

AK LEGISLATURE FINANCE COMMITTEES FILES 2007-2008 3337

219

## Summary of Main Points

- Project finance involves sharing risk of project failure, but equity sponsors always bear first risk of loss
- Project development and operating experience of sponsors, strength of their balance sheets, strategic importance of the project, size of the sponsor equity investment, and strength of contractual commitments are most important factors considered by lenders
- Some risks are mitigated or allocated to others through project agreements
- Finance terms and conditions must follow, and not precede, project structure and commercial arrangements

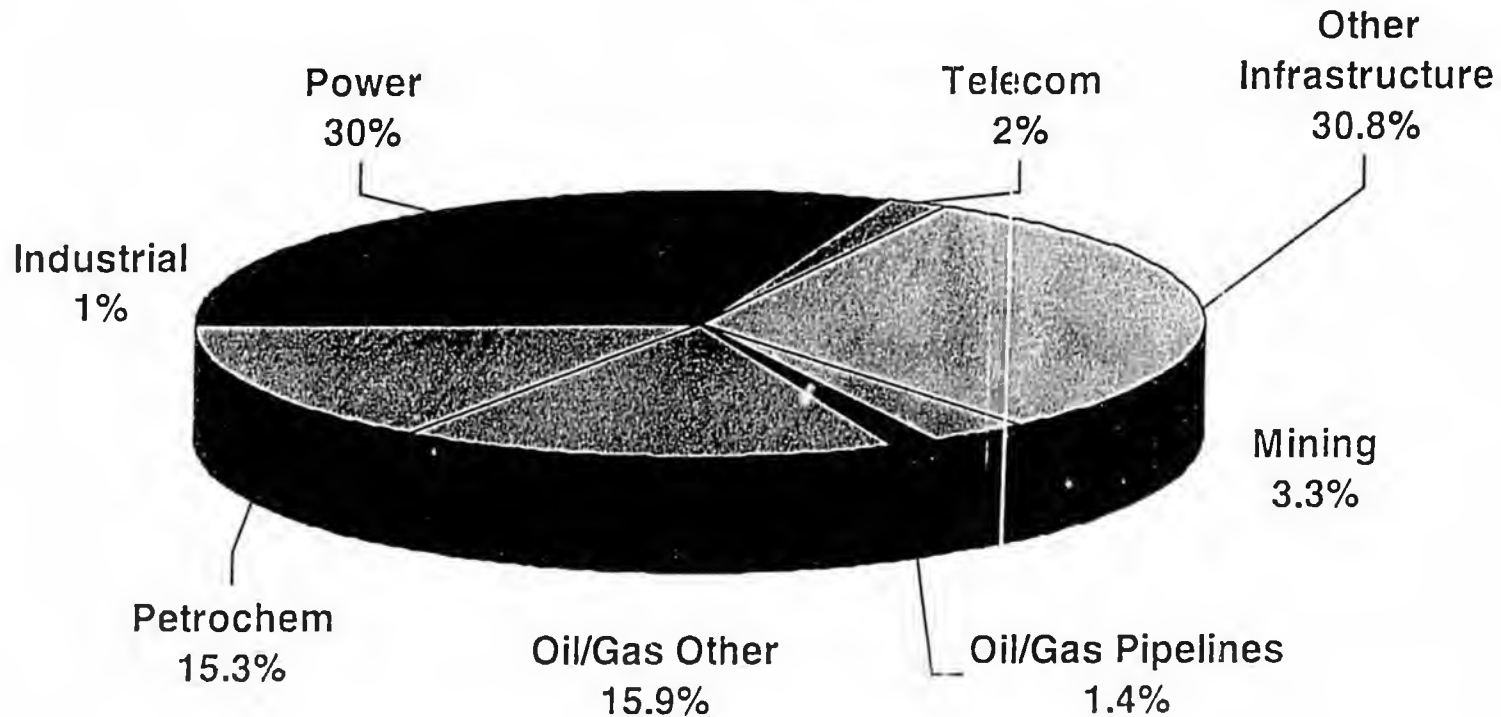
3  
*Section*

**The Current Project Finance Market**

# Who uses PF?

## Project Debt by Industry: 2006

*2006 Global Volume of Project Debt:  
US\$ 186.8 billion*

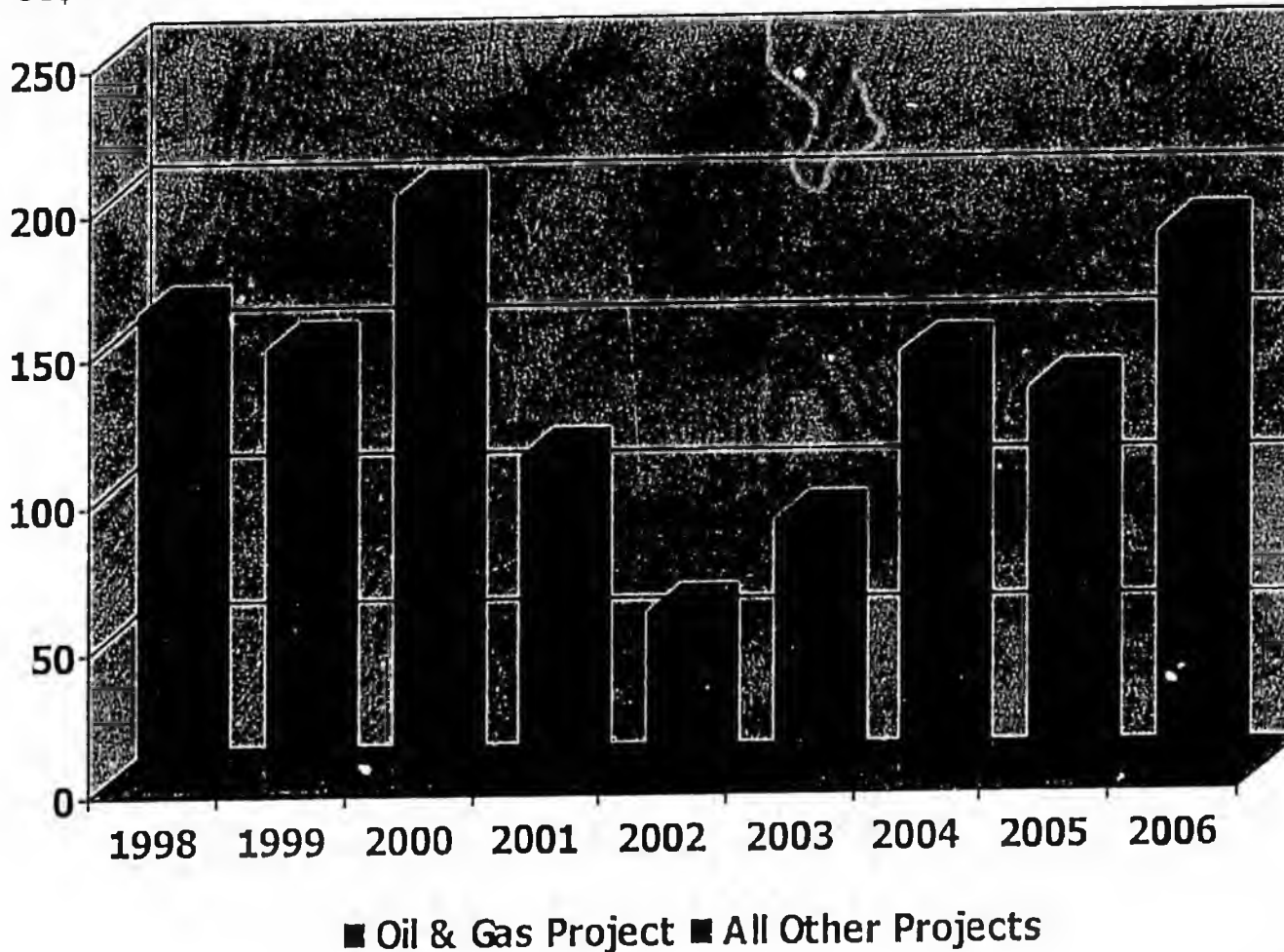


Source: Dealogic

# Total Project Finance Debt Market



US\$ Billions

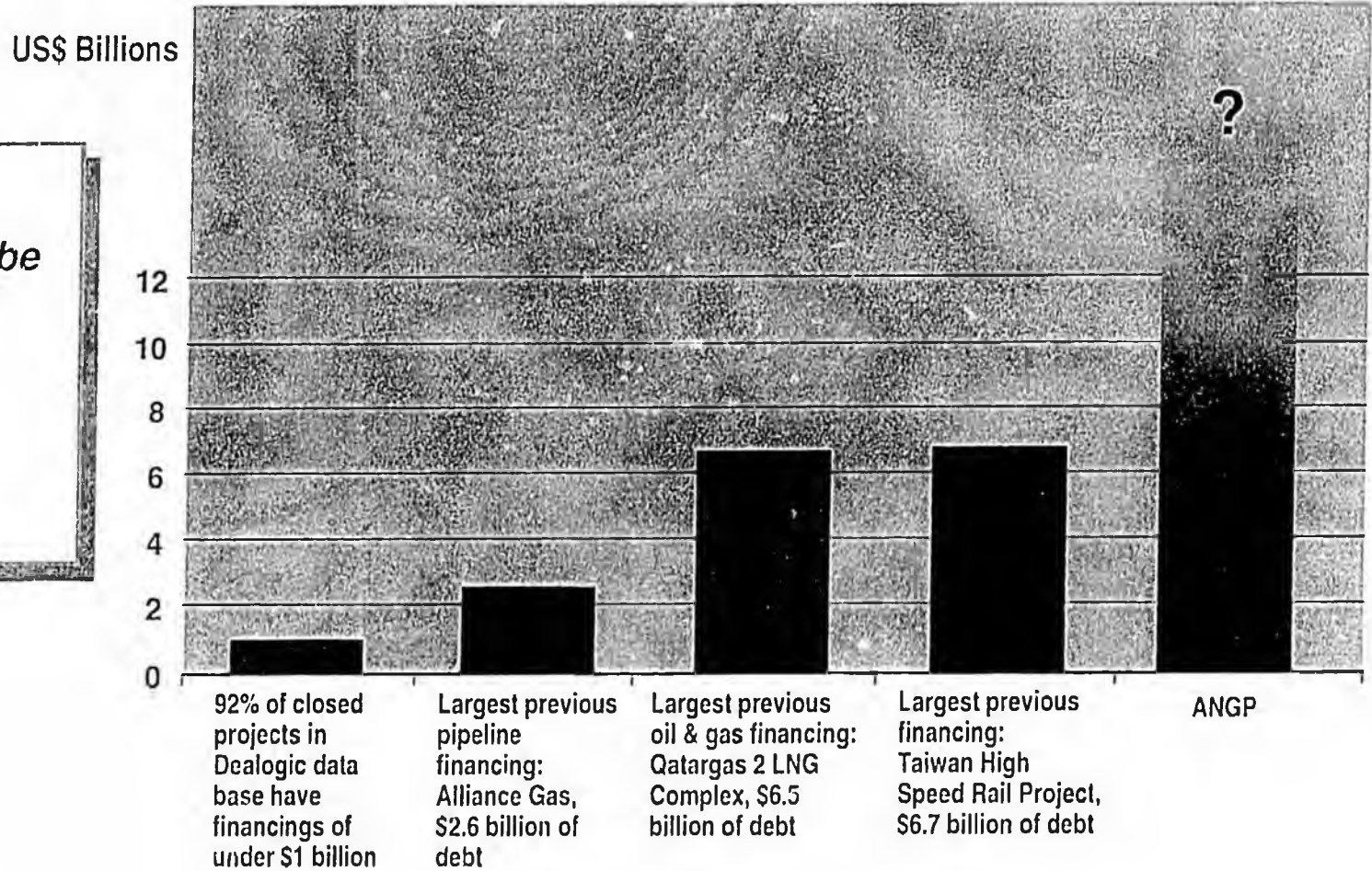


Source: Dealogic

# 3. The Current Project Finance Market



*If project financed, ANGP could be substantially larger than the largest project financing completed to date.*



## 3. The Current Project Finance Market

- **Bond market well-suited source for large borrowing program, currently favorable for oil & gas project bonds**
  - Capital markets deep, large liquid bonds attractive
  - Better pricing transparency
  - Longer tenor (term) than banks
  - Particularly well suited for pipelines given the regularity and predictability of cash flows, and the long life and large size of required investment
- **Voracious appetite by banks**
  - High degree of liquidity
  - Bullish view of risks

