the bottling up of land for speculative or other purposes or the postponement of reasonable development..."[36]

*MISCONCEPTION NUMBER 4*: **The oil companies, by owning the ANS leases, have the legal right to dictate the location and ownership of the pipeline.**

> REALITY: **The oil companies have a duty to prudently develop and market the ANS gas, independent of any profit-making plans they have concerning the pipeline or *other* projects.**
>
> **Further, under the antitrust laws, the oil companies *cannot* use their monopoly over the ANS gas to monopolize the pipeline or impede competition. To do so, would mean that the oil companies were engaged in "monopoly leveraging" a practice in direct violation of the antitrust laws.**

The law does not allow the ANS oil companies to compromise their performance under the ANS leases to serve seperate corporate profit objectives. To the contrary, the oil companies must consider what a reasonably prudent operator holding *just this lease(s)* would do, not how that oil company can overall make money by using these leases to leverage their way into, for instance, the pipeline project.[37] This aspect of a producer's duty has most frequently been declared by the courts in the context of producers sacrificing one property for the benefit of another; for example, where one property was produced less so that another could produce more. Not surprisingly, this has been held to violate the reasonably prudent operator standard.[38] The same principle has also been used to declare invalid a producer's attempt to use gas to satisfy other corporate obligations.[39]

Independent of their obligations as lessees under the ANS leases, the producers are also prohibited by federal[40] and Alaska[41] antitrust laws from using any monopoly over ANS gas to establish a monopoly over the pipeline. The federal courts have recognized that the Sherman Antitrust Act § 2 (monopolization) is violated when a party possessing a monopoly, or market power, seeks to use that market power to gain a competitive advantage in another market. "Leveraging" is a monopolist's use of power in one market to gain an advantage in a related market, or power held in one time period to gain advantage in a later period. Often, the leveraging occurs in a vertical context, as when an upstream producer with monopoly power uses that power to gain advantage in a downstream market.[42]

Section 2 of the Sherman Act focuses on the wrongful wielding or maintenance of monopoly power, or attempts to monopolize. A monopoly

involves action by a single entity. A joint venture is such an entity. Alaska has a well established definition of a joint venture.[43]

Here, a combination of the producers clearly possesses monopoly power over the sale of gas from the North Slope. This group controls roughly 90% of the ANS gas, excluding the royalty. If this upstream monopoly were to be used as leverage to discourage competition for a pipeline, and to thereby extend monopoly power into the downstream market for the transportation of the gas, this would violate the anti-trust laws. Such leveraging would injure the State by preventing it from receiving royalty as well as severance taxes.

The anti-trust laws obviously exist to protect competition in the transportation of ANS gas. This is precisely the kind of relevant market that the antitrust laws were intended to protect as the court in *Woods Exploration Producing Co. v. Aluminum Co.*,[44] explained:

> When one must "look" for a monopoly, determining a relevant market in which to look and in which to evaluate competitive effects is obviously an essential first step. But when, with an illegal practice such as is present here in mind, one can look at an area and see the existence of monopoly power, not by inference from market share, but by determining actual ability to exclude competition and control prices, there appears no real need to go further.

Section 1 of the Sherman Act deals with combinations in restraint of trade, a subject that will be more fully discussed in the last section of this presentation. The point to note here is that absent a joint venture, the same acts can also be characterized as a combination in restraint of trade which is a § 1 violation.

***MISCONCEPTION NUMBER 5*: The State is in a relatively weak negotiating position with the oil companies.**

REALITY: **Precisely the opposite is true. The State is in an extraordinarily strong position to insist on diligent marketing of ANS gas for three reasons:**

1. **The State can insist on diligent marketing of the ANS gas and if the oil companies refuse the leases can be cancelled.;**

2. ***If* the oil companies insist on *not* marketing Alaska's stranded gas, the damages would be measured by the amount of royalty that *should* have been, but was not paid. This would amount to *many* billions of dollars.; and**

3. **A concerted "refusal to deal" in the sense of refusing to sell the Alaskan gas into an available market is anticompetitive and actionable under the antitrust laws. These laws provide mandatory treble damages and injunctive relief.**

Let me address each of these three points in order.

First, as noted, the State leases provide what in the oil and gas legal world is a very strong and uncommon remedy. If the oil companies breach their lease, the Commissioner of the Department of Natural Resources, can cancel them. In this regard, the Alaska standard form of lease provides:

> 20. DEFAULT AND TERMINATION; CANCELLATION. (a) The failure of the lessee to perform timely its obligations under this lease, or the failure of the lessee otherwise to abide by all express and implied provisions of this lease, is a default of the lessee's obligations under this lease. Whenever the lessee fails to comply with any of the provisions of this lease...and fails within 60 days after written notice of that default to begin and diligently prosecute operations to remedy that default, the state may terminate this lease if at the time

> of termination there is no well on the leased area capable of producing oil or gas in paying quantities. If there is a well on the leased area capable of producing oil or gas in paying quantities, this lease may be terminated by an appropriate judicial proceeding....[45]

This remedy is recognized as being available by legal scholars, including Professor W.L. Summers, who sees no doubt as to the entitlement to cancellation as a remedy for breach of the covenant to market:

> *If the lease contains an express provision for forfeiture* of the lease for breach of all covenants thereof, which, either by express terms, or by construction of the court, includes implied covenants, and has the effect of making them conditions, *there would seem to be no doubt that the lessor is entitled to declare a forfeiture for breach of the implied covenant to market* and recover in an action to quiet title or cancel the lease.[46]

It is hard to convey how extraordinary and significant this remedy is in the context of getting the Alaskan gas reserves developed. It is extraordinary in the sense that I would estimate that *far less than one percent* of all leases between private royalty owners and producers contain such a remedy. It is *significant* in the sense that *if* the ANS producers breach their duties, they can legally lose the entirety – 100% of their interests which reverts back to the State of Alaska.

