

2/15/11

Discussion on
Planned
Closure of
Kenai
Liquified
Natural Gas
Plant

<TARGET><BILL></BILL><SUBJECT>2-15-11 Discussion on Planned
Closure of Kenai Liquified Natural Gas
Plant</SUBJECT><COMM>HEDT27</COMM></TARGET>

EDTT Hearing on the Kenai LNG Plant Closure – List of Participants
Tuesday, Feb. 15, 10:15 AM -- CAP 124

Presenting:

Speaker of the House Mike Chenault (Video)

Rep. Kurt Olson

Tom Nelson DoL, Dep. Comm.

Dan Clark Conoco Phillips Alaska, manager of Cook Inlet assets

Janis Wilson RCA Commissioner (Telecom)

Available for Questions:

Carri Lockhart Alaska Asset Production Manager for Marathon Oil (Telecom)

Colleen Starring Enstar President (Telecom)

Curtis Thayer DCCED Dep. Comm.

Governor representative (invited)

✓ LOCAL IMPACT

✓ LABOR SUPPORT

✓ CONOCO PRESENTATION

SOUTHCENTRAL ENERGY SUPPLY

LNG Questions

LABOR

Are there positions around Kenai for these workers to fill?

Will these workers have to pack up their families and move – to Anchorage, or even out of state – to find comparable work?

CONOCO

preserve plant *warm/cold*
mothball

Plant shutdown: Explain the reasoning behind. If the problem is an inability to secure contracts with buyers in Asia Pacific, what were the terms holding those contracts up? Political resistance in Alaska to continuing exports? Possible supply problems out of Cook Inlet? Inability to secure enough supply to export?

Were contracts with others than Tokyo Electric aggressively pursued?

What is seen as the longer-term picture for gas exports out of Alaska, and how is the LNG market changing? (Shift from regional to global pricing, spot markets instead of traditional long-term contracts)

To what degree will the plant be shut down? How complex/costly/time-consuming would a re-start be? Under what scenarios could you see restarting the facility?

Does Conoco intend to sell the plant? Are there discussions with utilities about buying the plant? Turning it into an import facility?

What role did state and community support – or the lack of support – play in your decision to close this plant? Looking forward, what could have fostered a better business environment for the facility?

Where did the plant's supply come from? What options will those producers have now for their gas, especially in the summer when local demand is much lower?

Was the state there helping you on contracts?

Conoco or RCA, maybe Enstar:

Is there an expectation that producers may shut wells in without markets?

Without the additional market of LNG exports, will newcomers just getting into the Cook Inlet gas game curtail their plans?

What incentive is there for companies to keep producing gas with a much smaller market?

Will this – and if so, how – affect gas storage developments?

How many Cook Inlet gas producers are also oil producers, and could this in turn impact oil production? (Without an outlet for associated gas, can they keep producing oil? Flaring, etc., is not allowed as wasting gas)

RCA

Implications of the shut-down on deliverability in Cook Inlet

How close is Southcentral to a major problem? What is being done about it, by the producers, utilities and RCA? How can the state help?

LNG imports – Is this in our near future? What would this entail?

If you choose to go toward LNG import questions, Larry Persily is well-versed in the federal rules and so on; he said he's happy to testify via phone, and could talk about the timelines, the politics (nationally, in a broad sense) and so on. Larry is at lpersily@arcticgas.gov or cell, 351-8276. He is in Anchorage today, Juneau tomorrow, back to DC by Tuesday morning.

Rob Earl

From: William Warren [williaminkenai@webtv.net]
Sent: Tuesday, February 15, 2011 7:21 AM
To: Rob Earl
Subject: RE: Kenai LNG Plant Closure

Hello Rob
Many questions
but
will be listening with both ears.

It's hard to understand why our state
is in this terrible position.

water-water everywhere-not a drop to drink.

Big oil and government is causing a lot
pain and harm to the people of Alaska.

Why this just in time delivery or no delivery
of nat gas??

A question to Dan Clark and Carrie Lockhart would be--
Would the state be better off taking care of
our own Nat. Gas needs(building our own gas line) or can we DEPEND on
you for our Nat. Gas?

Thanks
Bill

From: Rob Earl
Sent: Monday, February 14, 2011 2:52 PM
To: William Warren
Subject: RE: Kenai LNG Plant Closure

Thanks Bill.

Any questions you would want to ask any of these people:

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Janis Wilson RCA Commissioner (Telecom)

Available for Questions:

NEWS RELEASE

Feb. 14, 2011

Contact: Rep. Bob Herron, 907-465-4942

Nikiski LNG Plant Pending Closure

Legislators plan to explore ways to blunt the economic, community and energy supply impacts of the news that ConocoPhillips and Marathon Oil Co. will be shutting down the nation's only LNG export facility.

The House Special Committee on Economic Development, Trade & Tourism, will meet at 10:15 a.m. Tuesday, February 15 in Room 124 of the Capitol Building.

"I hope this hearing answers some of the questions Alaskans have about the closure, and opens future lines of inquiry as to how the stake-holders can offset some of the adverse effects and may generate further dialogue in the Energy, Resources, and Finance Committees" said committee chairman Representative Bob Herron of Bethel.

Herron and Vice-Chair Representative Kurt Olson of Soldotna said the hearing should provide details of the closure as well as how the closure could impact the energy situation in Southcentral. The committee expects to take testimony from the Department of Labor and Workforce Development, Conoco Phillips, the Regulatory Commission of Alaska and others.

"The Nikiski LNG export plant closure will have implications throughout Alaska," Herron commented. "Not only will Kenai Peninsula residents suffer, but Southcentral Alaska faces an energy supply threat. The region I represent, the Y-K Delta, is among those rural areas exploring the possibility of importing alternatives to diesel fuel to offset our high energy costs. Does this closure reduce the number of alternatives?"

ConocoPhillips and Marathon Oil announced February 9 they will shut down operations at the Nikiski export facility after 40 years filling contracts with Japanese buyers. Approximately 60 workers may be affected. The companies plan to mothball the facility in April or May after shipping one last load of LNG to Asia-Pacific markets. They cited changing LNG markets for the shut-down.

~~"Quote from Olson about DoL for workers, and about communities"~~

The public is welcome to attend the Juneau hearing, or to watch online at <http://alaskalegislature.tv>.

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Conoco, Marathon to close gas liquefaction plant on Peninsula Murkowski and Begich speak up for a North Slope line.

By ELIZABETH BLUEMINK
ebluemink@adn.com

(02/10/11 17:53:51)

The biggest single user of Cook Inlet natural gas is shutting down, raising fresh concern about the future of Southcentral Alaska's main energy supply.

Due to deteriorating market conditions, the Nikiski liquefied natural gas plant will no longer export gas to Japan starting this spring, its owners announced Wednesday.

It's a historic milestone in Cook Inlet, if a disappointing one: The plant has exported gas to Japan for 41 years.

The plant's owners, Conoco Phillips and Marathon Oil, said Wednesday that despite being granted a new export license by the federal government, they were unable to renew new supply contracts with LNG customers in Japan.

The producers said they will now focus their efforts on supplying gas to the regional utilities that use Cook Inlet gas to heat homes and provide electricity.

"This is a disappointment for Cook Inlet," said John Sims, a spokesman for Enstar Natural Gas Co., the region's largest gas utility. Enstar was already short on its guaranteed gas supplies for this year -- the first time that has ever happened. The company is concerned that without the overseas customers, Cook Inlet producers will have less incentive to explore for new sources of gas.

Enstar is now looking at importing gas from overseas within the next few years. It's possible that some of gas that was exported to Japan will now be sold to the utilities instead, limiting the amount of gas that will have to be imported.

The mothballing of the plant also brings new sizzle to the debate over piping North Slope gas via a bullet line to Southcentral to alleviate the region's gas supply crunch.

"Whenever we shut down an export facility in Alaska knowing that we have 35 trillion cubic feet of gas 800 miles away on the North Slope, and decide that it's easier to import gas, it should be cause for concern," said House Speaker Mike Chenault, a Republican whose home district in Nikiski is directly affected by the shutdown. "This, at the least, should serve as a wake-up call to Alaskans."

Is the plant's closure a bad sign for the viability of selling North Slope gas to Asian markets? Advocates of piping the gas to Valdez, including 2010 gubernatorial candidate Bill Walker, have touted the idea of liquefying the gas there and shipping it to Asia.

At least one gas line pundit said Wednesday night that it's inappropriate to assume that Asian customers will feel the same way about the small output of the Kenai plant versus the huge possibilities of North Slope gas. The Kenai plant shipped about 21 billion cubic feet of LNG in 2009, off a peak of 64 billion cubic feet. Trillions of cubic feet of gas are available from the North

Slope.

LOST JOBS

The gas exports by Conoco and Marathon provided roughly 30 jobs on land and 30 jobs on the Tyonek platform in northern Cook Inlet. Conoco said it is working to relocate the onshore workers in new jobs. The offshore workers on the platform will not be laid off because the platform will continue to supply gas for local consumption.

"The closure of the LNG plant will leave a huge hole in Kenai's economy," said U.S. Sen. Lisa Murkowski, R-Alaska. Echoed by U.S. Sen. Mark Begich, D-Alaska, Murkowski said the closure highlights the urgent need to commercialize the North Slope's gas reserves.

Though some state politicians objected to shipping Cook Inlet gas overseas because of the looming shortages for local residents, the plant was a "virtual storage facility" for regional gas and electric utilities when their supplies were stretched thin in the dead of winter, according to Enstar.

Enstar supported the plant -- the only in the United States now authorized to export LNG overseas -- because it stimulated exploration for natural gas in Cook Inlet and it sent gas to the utilities during the peak demand days of winter, Sims said.

"It was an insurance policy we no longer have," he said.

For now, it's unclear how the plant's closure will affect local gas supplies and the prices paid by local consumers. It's possible, for example, that Conoco and Marathon could sell more gas to the region's gas and electric utilities, company officials said.

"How it will change the market, we don't know," Sims said.

A FUTURE USE?

Conoco said Wednesday that it plans to mothball the plant in April or May and preserve it for future options. Those options include converting it into an LNG import plant, so local utilities can purchase foreign gas, or using it to export gas transported via bullet line from the North Slope.

"We don't have any agreements for that but we want to keep our options open," said Conoco spokeswoman Natalie Lowman.

In the meantime, closing the export plant could put some gas wells in Northern Cook Inlet in jeopardy of never producing again due to water intrusion in the geologic formations. That could occur when less gas is produced.

"There could be some negative things that happen to the (North Cook Inlet) field. We may have to shut in some wells or choke them back. That could cause production problems. We'll try to manage that so we don't lose too many of our wells," Lowman said.

Find Elizabeth Bluemink online at adn.com/contact/ebluemink or call 257-4317.

Print Page

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Thursday, February 10, 2011

Nikiski LNG plant to close: ConocoPhillips, Marathon to cease exports, mothball facility

By Molly Dischner | *Peninsula Clarion*

Employees at the Liquefied Natural Gas plant in Nikiski were notified on Wednesday that the plant will be shutting down later this spring.

The plant is co-owned by ConocoPhillips and Marathon Oil, with ConocoPhillips operating the plant.

ConocoPhillips representative Natalie Lowman said the company employs 30 people directly, and will work on helping them get jobs within the company.

"We'll definitely work with them to find opportunities for them," she said.

In a statement, Rep. Mike Chenault, R-Nikiski, said the loss of jobs would hurt the local economy.

"I can only imagine what this is doing for the workers there and their families, and those on the platform," he said. "I've gone to school with, know and represent today some of the families affected by today's decision. The plant offered 30-plus jobs, with another 30-plus on the platform. Those were high-paying, family-supporting wages. Gone."

Lowman didn't know if those opportunities would be on the Kenai Peninsula, elsewhere in Alaska or at the company's other locations throughout America and abroad.

Alaska Sen. Mark Begich, a Democrat, said in a statement that he was disappointed to hear the news about the plant closing.

"I am glad to hear ConocoPhillips will work to ensure these employees are quickly placed in jobs elsewhere," he said.

Lowman said the decision was a gradual one, made as the company tried to negotiate its contracts for the LNG it ships to Japan. The closure will also be gradual.

"We will be ceasing actual exports effective April or May of this year," Lowman said.

The closure will be a mothballing process, so it could be used again in the future if LNG demand warranted it, she said.

Lowman said the plant received needed license extensions last year, but was not able to get a satisfactory price for their LNG. Conoco Phillips has been producing LNG to ship to Japan for more than 40 years.

The Associated Press reported that Marathon Oil's Carri Lockhart said the "business case does not support continuing exports at this time."

The company will continue to produce natural gas from the Beluga and Tyonek fields to fulfill other natural gas contracts in Alaska, but Lowman didn't know if it would be producing the same quantity of gas.

"I think that there's some risk that production will go down," she said.

Lowman said it was too early to say whether the company will have more gas to sell to locally now that none is being shipped out of state. But the closure does reinforce the need for gas storage, Lowman said. The company has not signed on as a customer for the proposed Cook Inlet Natural Gas Storage Facility in the central Kenai Peninsula area, but supports gas storage efforts throughout the state, she said.

"We're definitely aware of the others that are seeking opportunities for gas storage," she said. "We certainly support that."

While not a storage facility per se, the plant has been a backstop for Southcentral utilities when gas wells in the area did not meet the peak winter demand during cold weather. Staying warm may be trickier without that fall-back, Chenault said in a statement.

"It's a sad day for the Inlet and our outlook," he said. "The problem now comes in the winter time when cold, dark days hit Southcentral and we can't supply gas that the plant saved as a back-stop."

Conoco Phillip's Dan Clark told The Associated Press that at its peak, about 64 billion cubic feet a year was exported. But volumes have been falling. He couldn't say what the most recent volumes were but said during 2010, the company went to using one ship when it previously had been running two.

In 2010, the company went to using one ship when it previously had been running two, he said.

Chenault said the planned closure highlights the need for gas development on the Peninsula, and elsewhere in the

state.

"This, at the least, should serve as a wake-up call to Alaskans," he said.