**But market conditions  
can change rapidly**



**Therefore, multi-track finance  
plans are common**

## 3. The Current Project Finance Market

- S&P credit study – across all industry sectors and including many emerging market projects:
  - Probability of Default (PD) — BBB+ (investment grade)
  - Loss Given Default (LGD) — Best of all the asset classes in S&P database

*“The majority of the defaulted project finance loans in this study resulted in a restructuring with 100% of loan value maintained”*

*These results include all industry sectors and emerging markets — U.S. energy projects would doubtless have more favorable PD and LGD*

## Summary of Main Points

- Project finance market has evolved, heavily influenced by capital markets and rating agencies
- Result is emphasis on underlying commercial drivers of credit
- Oil and gas pipelines a small part of the market
- Market very liquid now, but volatile, so sponsors must plan for both banks and bonds

*Section* **4**

**Building Blocks of a  
Typical Project Financing**

# 4. Building Blocks of a Typical Project Financing



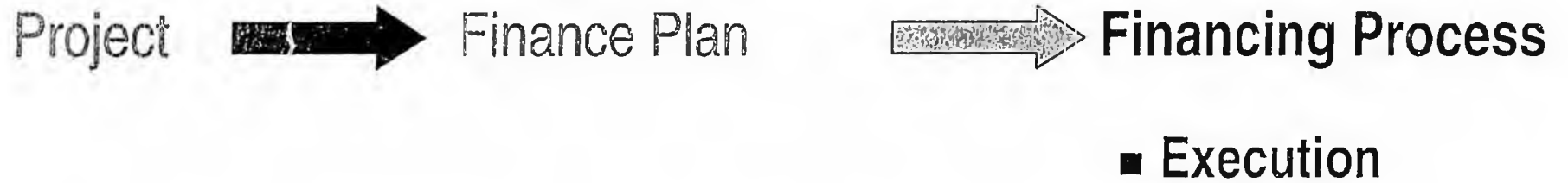
- Project Structure
- Project Agreements
- Commercial Contracts

# 4. Building Blocks of a Typical Project Financing



- Borrowing Structure
- Security and Accounts
- Completion Support

# 4. Building Blocks of a Typical Project Financing



# Project Structure



Project 

- Entity choice
  - Tax efficiency and regulatory considerations are key
  - “Pass-through” structures are common
    - Limited partnerships
    - Limited liability companies (LLCs)
    - Unincorporated joint ventures

# Project Agreements and Commercial Contracts

Project 

- **Agreements with Governments**
  - For resource projects, lease, concession, etc.
  - Investment incentive, fiscal stability and other agreements
  - Key licenses and permits
- **Agreements among Participants**
  - JV agreements
  - Management or operating arrangements
- **Commercial Agreements**
  - Key construction contracts
  - Key supply agreements
  - Offtake agreements (transportation commitments for pipeline)
  - Insurance

# Borrowing Structure

Project  Finance Plan

- Leverage – How much debt?
  - Concept of project “debt capacity” – driven by debt model and Debt Service Cover Ratios, viewed
    - periodically,
    - over the life of loan
  - Variations in leverage

# Security and Accounts

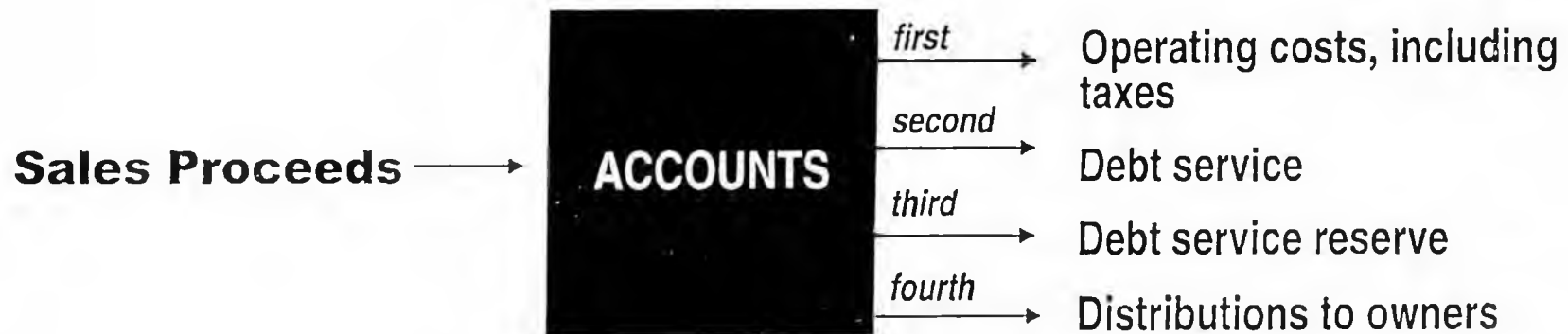
Project  Finance Plan

- Traditional security package: assets, project agreements (including offtake contracts), ownership interest, accounts, insurance
- Modern trend towards omission of asset security on a cost/benefit analysis, especially for strategic projects with strong sponsors
- Key for lenders is to capture cash flows in secured accounts

# Security and Accounts: The Waterfall

Project → Finance Plan

- Priority for continuing operations as only way to continue to service and repay debt



- Accounts create transparency, protection from other creditors (and, in emerging markets, some protection from exchange controls)

# Covenants



Project  Finance Plan

- Operational and legal covenants
  - Additional debt: norm is lender consent, sometimes objective tests based on *pro forma* debt-cover and leverage tests
  - Expansions, discretionary capital expenditure and certain other changes: norm is lender consent, sometimes more objective tests (more latitude if funded with equity)

# Completion Support



**Project**  **Finance Plan**

- **Need to define completion:  
physical and financial**
- **Sponsor support usually in form of  
additional equity commitments or debt  
guarantees**
  - **Equity commitments are common in  
pipelines and are limited in amount**
  - **Debt guarantees are in place through  
completion, requiring sponsors to repay  
the debt if the project is not completed**
- **All support falls away after completion  
tests are met**

# Lender Environmental Considerations

Project  Finance Plan

- In emerging markets, finance requirements can be greater than local law requirements
- In U.S. and Canada, not an issue, as local law requirements are robust
  - Lenders will only require compliance with law

# 4. Building Blocks of a Typical Project Financing



*Key objective is to complete financing in timely fashion so that start of construction is not delayed*

- Financing process requires extensive management and strong leadership
- Can be time-consuming and expensive
- Experienced sponsors and advisors are key
- Close collaboration among all parties is critical for success

## Summary of Main Points

- Project structure and commercial arrangements precede development of borrowing structure and finance plan
- Many large and strategic oil, gas and pipeline projects do not have full asset security package – instead focus is on accounts and waterfall
- Once finance execution starts, requires strong leadership and management, and experienced advisors, to complete financing in time and avoid any delay in start of project construction

*Section* **5**

**Project Finance for Oil, Gas and Pipelines**

# Why do lenders like oil, gas & pipeline projects?

- Past experience has been good
- Resource based lending for upstream projects; contractual based lending for pipeline projects
- Technologies are usually well-proven
- Particularly suited to cash-based credit analysis – cash flows clear
- Either commodity products without market risk (oil), or highly credit-worthy off-take/transportation commitments
- One of the main post-completion risks is usually price risk – which, traditionally, banks understand and can price
- Sponsors can be
  - highly creditworthy
  - experienced with large projects, conservative culture
  - judged by lenders unlikely to abandon strategically significant projects

# Upstream vs. midstream (pipelines)

## ■ Upstream

- Oil projects involve commodity products with little to no market risk; transportation may not be an issue
- Gas projects depend on available transportation and market, and strength of off-take commitments

# Upstream vs. midstream

## ■ Midstream

- Pipeline credits vary widely – depending on
  - Degree of project integration with upstream/downstream
    - Upstream and midstream as integrated project
    - Separate but with upstream producers as owners of midstream
    - Separate with upstream producers' role limited to customer
  - Contractual and credit links into upstream
    - Producer transportation commitment vs. buyer as shipper
    - Nature of transportation commitment
  - Tariff structure
    - Unregulated -- negotiated tariff
    - Common carrier
    - FERC/NEB
  - Emerging market vs. developed

# Main Pipeline Financing Approaches

- **Degree of Integration with Upstream/Downstream**
  - Especially for large strategic projects which rely on single transportation system, producers want (i) timely development of transportation, (ii) control over construction and operating costs, and (iii) reliability – usually leads to integration with upstream or producer participation if midstream is separate
  - Even if pipeline is organized as a separate project, development of upstream resources, transportation commitments and downstream markets are foundations of the pipeline credit

# Main Pipeline Financing Approaches

## ■ “Dual Project Risk”

- Dual completion risk if separate upstream project is also green-field
- Crux of issue: midstream lenders exposed to upstream risks without normal covenants with and remedies against upstream project
- Creates tremendous pressure (i) for common ownership or (ii) on terms and conditions of transportation agreements as only “link” into upstream
- Financing complexity, time and costs also can increase

# Transportation Agreements

- **Transportation Agreement defines cash flows for pipeline borrower**
  - producer or buyer as shipper
  - nature of shipping commitment
    - ship-or-pay (most common)
    - ship-and-pay
- **For ANGP, as FERC/NEB regulated project, open season bids would be on the basis of firm transportation commitments**

# Transportation Agreements

- Firm Transportation Commitment (ship or pay)
  - Key midstream financing issues are tenor, volume, tariff, shipper credit and force majeure
    - If Federal guarantees are available and used, these are issues for Federal government as guarantor, and for lenders as to any uncovered portion of debt . . . but force majeure exceptions to “ship or pay” obligations are key
  - Starting point for midstream post-completion credit is blended credit behind shipping commitments
  - Shipper credit analyzed based on (i) financial strength, (ii) upstream development and operating costs and break-even net-back, (iii) end-user markets, and (iv) sufficient volumes to fulfill firm commitment
  - In FERC regulated transaction, tariff adjusts — generally protects lenders because costs passed on to shippers
  - Producers may be reluctant to enter into firm “ship-or-pay” commitments if they do not own the pipeline

# Transportation Agreements

## ■ Force Majeure

- In “ship-or-pay”, force majeure provisions define circumstances where shippers do not have to pay
- Of key importance to lenders, since force majeure events result in interruption in cash flow available to service debt
- Main force majeure provisions cover operational/availability risk in midstream — if midstream cannot accept gas, shippers not obligated to pay
- Result is keen lender interest in (i) quality of original design and construction, (ii) operational expertise and track record of midstream operator, and (iii) technical and financial capacity of midstream project company and its owners to address operational issues
- Project size and complexity, together with long tenor and large size of midstream financing, likely to increase these concerns in ANGP

# Structural issues for cross-border pipelines

- Separate entities in each country most common
- Can be separately tranching loans to each entity, but
  - cross-completion risk
  - sometimes structured to create unified credit
- Two loans can equal more complexity and cost and longer time to develop

# 10 Largest Oil and Gas Pipeline Project Financings

(greenfield and expansion only – excludes acquisition financing and refinancings)<sup>1</sup>

	<b>Project Name, Location</b>	<b>Total Capital Cost (Senior Debt Portion)</b>	<b>Sponsors</b>	<b>Financial Advisers to the Consortium</b>
1.	Alliance Pipeline Project (Gas), Canada/US (3,000 km)	US\$3.73 billion (\$2.59 billion debt)	Coastal, IPL, Williams, Fort Chicago Energy, Westcoast Energy	Goldman Sachs, Scotia, Paribas.
2.	BTC Pipeline (Oil), Azerbaijan/Georgia/ Turkey (1,730 km)	US\$3.6 billion (\$2.59 billion debt)	Amerada Hess, ConocoPhillips, INPEX, SOCAR, Unocal, BP, Eni, Itochu, Statoil, TPAO	Lazard
3.	Bolivia-Brazil Pipeline Project (Gas), Bolivia/Brazil (3,075 km)	US\$2.23 billion (\$1.4 billion debt)	PETROBRAS, BG, El Paso, YPFB, BHP, Enron Corp., Shell	Credit Suisse First Boston, Kleinwort Benson
4.	Cupiagua-Cusiana Pipeline (Oil), Colombia (800 km)	US\$2.2 billion (\$1.54 billion debt)	Ecopetrol, BP, Total, Triton, TransCanada, IPL	Goldman Sachs, Credit Lyonnais
5.	Chad-Cameroon Pipeline (Oil), Chad (1,070 km)	US\$2.0 billion (pipeline only) (\$700 million debt)	Exxon Mobil, Petronas, Chevron	Citibank

<sup>1</sup> Also excludes primarily upstream projects with an integrated pipeline component. Based on Dealogic database.