A second aspect of the strength of the State's position is that the oil companies could, if they neglect to market Alaska's stranded gas, face very large damage claims. In cases where producers have breached their duties to develop or market oil or gas, producers have been held responsible by courts for all of the royalty that would have been paid *if* the producer had acted prudently.[47] Professor Kuntz summarized the damages remedy as follows:

> Damages are recoverable for breach of the implied duty to market the product. It has been held that...damages may be recovered concurrently with cancellation of the lease....The measure of damages for breach of the implied duty to market the product is the royalty which the lessor would have received if the product had been marketed.[48]

The losses that the State might seek to recover would not be fanciful. The fact is that *every day* that is lost in the development of this gas means that 3-4 billion cubic feet or so of gas effectively goes to the end of a 20-30 year line, perhaps worse. What do I mean by "going to the end of the line?" The gas, of course does not go away. But if the pipeline is delayed a year then that means that Alaska instead of receiving royalty and taxes in year one, only replaces *that* royalty and taxes, *if ever*, when the pipeline delivers its last gas. To make matters worse, if there is even a small percentage of the reserves projected as probable to be found in Northern Alaska, it is likely that the first year, or however long, effectively never gets made up.

Thirdly, the State's negotiating position is strong because the antitrust laws are very powerful means to preserve competition. As noted earlier, if the producers combine to refuse to sell ANS gas, then they may be liable under § 1 of the Sherman Antitrust Act.

Generally speaking, every company has the right to choose to do business with someone else or not. That is a basic tenet of our civil liberty. But when two or more persons agree not to do business with another, the potential for a combination in restraint of trade violating § 1 of the Sherman Act arises. An early example of this concerned a group of retail lumber dealers who agreed to boycott the business of a lumber wholesaler who also sold direct to consumers.[49] In another case, the Supreme Court found a § 1 violation when the NYSE and its member traders agreed to remove private phone lines to non-member traders, effectively denying them access to the market.[50]

Normally, concerted refusals to deal, or boycotts, are reviewed by the courts using a *per se* analysis. The per se rule means that any concerted refusal to deal is presumed to have anticompetitive effects warranting § 1 liability. In 1985, the Supreme Court modified this analysis slightly in the context of a business cooperative that excluded one of its members, which thereby deprived the excluded member of a pricing advantage. In that context, the Supreme Court held that the per se analysis is not correctly applied unless there is a showing that the business cooperative has "market power or unique access to a business element necessary for effective competition."[51] To the extent, if any, that this modification to a *per se* analysis applies to the present circumstances, which is doubtful, it is nevertheless clear that the requisite market power exists here and, could be exercised to control the ANS gas, which is essential to effective competition.

A "concerted refusal to deal" can also involve anticompetitive conduct by a monopolist creating a § 2 violation. An example is *Consolidated Gas Co. of Florida, Inc. v. City Gas Co. of Florida, Inc.*,[52] which has some similarities to the present circumstances. Consolidated was a small retail distributor of propane. City Gas held a monopoly on retail gas distribution over a large area of Florida, fully enveloping Consolidated's customers. The price differentials between propane and natural gas made it essential that Consolidated convert to natural gas, but it could only economically do so by purchasing the gas from City Gas. City Gas refused to sell gas at a reasonable price, offered to buy-out Consolidated at a low price, and simultaneously embarked on a marketing campaign to take away Consolidated's customers. The court held that the refusal to sell was an anticompetitive attempt to maintain a monopoly in violation of § 2 of the Sherman Act. Among other things, the court enjoined City Gas to sell Consolidated gas at reasonable prices (which at that time and place was regulated by a state agency).

Similarly a monopolist unlawfully maintains its monopoly in violation of § 2 of the Sherman Act when the monopolist controls a scarce facility, to which it refuses its competitors reasonable access. This is sometimes referred to as the "essential facilities" doctrine. In the seminal case of *Otter Tail Power Co. v. United States*,[53] Otter Tail controlled an electric power distribution system, access to which it denied to new municipal systems. The distribution system was an essential facility to any "would be" competitor. The Supreme Court affirmed the finding of a § 2 violation and the district court's injunction that Otter Tail sell wholesale electricity to the municipal systems. As for the present circumstances, the North Slope production facility is quite arguably an essential facility to any gas marketer or transporter. Depending on the characterization of the producers' combination as either a joint venture or an agreement, the producers' refusal to sell the ANS gas, or to allow access to the gas, could be either a § 1 or a § 2 violation.

The damages awardable under the antitrust laws are automatically trebled.[54] In addition, 15 U.S.C. § 26 provides that any person may obtain injunctive relief "against threatened loss or damage by a violation of the antitrust laws." In a request for injunctive relief there is no necessity to prove actual damages, but only a threatened loss or damage.

# CONCLUSION

It is a *misconception* that the State of Alaska cannot insist on the oil companies complying with their established duties to develop and market the ANS gas. The same oil and gas leases under which the ANS producers have benefited from the production of over 14 billion barrels of oil, also have burdens.

I think it is hard to overstate the importance of the Port Authority's being ready, willing and able to build a pipeline and buy ANS gas to the subject under discussion. In light of this market, the development of ANS gas can absolutely no longer be characterized as "discretionary." In fact, as of the Port Authority's offer, it can fairly be said the ANS gas is no longer stranded.

Unquestionably, Alaska has the power to compel the development and marketing of ANS gas reserves. If, how and when it exercises that power is up to Alaska's stewards, including this body as well as the Executive branch.

**Endnotes**

[1] Legislature Budget and Audit Committee, Stranded Gas Hearings, [Port Authority Testimony] June 16, 2004, p. 3.