Sen. Lisa Murkowski, a Republican, agreed.

"This announcement highlights the urgent need we face to find a way to commercialize our North Slope gas reserves and create the kind of economic growth that will keep families in Alaska," she said.

Molly Dischner can be reached at molly.dischner@peninsulaclarion.com.

adn.com

Anchorage Daily News

Print Page

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Kenai closure reminder of fragile gas market

TIM BRADNER
ECONOMY

(02/12/11 20:01:39)

The announcement last week by Conoco Phillips and Marathon Oil that they will close the Kenai natural gas liquefaction plant is another rude reminder of how fragile our petroleum economy has become.

I wasn't surprised about the decision except that I thought it would happen in 2013, when a federal LNG export license expires. But what disturbed me was that the closure now is caused partly by the inability of the companies to get the right price in the Asian LNG market for the small volumes they would ship.

There is now a lot of LNG on the world market and prices are dropping, Conoco told me.

That is profoundly disturbing because it means that one of our options for developing North Slope gas, building a pipeline to a new LNG plant in Valdez or Cook Inlet, might be closed off by changes in the market.

There's more to the decision by the companies, of course. Declining production of natural gas from Cook Inlet wells that supply the plant also weighed in.

This is just one more of a spate of disturbing developments, which include Shell's delay in being able to explore the offshore Arctic, BP's delay of its new Liberty project and Conoco's inability to get access to new oil and gas discoveries in the National Petroleum Reserve-Alaska due to a permit dispute with a federal agency.

Let's add to this list the close call we had over the possible freezeup of the trans-Alaska oil pipeline last month, when the pipeline shut down for several days.

NEW DEVELOPMENTS

Not everything in the oil patch is looking so glum, though.

Eni Oil and Gas is about to bring its new Nikaitchuq field in the Beaufort Sea into production, which will put new oil into the pipeline. Also on the Slope, Exxon Mobil continues development of the Point Thomson gas and condensate field east of Prudhoe Bay.

BP eventually will develop Liberty -- it's just a delay -- and I believe Shell and Conoco, with patience and perseverance, eventually will get access to promising areas these companies are interested in.

In Cook Inlet, new state exploration incentives are resulting in new exploration wells being drilled for gas and for a jack-up rig to be brought in to explore promising areas. And, there's a new company acquiring acreage in Cook Inlet, with plans to drill: Apache Oil and Gas.

So the game isn't over.

VALUE-ADDED INDUSTRY

Still, the early loss of the LNG plant should be a wakeup call for Alaskans because that plant, and the Kenai fertilizer plant that closed a few years ago, not only were industrial anchors of the Kenai Peninsula economy, they were shining examples of industry making value-added products from Alaska resources.

Let's reflect on this: The LNG plant and fertilizer plants were creative and innovative, and hugely successful, ventures by industry to take large gas reserves discovered in Cook Inlet in the 1960s, for which there was no market except for then-small local utilities, and make new products (fertilizer) or to put the gas into a form where it could be shipped to market (LNG).

The LNG venture was particularly daring because very long-distance international shipments of liquefied gas had never been done. The Kenai-to-Japan shipments were the world's first.

Looking for markets for their stranded gas, Phillips Petroleum (now Conoco Phillips) and Marathon Oil convinced major Japanese utilities that importing LNG from Alaska would work. The Japanese had never imported LNG, so this was a radical idea. They were attracted to the idea of using clean-burning gas for power generation rather than oil or coal.

Technology innovations were also involved. Phillips had developed a new design for manufacturing LNG, which was used for the first time in the Kenai plant. However, no LNG ships of the size and type needed existed. These had to be designed and built.

Kenai LNG was Phillips' biggest single investment at the time, and it was a gamble. It paid off, though. Once the Alaska plant set the example, other companies followed. Shell soon signed contracts to develop and sell LNG from gas fields in Brunei, in Southeast Asia, and the development of the world LNG industry followed.

Meanwhile, LNG ships have sailed regularly from Kenai to Japan from 1969 until now.

NEW OPPORTUNITIES

The history of this is worth pondering now because it shows what even relatively small companies (as Phillips and Marathon were then) can do when presented with challenges.

Today we have companies trying to figure out what to do with large North Slope gas reserves that are also stranded. There are big challenges with new competition from Lower 48 shale gas and now a flood on LNG on world markets.

Maybe the idea of building pipelines to move this gas is becoming obsolete. Perhaps we need to make something more valuable from the gas, a different kind of product.

A role for the state might be to encourage new thinking and new ideas for commercializing North Slope gas. Maybe we're too focused on old ideas.

It was a different time, but the innovation of Phillips and Marathon more than 40 years ago showed the power of new ideas.

Let's do it again.

Tim Bradner writes for an Alaska economic reporting service. He also consults for private clients and writes for business publications. His opinion column appears every month in the Anchorage Daily News.

State plans to aid workers hurt by closure of Kenai LNG plant

(02/13/11 22:17:11)

JUNEAU -- A Kenai lawmaker says the state plans to offer help to the workers and families affected by the impending closure of that community's liquefied natural gas plant.

Republican Rep. Kurt Olson says he met with the state labor commissioner and governor's office on the issue of state assistance. Olson says the preliminary plan is to offer re-employment workshops and job search services for workers and family members who want that help.

Conoco Phillips and Marathon Oil Corp. announced Wednesday that they're closing the plant after more than 40 years in operation, citing market conditions. The plant exported liquefied natural gas to Japan. A Conoco official said the closure will affect about 30 employees. Contractors also have worked at the plant, though the number has fluctuated.

-- *The Associated Press*

Bill advanced by Senate panel seeks 120-day session in '12

The Legislature would convene for a 120-day session next year under a measure advanced by a state Senate panel Thursday.

The bill, sponsored by Republican Senate President Gary Stevens, calls for the Legislature to meet for the current 90 days during odd-numbered years and for 120 days in even-numbered years.

Voters passed the 90-day structure in 2006. Stevens told the Senate State Affairs Committee it isn't working. He says it gives more power to the governor. The measure now goes to the Senate Finance Committee for consideration.

-- *The Associated Press*



STATE OF ALASKA
DEPARTMENT OF
COMMERCE
COMMUNITY AND
ECONOMIC DEVELOPMENT

Sean Parnell, Governor
Susan K. Bell, Commissioner
Robert M. Pickett, Chairman

Regulatory Commission of Alaska

February 18, 2011

The Honorable Bob Herron
House of Representatives
Alaska State Legislature
State Capitol Room 411
Juneau, Alaska 99801

Dear Representative Herron:

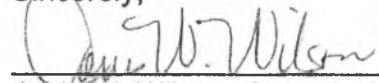
On behalf of Chairman Pickett I submit the following information for the record of the hearing of the House Special Committee on Economic Development, Trade, and Tourism held February 15, 2011, on the subject of LNG Plant Closure:

1. A document containing two schedules, one showing each Cook Inlet gas contract submitted to the Regulatory Commission of Alaska (RCA) for approval since 2000 and the second containing detailed information about each of the contested gas contract cases heard by the RCA.
2. A copy of each RCA order resolving disputed issues in a contested gas contract proceeding.
 - a. Order U-01-007(8)
 - b. Order U-03-084(7)
 - c. Order U-06-002(15)
 - d. Order U-08-58(8)

All separate statements of commissioners, appendices, and other orders and documents detailing the above proceedings are available on the RCA's website at www.rca.alaska.gov by entering the docket number (e.g., U-01-007) in the "Find a Matter" search box on the right-hand side.

Do not hesitate to call or email if you or members of the committee have questions or if we can send you further documents directly.

Sincerely,



Janis W. Wilson, Commissioner
Regulatory Commission of Alaska

RCA REVIEW OF RECENT MAJOR COOK INLET GAS SUPPLY CONTRACTS
ENTERED INTO BY ECONOMICALLY REGULATED GAS AND ELECTRIC UTILITIES

ENSTAR Natural Gas Company

Supplier	Date Contract Filed	Date of RCA Action	Processing Contract Time (Days)	Contested	RCA Action	Commission Proceeding
Phillips/Anadarko	6/15/2000	9/19/2000	96	No	Approved	TA114-4
Unocal	12/12/2000	10/25/2001	317	Yes	Approved, with modifications*	U-01-007
NorthStar Energy Group	8/08/2003	3/23/2004	228	Yes	Approved, with modifications*	U-03-084
Marathon	11/14/2005	9/28/2006	318	Yes	Not approved*	U-06-002
Marathon	4/11/2008	10/31/2008	203	Yes	Approved, with modifications*	U-08-058
ConocoPhillips	4/11/2008	10/31/2008	203	Yes	Approved, with modifications*	U-08-058
Anchor Point Energy LLC	9/21/2009	11/05/2009	45	No	Approved	TA180-4
Marathon	4/09/2010	5/24/2010	45	No	Approved	TA187-4
ConocoPhillips	8/13/2010	10/11/2010	59	No	Approved	TA193-4

*The attached page contains more detailed information about the contested contracts

Chugach Electric Association, Inc.

Supplier	Date Contract Filed	Date of RCA Action	Processing Contract Time (Days)	Contested	RCA Action	Commission Proceeding
ConocoPhillips	5/12/2009	8/21/2009	101	No	Approved	TA305-8
Marathon	4/02/2010	5/17/2010	45	No	Approved	TA316-8

Average Processing Time in Days for <i>Uncontested</i> Contracts (including 30-day public notice period)	65
Average Processing Time in Days for <i>Contested</i> Contracts (including 30-day public notice period)	254
Average Processing Time for <i>All</i> Contracts (including 30-day public notice period)	151

FURTHER INFORMATION ON CONTESTED GAS CONTRACT PROCEEDINGS
(all proceedings are ENSTAR proceedings)

Supplier and Year Filed	Parties in Proceeding	Days of Hearing	Number of Witnesses	Pages of Transcript	RCA Action
Unocal 2000 (U-01-007)	PAS, Marathon, Unocal, ENSTAR	4	7	841	RCA approved the contract <i>with modifications</i> (limiting volume to 450 Bcf, limiting third party gas to 15%, and giving ENSTAR a right of first refusal to buy non-economic gas) Unocal and ENSTAR accepted the modifications
NorthStar Energy 2003 (U-03-084)	RAPA, NorthStar, ENSTAR	3	5	591	RCA approved the contract <i>with modifications</i> (reducing floor price from \$3 to \$2.75, capping transportation rate at \$0.30 per Mcf, and limiting third party gas to 15%) NorthStar and ENSTAR accepted the modifications [no gas was ever sold under this contract]
Marathon 2006 (U-06-002)	RAPA, Tesoro, Trading Bay, Walker, Marathon ENSTAR	13	10	2619	RCA approved the contract to the extent the contract price did not exceed weighted average cost of gas from existing contracts Marathon and ENSTAR did not put the contract into effect
Marathon ConocoPhillips 2008 (U-08-058) [both contracts were considered in one proceeding]	RAPA, Chugach, HEA, Aurora Power Resources, Fairbanks Natural Gas, ENSTAR	13	11	2267	RCA approved the contract <i>with modifications</i> (ConocoPhillips contract—a floating price cap based on production basin prices) (Marathon contract—a similar floating price cap and deletion of a particular provision to the extent inconsistent with unbundling of price and volume) Modifications were not accepted

PAS was RCA Public Advocacy Section; RAPA is Regulatory Affairs and Public Advocacy Section of the Attorney General

Regulatory Commission of Alaska
701 West Eighth Avenue, Suite 300
Anchorage, Alaska 99501
(907) 276-6222; TTY (907) 276-4533

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STATE OF ALASKA
THE REGULATORY COMMISSION OF ALASKA

Before Commissioners:

G. Nanette Thompson, Chair
Bernie Smith
Patricia M. DeMarco
Will Abbott
James S. Strandberg

In the Matter of the Gas Sales Agreement)
Between ALASKA PIPELINE COMPANY, a)
Wholly-owned Subsidiary of SEMCO ENERGY,)
INC., of Which the ENSTAR NATURAL GAS)
COMPANY is a Division, and the UNION OIL)
COMPANY OF CALIFORNIA, Filed as TA117-4)

U-01-7
ORDER NO. 8

ORDER CONDITIONALLY APPROVING TA 117-4 (GAS SALES AGREEMENT) AND REQUIRING FILING

BY THE COMMISSION:

Summary

We conditionally approve a gas sales agreement (GSA) between Unocal¹ and Enstar² and require the parties to file an executed addendum to the GSA consistent with this Order.

¹Union Oil Company of California.

²Enstar Natural Gas Company is a division of SEMCO ENERGY, Inc. Alaska Pipeline Company (APL), is a wholly-owned subsidiary of SEMCO ENERGY. APL, not Enstar Natural Gas Company, is the actual party to the GSA. The Commission has historically regulated APL and Enstar as a single entity. The use of the name Enstar in this proceeding includes both APL and Enstar.

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Background

On December 12, 2000, Enstar filed a tariff advice letter (TA117-4)³ requesting approval of a new GSA between Unocal and Enstar. Enstar also requested that we approve the addition of the GSA to Section 708 of Enstar's tariff as a base supply contract and the inclusion of all costs related to the GSA in calculating Enstar's Gas Cost Adjustment. TA117-4 was publicly noticed on December 19, 2000.

We suspended TA117-4 for a period of six months⁴ to allow Enstar an opportunity to show that the GSA provisions were in the public interest, that a reasonably competitive procurement process was undertaken,⁵ and to explain the GSA's impact on long-term regional gas supply.

We received comments from the public regarding the GSA.⁶ Phillips Alaska, Inc., (Phillips) supported Enstar's desire to spur additional exploration, but expressed concern that the proposed GSA would make Unocal a gas broker because the GSA did not contain a definite term, volume or geographical limitation for Unocal's supply. Phillips stated that, for a gas explorer, uncertainty about when an opportunity to supply Enstar's unmet requirements might arise adds to the standard risks of

³The tariff advice letter was filed as TA117-4.

⁴Order U-01-7(1), dated January 18, 2001. In Order U-01-7(5) we extended the suspension for good cause to January 25, 2002.