# 10 Largest Oil and Gas Pipeline Project Financings

(greenfield and expansion only – excludes acquisition financing and refinancings)<sup>1</sup>

	Project Name, Location	Total Capital Cost (Senior Debt Portion)	Sponsors	Financial Advisers to the Consortium
6.	OCP Heavy Crude Pipeline (Oil), Ecuador (503 km)	US\$1.2 billion (\$900 million debt)	Alberta Energy, Repsol YPF, Occidental, Agip, Pecom Energia, Techint, Kerr-McGee	Chase Manhattan Bank
7.	Mozambique-South Africa Pipeline Project (Gas), Mozambique (865 km)	US\$1.2 billion (\$543 million debt)	Republic of South Africa, Republic of Mozambique, Sasol Polymers	Dresdner Kleinwort Wasserstein
8.	Malhas Project (Gas), Brazil (expansion)	US\$1.0 billion (\$900 million debt)	PETROBRAS, Mitsui, Itochu, Mitsubishi	
9.	Kern River Expansion II (Gas), United States (part refinancing)	US\$875.0 million loan	Williams, Tenneco	
10.	Camisea (Gas), Peru	US\$865.0 million (\$480 debt)	Techint, Sonatrach, PlusPetrol, SK, Hunt Oil, Tractebel	Citi

<sup>1</sup> Also excludes primarily upstream projects with an integrated pipeline component. Based on Dealogic database.

## Summary of Main Points

- Even in oil and gas sector, project financings vary considerably
- Major distinction is between developer- and producer-driven projects
- Many structural variations for upstream, midstream and integrated projects
- For pipelines, credit defined by Transportation Agreement (parties, nature of commitments and pricing), completion support and operating track record
- Universe of greenfield large developer-driven pipeline financings is very limited

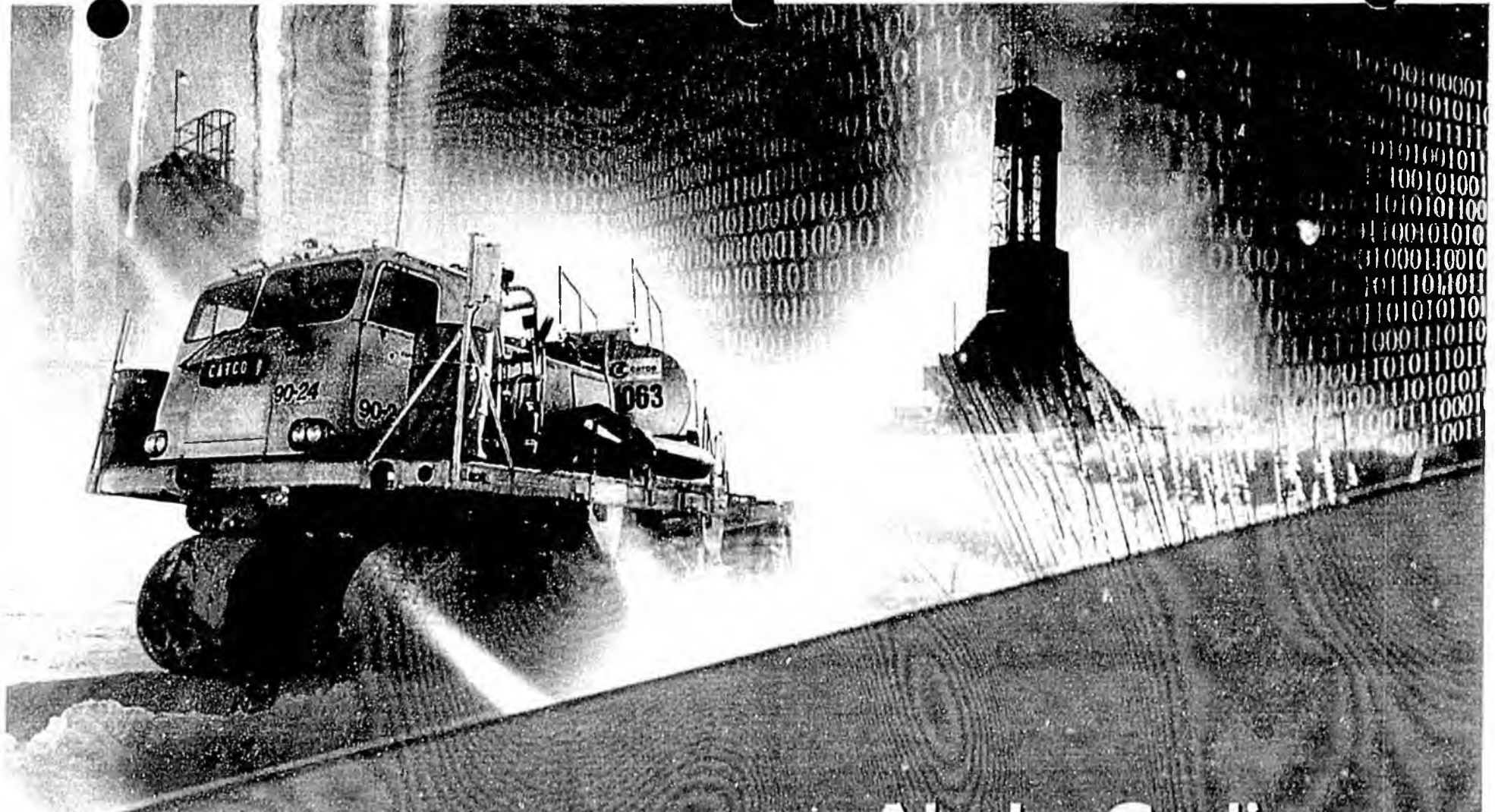
# CONCLUSION: KEY POINTS



- Every project is different and this one will likely set its own financing precedents
- Parties use project financing for different reasons
- Commercial fundamentals, together with contractual commitments, completion support and sponsor strength, are the foundation of a project credit
- With the right underlying economics and if properly structured, oil and gas projects can be strong credits
- Project finance execution is a complex enterprise requiring collaboration among many parties; flexibility is required to respond to moving markets

SULLIVAN & CROMWELL LLP

ANADARKO



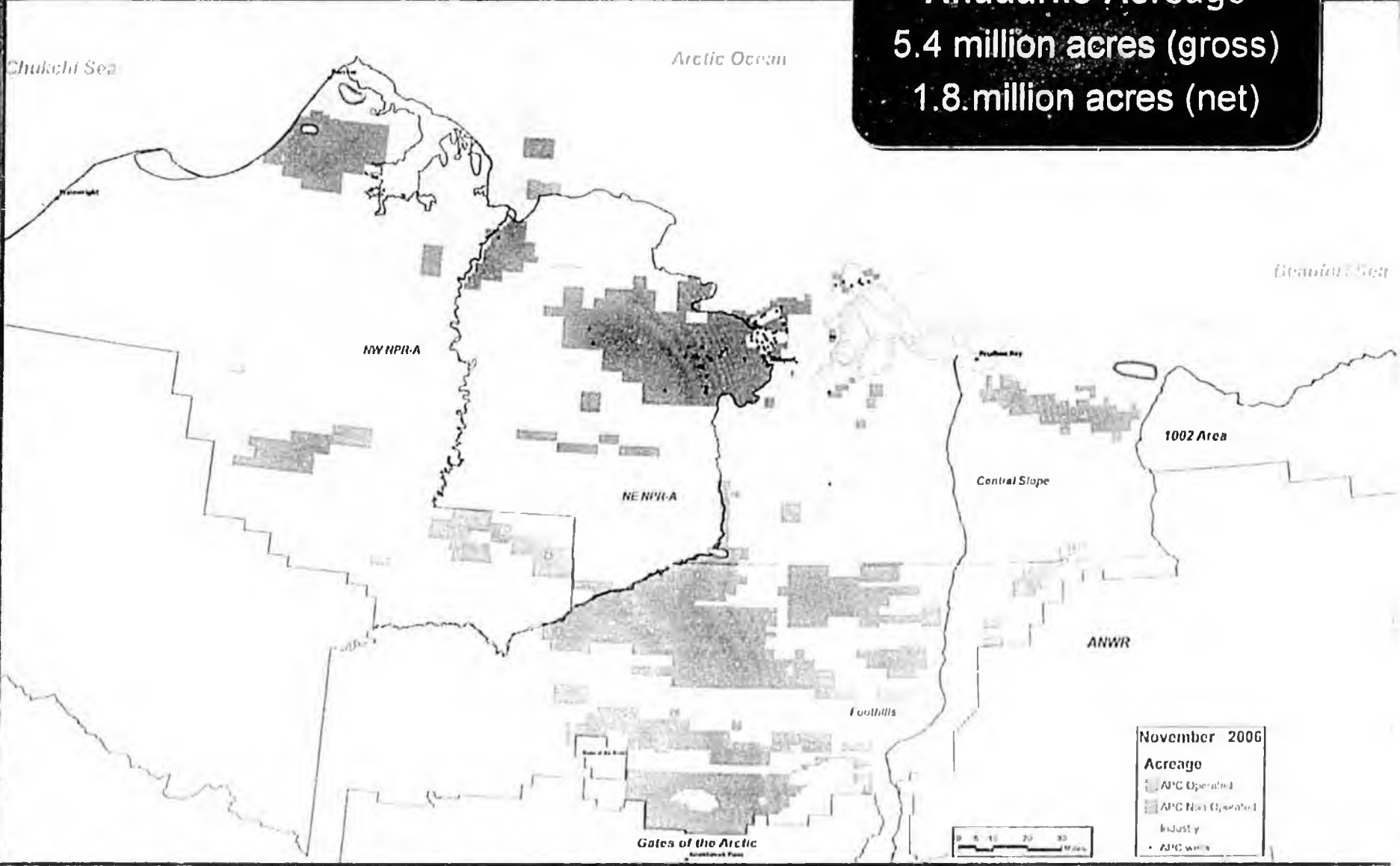
# Alaska Gasline Inducement Act

**Anadarko**<sup>®</sup>  
Petroleum Corporation

Senate Finance  
April 27, 2007

# Anadarko's Investment in Alaska-Land

**Anadarko Acreage**  
5.4 million acres (gross)  
1.8 million acres (net)



# Support AGIA

## Support Alaska Gasline Inducement Act

- *We like the process*
- *We support the specifics*
- *Addresses Key Explorer Concerns*
  - Fair access
  - Expandable pipeline
  - Reasonable tariffs

A N A D A R K O

# Support AGIA Process

## ▶ We like the process

- *Three opportunities for input and for key policy makers to consider issues before a deal is done*
  - Initial legislation
  - Public comment on submitted applications
  - Legislative review of selected application
- *Creates competitive process*
- *Lays out “must haves” that the state will require of any applicant*