[2] *Joseph M. Jackovich Revocable Trust v. State of Alaska,* 54 P.3d 294, 299 (Alaska 2002), *quoting, Lange v. State,* 86 Wash.2d 585, 547 P.2d 282, 288 (Wash. 1976)("Thus appellants were deprived of the most important incidents of ownership, the rights to use an alienate property.")

[3] *Id.*

[4] See notes 9-11 and accompanying text, *supra.*

[5] See notes 12-16 and accompanying text, *supra.*

[6] See notes 48-49 and accompanying text, *supra.*

[7] *Jupiter Oil Co. v. Gene M. Snow,* 819 S.W.2d 466, 468 (Tex. 1991)("The common oil and gas lease is a fee simple determinable estate in the realty.... A possibility of reverter is the interest left in a grantor after the grant of a fee simple determinable. ...The grantor's possibility of reverter in the mineral interest only upon the termination of the lease. ...Thus, upon the termination of the lease, the mineral estate ordinarily reverts to the grantors of the lease, their heirs or assigns."). There is a distinction that I want to draw from a very strict legal standpoint, lest there be later confusion about my point. There is a raging academic (in both senses of the word) debate in oil and gas law about the fundamental nature of oil and gas rights. Bennett, Jared C., *Ownership of Transmigratory Minerals , Utah and Zebras. Proof that Oil and Gas Ownership Law Needs Reform,* 21 J. Land Resources & Environmental L. 349, 349 (2001)("some scholars contend that the debate over theories of ownership are about as useful as arguing over whether a zebra is a black horse with white stripes or a white horse with black stripes.") Some states, such as Texas, consider a mineral owner as owning the minerals in the ground and are referred to as "ownership-in-place" jurisdictions. *Id.* at 351-2. Other jurisdictions, including the United States Supreme Court, have rejected that ownership characterization and are referred to as "non-ownership in place" jurisdictions, or in some cases "qualified ownership in place" jurisdictions. *Id.* pp. 359-60. Because all states recognize that until produced an owner is subject to the "rule of capture," there is for the most part no practical difference in the two theories. Wherever Alaska might fall in this debate, and its courts have not yet weighed in, the fundamental restrictions on the producers' ownership interests discussed herein remain.

[8] In circumstances where Alaska has yet to decide an issue of law, it looks to the common law as established by other states. See ALASKA STAT. § 0.10.010 (2004)("So much of the common law not inconsistent with the Constitution of the State of Alaska or the Constitution of the United States or with any law passed by the legislature of the State of Alaska is the rule of decision in this state"). This approach has been specifically endorsed by Alaska's Supreme Court in the

absence of prior Alaskan case law. *Guin v. Young*, 591 P.2d 1281, 1284 n. 6 (Alaska 1979)("Our duty is to adopt the rule of law that is most persuasive in light of precedent, reason and policy.").

[9] State of Alaska, Department of Natural Resources, Competitive Oil and Gas Lease Form #DOG200204 (re. 10/2003), p. 6.

[10] *See e.g.*, State of Alaska, Department of Natural Resources, Competitive Oil and Gas Lease Form #DOG 9609 (Revised 6/97) § 13, p. 5; State of Alaska, Department of Natural Resources, Competitive Oil and Gas Lease Form #DO&G-24-84 (Royalty)(Revised 8/84) DNR 10-1185 § 13, p. 4; State of Alaska, Department of Natural Resources, Division of Minerals and Energy Management, Competitive Oil and Gas Lease Form No. DMEM-1-79A (Net Profit Share) (Revised November 5, 1979) § 21, p. 4; State of Alaska, Department of Natural Resources, Division of Lands, Competitive Oil and Gas Lease Form No. DL-1 (Revised Oct. 1963) § 20, p. 2.

[11] The status of the common law concerning the implied duty to develop was summarized by Professor Richard W. Hemingway in THE LAW OF OIL AND GAS § 8.3, p. 544 (3d Ed. 1991) as follows:

> All jurisdictions impose a prudent operator rule to determine whether lease development satisfies the implied covenant of further development. This rule requires that operations be mutually profitable to both lessor and lessee and be diligently prosecuted in relation to the circumstances in each case. Within such relationship the lessee has an implied duty, after production is acquired, to develop the lease to its fullest extent.

*See also, Sauder v. Mid-Continent Petroleum Corp.*, 292 U.S. 272, 280 (1934)("Whatever, in the circumstances, would be reasonably expected of operators of ordinary prudence, having regard to the interests of both lessor and lessee, is what is required."); *Mize v. Exxon Corp.*, 640 F.2d 637, 641 (5th Cir. 1981)(collecting cases)("The rule imposing a duty of reasonable development is widely recognized."); *Chenoweth v. Pan American Petroleum Corp.*, 314 F.2d 63, 65-6 (10th Cir. 1963)("In cases questioning the development done by an operator under the prudent operator rule, the actions of the operator are examined item by item. This is essentially a comparison of his acts with standards or practices then prevailing in the area all in the context of economics."); *Meaher v. Getty Oil Co.*, 450 So.2d 443, 446 (Ala. 1984)("implied covenants to reasonably develop the leased lands, recognized to exist in every oil and gas lease, continue to obligate the lessee to develop all the leased lands, both within and without the producing unit."); *Byrd v. Bradham*, 280 Ark. 11, 14, 655 S.W. 2d 366, 367 (1983)("In oil and gas leases where royalties constitute the chief consideration, an implied covenant exists that the lessee will explore and develop the property with reasonable diligence."); *Olson v. Schwartz*, 345 N.W.2d 33, 38 (N.Dak. 1984)("It is well settled that the lessee of an oil and gas lease has an implied obligation to the lessor to do everything that a reasonably prudent operator would do in operating, developing, and protecting the property, with due consideration being given to the interests of

both the lessor and the lessee, if there is no express clause in the lease relieving the lessee of this implied duty."); *Lenape Resources Corp. v. Tennessee Gas Pipeline Co.*, 925 S.W.2d 565, 572 (Tex. 1996) ("to fulfill its obligations to lessors [under the 'implied covenant to reasonably develop'] a gas producer must drill additional wells as would a reasonably prudent operator"); *Sonat Exploration Co. v. Superior Oil Co.*, 710 P.2d 221, 224 (Wyo. 1985)("It is well established that oil and gas leases such as that with which we are concerned contain an implied covenant of development."). The Alaska Supreme Court, in passing on other issues, noted the existence of an implied covenant to develop in *Baxley v. State of Alaska*, 958 P.2d 422, 427 (1998)(All of the State's oil and gas leases contain an implied covenant for lessees to "diligently explore and develop their leases.")