⁵In Order U-01-7(7), dated August 9, 2001, we clarified our interest in ensuring that any contract that affected the public interest was the result of an arms-length transaction and that the ratepayers would receive a fair price. We limited our inquiry to the merits of the GSA terms, the GSA as a whole, and how it compares to other signed contracts.

⁶We received comments opposing GSA approval from, among others, Agrium; Alaska Sea Food Exports; Aurora Power Resources, Inc.; Chevron U.S.A Inc.; Marathon Oil Company and Marathon Alaska Natural Gas Company; and Phillips Alaska, Inc. We also received comments supporting GSA approval from the City of Kenai; Homer Electric Association, Inc.; Kenai Peninsula Borough; and Peak Oilfield Service Company.

3.10 10

1 exploration. Uncertainty reduces Phillips' incentive to invest in Cook Inlet exploration
2 relative to other exploration opportunities.⁷

3 Chevron U.S.A. Inc. (Chevron) stated it had significant volumes of
4 uncommitted natural gas reserves in the Beluga River Gas Field, and that it needs a
5 reasonable opportunity to secure a viable market for its Cook Inlet gas reserves.
6 Chevron said the GSA could reduce competition among producers and limit Cook Inlet
7 exploration activities. Producers will hesitate to make necessary capital investments
8 to locate and develop new reserves if they don't have a reasonable expectation of a
9 gas market. If Unocal is unsuccessful in finding new reserves during the GSA's term
10 and competitors do not explore, projected gas supply shortages will remain.⁸

11 Aurora Power Resources, Inc. (Aurora) opposed Enstar entering into a
12 "requirements" contract. Aurora stated that GSA approval would close the largest
13 potential market for natural gas through 2005 and would discourage exploration and
14 development activities in Cook Inlet. Aurora stated that the public interest would be
15 served by requiring Enstar to purchase reasonable quantities of gas from smaller
16 producers and smaller existing fields.⁹

17 Steve Toth of Alaska SeaFood Exports and six individuals opposed the
18 GSA as embodying a rate hike.¹⁰

21
22 ⁷Letter from Phillips Alaska, Inc., dated January 19, 2001.

23 ⁸*Chevron's Comments to Enstar's Tariff Advice Letter No. 117-4*, filed June 19,
2001.

24 ⁹Letter from Aurora Power, dated January 18, 2001.

25 ¹⁰Letter from Steve Toth dated January 15, 2001, and letters from M. Eaton, R.
26 Haye, C. Hickey, J. Schnell, R. Schnell, and B. Worley-Callander, dated January 18,
2001.

1 in 1995 that Enstar seek a new gas supplier.²¹ In protracted contract discussions for
2 additional gas, only a few options were available to Enstar. Enstar did contract for gas
3 from the Moquawkie field. Marathon could supply gas under various scenarios
4 including acceleration of long term gas commitments, but these scenarios did not fit
5 Enstar's strategic planning needs for future gas supplies. Little was offered in new gas
6 reserves. Enstar believed greater economic incentives were necessary to motivate
7 new drilling,²² so it agreed to move toward market prices. Enstar asserted this has
8 resulted in successfully executed gas supply agreements in 2000 with Anadarko,
9 Phillips and Unocal.²³

10 The opposing parties imply that the GSA shifts the risk for future Cook
11 Inlet gas exploration to the Enstar ratepayer. We understand that concern. However,
12 we find that Enstar has identified its future requirements and developed a credible
13 compendium of gas supply contracts to meet those requirements. While Marathon
14 and the PAS advocate disapproval of the entire GSA, we do not find cause for such
15 action. No party convincingly demonstrated a fatal flaw in any GSA condition. We are
16 satisfied that the negotiations were at arms-length, and that the GSA with the
17 modifications as more fully set forth in this Order is in the public interest.

18 As the GSA is a matter of public record we do not intend to set forth all of
19 its terms. Instead, we focus on the essential objections and issues raised by the
20 parties.
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24 ²¹Barnes prefiled testimony at 9.

25 ²²Barnes prefiled testimony at 12, 14.

26 ²³Barnes prefiled testimony at 15.

1 Price

2 The gas price Enstar pays Unocal will be determined annually by using a
3 thirty-six-month daily average of the Henry Hub²⁴ natural gas futures (HHF) and a floor
4 price of \$2.75 per thousand cubic feet (Mcf) adjusted for one-half of the inflation rate
5 after 2002.

6 The PAS argued we should not adopt a price tied to HHF because it is
7 volatile and the HHF is tied to gas prices in the eastern United States. The PAS
8 believes an HHF price results in higher prices and volatility not related to Cook Inlet
9 market conditions. The PAS also objected to the price because it includes a floor price
10 but no ceiling price. The PAS recommended a composite index of Light Sweet Crude
11 Futures and a dual index that captures the price of natural gas paid by Agrium and the
12 LNG plant for Cook Inlet gas. The PAS is also concerned that the price allows
13 arbitrage of gas from other sources.²⁵

14 Marathon argued that the price is not a fair price.²⁶ Marathon believes
15 the price reflects a price premium without a correlating firm contract volume
16 commitment to justify the premium.²⁷ Marathon states the GSA should "be tested in
17 the marketplace against actual firm volume commitments offered by other
18 producers."²⁸ Marathon argued that Enstar's commitment of its entire unmet
19
20

21 ²⁴Henry Hub is a large pipeline interconnection in Louisiana. Strickland prefiled
22 reply testimony at 52.

23 ²⁵McConnell prefiled testimony at 18-21.

24 ²⁶Marathon defines a fair price as one that reflects the obligations of the party
entitled to payment under a contract, as tested in the market. Risser prefiled
25 testimony at 26.

26 ²⁷*Id.*, at 27, 31.

²⁸*Id.*, at 30.

1 requirement to Unocal creates a disincentive for other producers to explore and
2 develop natural gas resources in Cook Inlet.²⁹

3 Unocal and Enstar characterize the GSA as an "exploration contract"
4 because the focus of the GSA is on exploration for new gas sources. Existing gas
5 fields are old and the likelihood of discovering large fields is slim.³⁰ While Unocal is
6 confident new gas will be discovered, the fields are likely to be small and the cost of
7 production and transporting the gas to market will be high.³¹

8 Exploration for new sources of gas is risky³² and investment capital in
9 Cook Inlet must compete with investment opportunities worldwide. Demands from
10 other gas users, like Marathon's LNG plant and Agrium's fertilizer plant, have not
11 created sufficient incentive for new exploration. We acknowledge that the discovery of
12 a large gas field poses a risk of depressing Cook Inlet gas prices; and that North Slope
13 gas may significantly impact the Cook Inlet area, but when it may be available is
14 speculative.

15 Exploration is needed in order to ensure an adequate supply of gas for
16 Enstar ratepayers. The risk associated with exploration must be compensated or
17 exploration will go elsewhere. While the HHF price structure is higher than previously
18 approved contracts, we weigh the risk that Enstar will not have an adequate natural
19 gas supply in the future against a higher exploration price. The HHF volatility risk is
20 mitigated by the use of a thirty-six month trailing average. Testimony disclosed that
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22 ²⁹*Id.*, at 31.

23 ³⁰Tr. at 593.

24 ³¹Tr. 637, 652-653.

25 ³²Strickland prefiled reply testimony at 28; Tr. at 622-624, 629-632.

26

1 companies would not explore for new gas without assurance that their investment
2 could be recovered.

3 The evidence persuades us that Enstar must pay a competitive price to
4 attract necessary capital and encourage exploration in Cook Inlet. The HHF price is
5 necessary to attract exploration capital. We find that a price tied to the HHF, with a
6 floor of \$2.75 is a reasonable balance of the risks associated with gas exploration and
7 the need to assure an adequate supply of gas for Enstar's ratepayers.

8 Peaking Fee

9 Any day that Unocal supplies more than its pro rata share of maximum
10 deliverability, Enstar must pay Unocal a peaking fee of \$1.00 per Mcf (in addition to
11 the price) for the excess.³³ Testimony by Unocal and Enstar estimate that peaking
12 fees will not exceed \$10,000 a year.

13 Peaking gas covers times when Enstar's shippers do not supply all the
14 gas that Enstar customers need on a particular day. The GSA allows Enstar to get the
15 needed gas from Unocal. There is a premium associated with this peaking gas
16 because of the additional costs Unocal bears to produce and deliver it. When a
17 particular shipper does not supply its committed gas to Enstar, the peaking fee will be
18 passed back to that shipper. When Enstar's swing is greater than normal (for
19 example, when Anchorage has an extremely cold temperature and the demand for gas
20 is unusually high), Enstar can go to Unocal for the extra swing gas and pay the
21 peaking fee. This peaking fee would be passed on to the ratepayer through Enstar's
22 Gas Cost Adjustment. In both cases Enstar needs the ability to get the extra gas for
23

24
25 ³³GSA 4.6 and 4.1.1.2. The fee will be adjusted each year.
26

1 its customers. Unocal considers peaking gas as a service to Enstar, not an
2 opportunity to make money.³⁴

3 The PAS views the peaking fee as a penalty assessed against Enstar
4 passed to ratepayers. The PAS suggests that Unocal should deliver peaking gas
5 without charge, subject to Enstar replacing the gas within six months.³⁵ The PAS
6 stated Enstar should be required to correctly forecast and contract for its needs. The
7 risk of an incorrect forecast should be borne by Enstar's shareholders, not by its
8 ratepayers.³⁶

9 We weigh the risk of ratepayers not having enough gas on peak days
10 against the price. The prospect of Enstar's customers not having sufficient gas
11 outweighs the price concern. Peaking gas is a safety net for Enstar.³⁷ We do not find
12 the peaking fee to be unreasonable.

13 Transportation Fees

14 Unocal has the responsibility to build all pipelines and other facilities
15 necessary to deliver gas to receipt points on Enstar's pipeline system. The price for
16 gas includes all RCA-approved tariffs for pipelines operating on the effective date of
17 the contract. Enstar will reimburse Unocal for RCA-approved tariff charges (up to
18 \$1.00 per Mcf) on pipelines constructed after the contract effective date. The parties
19 must agree to any reimbursement in excess of \$1.00 per Mcf.

20 The PAS indicates that the transportation fee provision could require
21 Enstar ratepayers to pay for the construction of Unocal's gas storage facilities, or any

22 _____
23 ³⁴Tr. 569-570.

24 ³⁵The PAS cites the APL-1 contract as an example of this type of provision.
25 McConnell prefiled testimony at 22.

26 ³⁶McConnell prefiled testimony at 22.

³⁷Tr. 570-571.

1 other unspecified service or facility that is used to transport gas to and from storage for
2 delivery to Enstar, or for a pipeline constructed to deliver gas to a third party in
3 exchange for gas delivered to Enstar. PAS states these costs are capital expenditures
4 that should be incurred by Enstar and then included in rate base.³⁸

5 If new gas is discovered, pipelines may need to be built. The cost of
6 construction and operation of pipelines are recovered in tariffed rates. The GSA new
7 pipeline transportation costs are capped at \$1.00 per Mcf.³⁹ Before these costs may
8 be passed through to ratepayers, we must approve the tariff. Therefore we have an
9 opportunity to determine if the rates are just and reasonable. We see no reason to
10 interfere with this portion of the GSA.

11 GSA Term

12 The proposed GSA does not contain a definite termination date. The
13 agreement will not terminate until Unocal has delivered all of the gas it has committed
14 to deliver. This is the equivalent of an all-requirements agreement as long as Unocal
15 can deliver Enstar's unmet requirements.

16 The PAS opposed this provision because Enstar cannot terminate the
17 GSA. The PAS supported an April 2009 termination date that coincides with the
18 Department of Energy LNG export license expiration and would allow the Commission
19 and Enstar to evaluate the availability of North Slope gas. The PAS also stated that
20 Enstar should be able to terminate the contract for good cause shown.⁴⁰

21 While an open-ended GSA may encourage exploration, it binds Enstar
22 and Enstar ratepayers indefinitely. New large gas reservoirs might be discovered.

23 ³⁸McConnell prefiled testimony at 23-24.

24 ³⁹The actual transportation rate may be less. Enstar insisted on the one-dollar
25 cap. Tr. at 573.

26 ⁴⁰McConnell prefiled testimony 27-28.

1 Gas from the North Slope may become available. Unocal testified that a volume of
2 450 Bcf created sufficient incentive to explore and recover its capital investment.⁴¹ We
3 limit the GSA term to delivery of 450 Bcf to preserve exploration incentive and give us
4 an opportunity to review whether continuation of the GSA remains in the public
5 interest.⁴²

6 Arbitrage

7 The GSA does not prevent Unocal from purchasing gas from other
8 sources at a lower price and reselling it to Enstar at the higher HHF contract price.
9 The PAS argued that Unocal should not be allowed to buy gas from other producers at
10 a lower price and sell it to Enstar at the GSA price. Marathon agreed.⁴³

11 Unocal sees the possibility of reselling lower priced gas to Enstar as an
12 unlikely scenario.⁴⁴ The Cook Inlet basin is old. Some of the fields are producing on a
13 flat or declining basis and do not have the swing capabilities to meet Enstar's needs.
14 Unocal says it should not be prevented from buying third party gas to meet Enstar's
15 unmet requirements. Unocal envisions a situation where it would take gas from flat or
16 declining fields or from a one well producer, inject it into storage and then produce it at
17 a rate that would match Enstar's needs. Through the process of injecting gas into
18 storage the value of the gas would be increased and could be used to meet Enstar's
19 needs.⁴⁵ Although Unocal believes a prohibition against purchasing third party gas
20 would strand a lot of gas that could be used by consumers, limiting its ability to sell gas
21

22 ⁴¹Tr. at 580, 595.

23 ⁴²A 2009 termination date, as suggested by the PAS, would cause an
avoidance of the contract and discourage exploration. Tr. at 581, 655.

24 ⁴³Risser prefiled testimony at 30.

25 ⁴⁴Tr. at 414, 416.

26 ⁴⁵Tr. at 416-419, 422, 565-568, 598.