A N A D A R K O

# Support Specifics in AGIA

## ▲ We support mandatory provisions on access and rates

### – Pipeline (licensee) must:

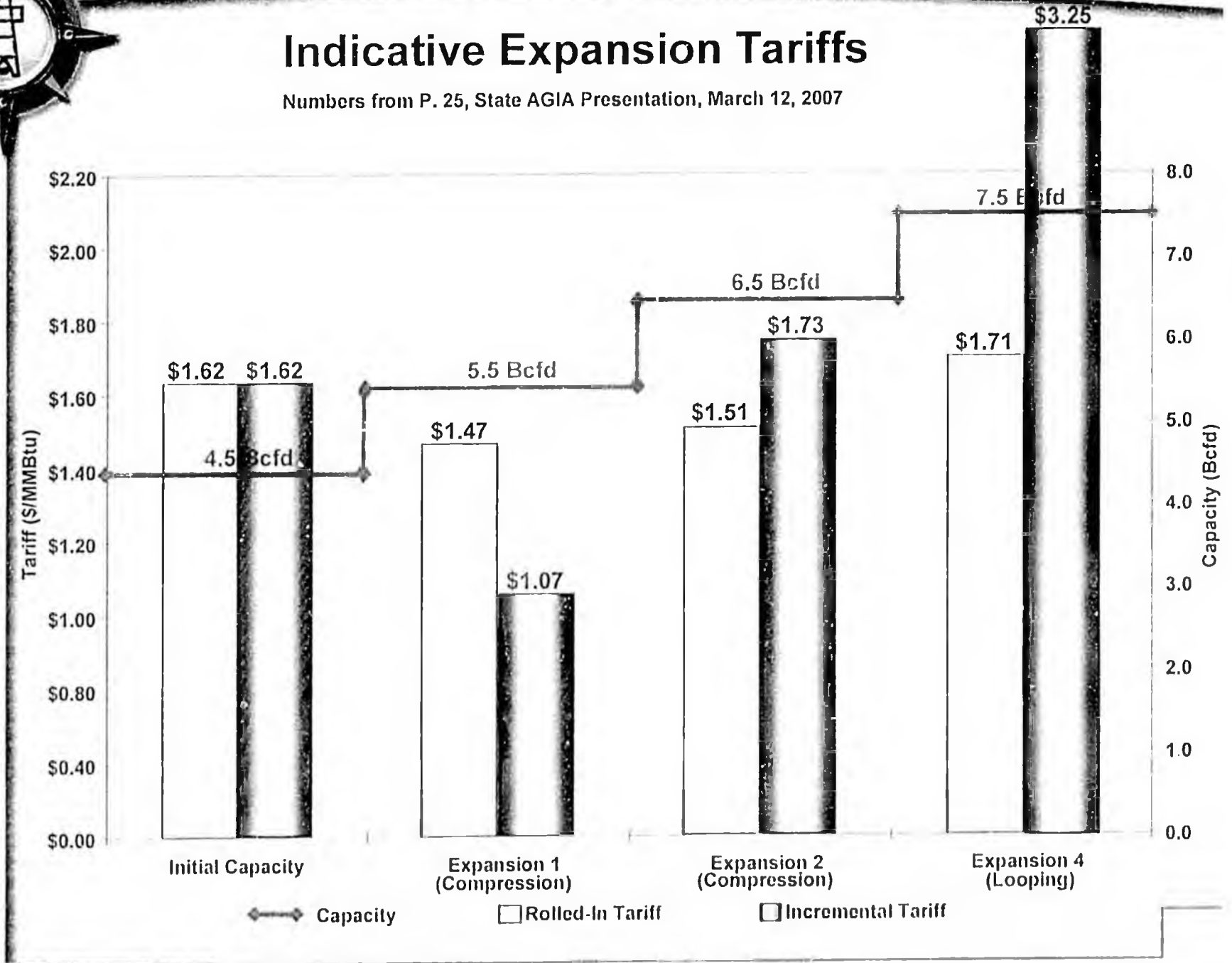
- Assess market demand for expansions every 2 years
- Commit to expand in reasonable increments on reasonable terms
- Propose and support rolled in rates up to 15% above initial rate and agree not to enter into negotiated rate agreements that would preclude the rolled in rates

A N A D A R K O



# Indicative Expansion Tariffs

Numbers from P. 25, State AGIA Presentation, March 12, 2007



# AGIA helps mitigate challenge of FERC rules

- Producers in court challenging FERC authority to ensure adequate pipeline capacity and low cost expansions
- Producers attempting to invalidate Sections 157.36 & 157.37
- 18 C.F.R. 157 Subpart B
- Section 157.36 Open seasons for expansions.
- Any open season for capacity exceeding the initial capacity of an Alaska natural gas transportation project must provide the opportunity for the transportation of gas other than Prudhoe Bay or Point Thomson production. In considering a proposed voluntary expansion of an Alaska natural gas pipeline project, the Commission will consider the extent to which the expansion will be utilized by shippers other than those who are the initial shippers on the project and, in order to promote competition and open access to the project, may require design changes to ensure that some portion of the expansion capacity be allocated to new shippers willing to sign long-term firm transportation contracts, including shippers seeking to transport natural gas from areas other than Prudhoe Bay and Point Thomson.
- Section 157.37 Project design.
- In reviewing any application for an Alaska natural gas pipeline project, the Commission will consider the extent to which a proposed project has been designed to accommodate the needs of shippers who have made conforming bids during an open season, as well as the extent to which the project can accommodate low-cost expansion, and may require changes in project design necessary to promote competition and offer a reasonable opportunity for access to the project.

A N A D A R K O

# Support AGIA

## ▲ Support Alaska Gasline Inducement Act

- *We like the process*
- *We support the specifics*
- *Addresses Key Explorer Concerns*
  - Fair access
  - Expandable pipeline
  - Reasonable tariffs

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# CORRECTION

THE FOLLOWING DOCUMENT(S)  
HAVE BEEN REFILMED TO  
ASSURE LEGIBILITY OR PAGINATION



Rev. 6/98

Central Microfilm Services  
Department of Education & Early Development  
State of Alaska

UNITED STATES COURT OF APPEALS  
FOR DISTRICT OF COLUMBIA CIRCUIT  
JUN - 5 2006  
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UNITED STATES COURT OF APPEALS  
FOR THE DISTRICT OF COLUMBIA CIRCUIT

Case No. 05-1299  
(and consolidated cases 05-1300 and 05-1301)

EXXON MOBIL CORPORATION,

Petitioner,

- v -

FEDERAL ENERGY REGULATORY COMMISSION,

Respondent.

Petitions for Review  
of Orders from the  
Federal Energy Regulatory Commission  
Order No. 2005 (Docket No. RM05-1-000) and Order No. 2005-A (Docket No. RM05-1-001)

JOINT BRIEF OF PETITIONERS  
BP EXPLORATION (ALASKA) INC., CONOCOPHILLIPS COMPANY,  
AND EXXON MOBIL CORPORATION

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ConocoPhillips Company, and  
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risk.<sup>50</sup> Second, as holders of leases for substantial discovered North Slope natural gas resources, the Companies are adversely affected because the regulations lower the value of such resources by increasing the risk that construction of a pipeline to bring the natural gas to market might not occur or might be delayed.

### SUMMARY OF ARGUMENT

The Commission unlawfully has asserted authority to condition a certificate of public convenience and necessity on the project sponsor's willingness to allow FERC to increase the capacity or expandability of the project. FERC's promulgation of the challenged regulations is contrary to the NGA and ANGPA. Therefore, the Court should find that §§ 157.36 and 157.37 \*  
are invalid.

The NGA does not empower FERC to order increases in pipeline capacity. Indeed, Section 7(a) of the NGA makes clear that FERC lacks the power to do so. In ANGPA, Congress, after careful consideration of competing interests, adopted a limited exception to this prohibition. However, that exception—set forth in ANGPA § 105—protects initial shippers, the pipeline, and the public interest by imposing prerequisites that must be satisfied before FERC may order a mandatory pipeline expansion. The challenged regulations would work an end-run around the checks and balances Congress saw fit to adopt. Therefore, the regulations are contrary to law.

The Commission suggests that the challenged regulations are permissible because, under them, the Commission would require increased capacity via certificate conditions, rather than by direct order. However, FERC may not do indirectly through its conditioning authority what it is precluded from doing directly. Nor is there any support for FERC's suggestions that the prohibition on ordering increased capacity can be ignored at the initial application stage or that

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<sup>50</sup> Petitioner Comments (Rec. 32) at 8-9; Brattle Comments (Rec. 39) at 6-7.

§ 157.36 Open seasons for expansions.

Any open season for capacity exceeding the initial capacity of an Alaska natural gas transportation project must provide the opportunity for the transportation of gas other than Prudhoe Bay or Point Thomson production. In considering a proposed voluntary expansion of an Alaska natural gas pipeline project, the Commission will consider the extent to which the expansion will be utilized by shippers other than those who are the initial shippers on the project and, in order to promote competition and open access to the project, may require design changes to ensure that some portion of the expansion capacity be allocated to new shippers willing to sign long-term firm transportation contracts, including shippers seeking to transport natural gas from areas other than Prudhoe Bay and Point Thomson.

§ 157.37 Project design.

In reviewing any application for an Alaska natural gas pipeline project, the Commission will consider the extent to which a proposed project has been designed to accommodate the needs of shippers who have made conforming bids during an open season, as well as the extent to which the project can accommodate low-cost expansion, and may require changes in project design necessity to promote competition and offer a reasonable opportunity for access to the project.

§ 157.38 Pre-approval procedures.

No later than 90 days prior to providing the notice of open season required by § 157.34(a), a prospective applicant must file, for Commission approval, a detailed plan for conducting an open season in conformance with this subpart. The prospective applicant's plan shall include the proposed notice of open season. Upon receipt of a request for such a determination, the Secretary of the Commission shall issue a notice of the request, which will then be published in the Federal Register. The notice shall establish a date on which comments from interested persons are due and a date, which shall be within 60 days of receipt of the prospective applicant's request unless otherwise directed by the Commission, by which the Commission will act on the proposed plan.

§ 157.39 Rate treatment of pipeline expansions.

There shall be a rebuttable presumption that rates for any expansion of an Alaska natural gas transportation project shall be determined on a rolled-in basis.

Law Seminars International  
Energy in Alaska: Opportunities and Challenges in Developing New Energy Sources

November 18, 2005

**THE LIKELY IMPACT OF  
THE FEDERAL ENERGY REGULATORY COMMISSION'S  
ALASKA NATURAL GAS PIPELINE OPEN SEASONS REGULATIONS  
ON THE DEVELOPMENT OF OIL AND GAS RESOURCES IN ALASKA**

Presented by

**J. Curtis Moffatt, Member  
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**INTRODUCTION**

Good morning. My name is Curt Moffatt. I am a partner with the law firm Van Ness Feldman, in Washington, DC, specializing in the regulation of interstate natural gas pipelines.

In the interests of full disclosure, our firm, and I personally, serve as counsel to TransCanada Corporation with respect to its efforts to promote and support the development of the Alaska Natural Gas Transportation System ("ANGTS") to transport stranded Alaskan natural gas by pipeline to the lower-48 states. I provide these remarks and opinions, however, not in that capacity, but rather as a practitioner with over 25 years experience representing independent natural gas pipelines subject to the plenary jurisdiction of the Federal Energy Regulatory Commission ("FERC" or "Commission") under the Natural Gas Act ("NGA"); particularly, section 4 relating to tariffs, rates, charges and terms and conditions of service, and section 7 relating to the securing of certificates of public convenience and necessity to authorize the ownership, construction, and operation of transmission facilities in interstate commerce and the authority to transport or sell natural gas in interstate commerce at wholesale.

One of the reasons I suppose I was asked to speak today is that I also have a long history with the development of an Alaska natural gas pipeline project, having been involved with the project since serving as an assistant to a member of the Federal Power Commission ("FPC") and later to the FERC Chairman in the late 1970s, at the time that the agency was making its recommendations to the President with respect to the development of the project.

From these perspectives, I offer these personal comments on the interplay between the Commission's open season regulations, the NGA, the Alaska Natural Gas Transportation Act of 1976 ("ANGTA"), and the Alaska Natural Gas Pipeline Act ("ANGPA") enacted in 2004 and its impact on the specific question of whether the Commission's open season regulations provide the necessary framework to ensure the development of Alaska's resource base.

For initial capacity on the transportation system, the Commission's rules implementing the ANGPA requirement do no harm and provide some additional guidance on how to proceed with an open season to allocate initial capacity on the pipeline. But, let's be realistic, and recognize that initial capacity is going to be subscribed by shippers who are shipping current proven reserves from Prudhoe Bay or Point Thomson. The initial open season will not have much impact on the development of Alaska's presumed-to-be vast *potential* resources of natural gas. Those development decisions will depend on expansion of the initial capacity.

Regarding expansion of the pipeline beyond initial capacity, the Commission did make an important decision to establish a presumption in favor of rolled-in, as opposed to incremental, pricing of expansion facilities, albeit limited to voluntary expansions.<sup>1</sup> This decision is critical to providing economic transportation when expanding the initial capacity to meet the shipping needs of independent explorers developing other natural gas reserves.

This decision, however, will be a hollow victory for future explorers if the owners of the transportation system are unwilling to expand the transportation facilities voluntarily. The Commission's presumption in favor of rolled-in pricing is only available if the expansion is undertaken voluntarily by the owner of the pipeline. The presumption will not be applicable in the case of a forced expansion after a complaint pursuant to Section 105 of ANGPA.

Therefore, if one is interested in creating the right investment climate for the development of Alaska's natural gas resources beyond the currently proven reserves at Prudhoe Bay and Point Thomson, then I submit that the focus should not be on the Commission's regulations governing open seasons or even open access or affiliated transactions. Rather, the development of Alaska's yet-to-be-discovered natural gas resources will depend on who owns the pipeline and whether that owner will be willing to expand the pipeline voluntarily and implement rolled-in versus incremental pricing.