It is worth noting that cases addressing the implied covenant to develop are often referred to in analyzing express provisions requiring "reasonable developments." *See e.g., Atlantic Richfield Co. v. Gruy*, 720 S.W.2d 121 (Tex. App. – San Antonio 1986, writ ref'd n.r.e.)(a lessor who asserted a breach of an express covenant to develop where lease required development with "due diligence" must show a reasonable probability of profit from the additional drilling).

[12] An established statement of the implied covenant to market is found in W.L. SUMMERS, 2 THE LAW OF OIL AND GAS § 400, pp. 582-3 (1959 and 2004 Supp.)(collecting cases):

> In the absence of such a duty [to market expressed in a lease], the courts, on the same theory that they imply covenants to test and develop, imply a covenant on part of the lessee to market the oil and gas produced. It would be of little benefit to the lessor to have express or implied covenants on part of the lessee to test, develop, and protect the land by drilling wells, if the lessee might cap them and refuse to market the product.

See also, RICHARD W. HEMINGWAY, THE LAW OF OIL AND GAS, § 8.9(c), p. 577 (3d Ed. 1991) ("As in the case of the covenant to produce, the lessee is also under an implied obligation to market with due diligence the products produced. Obviously, without marketing the lessor will not realize any benefit from the lease.").

The case law supporting the implied duty to market is legion. *See e.g., Wolfe v. Texas Co.*, 83 F.2d 425, 432 (10th Cir.), *cert. denied*, 299 U.S. 553 (1936)("In the absence of an express provision in an oil and gas lease with respect to marketing the production there is an implied duty on the part of the lessee to make diligent efforts to market the production in order that the lessor may realize on his royalty interest."); *Craig v. Champlin Petroleum Co.*, 300 F.Supp. 119, 125 (W.D. Okla. 1969), *aff'd*, 421 F.2d 236 (10th Cir. 1970)(a "lessee under oil and gas leases involved in this case has implied duty and obligation in the exercise of reasonable diligence, as a prudent operator…to obtain a market for gas…at the prevailing market price therefore. [citations omitted] A failure to comply with such duty…renders the defendants liable to the plaintiffs for any resulting loss."); *Davis v. Cramer*, 808 P.2d 358, 361 (Col. 1991)(*en banc*)("Embodied in the covenant to operate diligently and prudently is the implied covenant to market."); *Daughetee v. Ohio Oil Co.*, 263 Ill. 518, 523, 105 N.E. 308 (1914)(there is an implied obligation upon the

lessee "to fully develop the premises and market the oil or gas found."); *Gilmore v. Superior Oil Co.*, 192 Kan. 388, 392, 388 P.2d 602, 606 (Kansas 1964) ("Kansas has always recognized the duty of the lessee under an oil and gas lease not only to find if there is oil and gas, but to use reasonable diligence in finding a market for the product, or run the risk of causing the lease to lapse…in the absence of an express provision of the lease creating such duty, the lessee is under an implied obligation to exercise reasonable diligence in marketing the gas produced."); *Caskey v. Kelly Oil Co.*, 737 So.2d 1257, 1261 (La. 1999)(Louisiana recognizes "the obligation to diligently market the minerals discovered and capable of production in paying quantities."); *Severson v. Barstow*, 103 Mont. 526, 63 P.2d 1022, 1024 (Mont. 1936)("Where, as here, the principal consideration for a lease is the payment of royalty, the lease carries an implied covenant to use reasonable diligence to market the product when produced, although the lease is silent on the subject, and whatever is implied in a contract is as effectual as what is expressed…"); *Townsend v. Creekmore-Rooney Co.*, 358 P.2d 1103, 1104 (Okla. 1960)("Where the oil and gas lease does not, in express terms, provide for the marketing of production discovered under the lease, the lessee is under an implied covenant only to market production within a reasonable time. In complying with said covenant the lessee must exercise due diligence in securing a market or a new market, if the one secured proves unsatisfactory. The matter of whether the lessee exercised due diligence in obtaining a satisfactory market within a reasonable time depends upon the facts of each case."); *Berry Energy Consultants v. Bennett*, 175 W.Va. 92, 97 33 S.E.2d 823, 828 (W. Va. 1985)("the lessees in this action had an obligation to be reasonably diligent in marketing the gas. As indicated above, the parties entered into the lease for the purpose of 'exploring and operating for' and 'producing and marketing' oil and gas"); *Tana Oil & Gas Corp. v. Bates*, 978 S.W.2d 735, 739 (Tex. App. 1998)("Oil and gas law in Texas recognizes an implied covenant in gas leases such that a lessee must use due diligence to market the oil or gas produced within a reasonable time and at a reasonable price…[t]he behavior of a lessee in this regard must conform to the standard of a reasonably prudent operator.").

[13] 66 N.M. 260, 263, 346 P.2d 1041 (N.Mex. 1959).

[14] 41 S.W.2d 414, 121 Tex. 59 (1931).