1 to fifteen percent of the total annual gas volume sold would not affect its ability to
2 insure certain supply.⁴⁶

3 While we agree with Unocal that gas in declining fields should not be
4 stranded, we also understand the arbitrage concerns. We find limiting Unocal's ability
5 to sell third party gas to fifteen percent of the total annual gas volume sold is a
6 reasonable limitation to the GSA and adequately protects the ratepayer.

7 Non-economic provision

8 If Unocal forecasts and an independent engineer agrees that gas
9 production will not be economic, Unocal's obligation to produce, deliver and sell gas
10 will be suspended as long as production is not expected to be economic. However,
11 during any period that gas production is not economic, Unocal may make sales to third
12 parties at a swing rate⁴⁷ of 1.2 or less.⁴⁸

13 The PAS objects to allowing gas production to be declared non-
14 economic without our review. The PAS states that Unocal should not be free to sell
15 the non-economic gas to third parties whose swing rate is 1.2 or less and that Enstar
16 should have first priority to all such gas. The PAS also requested that we permit
17 Enstar to terminate the GSA with the same 180-day notice required of Unocal if
18 Unocal declares gas production not economic.⁴⁹

19 We understand that exploration and production of new gas at the
20 contract price may not be economic. We do not find the contract's non-economic
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22 ⁴⁶Tr. at 568.

23 ⁴⁷GSA at 8.

24 ⁴⁸GSA at 19-20.

25 ⁴⁹McConnell prefled testimony at 29.

26

1 clause to be unreasonable. However, before Unocal sells gas to third parties under
2 this provision, Enstar should have a right of first refusal to purchase the gas at a flatter
3 swing rate.⁵⁰ Accordingly, we direct the parties to modify the GSA to provide Enstar
4 with a right of first refusal before Unocal may sell non-economic gas to third parties.

5 Conclusion

6 We have reviewed the GSA and considered the evidence and testimony
7 presented. Enstar will be permitted to recover the costs of the GSA under Section 708
8 of its tariff, gas cost adjustment in accordance with the discussion. We find that the
9 GSA, with modifications as more fully set forth in this Order, is in the public interest.
10 Its purpose is to provide Enstar ratepayers with a reliable supply of reasonably priced
11 gas. While it is not certain that the exploration envisioned in the GSA will be
12 successful, it may lead to discovery of new gas reserves. The GSA also creates an
13 incentive for more than one gas producer to remain in Cook Inlet.

14 We will review whether continuation of the GSA, with modifications as
15 more fully set forth in this Order, remains in the public interest when Unocal delivers
16 450 Bcf of gas to Enstar or when the contract terminates due to Unocal's inability to
17 discover new gas reserves.

18 We do not by approval of the GSA, with modifications as more fully set
19 forth in this Order, waive any jurisdiction now or in the future. We will continue to take
20 all actions necessary or proper to fulfill our obligations and duties mandated by
21 AS 42.05.141.

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25 _____
26 ⁵⁰Unocal does not disagree. Tr. at 577.

Regulatory Commission of Alaska
701 West Eighth Avenue, Suite 300
Anchorage, Alaska 99501
(907) 276-6222; TTY (907) 276-4533

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ORDER

THE COMMISSION FURTHER ORDERS:

1. The Gas Sales Agreement between Union Oil Company of California and Alaska Pipeline Company as filed in TA117-4 is approved with modifications as more fully set forth in this Order.

2. By 4 p.m., November 14, 2001, the parties must file an executed addendum to the Gas Sales Agreement consistent with this Order. The executed addendum will limit the term of the Gas Sales Agreement to delivery of 450 Bcf, limit Unocal's ability to sell third party gas to fifteen percent of the annual gas volume sold, and provide Enstar with a first right of refusal to purchase non-economic gas before Unocal may sell non-economic gas to third parties.

DATED AND EFFECTIVE at Anchorage, Alaska, this 25th day of October 2001.

BY DIRECTION OF THE COMMISSION
(Commissioners Bernie Smith and Patricia DeMarco, not participating.)



620 193

1 STATE OF ALASKA

2 THE REGULATORY COMMISSION OF ALASKA

3 Before Commissioners:

4 Mark K. Johnson, Chair
5 Kate Giard
6 Dave Harbour
7 James S. Strandberg
8 G. Nanette Thompson

9 In the Matter of the Application by ENSTAR
10 NATURAL GAS COMPANY to Amend its
11 Natural Gas Public Utility Certificate of Public
12 Convenience and Necessity No. 4 to Include
13 Additional Areas in and Around Homer and
14 Seward

U-96-108

ORDER NO. 12

15 In the Matter of the Gas Sales Agreement
16 between ENSTAR Natural Gas Company, a
17 division of SEMCO ENERGY, INC. and
18 NORTHSTAR ENERGY GROUP, INC. filed as
19 TA125-4

U-03-84

ORDER NO. 7

20 **ORDER CONDITIONALLY APPROVING GAS SALES AGREEMENT.**
21 **INCLUSION OF COSTS OF GAS SALES AGREEMENT IN GAS COST**
22 **ADJUSTMENT. AND HOMER AREA SURCHARGE: DENYING,**
23 **WITHOUT PREJUDICE, THE REQUEST TO AMEND SERVICE AREA:**
24 **VACATING PREVIOUS FILING REQUIREMENT; AND REQUIRING**
25 **FILINGS**

26 BY THE COMMISSION:

Summary

We approve the Gas Sales Agreement (Agreement)¹ between ENSTAR² and NorthStar Energy Group, Inc. (NorthStar) on the condition that the parties execute

¹Gas Sales Agreement between NorthStar Energy Group, Inc. and ENSTAR Natural Gas Company, a Division of SEMCO Energy, Inc., executed July 31, 2003.

²ENSTAR Natural Gas Company, a division of SEMCO Energy, Inc.

1 and file an addendum to the Agreement that: (1) establishes a floor price of \$2.75; (2)
2 modifies the transportation rate to include a cap of \$.30 per thousand cubic feet (Mcf);
3 and (3) limits arbitrage to not more than 15 percent of the total volume of gas sold under
4 the Agreement. We find that the Agreement, as submitted for our approval, is not in the
5 public interest and require modifications to the Agreement that resolve our public
6 interest concerns. We approve 1) the inclusion of the Agreement with the addendum in
7 Section 708 of ENSTAR's tariff; 2) the inclusion of all costs related to the Agreement in
8 ENSTAR's Gas Cost Adjustment (GCA); and 3) a line extension surcharge for the
9 Anchor Point to Homer pipeline extension, subject to filing and approval of the
10 addendum. We deny ENSTAR's request for an additional amendment to its service
11 area. We also vacate Ordering Paragraph No. 2 of Order U-96-108(11).³

12 Background

13 Exploration in the area to the north of Homer has shown promise of
14 yielding an adequate supply of natural gas that would make feasible a natural gas utility
15 service in Homer. ENSTAR and others before have worked to bring gas supply to the
16 City of Homer for the last twenty years to no avail.⁴

17 ENSTAR and NorthStar are before us with a proposed gas supply
18 agreement to exploit gas reserves in the North Fork gas field, located north of Homer,
19 and deliver this gas to Homer. This gas field is close enough to Homer to make
20

21 ³*Order Acknowledging Filings, Granting Motion for Extension of Time, Requiring*
Filings and Vacating Filing Requirements, dated August 28, 2003.

22 ⁴The record shows there are potential alternative gas supplies to the north of
23 Homer in Happy Valley, and further north at Ninilchik. At one time, there were plans to
24 extend the Kenai Kachemak Pipeline (KKPL) to Anchor Point, but the Unocal
25 Exploration program did not reveal commercial quantities of gas. ENSTAR indicates at
26 some point in time Unocal gas may become available. However, ENSTAR considers
these as alternatives to be pursued, if NorthStar is unable to fulfill its contract terms.

1 transportation and distribution of gas to retail customers economically feasible, and the
2 volumes appear adequate to supply Homer's needs for at least twenty years.

3 There is public support for natural gas service in Homer. ENSTAR
4 surveyed 70 potential small and large commercial customers and 216 potential
5 residential customers, and both groups indicated strong support for natural gas service
6 in the Homer area. (T-3, p. 10.) Thomas Clark, a member of the public, testified during
7 the hearing in support of gas service for the Lower Kenai Peninsula, and particularly for
8 Anchor Point, where he lives.⁵ Mr. Clark asserted that natural gas is a foundational
9 mechanism for community growth. (Tr. 77.)

10 ENSTAR was granted a Certificate of Public Convenience and Necessity
11 (Certificate), subject to certain conditions, to serve Homer, Alaska, on November 3,
12 1997.⁶ The primary condition of certification was that ENSTAR provide natural gas
13 service to Homer by December 31, 2000. (T-1, p. 3.) At ENSTAR's request, that
14 deadline was extended to December 31, 2002,⁷ and then to March 31, 2003.⁸ On
15 April 1, 2003, ENSTAR requested an additional extension until August 31, 2003, which
16 we granted.⁹ We also granted ENSTAR's most recent request to extend the deadline to
17 January 2, 2004.¹⁰

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21 ⁵Mr. Clark is also vice chair of the Kenai Peninsula Borough Planning
Commission.

22 ⁶Order U-96-108(6)/U-96-109(6), dated November 3, 1997.

23 ⁷Order U-96-108(8), dated April 16, 2001.

24 ⁸Order U-96-108(9), dated December 26, 2002.

25 ⁹Order U-96-108(10), dated April 28, 2003.

26 ¹⁰See n. 2.

1 On August 8, 2003, ENSTAR filed a tariff revision, designated as
2 TA125-4, which included the Agreement between ENSTAR and NorthStar. ENSTAR
3 requested that we:

4 1) approve the Agreement between ENSTAR and NorthStar, which will
5 provide a 20-year gas supply for Homer;

6 2) approve the addition of the Agreement to Section 708 of ENSTAR's
7 tariff as a base supply contract;

8 3) include all costs related to the Agreement in ENSTAR's GCA; and

9 3) approve a line extension surcharge for Homer.

10 We suspended TA125-4 for investigation and scheduled a hearing.¹¹ The
11 hearing was held on January 13, 14, and 15, 2004. ENSTAR presented the testimony
12 of Dan Dieckgraeff, Manager, Finance and Rates, and Treasurer of ENSTAR; and Dr.
13 Bruce Fairchild, consultant. NorthStar presented the testimony of Stephen J. Easley,
14 Vice President for Corporate Development and External Affairs. The Attorney General
15 (AG) presented the testimony of Dr. Arlon R. Tussing, consultant.

16 The Agreement provides that NorthStar will supply, and ENSTAR will
17 purchase, all of the gas required to serve Homer for twenty years from the date of first
18 delivery. (T-1, p. 5; T-6, p. 11.) The Agreement requires NorthStar to use the gas well
19 at North Fork drilled in 1965, and to drill at least one additional well. (T-1, pp. 4-5;
20 T-6, p. 8.) NorthStar must also prove up its gas reserves and establish, according to an
21 independent petroleum engineer, that its leases constitute a commercial quality gas
22 field. (T-1, p. 5.)

23 NorthStar proposes to construct a pipeline to transport gas from its leases
24 to Anchor Point. (T-1, p. 5; T-6, p. 12.) ENSTAR will then construct a pipeline

25 _____
26 ¹¹Order U-03-84(2), dated October 31, 2003.

1 extension from Anchor Point to Homer and install local gas distribution facilities in
2 Homer. (T-1, p. 5.) The local distribution facilities would be a part of ENSTAR's
3 system-wide rate base. (T-1, p. 12.) Initially, these pipelines will not be interconnected
4 with the existing gas pipeline network on the Kenai Peninsula. (T-1, p. 5.) However,
5 NorthStar hopes to find sufficient gas reserves to exceed the gas volumes necessary to
6 meet ENSTAR's load in Homer and to interconnect with the KKPL. (T-1, p. 5.)
7 NorthStar would like to sell additional gas into the south-central market so it
8 contemplates building a pipeline to Anchor Point large enough to accommodate both
9 the gas necessary to serve ENSTAR plus additional volumes. (T-2, p. 9.) If the pipeline
10 were built just to serve ENSTAR's load, it would need to be a 4-inch line. (T-2, p. 10.)

11 NorthStar asserted that it will spend between \$8 and \$12 million for
12 expenses associated with drilling, completing, and testing wells that target new gas
13 reserves and in constructing a pipeline. (T-6, p. 12.) NorthStar asserted that it must
14 further spend in excess of \$500,000 on technical staff salaries and in excess of
15 \$500,000 in lease rentals, seismic data, and potentially, additional land acquisition
16 costs. (T-6, p. 12.)

17 Under the Agreement, the gas is priced annually using a 36-month daily
18 trailing average of the Henry Hub index of natural gas futures prices. (T-1, p. 6.) The
19 gas has a floor price of \$3.00/Mcf adjusted for half of inflation using the Gross Domestic
20 Product Implicit Price Deflator. (T-1, p. 6.)

21 ENSTAR will reimburse NorthStar for production costs and taxes, and
22 ENSTAR will pay NorthStar's approved tariff rate for transportation costs once those are
23 established. (T-1, p. 6.) The transportation costs are limited to payment for the pipeline
24 and do not include drilling and production facilities. (Tr. 101-102.)

25 The Agreement also requires NorthStar to maintain clear title to its leases,
26 demonstrate that its leases qualify as a commercial quality gas field, maintain financial

1 and operational "fitness, willingness, and ability" to perform according to ENSTAR,
2 construct necessary facilities and meet other ongoing obligations. (T-1, p. 6; T-6, p. 22.)

3 At hearing, ENSTAR requested an additional amendment to its service
4 area. (Tr. 87-88.)

5 Discussion

6 In deciding whether to approve the Agreement, we are guided by our
7 obligation to act in the public interest. Our primary concern is to ensure reliable and
8 reasonably priced utility service. We will determine whether the Agreement is fair as a
9 whole, and we make modifications to the Agreement to protect the public. We also
10 review the rate methodologies that ENSTAR has proposed to recover the costs of
11 providing gas to Homer customers.