If assuring access and voluntary, economic expansions to promote additional, diverse exploration and development capital were the only policy objectives facing the Federal and State governments as well as the North American energy markets, then there would be no question that the pipeline system should be controlled and operated as an independent pipeline. Such a corporate structure would then mirror the overwhelming majority of large diameter natural gas transportation systems throughout North America. But, at the moment, the larger public policy question is "how do we get the North Slope

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<sup>1</sup> 18 C.F.R. § 157.39.

producers to commit to produce and market the proven reserves?" Will the open season regulations assist in that endeavor? In my personal opinion: the regulations do no harm, but they also do not provide any answers.

THE CONCEPT OF OPEN ACCESS PIPELINES AND THE ROLE OF OPEN SEASONS AS APPLIED TO AN ALASKA NORTH SLOPE NATURAL GAS PIPELINE

For almost thirty years now, the development of an Alaska natural gas pipeline has presented profound policy questions that have been committed to deliberative processes at the Federal and State levels. The project is as large and complex as they come. It has been the subject of two special acts of Congress, a Presidential decision, an international agreement, and multiple FPC / FERC proceedings. And it is currently the subject of a major State statute, the Alaska Stranded Gas Development Act, involving significant deliberative processes in the State's executive and legislative branches. It is safe to say that no other project has had such a distinguished history.

The project presents several unique issues: (1) the considerable technical challenges involved in developing a project of this magnitude in an Arctic environment; (2) the sheer amount of capital required to develop and construct the project; and (3) given that there are not likely to be competitive pipeline alternatives to the initial pipeline transportation infrastructure, concern with the potential for exercise of market power by any owner of the project. I will not discuss the technical challenges or the capital requirements here. However, I will share some observations regarding what is in my view the fundamental public policy question: how independent of the Prudhoe Bay producers should the ownership of the pipeline be if Alaska and the United States are serious about developing Alaska's other natural gas resources?

All interstate natural gas pipelines in the United States, like electric transmission lines operating in interstate commerce, are subject to federal economic regulation because of the Congressional determination that they are natural monopolies. Since 1938, the NGA has provided the primary statutory scheme to assure that rates and charges are just and reasonable, and that the services are provided on a not unduly discriminatory basis.<sup>2</sup> Congress continues to believe that appropriate regulation is necessary to address market power concerns.

Implementing Congress's intent, the Commission has gone to great lengths to limit market power and to prevent undue discrimination. Moreover, the Commission has noted repeatedly that concerns regarding market power and undue discrimination are

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<sup>2</sup> Under section 4(a) of the NGA, all rates and charges for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission must be "just and reasonable," and any rates or charges that are not just and reasonable are declared to be unlawful. 15 U.S.C. § 717c(a). Under section 4(b), natural gas companies are prohibited from granting any undue preferences or advantages to, or unduly discriminating against, any person, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission. 15 U.S.C. § 717c(b).

heightened when a pipeline is owned by an entity or entities that are also affiliated with the shippers that will use the pipeline.<sup>3</sup>

There is significant precedent regarding ensuring competition and protecting against undue discrimination in the natural gas transportation industry. Indeed, such concerns were at the very foundation of the Commission's efforts to restructure the industry in the mid-1980s and early 1990s. Order 436,<sup>4</sup> issued in 1985, encouraged interstate pipeline companies to provide open access service, providing incentives for them to offer transportation service to producers and end users, as well as their regular local distribution company ("LDC") customers, on a first come, first served basis. It also prohibited pipeline companies from discriminating against transportation requests in order to protect their own merchant services.

Order 636,<sup>5</sup> issued in 1992, went a step further, actually requiring interstate pipeline companies to unbundle their transportation, sales, and storage services, in an effort to ensure that third-party suppliers would receive the same quality of transportation services that were previously provided to a pipeline company's own gas sales. Order 636 meant that interstate natural gas pipeline companies could no longer engage in merchant gas sales, and required that their production and marketing arms be restructured as arms-length affiliates. Under the Order, pipeline companies were prohibited from providing their affiliates with any advantage (such as in price, volume, or timing of gas transportation) over any other potential shippers.

Such concerns also are at the base of the Commission's Order 2004<sup>6</sup> standards of conduct governing interactions between transmission providers (including interstate natural gas pipelines) and their energy affiliates.<sup>7</sup> Order 2004 recognized that "Transmission Providers continue to have economic incentives to show undue preferences toward their Energy Affiliates."<sup>8</sup> Thus, the standards of conduct are designed to ensure that transmission providers cannot extend their market power over transmission to wholesale energy markets by giving their energy affiliates unduly preferential treatment. As FERC explained in the Order:

Producers that are selling energy are competing with other  
non-affiliated shippers for access to the pipelines'

<sup>3</sup> See, e.g., Standards of Conduct for Transmission Providers, Order No. 2004, 68 Fed. Reg. 69,134 (Nov. 25, 2003), *order on reh'g*, Order No. 2004-A, 69 Fed. Reg. 23,562 (Apr. 29, 2004), *order on reh'g*, Order No. 2004-B, 69 Fed. Reg. 48,371 (Aug. 10, 2004).

<sup>4</sup> Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Order No. 436, 50 Fed. Reg. 42,408 (Oct. 18, 1985).

<sup>5</sup> Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations, Order No. 636, 57 Fed. Reg. 13,267 (Apr. 16, 1992).

<sup>6</sup> Standards of Conduct for Transmission Providers, Order No. 2004, 68 Fed. Reg. 69,134 (Nov. 25, 2003). In Order No. 2004-A, 69 Fed. Reg. 23,561 (Apr. 29, 2004), and in Order No. 2004-B, 69 Fed. Reg. 48,371 (Aug. 10, 2004), the Commission made a number of clarifications and revisions to, but largely reaffirmed, Order No. 2004.

<sup>7</sup> 18 C.F.R. § 358.3.

<sup>8</sup> 68 Fed. Reg. at 69,137.

transmission systems. Whether a producer is selling gas from its own production or from the production of another, it is competing with non-affiliates for access to the pipeline's transportation system. We conclude that providing a producer, gatherer or processor with preferential access to the pipeline's transmission system or information concerning the pipeline's system is inconsistent with NGA Section 4's prohibition against undue preferences or discrimination in the provision of interstate transportation services; accordingly, this Final Rule will prevent such conduct.<sup>9</sup>

In order to address this concern, the standards establish two general principles applicable to all interstate natural gas pipeline companies that have energy affiliates: (1) employees of the pipeline company who are engaged in transmission system operations must function independently from employees of the company's energy affiliates; and (2) the pipeline company must treat all transmission customers, affiliated and non-affiliated, on a non-discriminatory basis, and must not operate its transmission system to benefit preferentially an energy affiliate.<sup>10</sup>

All of these Commission orders and regulations, however, relate to non-discriminatory service on *only* the operating facilities—*i.e.*, once the pipeline is built and operating. They have nothing to do with whether a pipeline company will agree to expand its system.

Indeed, nowhere in any of these orders is there any discussion of the Commission ordering a pipeline to expand its system to serve new customers. That is because, prior to the enactment of ANGA and its section 105 complaint procedure, the Commission has had virtually no authority to order an expansion of a pipeline's system to serve new load—*i.e.*, in the case of Alaska, beyond proven reserves in Prudhoe Bay and Point Thomson.<sup>11</sup> This is the precise reason that concerns regarding access to the pipeline and

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<sup>9</sup> *Id.* at 69,143-44.

<sup>10</sup> 18 C.F.R. § 358.2.

<sup>11</sup> Section 7(a) of the NGA authorizes the Commission to order natural gas companies to "extend or improve" their transportation facilities, but expressly provides that "Commission shall have no authority to compel the enlargement of transportation facilities . . ." 15 U.S.C. § 717f. See *El Paso Natural Gas Co.*, 104 FERC 61,045, at P 104, n. 104 ("The Commission does not have the authority under the NGA to order a pipeline to construct additional capacity."); see also, e.g., 18 C.F.R. § 284.7(f) (providing that open access pipelines are "not required to provide any requested transportation service for which capacity is not available or that would require the construction or acquisition of any new facilities"); *Panhandle Eastern Pipe Line Co. v. FERC*, 204 F.2d 675 (3rd Cir. 1953) (opining that "the provisions of section 5(a), which confer upon the Commission power to direct the elimination of unduly discriminatory and preferential practices, must be read in the light of and construed as subject to the proviso in section 7(a) that the Commission may not compel the enlargement of the transportation facilities of a natural gas company."); *Regulation of Short-Term Natural Gas Transportation Services, Regulation of Interstate Natural Gas Transportation Services*, 106 FERC 61,088 at P 30 (2004) (recognizing "concerns about the Commission's ability, under Section 7 of the NGA, to require a pipeline to construct capacity"); *Calpine Energy Services, L.P.*, 103 FERC 61,273, at P 30 (2003) ("It is well established that Section 7 of the Natural Gas Act does

attempts to exercise market power have pervaded the more than three decades of attempts to develop an Alaska North Slope natural gas line.

With respect to the Alaska natural gas pipeline, participation by the Alaska North Slope natural gas producers in the ANGTS was originally prohibited by the President's Decision on an Alaska Natural Gas Transportation System, with the exception of providing guarantees for project debt. This prohibition reflected concerns expressed by the Attorney General to the President and Congress relating to the impact of producer participation in the Project on competition in the natural gas industry. Pursuant to sections 6 and 19 of the Alaska Natural Gas Transportation Act ("ANGTA"),<sup>12</sup> the U.S. Department of Justice thoroughly analyzed the antitrust and competitive impact effects of an Alaska natural gas transportation system.<sup>13</sup> The Department concluded that producers of significant amounts of natural gas should not be permitted to own any portion of, or otherwise participate in, the selected Alaska natural gas transportation system, and recommended that the license to be issued to the selected system should contain a condition that prevents participation in any manner by such gas producers.<sup>14</sup> The Department's conclusion and recommendation were based on the premise that "such ownership or participation under a regime of deregulated or relaxed wellhead price regulation could lead to the evasion of effective pipeline regulation and create the opportunity for the earning of monopoly profits through anticompetitive activity."<sup>15</sup>

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not obligate pipelines to build new facilities for shippers."), citing *Panhandle Eastern Pipe Line Co. v. FERC*, 204 F.2d 675, and *Panhandle Eastern Pipe Line Co.*, 91 FERC 61,037, at 61,141-42 (2000) (emphasizing that the Commission's interconnection policy, relating to the construction of new interconnections, "does not require a pipeline to expand its facilities, to construct any facilities leading up to an interconnection, or even to construct the interconnection itself"). Notably, the North Slope producers cited these principles and this and other precedent in their request for rehearing of the Commission's open season regulations, in support of their argument that the Commission lacks authority under the NGA to order design changes with respect to the initial facilities and voluntary expansions pursuant to new 18 C.F.R. §§ 157.36 and 157.37. *Request of BP Exploration (Alaska) Inc., ConocoPhillips Company and Exxon Mobil Corporation for Rehearing and Clarification of Order 2005*, Docket No. RM05-1-000, et al., FERC (Mar. 11, 2005); see 70 Fed. Reg. at 35,013.

<sup>12</sup> Section 6 of ANGTA authorized Federal officers or agencies to submit written comments to the President with respect to the recommendation and report of the FPC, including with respect to impacts upon competition. 15 U.S.C. 719d. Section 19 authorized and directed the Attorney General to "conduct a thorough study of the antitrust issues and problems relating to the production and transportation of Alaska natural gas and . . . to submit to Congress a report containing his findings and recommendations with respect thereto." 15 U.S.C. § 719 note.

<sup>13</sup> Under Section 19, the Attorney General prepared and submitted to Congress, on July 14, 1977, a detailed analysis of potential antitrust issues and problems. Under Section 6, the Attorney General submitted that same report to the Alaskan Natural Gas Task Force, along with a commentary on the FPC's findings with respect to competitive impact. In addition, the Justice Department submitted a letter to the White House on August 9, 1977, which elaborated its views concerning possible participation by the gas producers in financing the transportation system. Letter from H. Morrison, Jr., Acting Assistant Attorney General, Antitrust Division, U.S. Dep't of Justice, to L. Goldman, Assistant Administrator, Energy Resources Development, The White House (Aug. 9, 1977). See Report Accompanying a Decision on an Alaska Natural Gas Transportation System, Ch. VII, at 208.