[15] *See also, Eggleson v. McCasland*, 98 F.Supp. 693, 695 (Okl. 1951)("Generally, even in the absence of an express covenant to produce and market, there is an implied covenant that the lessee will do so. * * * In this lease, there is an express covenant to produce, and the covenant to market will be implied."); *Carroll Gas & Oil Co. v. Skaggs*, 231 Ky. 284, 21 S.W.2d 445, 447 (Ky. Ct. App. 1929)(a "lessee is under a duty to market the oil or gas found in the land," and there is a "necessary inference" from the lease clause providing for payment of royalty "that the gas was to be marketed within a reasonable time."); *Molter v. Lewis*, 156 Kan. 544, 549, 134 P.2d 404 (Kan. 1943)("It would be of little benefit to the lessor to have express or implied covenants on the part of the lessee to test, develop, and protect the land by drilling wells, if the lessee might cap them and refuse to market the product.").

[16] Bruce M. Kramer and Chris Pearson, *The Implied Marketing Covenant in Oil and Gas Leases: Some Needed Changes for the 80's*, 46 LA. L.REV. 787, 810-11 (1986)(notes omitted).

[17] As in a typical tort situation, the "reasonable prudence" of an operator is determined in light of all of the pertinent circumstances. The Colorado Supreme Court explained this in *Davis v. Cramer*, 808 P.2d 358, 363 (Colo. 1991):

> The covenant to market requires that the lessees exercise reasonable diligence to market the products. Reasonable diligence is whatever, in the circumstances, would be reasonably expected of all operators of ordinary prudence, having regard to the interests of both lessor and lessee. . . .The existence of reasonable diligence is primarily a question of fact.

[18] 121 Tex. 59, 41 S.W.2d 414 (Tex. 1931).

[19] 41 S.W.2d at 415-6.

[20] 41 S.W.2d at 416.

[21] 41 S.W.2d at 417.

[22] One case applying the implied covenant to market in a failure to secure pipeline connection situation is *Crain v. Hill Resources, Inc.*, 972 P.2d 1179, 1181 (Okla. Ct. App. 1998). In *Crain*, the "wells were never hooked up to a pipeline," and the court found that therefore the "lessees failed to comply with the implied covenant to market the gas and cancelled the lease." Another case presents an analogous circumstance concerning a producer's failure to prudently market gas. The Colorado Court of Appeals in *Davis v. Cramer*, 837 P.2d 218, (Colo. Ct. App. – 1992) upheld the trial court's determination that the implied covenant to market had been breached during the primary term of the oil and gas lease; the well was completed in 1972 and the pipeline was completed near the well in 1975, but product was not marketed until 1978. The court found lease cancellation to be an appropriate remedy. In *Barby v. Cabot Corp.*, 550 F.Supp. 188, 190 (W.D. Okla. 1981) the court found "[d]efendant was dilatory in renegotiating" expired gas contracts. Given this conclusion, the court found that damages were appropriate for "Defendant's breach of its duty to diligently market the gas produced."

[23] *See e.g., Christianson v. Champlin Refining Co.*, 169 F.2d 207, 210 (10th Cir. 1948)(In determining whether an operator had "exercise[d] due diligence" the court emphasized the defendants "secure[d] within a year the construction of an expensive pipe line and made it possible to market the gas which was an inferior quality, which in itself, entailed additional difficulty, and were actually marketing the gas from the well within fifteen months from the date of completion."); *Tate v. Stanolind Oil Co.*, 172 Kan. 351, 358 240 P.2d 465, 470-71 (Kan. 1952)(In deciding whether marketing had occurred "within a reasonable time," the court considered that the pipeline "refused to take the gas," and the producer "proceeded before the commission to compel" the pipeline to take it and the pipeline "then agreed to do so."); *Fey v.*

*A.A. Oil Corp.*, 129 Mont. 300, 320 285 P.2d 578, 588 (Mon. 1955) (In determining "[w]hether due diligence [in marketing] has been exercised," the court emphasized that "[t]he record is replete with the efforts of defendants to procure a pipe line company that would take the gas at the profit to lessors and lessees."); *Commissioners of the Land Office v. Carter Oil Co. of W. Va.*, 336 P.2d 1086, 1096 (Okla. 1958) ( In determining whether "due diligence was exercised in the seeking and obtaining of a market" the court considered the fact that "[c]ontinued negotiations were carried on with other [potential buyers] and the operator found a buyer "taking the gas from the well head.").

[24] Holliman, *Exxon Corp. v. Middleton: Some Answers but Additional Confusion in the Volatile Area of Market Value Gas Royalty Litigation*, 13 St. Mary's L.J. 1, 6 (1981).

> Unlike liquid hydrocarbons, gas cannot be stored in surface containers, nor can it be transported by truck. Rather, gas normally is marketable only when the reserves in the field where the lease is situated justify the sizeable capital expenditure necessary to construct and lay a pipeline capable of transporting the gas to its market destination. Pipeline systems, of course, are complex creatures and are quite expensive to construct. Investors traditionally have not been willing to build pipelines unless gas is available in a sufficient quantity and has been committed to the pipeline for an adequately long period, thereby providing the investors with reasonable assurance that they will make a profit on their investment. Thus, the justification for the capital expenditure necessary to construct the pipeline usually comes in the form of long-term gas sale contracts which effectively commit the volume of gas to be sold to the purchaser who will transport the gas through its pipeline to the point of consumption.

*See also. Panhandle Eastern Pipe Line Co. v. The United States*, 187 Ct. Cl. 129, 170 408 F.2d 690 (Ct. Cl. 1969)("Since pipelines are expensive to construct, pipeline companies have been required to insure for themselves long-term supplies of natural gas in order to amortize their investments..."); *The Superior Oil Co. v. Western Slope Gas Co.*, 549 F.Supp. 463, 469 (D. Colo. 1982)("Because gas purchasers must make substantial capital outlays in order to move the gas product to the retail consumer, they require same assurance that sufficient long-term supplies of gas will be available to them.").