12 Uncontested Issues

13 ENSTAR proposed the use of postage stamp rates for Homer customers
14 and a Homer specific line extension surcharge. The AG did not oppose these rate
15 methodologies.

16 We find that the rate structure proposed by ENSTAR is consistent with its
17 historical rate methodology, and reasonable. We find that permitting ENSTAR to
18 charge "postage stamp" rates and a line extension surcharge for service to Homer
19 customers is just, fair, and reasonable. We find that ENSTAR should be permitted to
20 recover the costs of the Agreement through its GCA.¹² The GCA will blend the cost of
21

22
23 ¹²ENSTAR recovers its general non-gas revenue requirement, consisting of its
24 capital accounts including depreciation and interest, under one track; while the second
25 track consists of the costs of purchased gas, or a gas cost adjustment. ENSTAR's
26 general revenue requirement is periodically reviewed in a general rate case, while the
cost of gas is flowed through to customers on a dollar-for-dollar basis.

1 NorthStar gas into ENSTAR's overall cost of gas, including the transportation charge, to
2 be borne by all ratepayers.

3 Homer ratepayers will directly bear some of the costs unique to serving
4 Homer through the imposition of a \$1.00/Mcf surcharge. The surcharge permits a
5 delayed recovery of the contribution customers must make for ENSTAR to build its line
6 extension from Anchor Point to Homer, termed CIAC.¹³ This CIAC is normally required
7 to be paid before a customer can receive service under ENSTAR's current tariff.

8 ENSTAR proposed to collect the Homer surcharge only until the total
9 actual capital costs associated with the pipeline (including construction costs, rate of
10 return, and income taxes) are recovered. (T-1, p. 11.) ENSTAR estimates that it will be
11 necessary to collect the Homer surcharge for approximately ten years. (T-4, p. 4;
12 T-1, p. 11.) In order to track recovery of the cost of the line extension, we require
13 ENSTAR to file yearly reconciliation of Homer surcharge collections. ENSTAR shall
14 append the yearly accounting to its annual report.

15 Contested Issues

16 The AG argued that the fairness and reasonableness of the Agreement
17 must be evaluated, as well as its consistency with the public interest. (T-8, p. 5.)
18 Specifically, the AG expressed concern with the gas pricing methodology, price of gas,
19 the treatment of arbitrage opportunities, and the term of the agreement and need for a
20 market-out clause.

21 Gas Pricing Methodology

22 The AG argued there were two fundamental errors of principle
23 incorporated in the Agreement and that these errors can create serious harm to the
24 ratepayers and public interest. (T-8, p. 12.) According to the AG, the first error is the

25 _____
26 ¹³CIAC = Contribution in aid of construction.

1 use of the 36-month trailing average of Henry Hub natural gas futures prices. The AG
2 argued there is no logical or economic relationship between Southern Louisiana and the
3 Cook Inlet natural gas markets.¹⁴ The AG asserted that the second error is the link
4 between Henry Hub futures prices and the purchase price computed by the Agreement.
5 (T-8, p. 14.) The AG contended that this link is unorthodox, inconsistent with the
6 customary language and practice of commerce, and is misleading. (T-8, p. 14.)

7 We do not find the use of the Henry Hub futures prices as an index
8 inconsistent with customary language and practice of commerce. ENSTAR's current
9 long-term gas supply agreements have typically included annual price adjustment
10 clauses that are tied to various price indices. These include the 3-month average for
11 Light Sweet Crude futures in addition to the Henry Hub futures.¹⁵ We recently allowed
12 use of the Henry Hub futures price as an index for the Unocal Gas Supply Contract.¹⁶

13 The AG further stated that the link greatly understates the true price of
14 North Fork gas taken into the ENSTAR system and obscures the fact that it obligates
15 ENSTAR to pay, and to pass on to its ratepayers, a cost of gas that is priced higher
16 than Henry Hub prices. (T-8, p. 14.) The AG asserted that the Henry Hub price

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18 ¹⁴The Henry Hub is a cluster of direct pipeline connections among thirteen
19 natural gas pipelines in southern Louisiana that directly connect to thirteen other
20 pipelines. (T-8, p. 12.) The dense network of pipelines results in gas prices that vary by
21 only a few cents per unit and fluctuate in close formation. (T-8, p. 13.) The twenty-six
22 pipelines that directly interconnect at Henry Hub connect with each other and with
23 hundreds of other pipelines throughout North America. Altogether, these pipelines
24 constitute a unified transport infrastructure that extends into every state except Alaska
25 and Hawaii, into all but two Canadian provinces, and into much of Mexico. (T-8, p. 13.)

26 ¹⁵Order U-03-84(1), dated September 18, 2003, at 9.

¹⁶Order U-01-7(8), dated October 25, 2001. Docket U-01-7 is titled *In the Matter of the Gas Sales Agreement Between ALASKA PIPELINE COMPANY, a Wholly-owned Subsidiary of SEMCO ENERGY, INC., of Which the ENSTAR NATURAL GAS COMPANY is a Division, and the UNION OIL COMPANY OF CALIFORNIA, Filed as TA117-4.*

1 includes both production taxes and transport charges between the wellhead and the
2 Henry Hub. Because the Agreement includes Alaska specific production taxes and
3 transportation charges as a separate item, the AG asserted the ratepayer pays twice for
4 these charges. (T-8, p. 14.)

5 We do not agree with the AG's allegation that ENSTAR will be paying for
6 transportation fees and production taxes twice. (T-8, p.14.) We are persuaded that
7 these costs are included in Henry Hub prices, but ENSTAR correctly points out that
8 Henry Hub prices are market-driven auction prices that are not cost-based, but rather
9 supply/demand driven. (Tr. 519.)

10 This Agreement was negotiated using a number of considerations that
11 likely included cost, but not exclusively cost; therefore, we will not order the Agreement
12 price to be changed to remove production taxes and transportation fees. Such a cost
13 disallowance is not appropriate for the specific circumstances surrounding this
14 Agreement.

15 Price of Gas

16 The AG argued that the Agreement was most comparable to the
17 Moquawkie contract where the producer also developed a known field for production
18 through an existing well and drilled a second well. (Tr. 137.) The pricing provision
19 under the Moquawkie contract was a flat rate of \$2.75/Mcf, adjusted for inflation.
20 (Tr. 130-131.) The Moquawkie contract was entered into approximately six months
21 before the Unocal contract, so the AG contended that it was contemporaneous with the
22 Unocal contract. (Tr. 130.)

23 Under the Unocal contract, Unocal was required to explore for gas in new
24 areas rather than develop existing gas fields. (Tr. 140.) The AG further argued that
25 Unocal had a commitment to expend a minimum amount of funds on exploration
26

1 whereas NorthStar does not. (Tr. 163-164.) Unocal actually expended \$50 million last
2 year and anticipates spending \$60 million this year. (Tr. 166.)

3 The AG argued that because the North Star gas well development
4 requirement is comparable to Moquawkie, the well head price should be \$2.75/Mcf,
5 without the Henry Hub pricing index.

6 In contrast, ENSTAR asserted the Agreement is more like the Unocal
7 contract and proposed a \$3.00/Mcf floor, and use of the Henry Hub pricing index.
8 NorthStar must drill a new well and create a redundant gas supply, and address the
9 risks associated with establishing a second commercial well where earlier drilling efforts
10 had yielded dry holes. (T-6, p. 14.)

11 We agree with ENSTAR that employing the Henry Hub pricing index, as
12 we did in the Unocal contract, is reasonable for this specific case given the risks
13 associated with development of further proven reserves. First, the Moquawkie contract
14 did not require additional drilling before gas deliveries could begin. (Tr. 155.) This is
15 clearly not the case for this Agreement. ENSTAR and NorthStar established that under
16 this Agreement, NorthStar would need to expend significant investment before it would
17 have the opportunity to sell gas.¹⁷ NorthStar must prove it has 14.5 billion cubic feet
18 (Bcf), and the present proven reserves for the North Fork field are 12.0. (T-2, p. 2.)
19 NorthStar must also drill a second "commercial quality gas field" well to provide a
20 second gas well. (T-6, pp. 12, 14.)

21 The AG's assertions of similarity to Moquawkie are not persuasive, and
22 we allow the Unocal pricing structure. However, we do not find adequate support to
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24 ¹⁷"They [NorthStar] have to spend whatever it takes to find the gas...that meets
25 the qualification." (Tr. 162.)

26 "NorthStar does not have a contract unless they are successful." (Tr. 166.)

1 allow the proposed \$3.00/Mcf floor price, which is a \$0.25/Mcf increase over the Unocal
2 floor price. NorthStar arguments of inflation, higher costs of capital and current elevated
3 costs of gas are not supported in the record. We therefore require that the contract floor
4 price be set at \$2.75/Mcf.

5 Arbitrage

6 ENSTAR asserted that a limit on arbitrage, the possibility that NorthStar
7 could purchase less expensive gas from a third party and provide it to ENSTAR at the
8 contract rate, was unnecessary. (T-2, p. 16.) ENSTAR contended this was because
9 there are no other proven gas sources for NorthStar, there is value and security in
10 NorthStar having the ability to "cover" with gas from other sources, if necessary, and the
11 opportunity for a market may cause some other producer to drill in the area.
12 (T-2, p. 16.) NorthStar stated that the potential for arbitrage was not a legitimate
13 concern because there are no producers in the Cook Inlet with extra gas to sell to
14 NorthStar. (T-6, p. 28.) NorthStar further argued that if there were such a producer, it
15 would sell its gas directly to ENSTAR. (T-6, p. 28.) Finally, NorthStar argued that there
16 would be no way to transport such gas to Homer. (T-6, pp. 29-30.) However, NorthStar
17 did not oppose a limitation on arbitrage, if we decided to impose one. (Tr. 436.)

18 We conclude that at the present time there is little opportunity for
19 NorthStar to engage in arbitrage because there are no alternate proven gas sources for
20 NorthStar other than the North Fork field. However, NorthStar has indicated an interest
21 in interconnecting with another pipeline in the future if there are gas reserves sufficient
22 to meet ENSTAR requirements to serve the Homer market as well as other customers.
23 Under these circumstances, we must be concerned with the possibility of arbitrage.

24 NorthStar did not oppose a limitation on arbitrage, so we condition our
25 approval of the Agreement to an arbitrage limitation equivalent to the one approved in
26

1 the Unocal contract; not more than 15 percent of the total gas volume sold under the
2 Agreement may come from third party sources.

3 Term & Market-Out Clause

4 The AG asserted that the 20-year term of the Agreement is not, in itself,
5 unreasonable. (T-8, p. 17.) However, the AG argued that the length of the Agreement,
6 coupled with unprecedented high prices, an unprecedented high floor price, an
7 indefinite price escalator unrelated to Alaska markets, and the total lack of downward
8 flexibility, renders the Agreement unreasonable. (T-8, p. 17.)

9 NorthStar argued that a market-out provision was inconsistent with the
10 risks inherent in a development contract. (T-7, p. 8.) NorthStar argued that before it
11 committed its resources to undertake gas development, it must be reasonably assured
12 that it has a market for the gas at a reasonable price over a long enough time period for
13 the investment to make financial sense. (T-7, p. 8.) NorthStar further argued that
14 investors and financiers must be reasonably assured that NorthStar would obtain
15 sufficient revenues over a long enough period to justify investment. (T-7, p. 8.)

16 We conclude that twenty years is a reasonable contract term. This
17 contract term ensures that there is a firm gas supply to meet the needs of the additional
18 customers to be served in Homer. We also recognize that the Homer customers will
19 have to bear the costs associated with retrofitting their current heating systems to
20 accept an alternate fuel, natural gas. A twenty-year contract also ensures that there is
21 sufficient gas for a reasonable period of pay-off for customers to recover retrofitting
22 costs. It also provides for investors to reasonably anticipate a return of and a return on
23 investment.

24 While we agree that it could be beneficial five years into this Agreement to
25 provide a means to allow ENSTAR to secure gas from another available lower-cost
26 provider, this is not appropriate under these circumstances. The AG worries that future

1 discoveries could make this Agreement a windfall for NorthStar shareholders, to the
2 detriment of ENSTAR ratepayers; however, there is nothing in the record to justify such
3 a contract modification at this time. We must deal with current information, rather than
4 speculate on the future. We therefore reject the AG's proposed market-out clause.

5 Contract Conditions

6 We conclude that the Agreement is not in the public interest as it was
7 presented. As with the Unocal contract approval, we require certain provisions to be
8 modified. First, ENSTAR did not support an increase in the floor price for gas in excess
9 of the rate we approved in the Unocal contract. The Agreement should be modified to
10 establish a \$2.75/Mcf floor price.

11 In the Moquawkie contract, we established a flat rate transportation
12 charge of \$.15/Mcf. In the Unocal contract, we approved a \$1.00/Mcf cap on any
13 transportation charges approved in a separate tariff filing. In this case, ENSTAR and
14 NorthStar also advocate establishing the transportation rate in a separate tariff. That
15 tariff filing requires our approval before it may be implemented. We conclude that the
16 NorthStar Agreement should also have a transportation rate cap. We find that a
17 \$.30/Mcf rate cap is reasonable because this pipeline is approximately one-third the
18 length of the pipeline addressed in the Unocal contract and the diameter of the pipeline
19 necessary to serve ENSTAR's projected Homer gas load is approximately one-third the
20 diameter of the KKPL pipeline.

21 We limit NorthStar's ability to sell third party gas to not more than
22 15 percent of the total gas volume sold under the Agreement. ENSTAR must file an
23 addendum to the Agreement reflecting these modifications by the deadline established
24 in this Order.

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1 Transportation Rate

2 We also determine that we will not approve transportation rates on
3 NorthStar's pipeline that are in excess of the charges necessary to support a 4-inch
4 pipeline from North Fork to Anchor Point. We will determine the actual transportation
5 rate after we have reviewed and approved NorthStar's future tariff filing on this issue
6 once NorthStar becomes a certificated public utility and becomes dependent, in part, on
7 the actual cost of the pipeline construction. The transportation rate will be recovered
8 from all ratepayers as part of ENSTAR's GCA. (Tr. 188.)