<sup>14</sup> See Letter from H. Morrison, Jr., Acting Assistant Attorney General, Antitrust Division, U.S. Dep't of Justice, to L. Goldman, Assistant Administrator, Energy Resources Development, The White House (Aug. 9, 1977).

<sup>15</sup> *Id.*

Concern that private financing could not be accomplished without greater participation by the producers, however, ultimately led President Reagan to request and obtain from Congress a waiver overturning the prohibition against producer participation through the ANGTA section 8 waiver process. Importantly, however, the waiver was subject to the proviso, "that any agreement on producer participation may be approved by the Federal Energy Regulatory Commission only after consideration of advice from the Attorney General and upon a finding of the Federal Energy Regulatory Commission that the agreement will not (a) create or maintain a situation inconsistent with the antitrust laws, or (b) in and of itself create restrictions on *access* to the Alaska segment of the approved transportation system for *nonowner shippers* or restrictions on *capacity expansion . . .*"<sup>16</sup> The President submitted the proposed waiver of law to Congress on October 15, 1981, and the waiver was approved as part of Public Law No. 97-93 in December 1981.<sup>17</sup>

Thus, while the waiver package allowed the producers to participate in the ownership of the project, it also included a proviso to address antitrust and anticompetitive concerns. It was generally believed that the safeguards in this proviso provided sufficient Federal review to eliminate any possible antitrust violations. As explained in the Administration's Synopsis of Waiver:

The prohibition was based upon antitrust concerns, as expressed by the Department of Justice. A more thorough analysis of the antitrust concerns reveals that the producers' ability to exert monopoly control over the project, or to inhibit further development of North Slope reserves by controlling the sole transportation available to natural gas markets, would most likely stem from their ability to limit access to the system or restrict its expansion. By requiring the Commission, in consultation with the Attorney General, to address the access and expansion issues at the time of the final ANGTS certificate issuance, the proposed waiver provides sufficient antitrust protection to meet the express concerns.<sup>18</sup>

Thus, a review of the history of the prohibition against producer participation and the subsequent waiver of that prohibition by Congress illustrates that there were two primary competition and antitrust concerns raised by potential producer ownership of an Alaska North Slope natural gas pipeline: (1) the producers could use their ownership of the pipeline and their control over natural gas supplies to manipulate gas commodity markets; and (2) the producers could prevent access to the pipeline by other producers and limit expansions of the original facility.

<sup>16</sup> See H. R. REP. NO. 97-350, pt. 2, at 13-14 (Nov. 20, 1981) (emphasis added).

<sup>17</sup> 95 Stat. 1204 (Dec. 15, 1981).

<sup>18</sup> Administration Synopsis of Waiver, reprinted at S. REP. NO. 97-272, at 46-47 (1981). See H. R. REP. NO. 97-350, pt. 2, at 13-15 (1981).

Although we are working in a different world than we had in the 1970s and early 1980s, concerns arising from the mere fact of affiliations between pipeline shippers and pipeline owners still exist today. This is evident from all of the Commission's continuing efforts to regulate affiliated transactions. In fact, it is these very concerns that gave rise to Congress, in ANPGA, directing the Commission to issue rules governing open seasons for an Alaska natural gas pipeline. It is also these concerns that were articulated by independent, explorer companies that led to the complaint procedures in ANPGA under which FERC may order expansions of the pipeline.

#### BACKGROUND ON FERC OPEN SEASON REGULATIONS

On February 9, 2005, FERC issued a Final Rule establishing requirements to govern the conduct of open seasons for proposals to construct "Alaska natural gas transportation projects."<sup>19</sup> This Rule fulfilled the Commission's responsibilities to issue open seasons regulations under section 103 of ANPGA, enacted on October 13, 2004. Section 103(e) of the ANPGA directed the Commission, within 120 days after enactment of the Act, to issue regulations governing the conduct of open seasons for Alaska natural gas transportation projects, including procedures for allocation of capacity. It further required that the regulations: (A) include the criteria for and timing of any open seasons; (B) promote competition in the exploration, development, and production of Alaska natural gas; and (C) for any open season for capacity exceeding the initial capacity, provide the opportunity for the transportation of natural gas other than from the Prudhoe Bay and Point Thomson units. It defined an "Alaska natural gas transportation project" as "any natural gas pipeline system that carries Alaska natural gas to the border between Alaska and Canada (including related facilities subject to the jurisdiction of the Commission that is authorized" under ANGTA or under section 103 of ANPGA.

The regulations are applicable to the allocation of both initial capacity and *voluntary* expansion capacity.<sup>20</sup> The regulations do not apply to expansions ordered by the Commission under section 105 of ANPGA.<sup>21</sup> Section 105 of ANPGA authorizes FERC to order an expansion of the capacity of any Alaska natural gas transportation project (whether authorized under the ANPGA or ANGTA), upon request and after giving notice and an opportunity for hearing, if it determines that such expansion is required by the present or future public convenience and necessity.<sup>22</sup> In addition, before it can order an expansion under section 105, FERC is required to make the following findings:

- that a proposed shipper will comply with, and the proposed expansion and the expansion of service will be undertaken and implemented based on,

<sup>19</sup> Regulations Governing the Conduct of Open Seasons for Alaska Natural Gas Transportation Projects, Order No. 2005, 70 Fed. Reg. 8,269 (Feb. 18, 2005).

<sup>20</sup> 18 C.F.R. § 157.32.

<sup>21</sup> *Id.* (stating that, "[a]bsent a Commission order to the contrary," the open season regulations "are not applicable in the case of an expansion ordered by the Commission pursuant to section 105 of the Alaska Natural Gas Pipeline Act").

<sup>22</sup> 15 U.S.C. § 720c(a).

- terms and conditions consistent with the tariff of the Alaska natural gas transportation project in effect as of the date of the expansion;
- that the proposed facilities will not adversely affect the financial or economic viability of the Alaska natural gas transportation project;
- that the proposed facilities will not adversely affect the overall operations of the Alaska natural gas transportation project;
- that the proposed facilities will not diminish the contract rights of existing shippers to previously subscribed certificated capacity;
- that all necessary environmental reviews have been completed; and
- that adequate downstream facilities exist or are expected to exist to deliver incremental Alaska natural gas to market.<sup>23</sup>

Provided that it makes the required determinations and findings, and orders the requested expansion, the Commission must then approve or establish rates for the expansion service that are designed to ensure the recovery, on an incremental or rolled-in basis, of the cost associated with the expansion (including a reasonable rate of return on investment).<sup>24</sup> Importantly, the Commission also must ensure that the rates "do not require existing shippers on the Alaska natural gas transportation project to subsidize expansion shippers."<sup>25</sup> Thus, although the statute does not prohibit the Commission from ordering rolled-in rates in connection with such "forced" expansions, it does significantly limit its ability to do so through the prohibition on subsidization. This limitation has the potential to act as a substantial impediment to new exploration and the development of Alaska's resource base.

Congress's direction to FERC to issue regulations governing the conduct of open seasons for Alaska natural gas transportation projects was a direct response to concerns raised by independent explorers that, in order for them to invest in the exploration and development of the State's gas resources, they would need to be assured fair and reasonable access to a pipeline to bring any discoveries to market. Thus, in directing FERC to issue the open seasons regulations, it required that the regulations "promote competition in the exploration, development, and production of Alaska natural gas," and "for any open season for capacity exceeding the initial capacity, provide the opportunity for the transportation of natural gas other than from the Prudhoe Bay and Point Thomson units."<sup>26</sup>

Similar concerns led the Commission to include in the open season regulations a rebuttable presumption that rates for any *voluntary* expansion of an Alaska natural gas transportation project are to be determined on a rolled-in basis.<sup>27</sup> As the Commission explained:

<sup>23</sup> 15 U.S.C. § 720c(b).

<sup>24</sup> 15 U.S.C. § 720c(b)(1).

<sup>25</sup> 15 U.S.C. § 720c(b)(2).

<sup>26</sup> 15 U.S.C. § 720a(e).

<sup>27</sup> 18 C.F.R. § 157.39. As FERC recognized in its final rulemaking, Alaska legislators and a number of independent explorers all commented that rolled-in pricing should be required for pipeline expansions. According to FERC, the State legislators contended "that incremental treatment for expansions would

Incremental pricing of expansion could put expansion shippers at a significant rate disadvantage compared with initial shippers, and accordingly could discourage exploration, development and production of Alaska natural gas. Having markedly different rates for similar service could be in conflict with one of the chief objectives of the statute, which is to encourage further exploration and development of Alaska natural gas. On the other hand, consistent with the arguments of a number of commenters, a presumption in favor of rolled-in pricing may spur investment in and development of Alaska reserves, and the ultimate delivery of that gas to the lower 48 states.<sup>28</sup>

FERC's open seasons regulations certainly do some things that, all other things being equal, could be helpful to the overall development of the project. For instance, they provide project sponsors with important flexibility to design open seasons that could help yield firm transportation contracts needed to secure the capital to develop and construct the project. In addition, they allow pre-subscriptions of reserved capacity, which may prove necessary to secure the significant capital required to develop and construct the project. And they establish the rebuttable presumption of rolled-in rate treatment for voluntary expansions. However, they are unlikely to address the concerns raised by the independent explorers and encourage the development of the State's remaining, undiscovered oil and gas resources.

#### WHY ARE FUTURE EXPANSIONS SO IMPORTANT? ISN'T 35 TRILLION CUBIC FEET ENOUGH?

Much is made of the 35 trillion cubic feet (tcf) of known reserves on the North Slope in Prudhoe Bay and Point Thomson—to which the three major Alaska North Slope producers hold most of the rights—that an Alaska natural gas pipeline project would bring to market. However, this 35 tcf is just the tip of the iceberg compared to the overall gas resource potential that ultimately could—and should—be served by the project. Federal and State geologists estimate that there are undiscovered, but technically recoverable, deposits of more than 200 additional tcf of natural gas in the North Slope basin. The development of this additional resource base is critical to the State's long-term fiscal and development interests. Because the current proved reserves will sustain the project's current design capacity for only 16 or 17 years, development of these additional resources is also important to the economics of the project.

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discriminate against expansion shippers who, merely because of the timing of their capacity needs, may pay higher rates than initial shippers." Moreover, "[i]n addition to arguing that incremental rates operate to discriminate against expansion shippers, Alaska Legislators argue that the prospect of incremental rates will also act to reduce competition and impede the development of Alaska natural gas," with the result that "the explorers and developers may be deterred from investing the large sums required to drill for Alaska natural gas . . ." 70 Fed. Reg. at 8,283.

<sup>28</sup> 70 Fed. Reg. at 8,284. See also 70 Fed. Reg. at 35,017-18.

Such development of the State's resource base requires that explorers have the confidence that they will be able to obtain fair and reasonable access to the project, through expansions of the project on fair and reasonable terms. If explorers do not have solid assurances that they will have ready access to pipeline capacity on reasonable terms and at a reasonable price, they will not invest the tens of millions of dollars needed for exploration and development, and the State's potentially vast natural gas resources will remain undiscovered and undeveloped.

The answer to the question whether the Commission's open seasons regulations provide the necessary framework to ensure the development of Alaska's resource base is that they may, depending upon whether the project is owned, constructed, and operated by an independent pipeline company, or by the major oil and gas producers on the North Slope. It is not clear that the open season regulations themselves provide the owners of the project with adequate incentives to develop and expand the project.

It is a simple matter of fact that independent pipeline companies and integrated producer-pipeline companies act according to different sets of economic considerations. This has nothing to do with either category of companies pursuing improper motives. Rather, it derives from the profit-maximizing objectives of any corporation that is responsible to the interests of its shareholders.

Who is more likely to be motivated to provide expansions of the project as needed to accommodate new discoveries? This is something that the independent exploration companies will seriously consider when putting together their plans for development and determining whether to invest their resources in the exploration and development of unknown natural gas deposits in Alaska.