The Oklahoma Supreme Court recognized the connection between the duty to market and such long-term commitments in *Tara Petroleum Corp. v. Hughey*, 630 P.2d 1269, 1273 (Okla. 1981), (footnotes omitted) when it stated:

> Once a producing well is drilled, a producer has a duty to market the gas. In order to market gas it is usually necessary to enter into a gas purchase contract – frequently a long term one...We have

recognized this necessity of the market, and we believe that lessors and lessees know and consider it when they negotiate oil and gas leases.

*See also, Hillard v. Stephens*, 276 Ark. 545, 550, 637 S.W.2d 581, 583-4 (Ark. 1982)("Once the lessee-producer drills a well resulting in the commercial production of natural gas on the leased premises, the lessee-producer has the immediate duty to market the gas. In order to market such gas effectively, it is the custom in the industry and is usually necessary for the lessee-producer to sell the gas under a long-term gas purchase contract.").

[25] Alaskan law concerning the duty of good faith and fair dealing in contracts was summarized by the court in *Guin v. Ha*, 591 P.2d 1281, 1291 (Alaska 1979):

> In every contract, including policies of insurance, there is an implied covenant of good faith and fair dealing that neither party will do anything which will injure the right of the other to receive the benefits of the agreement.

[26] The Alaska Supreme Court explained in *Mitford v. de Lasala*, 666 P.2d 1000, 1006 (1983):

> Restatement (Second) of Contracts § 205 (1981) provides:
>
> Every contract imposes upon each party a duty of good faith and fair dealing in its performance or its enforcement.
>
> The prevention doctrine is subsumed in this duty under the view of the new Restatement. *Id.* comment d (among judicially recognized types of bad faith is "interference with or failure to cooperate in the other party's performance.").

[27] As the court in *Casey v. Semco Energy, Inc.*, 92 P.3d 379, 384-5 (Alaska 2004) (internal quotes omitted) explained:

> The covenant of good faith and fair dealing is implied in all contracts in Alaska. Where a party has promised to attempt to satisfy a condition, the attempt must be made in good faith. A party must act in subjective good faith, meaning that it cannot act to deprive the other party of the explicit benefits of the contract, and in objective good faith, which consists of acting in a manner that a reasonable person would regard as fair. Where a duty of one party is subject to the occurrence of a condition, the additional duty of good faith and fair dealing. . .may require. . . refraining from conduct that will prevent or hinder the occurrence of that condition or. . .taking affirmative steps to cause its occurrence.

*See also, Aronoff v. The Linkin Co.*, 618 A.2d 669, 682 (D.C. Cir. 1992)("There is an implied covenant in each contract that the parties will 'extend reasonable cooperation' in clearing the way for performance.").

[28] Notwithstanding the general implied duty to market, substantial authority can be mustered for the proposition that lessees, in discharging this duty, are not required to undertake expensive projects and risks in constructing a pipeline to take oil or gas to market. *Kretni Development Co. v. Consolidated Oil Corp.*, 74 F.2d 497, 500 (10th Cir. 1934)("It may be conceded for the purpose of this case that a lessee is obligated to put forward a reasonable effort to market gas produced on the leased premises, but certainly that duty does not extend to the point of providing pipe line facilities ninety miles in length at a large outlay of money with an attending financial hazard due to possible exhaustion of the supply and other frequently encountered factors, in order to reach a market at which the product may be sold."); *Matzen v. Hugoton Production Co.*, 321 P.2d 576, 581, 182 Kan. 456 (1958)(a lessee's duty to market gas "did not extend to providing a gathering system to transport and process the gas off the leases at a large capital outlay with attending financial hazards in order to obtain a market at which the gas might be sold."); Richard W. Hemingway, THE LAW OF OIL AND GAS, (3d Ed. 1991)("Although the lessee has an obligation to market the products from the wells, it has been repeatedly held that he does not have to stand the expense of a long and costly gathering system to transport the products to the nearest market.").

[29] *Texas Pacific Coal and Oil Co. v. Barker*, 117 Tex. 418, 6 S.W.2d 1031, 1036 (1928)("The court's charge should make plain that it was the duty of the lessee to drill an offset or additional well, if, considering the cost of the same and the probable profit thereform, he would have been doing what an ordinarily prudent person would have done under the circumstances."); *Temple v. Continental Oil Co.*, 182 Kan. 213, 320 P.2d 1039, 1056 (Kan. 1958)("A lessor is entitled to the benefit of oil produced from the lease at the time it should be produced and not some remote period of time in the future. The lessee is not the sole judge of what constitutes prudent development of the tract. The test is what would be expected of an operator of reasonable prudence, in the furtherance of the interests of both the *lessor* and the lessee."); Eugene Kuntz, 5 A Treatise on the Law of Oil and Gas, § 58.3, p. 79 (1991 and 2004 Supp.)("The factor most frequently considered is the factor of profitability of drilling. This is on the assumption that a prudent operator will drill on additional development well if it would be profitable to do so and will not drill if the proposed well would be unprofitable. Thus, profitability is a common measure of prudence in drilling.").

It is important to note that there is a distinction between "reasonable expectation" and probability of profit. This distinction was explained in Vander Ploeg, Claude L., *The Implied Covenant of Reasonable Development – A Delicate Balance*, 3 EASTERN MIN. L. INST. 181-3 (1982):

> Actually, very few cases require the lessor to prove that the proposed well will be profitable. Instead the courts speak in terms of "reasonable expectation" of profit or "reasonable probability"

of profit.