9 We understand that NorthStar hopes to find sufficient gas reserves to
10 meet ENSTAR's need and to serve third parties. As ENSTAR asserted, if NorthStar is
11 successful ". . . the vast majority of the gas going through that line may be for other
12 purposes and other people." (Tr. 185.) We find that it is not reasonable to include in
13 ENSTAR's rates transportation charges on NorthStar's pipeline in excess of those
14 necessary to support a pipeline of the length and diameter¹⁸ necessary to serve the
15 projected Homer gas load. We place NorthStar on notice that we will only approve
16 transportation charges that recover the costs of a pipeline four inches in diameter from
17 its leases to Anchor Point. With these limitations, we conclude that approval of the
18 Agreement without known transportation charges is reasonable.

19 We are interested in ensuring that any contract that affects the public
20 interest is the result of an arms-length transaction.¹⁹ Because ENSTAR's affiliate,
21 Alaska Pipeline Company, could be asked to build NorthStar's pipeline, we levy an
22 additional condition on the contract to ensure that the public interest is protected. We

23
24 ¹⁸ENSTAR has projected that it will have approximately 1,500 customers in
25 Homer after three years and that a pipeline four inches in diameter will be required.

26 ¹⁹See Order U-01-7(7), dated August 9, 2001.

1 place NorthStar on notice that its transportation tariff filing must demonstrate that a
2 valid, reasonably advertised, competitive procurement process was undertaken for the
3 construction of the NorthStar pipeline.²⁰

4 Tariff

5 ENSTAR has asked us to approve the addition of the Agreement to
6 ENSTAR's tariff, the inclusion of the costs of the Agreement in its GCA, and the addition
7 of a surcharge. We find those requests reasonable, and we grant the requested
8 approvals on the condition that ENSTAR files an addendum to the Agreement that
9 complies with this Order. We require ENSTAR to make tariff filings implementing the
10 requested approvals 90 days before gas is delivered. These tariff filings must include
11 transportation rates, and terms and conditions, subject to the conditions for inclusion of
12 Homer-specific transport costs.

13 Service Area Amendment

14 In supplemental testimony, ENSTAR proposed to revise its Homer service
15 area boundaries. (T-2, p. 24.) ENSTAR asserted that it expected to file an application²¹
16 to amend its Certificate to include the area along the KKPL so that it can provide service
17 from the KKPL to those nearby communities.

18 In reply testimony, ENSTAR proposed an additional service area
19 amendment to include some sections that were inadvertently excluded from the original
20 service area in Docket U-96-108.

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24 ²⁰ See Order U-01-7(1), dated January 18, 2001; Order U-01-7(7).

25 ²¹ ENSTAR anticipated filing the application approximately 60 days from the
26 submission of its supplemental direct testimony on October 31, 2003.

1 We deny ENSTAR's request to amend its service area. In this
2 proceeding, we are only addressing ENSTAR's proposed Agreement with NorthStar.
3 We will address ENSTAR's request to amend its service area concurrently in Dockets
4 U-96-108 and U-04-31.²²

5 Service to Homer

6 We originally approved ENSTAR's application to provide service to
7 Homer, subject to conditions, including a requirement that it begin service to Homer by
8 December 31, 2000. At ENSTAR's request, we extended that deadline several times,
9 most recently to January 2, 2004, and required it to request an extension of time to
10 provide service, if needed. ENSTAR did neither. While our decision in this case
11 warrants vacating that requirement, we remind ENSTAR that it must comply with all
12 Commission orders or seek appropriate relief. We will not issue a certificate for Homer
13 until gas service begins. We reserve the right to re-impose conditions if there are
14 significant delays.

15 This Order constitutes the final decision in this proceeding. This decision
16 is appealable within thirty days of the date of this Order in accordance with
17 AS 22.10.020(d) and the Alaska Rules of Court, Rules of Appellate Procedure, Rule
18 602(a)(2). In addition to the appellate rights afforded by the aforementioned statute, a
19 party may file a petition for reconsideration in accordance with 3 AAC 48.105. In the
20

21 _____
22 ²²On March 17, 2004, ENSTAR filed an amendment to its service area to serve
23 communities along the KKPL in Docket U-04-31. In that filing, ENSTAR asserted that
24 its Homer service area was already amended following a request presented in Docket
25 U-03-84. The proceeding in Docket U-04-31 is titled *In the Matter of an Application filed
26 by ENSTAR Natural Gas Company, a Division of SEMCO Energy, Inc., to Amend
Certificate of Public Convenience and Necessity No. 4 to Extend its Service Area to
Serve Communities along the Kenai Kachemak Pipeline (KKPL) and KKPL's Proposed
Extension, Including Kasilof and Ninilchik.*

1 event such a petition is filed, the time period for filing an appeal is then calculated in
2 accordance with Alaska Rules of Court, Rules of Appellate Procedure, Rule 602(a)(2).

3 **ORDER**

4 **THE COMMISSION FURTHER ORDERS:**

5 1. The Gas Sales Agreement between ENSTAR Natural Gas
6 Company, a division of SEMCO Energy, Inc., and NorthStar Energy Group, Inc., filed as
7 TA125-4, is approved on the condition that an addendum is filed with the modifications
8 set out in the body of this Order.

9 2. Inclusion by ENSTAR Natural Gas Company, a division of SEMCO
10 Energy, Inc., of the Gas Sales Agreement filed as TA125-4 in Section 708 of its tariff, is
11 approved on the condition that the addendum required by Ordering Paragraph No. 1 is
12 filed and approved.

13 3. Inclusion by ENSTAR Natural Gas Company, a division of SEMCO
14 Energy, Inc., of all costs of the Gas Sales Agreement filed as TA125-4 in its Gas Cost
15 Adjustment, is approved on the condition that the addendum required by Ordering
16 Paragraph No. 1 is filed and approved.

17 4. A surcharge of \$1.00 per thousand cubic feet for the Homer service
18 area is approved on the condition that the addendum required by Ordering Paragraph
19 No. 1 is filed and approved.

20 5. The request to amend the service area of ENSTAR Natural Gas
21 Company, a division of SEMCO Energy, Inc., is denied, without prejudice.

22 6. Ordering Paragraph No. 2 of Order U-96-108(11) requiring ENSTAR
23 Natural Gas Company, a division of SEMCO Energy, Inc., to commence service to
24 Homer, Alaska, or to file a motion for extension of time by January 2, 2004, is vacated.

25 7. By 4 p.m., April 23, 2004, the parties must file an executed
26 addendum to the Gas Sales Agreement consistent with this Order.

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8. By 4 p.m., March 31 of each year, ENSTAR Natural Gas Company, a division of SEMCO Energy, Inc. must file an annual reconciliation of Homer surcharge collections, as set out in the body of this Order. ENSTAR Natural Gas Company, a division of SEMCO Energy, Inc. shall append the yearly accounting to its annual report.

DATED AND EFFECTIVE at Anchorage, Alaska, this 23rd day of March, 2004.

BY DIRECTION OF THE COMMISSION
(Commissioner Kate Giard, dissenting, in part, and Commissioners Mark K. Johnson and G. Nanette Thompson, not participating.)



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STATE OF ALASKA

THE REGULATORY COMMISSION OF ALASKA

Before Commissioners:

Mark K. Johnson, Chair
Kate Giard
Dave Harbour
James S. Strandberg
G. Nanette Thompson

In the Matter of the Application by ENSTAR)
NATURAL GAS COMPANY to Amend its)
Natural Gas Public Utility Certificate of Public)
Convenience and Necessity No. 4 to Include)
Additional Areas in and Around Homer and)
Seward)

U-96-108

_____)
In the Matter of the Gas Sales Agreement)
between ENSTAR Natural Gas Company, a)
division of SEMCO ENERGY, INC. and)
NORTHSTAR ENERGY GROUP, INC. filed as)
TA125-4)

U-03-84

CERTIFICATION OF MAILING

I, Jessica Desmarais, certify as follows:

I am Administrative Clerk III in the offices of the

Regulatory Commission of Alaska, 701 West Eighth Avenue, Suite 300, Anchorage,
Alaska 99501.

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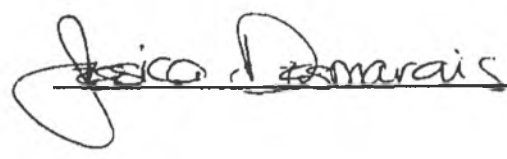
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On March 23rd, 2004, I mailed copies of
ORDER NOS. 12 and 7, respectively, entitled:

**ORDER CONDITIONALLY APPROVING GAS SALES AGREEMENT,
INCLUSION OF COSTS OF GAS SALES AGREEMENT IN GAS COST
ADJUSTMENT, AND HOMER AREA SURCHARGE: DENYING,
WITHOUT PREJUDICE. THE REQUEST TO AMEND SERVICE AREA:
VACATING PREVIOUS FILING REQUIREMENT: AND REQUIRING
FILINGS**
(Issued March 23, 2004)

in the proceeding identified above to the persons indicated on the attached service list.

DATED at Anchorage, Alaska, this 23rd day of March, 2004.



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SERVICE LIST
U96108.12/U03084.7

Page: 1 of 1
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STATE OF ALASKA

THE REGULATORY COMMISSION OF ALASKA

Before Commissioners:

Kate Giard, Chairman
Dave Harbour
Mark K. Johnson
Anthony A. Price
Janis W. Wilson

In the Matter of the Gas Sales Agreement)
Between ENSTAR NATURAL GAS COMPANY,)
A DIVISION OF SEMCO ENERGY, INC. and)
MARATHON OIL COMPANY Filed as TA139-4)

U-06-2
ORDER NO. 15

**ORDER REJECTING TA139-4 AS A BASE SUPPLY CONTRACT
HAVING THE EFFECT OF INCREASING THE CURRENT AVERAGE
COST OF SYSTEM GAS SUPPLY BUT ALLOWING TA139-4 TO TAKE
EFFECT IMMEDIATELY AS A BASE SUPPLY CONTRACT HAVING
THE EFFECT OF DECREASING THE CURRENT AVERAGE COST OF
SYSTEM GAS SUPPLY AND REQUIRING FILINGS**

BY THE COMMISSION:

Summary

We reject Tariff Advice Letter 139-4 (TA139-4) which includes the gas supply contract, APL-5, because ENSTAR¹ did not meet its burden of demonstrating that gas supplies pledged under the contract are reliable and that the price is reasonable. We allow APL-5 to go into effect without our approval to the extent that APL-5 has the effect of decreasing the current average cost of system gas supply in any

¹ENSTAR Natural Gas Company is a division of SEMCO Energy, Inc. (SEMCO). Alaska Pipeline Company (APLC) is a wholly-owned subsidiary of SEMCO. APLC, not ENSTAR Natural Gas Company, is the actual party to APL-5. The commission has historically regulated APLC and ENSTAR as a single entity. The use of the name ENSTAR in this proceeding includes both APLC and ENSTAR.

1 year of its implementation subject to ENSTAR making supplemental filings addressing
2 Section 2.7.4 of APL-5.

3 Background

4 At issue in this proceeding is TA139-4 filed November 14, 2005, in which
5 ENSTAR requested our approval of a new gas supply contract, APL-5, with Marathon
6 Oil Company (Marathon) providing for deliveries beginning in 2009.² ENSTAR operates
7 under Certificate of Public Convenience and Necessity Nos. 4 and 141 as a natural gas
8 transmission and distribution utility in Southcentral Alaska. Marathon is a current
9 ENSTAR supplier under a Gas Purchase Agreement dated May 1, 1988.³

10 ENSTAR requested that the commission approve the addition of APL-5 as
11 a base supply contract to its tariff⁴ and also requested inclusion of all costs related to
12 the contract in the calculation of ENSTAR's Gas Cost Adjustment.⁵

13 ENSTAR's tariff requires we approve any gas sales agreements that
14 increase ENSTAR's current average cost of gas. Tariff Sheet 90, Section 708f,
15 provides:

16 Base Supply Contracts.

17 The base supply contracts are those contracts in effect on September 1,
18 1987. Additional contracts or revisions of base supply contracts having the
19 effect of increasing the current average cost of system gas supply will be
20 made, subject to Commission approval, by filing with the Commission, 45
21 days prior to the proposed effective date of such addition or revision, a copy
22 of such addition or revision. Additional contracts or revisions of base supply
contracts having the effect of decreasing the current average cost of system
gas supply become effective immediately without notification.

23 ²H-1 at 1.

24 ³T-9 at 5.

25 ⁴H1-C (Tariff Sheet Nos. 89 and 221).

26 ⁵/d.

1 ENSTAR believes that a secure supply of gas that is reliably available
2 when its customers most need it is the utility's absolute top priority.⁶ ENSTAR's gas
3 supply contracts require ENSTAR to provide an annual forecast of its needs and
4 supplies for the next ten years each October⁷ in its "Buyer's Annual Forecast."⁸
5 ENSTAR calculates its annual gas requirements based on existing supplier
6 commitments and identifies any year in which there may be a supply shortfall ("Buyers
7 Unmet Requirements").⁹ Under ENSTAR's contract with Unocal,¹⁰ Unocal has the right
8 to supply any projected shortfall for five years into the future, beginning October 10,
9 2004. ENSTAR may not take gas from any third party so long as Unocal's total
10 commitment of gas brings ENSTAR's unmet requirements to zero.¹¹

11 In October 2004, ENSTAR projected unmet requirements beginning in
12 2008 and 2009.¹² Unocal was unable to commit to provide all of the additional gas
13 needed for 2009.¹³ ENSTAR notified other Cook Inlet producers of its need for new gas
14 supplies. Marathon was the only gas producer that offered to meet ENSTAR's unmet
15 requirements, including its full swing requirements, beginning in 2009 and continuing for
16 a reasonable period.¹⁴

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19 ⁶T-1 (Izzo) at 3.

20 ⁷T-7 (Dieckgraeff) at 19.