**INDEPENDENTLY-OWNED PIPELINE COMPANIES HAVE A CLEAR INCENTIVE TO MAXIMIZE THROUGHPUT THROUGH INITIAL CAPACITY DESIGN AND EXPANSIONS**

Independent, transportation-only pipeline companies are in the sole business of making money by transporting gas to market. As such, independent pipeline companies have a clear incentive to maximize throughput on their facilities by constructing pipelines large enough to accommodate all interested initial shippers and by expanding their facilities when new reserves and shipping commitments become available. For an independent pipeline company, expansions can be critically important to a project's bottom line. Thus, as a prudent project owner, an independent pipeline company generally will expand an existing project to accommodate new reserves and/or shippers, provided that, based solely upon revenues from transportation services, the expansion ensures the company a profitable rate of return. Therefore, based solely upon corporate, profit-maximizing motives, ownership of the project by an independent pipeline company will support the interests of both initial and future shippers on the pipeline, and help encourage the development of the State's resource base.

A PRODUCER-OWNED PROJECT WOULD HAVE CONFLICTING INCENTIVES, WHICH  
COULD DISFAVOR EXPANDING CAPACITY FOR COMPETING INDEPENDENT  
EXPLORERS/PRODUCERS

Integrated producer-owners, on the other hand, again based purely upon corporate, profit-maximizing motives, can be expected to operate according to a different set of economic incentives and make very different decisions. A producer that is also the owner/developer of the pipeline would be in the position of deciding whether, and if so, to what extent, it will allow other, non-affiliated explorers to gain access to its facilities to transport natural gas that will compete with its own gas for sale in the commodity markets. Allowing competing supplies into the commodity markets could affect the price that the producer can obtain for its own gas. Therefore, economic factors wholly unrelated to the economics of setting the initial pipeline capacity and providing expansions may provide a disincentive for producer-owners to maximize initial and future capacity. This is particularly the case where the rate of return on a regulated asset like the pipeline would be expected to be considerably lower than the rate of return to be obtained from the sale of the commodity.

Another reality is that producer-owners are not in the business of building transportation capacity for others. Internal corporate competition for personnel and development capital will be harder to secure in an entity more focused on exploration and production, refining, and marketing, than on expanding regulated natural gas pipelines.

To ensure development of the State's resource base, explorers must have some reasonable expectation and confidence that the pipeline will be expanded, if necessary, in order to afford them fair and reasonable access to capacity to transport any gas they might discover. With the transportation system controlled by an entity that is independent of the incumbent producers and whose primary focus is building and operating pipelines, explorers may draw some comfort from this familiar structure. If, however, the pipeline system is owned and controlled by the incumbent producers, who will not have the singularity of purpose that an independent pipeline would have, logical<sup>29</sup> such confidence must come from other sources. But where?

Absent a long, drawn out complaint process at FERC under Section 105 of ANGPA,<sup>29</sup> FERC has no independent authority under the NGA—of which I am aware—to order an expansion of the original mainline facilities.<sup>30</sup> Further, even though the 1981

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<sup>29</sup> I fully concur with the statement of counsel to the Alaska Department of Law, Robert Loeffler, that, "Based on everything else connected with this project, I would not expect an expansion proceeding at the FERC to be short, uncomplicated, and uncostly." Stranded Gas Hearings before the Alaska Legislative Budget and Audit Committee (July 28, 2004) (prepared statement of Robert H. Loeffler, Morrison & Foerster LLP, for the Alaska Department of Law, "Access Under Current Law vs. Access Under Proposed Changes to Federal Law," at 11-12).

<sup>30</sup> As counsel for the Alaska Department of Law, Robert Loeffler, testified in July 2004 before the Alaska State legislature, prior to enactment of ANGPA: "The question is whether the Alaska Gas Pipeline owners can be forced to expand the pipeline in the event they do not voluntarily agree to do so. Under current law, the short answer is no. . . . [W]hat you're dealing with is really the belief that private people are building a project and you cannot force them to put more money into a project if they don't want to."

waiver of ANGTA referenced above seemed to provide a mechanism for the Commission to condition any ownership by the incumbent producers on assuring access and expansion, this mechanism—whatever its scope—is only available if the project proceeds under ANGTA. Thus, at the Federal level, there is no obvious means to provide the degree of certainty explorers will require prior to making capital investments if an expansion is likely needed to move the production. It just does not appear satisfactory to simply say that FERC will take care of it.

Turning then to the State, and to the Stranded Gas Development Act negotiations, it is not clear whether the State's minority ownership interest in the pipeline would provide adequate assurance to explorers unless the State has negotiated governance or other super-voting rights on expansion issues. But little information has been made available on the terms of the proposed Stranded Gas Development Act deal between the State and the producers. According to public reports, however, the State seems to believe that it has adequately ensured that any required expansions of the initial capacity will occur; in part, I suppose, because of the place at the table its minority ownership of the project will provide it. Of course, whether this actually would be the case depends on the terms of the project agreements negotiated between the State and the producers.

There is a significant question, however, whether the FERC's authority to order an expansion under section 105 of ANGPA will provide adequate assurances to explorers. It is not readily apparent that a company weighing a major exploration and development budget that could take many years to yield commercially viable quantities of gas will be satisfied with the FERC complaint process. After all, that process will be lengthy, costly, and then subject to judicial review. With that uncertainty and the extensive list of findings that must be made, it is hard to imagine that large amounts of additional capital will be readily deployed in reliance upon that mechanism. And even if the explorers do meet their burden of proof for ordering expansion of the pipeline, FERC is substantially limited in its ability to order rolled-in tolls, meaning that explorers will likely have to bear the full cost of any compulsory expansion. These are significant disincentives for explorers to pursue the exploration and development of the State's natural gas resources, which simply are not as likely to come into play with an independently-owned pipeline where the predominant economic incentives favor voluntary expansion; and that is when the Commission's open season regulations for rolled-in pricing of voluntary expansions would provide a definite positive incentive for long-term, basin-wide development.

#### CONCLUSION

FERC's open access regulations can help ensure that all interested shippers are afforded not unduly discriminatory access to any available capacity. But I submit that FERC cannot, and will not, ensure that the owner or owners of the pipeline have the needed incentives to expand the pipeline in order to make additional capacity available to

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And that really is the standard under existing law." Stranded Gas Hearings before the Alaska Legislative Budget and Audit Committee (July 28, 2004) (testimony of Robert H. Loeffler, Morrison & Foerster LLP, for the Alaska Department of Law).

accommodate new supplies and thus encourage the exploration for, and development of, Alaska's potential natural gas resources. FERC's open access regulations issued pursuant to ANGPA will not significantly affect whether the original capacity will be expanded. FERC currently does not possess any statutory authority to order expansions outside of the time-consuming, expensive expansion provisions of Section 105 of ANGPA. Thus, the issue of whether the owners of the pipeline are affiliated or independent will probably have a greater impact on the extent to which the project will lead to the development of Alaska's potential natural gas reserves than will FERC's open season regulations.

UNITED STATES OF AMERICA  
BEFORE THE  
FEDERAL ENERGY REGULATORY COMMISSION

Notice of Proposed Rulemaking on Standards of  
Conduct

Docket No. RM07-1-000

**COMMENTS OF THE STATE OF ALASKA ON PROPOSED RULEMAKING**

The State of Alaska ("State") offers the following comments pursuant to the Commission's Notice of Proposed Rulemaking ("NOPR")<sup>1</sup> in the above-referenced docket, which concerns revisions to the Standards of Conduct for Transmission Providers.<sup>2</sup>

In *National Fuel Gas Supply Corp. v. FERC*, 468 F.3d 831 (D.C. Cir. 2006) ("*National Fuel*"), the court vacated and remanded Order No. 2004 insofar as it pertains to interstate natural gas pipelines. On January 9, 2007, the Commission issued an interim rule to repromulgate temporarily the standards of conduct not challenged before the court.<sup>3</sup> On January 18, 2007, the Commission issued this NOPR, which proposes permanent regulations regarding the standards of conduct.

For the reasons set forth below, the State asks the Commission in its final rule to (i) make the standards of conduct for an interstate Alaska North Slope gas pipeline or pipelines applicable

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<sup>1</sup> *Notice of Proposed Rulemaking*, 118 FERC ¶ 61,031 (2007).

<sup>2</sup> *Standards of Conduct for Transmission Providers*, Order No. 2004, III FERC Stats. & Regs., Regulations Preambles ¶ 31,155 (2003), *order on reh'g*, Order No. 2004-A, III FERC Stats. & Regs. ¶ 31,161 (2004), 107 FERC ¶ 61,032 (2004), *order on reh'g*, Order No. 2004-B, III FERC Stats. & Regs. ¶ 31,166 (2004), 108 FERC ¶ 61,118 (2004), *order on reh'g*, Order No. 2004-C, 109 FERC ¶ 61,325 (2004) ("Order No. 2004").

<sup>3</sup> Order No. 690, Docket No. RM07-6-000, January 9, 2007.

to that pipeline's relationship with both Marketing Affiliates and Energy Affiliates, and (ii) confirm that Order Nos. 2005 and 2005-A<sup>4</sup> are unaffected by the decision in *National Fuel* to the extent they incorporate elements of Order No. 2004.

#### The Promise of Alaska Natural Gas

Before discussing some of the specifics of the NOPR, the State wants to emphasize, as it has done in other proceedings before the Commission, the vast potential of Alaska natural gas resources to help meet this nation's energy needs. The Prudhoe Bay and Point Thomson fields on the Alaska North Slope, for example, contain 35 Tcf of confirmed gas reserves.<sup>5</sup> With reasonable deliverability assumptions, these fields alone could sustain approximately 4.3 Bcf/day of pipeline throughput for approximately 15-20 years. These resources, however, are only the tip of the iceberg with respect to future gas development in Alaska. Geological information available to the State suggests a mean estimate of conventional, technically recoverable North Slope and offshore arctic gas that exceeds 225 Tcf. The National Petroleum Reserve, the Foothills of the Brooks Range, the central North Slope, and ANWR all have promising natural gas futures. In short, Alaska natural gas is poised to make a huge contribution to help reduce the nation's dependence on foreign sources of oil and gas.

A pipeline, however, must be built to realize the promise of these gas resources. Despite private, federal, and state activity for nearly four decades beginning in 1973, and intense activity during the past three years, there is no pipeline but only a set of proposals to build one. Over the

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<sup>4</sup> *Regulations Governing the Conduct of Open Seasons for Alaska Natural Gas Transportation Projects*, Order No. 2005, 110 FERC ¶ 61,095 (2005), *order on reh'g*, Order No. 2005-A, 111 FERC ¶ 61,332 (2005).

<sup>5</sup> U.S. Energy Information Administration, Oil and Gas Supply Module, Assumption to the Annual Energy Outlook, *available at* [http://www.eia.doe.gov/oiaf/aeo/assumption/oil\\_gas.html](http://www.eia.doe.gov/oiaf/aeo/assumption/oil_gas.html).

same time period, as lower 48 fields have matured and become less productive, industry has turned to alternative sources of supply, particularly LNG imports from outside the United States. Alaska gas is available in the nation's own backyard and its development should be the first priority of the nation's energy policy.

In addition to its potential to lessen our nation's dependence on foreign hydrocarbons, Alaska's natural gas is fundamental to the State's future well being. The State owns the lands at Prudhoe Bay and Point Thomson that are leased to the developers of those gas fields. The State holds a royalty interest in production from those fields and also levies a gas production tax on production from those fields. A gas pipeline would create a new source of revenue for Alaska as oil revenues taper down. Sarah Palin, Alaska's new Governor, has set efforts to spur development of the gas line as a high priority of her administration.

#### Longstanding Concerns Over North Slope Hydrocarbon Competition

Concerns over competitive conditions on the North Slope for gas (and oil) go back to the early 1970s, shortly after oil was first discovered at Prudhoe Bay in 1968. In 1975, the Federal Power Commission ("FPC") ordered a comparative hearing to select among three potential gas projects originating on the North Slope. In 1976, as the hearing was underway, Congress passed the Alaska Natural Gas Transportation Act ("ANGTA") to expedite and elevate the normal FPC administrative and federal court appellate procedures required for the necessary government authorizations of an Alaska gas transportation system. *Alaska Natural Gas Transportation Act of 1976*, Pub. L. No. 94-586, 90 Stat. 2903 (1976). The ANGTA established a framework for presidential selection of the best delivery system after the comparative hearings before the FPC.