> There is a difference between proving a reasonable expectation of profit and proving by a preponderance of the evidence that the proposed well will be profitable.
>
> The object of the court's inquiry in these cases is to determine whether the proposed well would be drilled by a prudent operator. The modern operator is a risk taker. Both exploration and development wells are proposed and drilled on the basis of risk analysis. The risk of a dry hole is balanced against the potential reward of a producer. Even development wells are drilled by extremely prudent operators when a dry hole is more probable than a producer. A successful well may pay out in a short period of time. A two-to-one risk of a dry hole is more than balanced by a ten-to-one recovery of capital ratio. It could be argued that an operator should be required to drill a development well in that situation.

[30] 97 P.3d 135, 137-8 (Colo. Ct. App. 2003)

[31] Legislative Budget and Audit Committee, Stranded Gas Hearings, October 14, 2004. *See e.g.*, testimony of Ken Thompson, Past Executive Vice-President of ARCO and Joe Marushark, Vice-President of Alaska Gas Development, ConocoPhillips Alaska.

[32] Thompson, Ken, *Making Oil and Gas Upstream/Midstream Investment Decisions*, Presentation to the Senate Resources Committee, Legislative Budget and Audit Committee Hearings: Alaska Natural Gas Pipeline Issues, October 14, 2004, pp. 7-8, 12.

[33] *Id.* at p. 18.

[34] See note 30 and accompanying text, *supra*.

[35] 5 H. Williams & C. Myers, OIL AND GAS LAW, § 842.1, at 266.10 (1986); *Carter v. United States Smelting, Refining and Mining Co.*, 485 P.2d 748, 752 (Okla. 1971)(condemning holding a lease for "sheer speculation and without any purpose for further development."); *Garcia v. King*, 139 Tex. 578, 164 S.W.2d 509 (1942)("The lessors should not be required to suffer a continuation of the lease after the expiration of the primary period merely for speculation purposes on the part of the lessess.").

[36] *Amoco Production Co. v. Douglas Energy Co.*, 613 F.Supp. 730, 733 (D.Kan. 1985).

[37] WILLIAMS & MEYERS, 8 OIL AND GAS LAW, § 806.3 (2003), *citing Shelton v. Exxon Corp.*, 719 F. Supp at 549 (S.D. Tex. 1989), aff'd in part, and rev'd in part, on other grounds, 921 F.2d 595 (5th Cir. 1991), explains in this regard:

> This analogy to the reasonable man of tort law also helps to explain the meaning of the prudent-operator standard. The prudent operator is a reasonable man engaged in oil and gas operations. He is a hypothetical operator who does what he ought to do not what he ought to do with respect to operations on his leasehold. Since the standard of conduct is objective, a defendant cannot justify his act or omission on personal grounds or by reference to his particular circumstances. *It is no excuse that defendant failed to drill the offset well a prudent operator would have drilled because defendant* is short of cash, over-committed on drilling programs, has no need for more production or *prefers to spend his money on other things.* In short, the question is not what was meet and proper for this defendant to do, given his particular circumstances, but what a hypothetical operator acting reasonably would have done, given circumstances generally obtained in the locality.

(Emphasis supplied.)

[38] *Newell v. Phillips Petroleum Co.*, 144 F.2d 338, 339 (10th Cir. 1944)("It was the duty of Phillips to operate this well prudently and with reasonable diligence... It's duty in that respect was not affected in any manner by its ownership of other wells in the vicinity. And its failure to discharge that duty, whether motivated by its interest in wells located lower on the structure, or otherwise, would render it liable in damages for any injury suffered by the owner of the royalty interest."); *Smith v. Amoco Production Co.*, 272 Kan. 58, 31 P.3d 255, 272 (Kan. 2001)("Amoco admits that its obligations as lessee apply independently to each lease. The independent duty principle is applied to prevent Amoco from making the management of a given lease dependent upon the management of another lease."); *Amoco Production Co. v. Alexander*, 622 S.W.2d 563, 569 (Tex. 1981)("The reasonably prudent operator standard is not to be reduced to the Alexanders because Amoco has other lessors in the same field. Amoco's status as a common lessee does not affect its liability to the Alexanders."); Pearson and Dancy, "Negotiating and Renegotiating the Gas Contract: Producer Duties to Third Parties," 56 Okla. B.J. 2181 at 2182 (1985)("lessee cannot justify his actions merely on the grounds that his course of action was reasonably based on circumstances peculiar to himself.").

[39] *Shelton v. Exxon Corporation*, 719 F.Supp. 537, 549 (S.D.Tex. 1989)("In its simplest form the holding of *Alexander* was that the lessee's duty was to do that which would be done by a reasonably prudent operator holding only the lease in question."), *aff'd, in part, and rev'd, in part, on other grounds*, 921 F.2d 595 (5th Cir. 1991).

[40] 15 U.S.C. § 1 *et. seq.*

[41] ALASKA STAT. § 45.50.562 *et. seq.*

[42] L. SULLIVAN & W. GRIMES, THE LAW OF ANTITRUST: AN INTEGRATED HANDBOOK at 106 (West 2000).

[43]

> Alaska has approved Professor Williston's formulation of the requirements of a joint venture. According to Williston the requirements are: (a) A contribution by the parties of money, property, effort, knowledge, skill, or other asset to a common undertaking; (b) A joint property interest in the subject matter of the venture; (c) A right of mutual control or management of the enterprise; (d) Expectation of profit, or the presence of "adventure," as it is sometimes called; (e) A right to participate in the profits; (f) Most usually, limitation of the objective to a single undertaking or ad hoc enterprise.