21 ⁸H-1B at 3.

22 ⁹H-1B at 4.

23 ¹⁰H-26 at 11.

24 ¹¹*Id.*

25 ¹²T-7 (Dieckgraeff) at 6.

26 ¹³*Id.*

¹⁴T-7 (Dieckgraeff) at 10.

1 ENSTAR's swing ratio is approximately 3.0, meaning its forecasted peak
2 winter demand can be three times greater than its average daily demand. Chugach¹⁵
3 and ML&P¹⁶ have swing ratios ranging from 1.4 to 1.6 because electricity usage does
4 not fluctuate as dramatically from season to season as does the demand for gas for
5 space heating purposes. The industrial plants operating on the Cook Inlet - Agrium, the
6 LNG¹⁷ plant, and the Tesoro Refinery - have virtually no swing. They consume a more
7 or less steady volume year-round.¹⁸

8 ENSTAR has elected not to develop storage to meet its deliverability
9 requirements. Rather, ENSTAR "subcontracts" this important service to its suppliers.¹⁹
10 Many gas distribution utilities in the Lower 48 use gas storage facilities to meet
11 deliverability. SEMCO, in Michigan, uses a combination of leased and company-owned
12 storage totaling 15.1 Bcf²⁰ to provide approximately 40 percent of its winter supply
13 requirements and 25 percent of its peak-day requirements.

14 ENSTAR has contractual commitments from a 1988 contract with
15 Marathon (APL-4), a 1982 contract with the Beluga producers (Chevron,
16 ConocoPhillips, and ML&P), a 2000 contract with Aurora (also called the Moquawkie
17 Contract), and a 2000 contract with Unocal.²¹

18
19
20
21 ¹⁵Chugach Electric Association, Inc. (Chugach).

22 ¹⁶Municipality of Anchorage d/b/a Municipal Light & Power (ML&P).

23 ¹⁷Liquefied natural gas (LNG).

24 ¹⁸T-1 (Izzo) at 13.

25 ¹⁹*Id.*

26 ²⁰One billion standard cubic feet (Bcf).

²¹T-7 (Dieckgraeff) at 6.

1 The committed volumes supplied by the Beluga, Moquawkie, and APL-4
 2 contracts are declining as illustrated by ENSTAR's 2005 Buyers Annual Forecast as
 3 follows.²²

EXHIBIT A

**TO THE OCTOBER 14, 2005 GAS SALES AGREEMENT BETWEEN
 MARATHON OIL COMPANY AND ALASKA PIPELINE COMPANY**

ARTICLE XIV BUYER'S ANNUAL FORECAST

	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>
Buyer's Annual Gas Requirements (Bcf)										
Total Annual Requirements	<u>26.70</u>	<u>27.50</u>	<u>28.30</u>	<u>29.0</u>	<u>29.7</u>	<u>30.30</u>	<u>31.00</u>	<u>31.60</u>	<u>32.20</u>	<u>32.70</u>
Existing Commitments:										
Beluga	1.10	0.80	0.70	0.60	0.00	0.00	0.00	0.00	0.00	0.00
Marathon APL4	13.00	11.00	9.00	7.00	5.00	5.00	5.00	5.00	5.00	5.00
Moquawkie	1.80	1.50	1.10	0.80	0.60	0.50	0.30	0.30	0.20	0.00
Unocal Commitments	<u>10.80</u>	<u>14.20</u>	<u>17.50</u>	<u>19.00</u>	<u>16.00</u>	<u>13.00</u>	<u>10.00</u>	<u>7.00</u>	<u>4.00</u>	<u>1.00</u>
Total Existing Commit.	<u>26.70</u>	<u>27.50</u>	<u>28.30</u>	<u>27.40</u>	<u>21.60</u>	<u>18.50</u>	<u>15.30</u>	<u>12.30</u>	<u>9.20</u>	<u>6.00</u>
Unocal Conditional Option	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>3.00</u>	<u>6.00</u>	<u>9.00</u>	<u>12.00</u>	<u>15.00</u>	<u>18.00</u>
Marathon APL5 Initial										
Annual Commitment	0.00	0.00	0.00	1.60	5.10	5.80	6.70	7.30	8.00	8.70
Marathon APL5 Additional	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>
Commitment										
Total Marathon Commit.	0.00	0.00	0.00	1.60	5.10	5.80	6.70	7.30	8.00	8.70
Additional Third-Party										
Commitments	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>
Unmet Requirements*	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>

16 Starting in the mid-1970s, ENSTAR's first gas supply contract (APL-I) had
 17 a portion of its price indexed on a component of the producer price index. The price
 18 adjustment term for the Marathon APL-4 contract and Beluga Contract is based on the
 19 NYMEX²³ oil futures. The price adjustment term for the Moquawkie contract is based
 20 on the Gross Domestic Product Implicit Price Deflator (GDPIPD), a national measure of
 21 inflation. In the Unocal and NorthStar²⁴ contracts, the price itself is based on a

22
 23 ²²H-1A, Ex. A at 44-46.

24 ²³New York Mercantile Exchange (NYMEX).

25 ²⁴As of the hearing date, there were no volumes committed from the NorthStar
 26 contract.

1 36-month daily average Henry Hub natural gas futures.²⁵ We have attached an
2 appendix which illustrates the differing prices of ENSTAR's gas supply contracts.

3 ENSTAR presents its new supply contract with Marathon which "should
4 insure that ENSTAR has sufficient gas to meet all of its customers' requirements
5 through at least 2016."²⁶ Marathon provides all the gas needed by ENSTAR above that
6 which comes from fixed volume contracts. APL-5 is effective October 14, 2005, with the
7 full requirements provisions effective for Contract Years 2009 through 2016.²⁷
8 Marathon makes available 62.8 BCF of Proven Reserves to meet its Initial Annual
9 Commitment.²⁸ There are limits on Marathon's rights to sell gas produced from its
10 Proven Reserves if it can not meet its obligations under APL-5.²⁹ ENSTAR will have a
11 priority on Marathon's gas delivered into the Cook Inlet area, except for Marathon's
12 existing commitments;³⁰ and any subsequent contract entered into or any existing
13 contract modified by Marathon must recognize this priority.³¹

14 The contract price (Index Price) of gas under APL-5 is set annually in
15 October for the next year beginning January 1.³² The Index Price is calculated using
16 the simple daily average price of the NYMEX Henry Hub natural gas futures market
17 during the preceding twelve months ending September 30.³³

18
19 ²⁵T-7 (Dieckgraeff) at 16.

20 ²⁶H-1 at 2.

21 ²⁷H-1A at 1.

22 ²⁸*Id.*

23 ²⁹*Id.* at 2.

24 ³⁰H-1A, Ex. E.

25 ³¹T-7 (Dieckgraeff) at 15.

26 ³²H-1A at 2.

³³*Id.* at 3.

1 The Index Price is discounted as follows to determine the Contract Price
2 (defined in Section 3.1, p. 22 of APL-5) which is subject to a Floor and a Ceiling:

3 i. If the Index Price is \$6.00 per Mcf³⁴ or less, the Contract Price equals
4 the Index Price;

5 ii. If the Index Price is greater than \$6.00 per Mcf and equal to or less
6 than \$8.00 per Mcf, the Contract Price equals \$6.00 plus 80 percent of the
7 difference between the Index Price and \$6.00;

8 iii. If the Index Price is greater than \$8.00 per Mcf and less than or equal
9 to \$10.00 per Mcf, the Contract Price is \$7.60 plus 95 percent of the
10 difference between the Index Price and \$8.00;³⁵

11 iv. If the Index Price is greater than \$10.00 per Mcf, the Contract Price is
12 \$9.50 plus 85 percent of the difference between the Index Price and
13 \$10.00;³⁶

14 APL-5 has a floor price, the minimum price Marathon will receive from
15 ENSTAR, which is set at \$4.25 adjusted annually by one-half the annual rate of inflation
16 based on the GDPIPD.³⁷

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21 ³⁴One thousand standard cubic feet (Mcf)

22 ³⁵H-1B, Section 3.1(iii) at 23.

23 ³⁶H-1A at 3.

24 ³⁷H-1B, Section 3.3 at 23-24 - The Floor Price is equal to the initial price of \$4.25
25 times one plus the floor price adjuster divided by 2. The floor price adjuster is the
26 GDPIPD for the quarter ended June 30 of the year before the price is calculated,
divided by GDPIPD for the quarter ended June 30, 2006.

1 APL-5 also has a ceiling price of \$15.00 that is adjusted annually by one-
2 half the annual rate of inflation based on the GDPIPD; however, the cap cannot change
3 by more than 1.5 percent per year.³⁸

4 APL-5 requires ENSTAR to pay Marathon \$0.25 per Mcf as a gas
5 transportation fee to ship the gas to ENSTAR's pipelines. There is also an Excess
6 Peaking gas fee of \$2.50 per Mcf for gas that Marathon provides in excess of its
7 pro rata share of ENSTAR's peak day gas requirements. Additionally, APL-5 requires
8 ENSTAR to reimburse Marathon for all production taxes on gas purchased by
9 ENSTAR.³⁹

10 We have previously decided the ENSTAR-Unocal Gas Sales Agreement
11 (Unocal GSA)⁴⁰ and the ENSTAR-NorthStar Gas Sales Agreement (NorthStar GSA).⁴¹

12 Unocal Gas Sales Agreement

13 On October 25, 2001, we issued Order U-01-7(8) conditionally approving
14 a Unocal GSA between ENSTAR and Unocal. Unocal and ENSTAR characterized the
15 Unocal GSA as an exploration contract because the focus of the contract was
16

17 ³⁸H-1B, Section 3.4 - The Ceiling Price is equal \$15.00 times one plus the ceiling
18 price adjuster divided by 2. The ceiling price adjuster is the GDPIPD for the quarter
19 ended June 30 of the Year before the Year for which the Price is calculated, divided by
20 GDPIPD for the quarter ended June 30 of the Year two years before the year the
21 Contract Price is calculated. However, the calculation of the ceiling price in any contract
22 year, the ceiling price adjuster used in such calculation will not be more than 1.0300.

23 ³⁹H-1B, Article V.

24 ⁴⁰Docket U-01-7, *In the Matter of the Gas Sales Agreement Between ALASKA*
25 *PIPELINE COMPANY, a Wholly-owned Subsidiary of SEMCO ENERGY, INC., of*
26 *Which the ENSTAR NATURAL GAS COMPANY is a Division, and the UNION OIL*
COMPANY OF CALIFORNIA, Filed as TA117-4. TA117-4 was filed December 12,
2000.

⁴¹Docket U-03-84, *In the Matter of the Gas Sales Agreement between ENSTAR*
Natural Gas Company, a division of SEMCO ENERGY INC. and NORTHSTAR
ENERGY GROUP, INC. filed as TA125-4. TA125-4 was filed August 8, 2003.

1 exploration for new gas sources.⁴² Under the contract Unocal committed to spend in
2 excess of \$10 million over two years looking for new gas fields.

3 The Unocal GSA was the first time we allowed a gas supply contract to be
4 priced to a market index, Henry Hub natural gas futures. We found that ENSTAR
5 needed to pay a competitive price to attract exploration capital and that a price tied to
6 Henry Hub with a floor of \$2.75 was a reasonable balance of the risks associated with
7 gas exploration and the need to assure an adequate supply of gas to ENSTAR.⁴³

8 Northstar Gas Sales Agreement

9 On March 23, 2004, we issued Order U-03-84(7), conditionally approving
10 a full requirements gas sales agreement between ENSTAR and Northstar to serve
11 Homer for twenty years beginning at the first delivery under the contract.⁴⁴

12 NorthStar stated it would spend between \$8 and \$12 million for expenses
13 associated with drilling, completing, and testing wells that target new gas reserves and
14 constructing a pipeline.⁴⁵ We found that the investment required of NorthStar prior to
15 the opportunity to sell gas, the requirement to prove additional reserves, and the
16 requirement to drill a second 'commercial quality gas field' well as justifications for
17 Henry Hub pricing.⁴⁶

18 Hearing Proceeding

19 We convened a hearing on APL-5. It began on July 6, 2006, and
20 continued through July 13, 2006, when it was recessed because Marathon refused to
21

22 ⁴²Order U-01-7(8) at 8.

23 ⁴³*Id.* at 9.

24 ⁴⁴Order U-03-84(7) at 4

25 ⁴⁵*Id.* at 5.

26 ⁴⁶*Id.* at 10.

1 provide discovery we ordered. ENSTAR presented the testimony of Paul R. Carpenter
2 (Carpenter); Anthony M. Izzo (Izzo); Oliver Scott Goldsmith (Goldsmith), and Daniel M.
3 Dieckgraeff (Dieckgraeff).⁴⁷

4 The hearing resumed on August 22, 2006. Intervenor James L. Walker
5 (Walker) presented testimony and was cross-examined⁴⁸. Marathon presented the
6 testimony of Bruce B. Henning (Henning) and Catherine M. Elder (Elder).⁴⁹ The
7 Attorney General (AG) presented its witness Arlon R. Tussing (Tussing).⁵⁰ Tesoro
8 presented Benjamin Schlesinger (Schlesinger).⁵¹ The final witness was C. Les Webber
9 (Webber), sponsored by Marathon, who had previously been unavailable due to
10 scheduling conflicts.⁵² On Sunday, August 27, 2006, we heard closing argument by the
11 parties.⁵³ The positions of the parties are summarized below.

12 Positions of the Parties

13 ENSTAR

14 ENSTAR requests Commission approval for the addition of APL-5 to
15 Section 708 of ENSTAR's tariff as a base supply contract and for inclusion of all costs
16 related to the contract in the calculation of ENSTAR's Gas Cost Adjustment, including
17 Henry Hub pricing.

18 ENSTAR stated that it supports using a 12-month trailing average of the
19 Henry Hub Index (Trailing HHI) because it provides 240 data points of actual

20 ⁴⁷Tr. at 118-1261.

21 ⁴⁸Tr. at 1298-1399.

22 ⁴⁹Tr. at 1399-1656.