In September 1977, President Carter, in his Decision and Report to Congress on the Alaska Natural Gas Transportation System ("ANGTS"), selected what is now known as the

Alaska Highway route and Alcan Pipeline Company, a subsidiary of Northwest Alaskan Pipeline Company, to build the Alaskan segment of the project. Foothills Pipe Lines, Ltd. was to build the Canadian portion of the ANGTS, and the Northern Border Pipeline Company and Pacific Gas Transmission were to construct the lower 48 portions.<sup>6</sup>

As required by the ANGTA, President Carter explained the rationale of his decision and imposed multiple conditions on the project. Among those conditions was a prohibition barring ANS producers and their affiliates from owning any interest in the pipeline, although they were permitted to guarantee project debt:

“The aforesaid producers of Alaska gas may not be equity members of the sponsoring consortium, having any voting power in the project, have any role in the management or operations of the project, have any continuing financial obligation in relation to debt guarantees associated with initial project financing after the project is completed and the tariff is put in effect, or impose conditions on the guarantees of project debt permitted above which may give rise to competitive abuse, including power to veto pro-competitive policies.” (Executive Office of the President – Energy Policy and Planning, 1977).

As the project sponsors and government agencies worked on the project during the ensuing five-year period, they found that several conditions imposed by the 1977 Decision required revision. As authorized by the ANGTA, President Reagan submitted eight “Waivers of Law” to Congress, and Congress enacted these by Joint Resolution in December 1981. One of these waived the prohibition of producer participation and substituted a requirement that FERC, after advice from the Attorney General, make a determination that there would be no antitrust problems from producer participation. S. Rep. No. 97-272, at 31 (1981). As the administration

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<sup>6</sup> Today, TransCanada is the successor in interest to Alcan Pipeline Company (later renamed Northwest Alaskan Pipeline Company) and Foothills Pipe Lines, Ltd. Foothills is a wholly-owned subsidiary of TransCanada.

explained at the time, a “more thorough analysis of the antitrust issues” revealed that “sufficient antitrust protection” could be achieved by addressing “access and expansion” issues at the time of issuance of the final FERC certificate. All of this effort proved academic because the proposed pipeline was not economically viable. Realistic hopes for a gas pipeline then lay dormant for some two decades.

Fast forward to 2004. In order to encourage the development of an Alaska gas pipeline once again, Congress passed the Alaska Natural Gas Pipeline Act.<sup>7</sup> It directed that in any pipeline certification proceeding, FERC should presume that “a public need exists to construct and operate the proposed Alaska natural gas transportation project.”<sup>8</sup> Addressing competitive concerns again, Congress further directed FERC to issue Alaska-specific open season regulations that, among other things, would “promote competition in the exploration, development, and production of Alaska natural gas.”<sup>9</sup>

The proposed open season regulations were subject to commentary that focused largely on competitive, level playing field issues. For example, the Department of Interior filed comments reflecting its view that North Slope competitive access abuses had in fact occurred. “Clearly, past abuses related to access to facilities have occurred for oil production on the North Slope. Companies interested in pursuing new development in northern Alaska are aware, directly or indirectly, of the past abuses by facility and pipeline owners.”<sup>10</sup> Anadarko, on its part,

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<sup>7</sup> *Alaska Natural Gas Pipeline Act*, Pub. L. No. 108-324, div. C, §§ 101-116, 118 Stat. 1220 (2004). (“ANGPA”).

<sup>8</sup> ANGPA §§ 103(b)(2)(A).

<sup>9</sup> ANGPA §§ 103(e)(2)(B). Congress also approved an unprecedented pipeline expansion provision largely, if not entirely, in response to competitive concerns. *See id.* at § 105.

<sup>10</sup> *Comments of Department of the Interior*, Docket No. RM05-1-000, December 17, 2004, at 7.

emphasized the unique circumstances in Alaska where three companies control the vast majority of the gas reserves currently available for transportation, while others are hoping to successfully explore but are concerned about gas pipeline access issues.<sup>11</sup>

Even a company as large as ChevronTexaco was quite clear that Order No. 2004 requirements were needed in the open season:

ChevronTexaco believes that since any Alaska Gas Pipeline is expected to be operated on an open access basis, the Commission should assess Standards of Conduct-like requirements. That is, before any project sponsor conducts an open season, it must meet the type of guidelines established by the Commission for interstate transporters in Order No. 2004. It is inevitable that project sponsors will need to engage in detailed discussions with potential shippers. The tension presented is the mixed role that many project sponsors may have-in that their affiliates or marketing divisions also might be potential shippers. ChevronTexaco submits that project sponsors should not be permitted to transmit non-affiliate information to affiliates or marketing divisions; rather, they should be required to keep such information confidential.<sup>12</sup>

In its final open season regulations, FERC acknowledged Congress' competitive concerns: "Indeed, the tremendous size, scope, and cost of an Alaskan pipeline, the long lead-time needed for such a project, environmental sensitivities, *and the competitive conditions that are unique to such a project warrant special consideration and oversight.*" Order No. 2005 at ¶ 9 (emphasis added). FERC further found that "there are complex, competitive conditions surrounding an Alaska natural gas transportation project, which are intensified by the generally agreed upon fact that there will be only one such pipeline for the foreseeable future." *Id.* at ¶ 10.

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<sup>11</sup> *Comments of Anadarko Petroleum Corporation*, Docket RM05-1-000, December 17, 2004 at 2.

<sup>12</sup> *Comments of ChevronTexaco Natural Gas*, Docket No. RM05-1-000, December 17, 2004, at 8.

FERC added that “we are well aware of the risks to competition imposed by a project that is owned or primarily sponsored by a small group.”<sup>13</sup> It shaped its open season regulations accordingly, and fashioned detailed provisions to mitigate competitive concerns (e.g., the open season notice provisions of § 157.34).

A few days before Order No. 2005 was issued, Chairman Wood, in a letter to the Alaska House of Representatives Minority Leader Berkowitz, addressed some of the competitive concerns Mr. Berkowitz had raised in an earlier letter about a pipeline owned by the three major North Slope producers. He wrote “it would be prudent to conclude that the antitrust issues which concerned Congress and the President over twenty years ago are still valid and will be addressed by our Commission in our proceedings.”<sup>14</sup> He then added that “the Commission will do everything it can to preclude antitrust abuse and promote competition in the authorization, construction, and operation of a future Alaskan natural gas pipeline.” *Id.* (emphasis added).

To ensure that the unique and complex competitive conditions surrounding the Alaska gas project were recognized even at the pre-application open season stage, Order No. 2005 incorporated, for example, relevant portions of the Commission’s previously enacted Order No. 2004 standards of conduct.<sup>15</sup> Order No. 2005 went a step further and required that a separate

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<sup>13</sup> *Id.* at 12. The Commission made similar statements in Order No. 2005-A: “a successful Alaska natural gas transportation project will have to overcome a variety of significant obstacles, including unique and complex competitive conditions ... [and] including the need in certain instances to accommodate existing Commission policy to the unique circumstances surrounding the exploration, production, development, and transportation to market of Alaska natural gas.” Order No. 2005-A at ¶ 36.

<sup>14</sup> Letter from Pat Wood to Ethan Berkowitz, January 28, 2005, at 2, *available at* <http://elibrary.ferc.gov/idmws/common/opennat.asp?fileID=10402511>.

<sup>15</sup> Order No. 2005 at ¶ 74. Under Order 2004, the standards of conduct do not apply until 30 days after FERC issues a certificate allowing the gas pipeline to begin construction. *See* Order (Footnote continues on next page.)

unit or division be created to conduct the open season and that such unit/division “will be required to function independent of the other non-regulated divisions of the project applicant as well as the project applicant’s Marketing and Energy Affiliates and subject to certain provisions of the Standards of Conduct.” Order No. 2005 at ¶ 74. While rehearing and/or clarification of various aspects of Order No. 2005 were sought, no commenter took issue with the applicability of the standards of conduct to the open season process.<sup>16</sup>

#### The Court’s Remand

In *National Fuel*, the court found Order No. 2004 to be arbitrary and capricious because it extended, without record support, the previous standards of conduct contained in Order No. 497 (which applied only to marketing affiliates) to non-marketing affiliates, *i.e.*, “Energy Affiliates” as defined in Order No. 2005. The court agreed with two dissenting FERC commissioners that “the factual record on which FERC relied was barren and did not contain a single example of abuse involving non-marketing affiliates, much less evidence of an industry-wide problem.”<sup>17</sup> The court found that Order No. 2004 had made two fundamental changes from Order No. 497: (i) it extended the standards beyond pipelines’ relationship with marketing affiliates to include non-marketing affiliates (Energy Affiliates) – processors, gatherers,

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No. 2005 at ¶ 74, n.24. By moving up the applicability date of those standards, FERC was implicitly recognizing Alaska’s unique competitive conditions.

<sup>16</sup> The dominant North Slope Producers (ExxonMobil, BP and ConocoPhillips) sought clarification that if a separate entity is created to be the project sponsor, then they need not create still another unit/division to conduct the open season. The Commission concurred that if that project sponsor functioned and operated independently from Marketing and Energy Affiliates, as well as the other divisions of the project applicant, then the creation of a further subdivision would not be necessary. Order No. 2005-A at ¶ 107-108.

<sup>17</sup> *National Fuel*, 468 F.3d at 834. *See also id.* at 841: “Indeed, Order 2004 does not include a single example of abuse by non-marketing affiliates.”

producers, local distribution companies, and traders; and (ii) it broadened the standards to cover a pipeline's relationships with an Energy Affiliate even if that Energy Affiliate did not control or hold capacity on that particular pipeline. *Id.* at 838.

The court said that FERC on remand could choose a path of developing a factual record of abuse that justified the reach of Order No. 2004, *id.* at 844, or in the absence of such factual evidence, "FERC may try to support the Standards by setting out its best case for relying *solely* on a theoretical threat of abuse." *Id.* (emphasis in original). The court expressed no view on whether a case could be made that such a theoretical threat alone would justify the reach of Order No. 2004, but cautioned FERC that its analysis of a theoretical threat would have to be thorough and careful. *Id.* at 844-45.

#### The Need for an Alaska North Slope Exception to the Expected Final Rule

Under the NOPR, the standards of conduct do not apply to any relationship between natural gas transmission providers and Energy Affiliates; they only apply to dealings with Market Affiliates. NOPR at ¶ 19. In response to *National Fuel*, FERC has chosen to take neither a path of developing a factual record of energy affiliate/pipeline abuses nor a path of developing a theoretical threat of abuse case. Nor has the Commission expressly asked the public for comments on either of those two paths. It therefore appears highly likely that the final rule will be the same as the proposed rule and encompass only Marketing Affiliates, at least insofar as gas pipelines are concerned.

What this means in a practical sense is that under the NOPR a North Slope producer selling its own gas will not be considered a Marketing Affiliate.<sup>18</sup> Hence an Alaska gas pipeline

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<sup>18</sup> See proposed § 358.3(e)(3)(i): "*Marketing* means a sale of natural gas to any person or entity by a seller that is not an interstate pipeline, except where: (i) The seller is selling gas solely from its own production....." See also proposed § 358.3(k): "Marketing Affiliate means an Affiliate  
(Footnote continues on next page.)

owned in whole or in part by the three major North Slope producers would not be prohibited under the proposed regulations from disclosing commercially valuable information to those producers. For example, the pipeline could selectively disclose pipeline constraint, curtailment, or other critical operational information to affiliates without violating the NOPR. The Commission is correct in pointing out that it has statutory powers under Sections 4 and 5 of the Natural Gas Act to prevent undue preference or undue discrimination. See NOPR at ¶ 17. However, the Commission appears to concede that statutory relief under those sections would be less readily available than would relief under Order No. 2004: "If a transmission Provider provides an undue preference or advantage in favor of an affiliate that is not covered by the standards of conduct, that undue preference *may* still be prohibited by the Natural Gas Act or Federal Power Act." NOPR at ¶ 17 (emphasis added). It stands to reason that an outright prohibition under the standards of conduct against certain dealings with an Energy Affiliate avoids the requirement, as would be necessary under Section 4 or 5, to show that those dealings rose to the level of becoming *unduly* preferential or *unduly* discriminatory.

The Commission is certainly aware that a producer-owned pipeline originating on the North Slope is a very real possibility. Three North Slope producers now own more than 90% of the 35 tcf of confirmed gas reserves, and the potential for a like percentage ownership of a pipeline for those companies must be acknowledged. Whether those three producers own all of the pipeline, a portion of the pipeline, or none of the pipeline, their control over the gas reserves that will provide the initial throughput of the pipeline will give those producers much influence over the rates, and the terms and conditions of service under which the pipeline will transport

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as that term is defined in § 358.3(b) or a unit that engages in marketing, sales or brokering activities as those terms are defined § 358.3(c)."