*Basel v. Westward Trawlers*, 869 P.2d 1185, 1190-1191 (Alaska 1994)

[44] 438 F.2d 1286, 1306 ($5^{th}$ Cir. 1971). Among the relevant factors often employed to define market power are: (1) defining the product; (2) defining the geographic market; (3) considering the barriers to entry into the market; and (4) measuring industry concentration. *See e.g.*, SULLIVAN & GRIMES at 60-68. Here the product is natural gas, for which there is no viable substitute. The geographic location is the ANS. The barriers to producing the product and entering the market are enormous. Finally, the producers have an oligopoly. The interdependence of oligopolies is a well-documented economic reality.

[45] State of Alaska, Department of Natural Resources, Competitive Oil and Gas Lease Form No. DOG 200204 (Revised 10/2003).

[46] THE LAW OF OIL AND GAS, § 400 at p. 594 (1959 and 2004 Supp.)(Emphasis supplied). See also, *Cole Petroleum Co. v. United States Gas & Oil Company*, 121 Tex. 59, 41 S.W.2d 414, 416 (Tex. 1931); *Deadwood-Osage Co. v. Walker*, 28 P.2d 428, 443, 46 Wyo. 482 (Wyo. 1934).

[47] The common law has established that the damages for a producer's failure to perform an express or implied covenant to develop or market are measured by the royalties that would have resulted if the producer had reasonably developed the lease or unit. RICHARD H. HEMINGWAY, THE LAW OF OIL AND GAS (3d Ed. 1991)("Breach of implied covenants that result in undue loss of production may be compensated by the royalty that the lessor would have received had the wells been properly operated or drilled."); *ANR Western Coal Development Co. v. Basin Electric Power Cooperative*, 276 F.3d 957, 969-970 ($8^{th}$ Cir. 2002)(adopting the "royalty rule" and rejecting argument that "plaintiff still has the mining property" as the basis for a deduction from royalty due); *Gold Min. & Water Co. v. Swinerton*, 23 Cal.2d 19, 29 142 P.2d 22 (1943)("The majority rule relating to oil and gas leases appears to be that where a lessee fails to perform…the lessor may recover the full amount of the royalty to which he would have been entitled had the lessee fully performed."); *Fisher v. Hampton*, 44 Cal. App. 3d 471, 118 Cal. Rptr. 811, 814 (1975) (reaffirming California's adherence to the royalty rule); *Cawood v. Hall*

*Land & Mining Co.*, 293 Ky. 23, 168 S.W.2d 366, 369-70 (1943)("To sustain this contention ["since the coal is still there…the only loss…is the use of money"] might result in the indefinite postponement of the payment of royalties…The lessor did not contract for indefinite investment of his royalties at interest but for the royalties themselves."); *Carroll Gas & Oil Co.*, 21 S.W.2d at 291 ("If it can be shown with reasonable certainty that the land covered by the lease would have produced a certain quantity of gas, and that the lessor was entitled to a certain portion of the proceeds, the proper measure of damages is the value of the royalty of the lessor which he did not receive and which he would have received if the production had been marketed."); *Macon v. Trowbridge*, 38 Colo. 330, 87 P. 1147 (1906)("The amount of such recovery, if any, [for lessee's failure to "work and develop the property"] would depend upon the amount of ore that could have been mined, if reasonable diligence had been exercised."); *Gilmore v. Ontario Iron Co.*, 86 N.Y. 455, 459-60 (Ct. App. 1881)(rejecting argument "the ore may remain and not be lost" as justifying deduction from royalty due); *Daughetee*, 263 Ill. 518 at 527 ("It is no answer to a suit of this character to say that the oil or gas is still on the premises and may be extracted at some point in the future. The point is [the lessee]…agreed to do this in order that the lessor could realize upon the value of these products."). *See also*. Maxwell, Richard C., *Appropriate Damages for Breach of Implied Covenants in Oil and Gas Leases*, 42 SW Legal Fdn. Oil & Gas Inst. 7-20 – 7-24 (1991)("So many uncertainties exist as to what the future development of a tract subject to litigation may be that the solution of placing a sum in the hands of the lessor equaling, so far as the limits of proof will allow, the royalties that would have been paid if development had been prudent seems appropriate. This approach puts the risk of future development on the defaulting lessee."); *Texas Pacific Coal & Oil Co.*, 6 S.W.2d at 1031("Under sound fundamental principals, no deduction should be made from the value of the lessor's ryalty on account of the value of unmined minerals which the lessee was entitled to remove from the leased premises."); *Freeport Sulphur Co. v. American Sulphur Royalty Co.*, 117 Tex. 439, 6 S.W.2d 1039, 1045 ("the royalty company should be allowed to recover as the damage suffered by it the amount which the jury finds the appellant (the royalty company) would have received in royalties if the mines had been operated during the time they found operation was unreasonably suspended, with interest at 6 per cent from the date such royalty would have accrued.")

[48] 5 EUGENE A. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS, § 60.5(d), p. 143 (1991 and 2004 Supp.).

[49] *Eastern States Retail Lumber Dealers Ass'n. v. United States*, 234 U.S. 600 (1914).

[50] *Silver v. NYSE*, 373 U.S. 341 (1963).

[51] *Northwest Wholesale Stationers, Inc. v. Pacific Stationers & Printing Co.*, 472 U.S. 284, 298 (1985).

[52] 665 F. Supp. 1493 (S.D. Fla. 1987) *aff'd*, 880 F.2d 297 (11th Cir.), vacated, 889 F.2d 264 (11th Cir. 1989), *reh'g granted*, 912 F.2d 1262 (11th Cir. 1990), *rev'd per curiam on non-antitrust grounds*, 499 U.S. 915 (1991)(finding that a natural gas pipeline was essential and duplication was possible, though expensive and unnecessary, because the defendant's pipeline could easily carry gas for the plaintiff as well as the defendant.).

[53] 410 U.S. 366 (1973).

[54] 15 U.S.C. § 15 (a).