23 ⁵⁰Tr. at 1687-2050.

24 ⁵¹Tr. at 2052-2308.

25 ⁵²Tr. at 2318-2478.

26 ⁵³Tr. at 2054-2619.

1 transactions in a highly liquid, transparent, and competitive natural gas market.
2 ENSTAR added that the Trailing HHI reflects price changes more quickly than the 36-
3 month trailing average HHI used in Unocal GSA and NorthStar GSA. ENSTAR stated
4 that a 12-month trailing average in APL-5 buffers the Unocal GSA by reflecting falling
5 prices. An additional advantage of the Trailing HHI price is that it is market-responsive,
6 thereby mitigating the risk that, over the term of the contract, the price will be higher
7 than the HHI price.⁵⁴

8 ENSTAR asserted that the Henry Hub is a dominant market reference and
9 the commission twice sent signals to the market indicating that contracts with trailing
10 averages of Henry Hub represent a fair price. ENSTAR absolutely believes APL-5 is a
11 fair market price, and that ENSTAR got this gas for less than straight Henry Hub price
12 even with a ceiling. ENSTAR asserted that Cook Inlet gas is in scare supply and that
13 APL-5 diversifies ENSTAR's supply portfolio.

14 ENSTAR maintained that the purpose of the Henry Hub price was to
15 stimulate additional exploration and development of reserves in Cook Inlet. ENSTAR
16 added that the price needs to be high enough to attract investment capital to this market
17 compared to other markets. ENSTAR stated that the Henry Hub is what the
18 Department of Energy (DOE) uses as a comparative reference. ENSTAR stated that
19 two alternatives have been proposed, one on the West Coast and one in Alberta, but
20 points out that both those markets have a lot of supply. ENSTAR added that the supply
21 and demand balance in those markets is not the same as it is in the Cook Inlet market.
22 ENSTAR hoped that, over the long haul, the Cook Inlet market would come into some
23 sort of a balance.⁵⁵

24 ⁵⁴TA139-4 at 5.

25 ⁵⁵Tr. at 671-578.

1 ENSTAR proposed the \$4.25/Mcf price floor and the ceiling being capped
2 at \$15.00/Mcf, noting that the floor and cap are adjusted annually by one-half of
3 inflation, but the cap cannot change by more than 1.5 percent from year-to-year. The
4 purpose of the cap and floor is to force the price to fall within a relatively narrow range
5 and to avoid extreme swings in price.⁵⁶

6 ENSTAR explained that the floor and the ceiling were agreed to by the
7 parties as a mutual allocation of risk.⁵⁷ ENSTAR explained that the floor and ceiling
8 price were negotiated terms, and in its opinion, not arbitrary.⁵⁸

9 APL-5 requires ENSTAR to pay a transportation fee of \$0.25/Mcf to
10 Marathon for transportation of all gas provided to ENSTAR. The transportation fee is
11 intended to cover the construction, installation, and operation of Marathon's production,
12 gathering, treating, and processing facilities; and all pipelines necessary to deliver gas
13 to ENSTAR. The alternative, according to ENSTAR, would be to pay the actual tariff for
14 each pipeline, which creates risks that arise from the new regulation of most Cook Inlet
15 gas pipelines. ENSTAR added that the use of actual tariffs is also unworkable because
16 Marathon will have two contracts with ENSTAR; and gas will be delivered
17 simultaneously under both contracts starting in 2009, so there is no way to determine
18 which gas molecules are from APL-4 or APL-5. ENSTAR does not think it wise to
19 expose its customers to these risks and proposes a fixed rate as best for its
20 ratepayers.⁵⁹

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23 ⁵⁶TA139-4 at 5, Tr. 453.

24 ⁵⁷Tr. at 229.

25 ⁵⁸Tr. at 139.

26 ⁵⁹TA139-4 at 6.

1 ENSTAR asserted that there is no limitation to the transportation fee,
2 whether a pipeline is preexisting or constructed later.⁶⁰ ENSTAR added that Marathon
3 has not indicated from where it plans to ship the gas. ENSTAR further added that it is
4 conceivable that Marathon will be shipping gas through preexisting pipelines, newly-
5 constructed pipelines, and newly-regulated pipelines.⁶¹ ENSTAR stated that Marathon
6 indicated it may ship gas over the Kenai-Nikiski Pipe Line, Cook Inlet Gas Gathering
7 System, and Beluga, which are now regulated pipelines.⁶²

8 APL-5 requires ENSTAR to pay a peaking gas fee of \$2.50/Mcf, in
9 addition to the price of the gas for all gas delivered in excess of Marathon's pro rata
10 share of ENSTAR's peak day gas requirements. According to ENSTAR, the additional
11 charge of \$2.50/Mcf (in addition to the HHI price) was necessary, if ENSTAR requests
12 and Marathon provides gas (1) in excess of Marathon's pro-rata share of what it would
13 provide on the peak day or (2) in excess of the flow rate that if sustained for 24-hours
14 would cause Marathon to supply more than its pro-rata share of the peak day
15 requirement. However, if the reason for the request for excess gas is due to an
16 inaccurate forecast by ENSTAR of its estimated peak day requirement, the incremental
17 charge of \$2.50/Mcf is not applied and the price payable is the HHI price.⁶³

18 ENSTAR stated that the peaking fee contract provision supports the
19 notion that a full requirements contract with swing has a great deal of value. ENSTAR
20 continued that providing for swing is also costly for a producer not in a position to be
21

22
23 ⁶⁰Tr. at 851.

24 ⁶¹Tr. at 852.

25 ⁶²Tr. at 853-854.

26 ⁶³TA139-4 at 6.

1 able to itself go to the spot market and pick up emergency supplies to backfill a contract.

2 ENSTAR stated that swing has value to a buyer and costs to a seller.⁶⁴

3 ENSTAR also reported awareness that Marathon provided peaking gas to
4 a third party at basically the same price as the peaking price under the Unocal contract.

5 ENSTAR stated that the price for the peaking gas in the Unocal contract price is base
6 price plus \$1.00 per Mcf. ENSTAR stated that the reason Marathon received the
7 \$2.50/Mcf peaking fee was that it was part of the overall contract negotiations.⁶⁵

8 APL-5 provides that ENSTAR will reimburse Marathon for all production
9 taxes. ENSTAR asserted that the price includes all royalties. ENSTAR added that
10 these provisions are essentially identical to the Unocal and NorthStar contracts.⁶⁶

11 ENSTAR added that the producers have insisted upon provisions for tax reimbursement
12 in all of ENSTAR's gas supply arrangements since the mid-1970s. ENSTAR stated that
13 no one needs to look further than the flurry of activity around production taxes in the
14 recent legislative session to understand why. ENSTAR added that under the current
15 statutory scheme, the provisions for oil production taxes also apply to gas production
16 taxes.⁶⁷

17 Marathon will be ENSTAR's full requirements supplier beginning in
18 contract year 2009 and ending in contract year 2016; however, Marathon may provide
19 gas into the future beyond 2018. ENSTAR added that APL-5 is a relatively short-term
20 contract compared to ENSTAR's other gas supply contracts. Further, Marathon has
21 committed to supply ENSTAR's unmet requirements through 2016 and Marathon has
22

23 ⁶⁴Tr. at 283-286.

24 ⁶⁵Tr. 1179-1180.

25 ⁶⁶TA139-4 at 7.

26 ⁶⁷T-7 at 19.

1 no right to "put" additional gas to ENSTAR unless shortfalls occur for specified reasons
2 during those years. ENSTAR added that Marathon has an option to offer additional gas
3 to ENSTAR under various circumstances; however, ENSTAR has the option to take or
4 not take the optional gas. ENSTAR asserted the contract's term balances the need for
5 an assured gas supply against the possibility that less expensive or alternative gas
6 supplies might become available from the North Slope or new Cook Inlet discoveries or
7 developments.⁶⁸

8 ENSTAR offered three reasons why APL-5 does not have a limitation on
9 the amount of gas that Marathon can purchase each year and resell. First, when gas is
10 scarce it is not desirable to make it more difficult to discover, produce, deliver, or to
11 otherwise limit the seller's alternatives to procure gas to meet ENSTAR's requirements.
12 Second, Marathon is not obligated to but may wish, in the future, to develop storage
13 facilities for meeting some of its commitments to ENSTAR. ENSTAR stated that
14 purchasing gas when it is available (typically during the summer) and putting it into
15 storage for the winter is very desirable because that maximizes the gas available for
16 ENSTAR. Third, the proposed APL-5 is relatively short-term and it would be beneficial if
17 Marathon can offer additional gas as a result of purchases. ENSTAR does not expect
18 that Marathon will purchase significant quantities of gas to meet its obligations, but
19 believes it unwise to constrain that option during the term of APL-5.⁶⁹

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⁶⁸TA139-4 at 4.

25 ⁶⁹TA139-4 at 5.

1 Marathon

2 Marathon supports APL-5 and offers its opinion that the agreement
3 satisfied the "public interest" standard adopted by the commission.⁷⁰ Marathon stated
4 that it invested significant amounts of capital to prove up and develop its gas reserves
5 so it can fully serve ENSTAR. As a result of its investment Marathon can now provide a
6 long term secure supply to ENSTAR and its customers.⁷¹ Marathon added that in the
7 contract negotiations it made significant concessions to benefit ENSTAR's customers
8 regarding the pricing of the gas and other key terms.⁷² Marathon stated that APL-5 was
9 carefully structured to satisfy the commission's public interest standard, as well as to
10 balance the needs of each of the parties and that in its opinion the public benefits from
11 approval of APL-5.⁷³ Marathon was the only gas producer that offered to meet specific
12 load-following needs of the ENSTAR customer base and is willing to also meet
13 ENSTAR's unmet requirements beginning in 2009 and for a reasonable period
14 thereafter.⁷⁴ In its role as an ENSTAR gas supplier meeting ENSTAR's considerable
15 swing and peak requirements, Marathon suggests that it will incur significantly more
16 cost than the cost of meeting the load of a customer who takes a relatively constant
17 daily volume of gas over an extended period.⁷⁵ Marathon witness Henning⁷⁶ stated this
18 contract has a very high likelihood of reducing ENSTAR's WACOG (weighted average
19

20 ⁷⁰*Comments of Marathon Oil Company* filed December 22, 2005 in TA139-4,
21 at 1.

22 ⁷¹*Id.* at 2.

23 ⁷²*Id.* at 3.

24 ⁷³*Id.* at 4.

25 ⁷⁴*Id.* at 2.

26 ⁷⁵*Id.* at 4

⁷⁶T-14 (Henning) at 24.

1 cost of gas). Marathon also stated in closing argument there was an extraordinary
2 likelihood in this record that the result of APL-5 will be a decrease to ENSTAR's
3 WACOG.⁷⁷

4 Attorney General

5 The AG noted seventeen specific concerns with APL-5 and set them out in
6 his statement of issues and early filed comments.⁷⁸ The AG's principal concern is
7 whether the price of gas under APL-5 is unjust and unreasonable such that the pricing
8 provision of APL-5 should be rejected in its entirety.⁷⁹ The AG identified three
9 subcomponents of the price inquiry including:

- 10 (a) Whether it is appropriate to use the Henry Hub index (HHI) as a
11 pricing proxy under the facts presented in APL-5;
- 12 (b) Whether APL-5's use of a twelve-month HH average would be
13 prudent given HH market volatility and the resulting potential for
14 consumer rate shock;
- 15 (c) Whether the price floor (\$4.25/Mcf) and price cap (\$15.00/Mcf) in
16 APL-5 are reasonable.

17 The AG identified other concerns including such matters as the
18 opportunity for arbitrage, peaking fees, transportation fees, and production taxes. The
19 AG asked whether storage might render suspect Marathon's claim of high cost to meet
20 deliverability and suggested that approval of one or all of the pricing provisions will
21 require a determination of whether the inclusion of such term in APL-5 meets the
22

23 ⁷⁷Tr. at 2529.

24 ⁷⁸*Attorney General's Statement of Issues*, filed June 28, 2006, and *Comments of*
25 *the Attorney General* filed in TA139-4 on December 22, 2005.

26 ⁷⁹*Comments of the Attorney General*, filed December 22, 2005, in TA139-4, at 2.

1 standard of fair, just, and reasonable.⁸⁰ The AG suggested that the APL-5 raises
2 significant public policy issues and would, if adopted, impact all of ENSTAR's captive
3 ratepayers.⁸¹

4 Intervenor Walker

5 Walker is a residential ratepayer who opposes APL-5.⁸² Walker asked
6 that the contract be rejected as the price terms are neither just nor reasonable.⁸³
7 Walker stated that the ENSTAR gas cost adjustment mechanism means ENSTAR's
8 captive ratepayers will bear all of the economic and supply risk under APL-5. ENSTAR
9 will bear no economic risk or supply risk at all if APL-5 is approved by the commission.⁸⁴
10 Walker added that public policy should encourage construction of gas storage facilities
11 to ensure the long-term provision of utility services necessary for the public convenience
12 and necessity.⁸⁵ Walker stated that the lack of gas production capability in Cook Inlet is
13 not solved by this contract.⁸⁶ Walker objected to allowing companies the opportunity to
14 take profits from Cook Inlet without requiring them to reinvest in Cook Inlet, thereby
15 ensuring a long term gas supply for Alaska consumers.⁸⁷

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18
19 ⁸⁰*Id.* at 2.

20 ⁸¹*Id.* at 3.

21 ⁸²*Comments of James L. Walker*, filed December 19, 2005, in TA139-4, at 1.

22 ⁸³*Id.* at 1.

23 ⁸⁴*Id.* at 1.

24 ⁸⁵Tr. 1384-1385 and *Comments of James L. Walker*, filed December 19, 2005, in
TA139-4 at 3.

25 ⁸⁶*Comments of James L. Walker*, filed December 19, 2005 at 1.

26 ⁸⁷*Id.* at 4

1 Intervenor Tesoro

2 Tesoro's primary concern with APL-5 is the objectionable pricing
3 mechanisms. Tesoro asserted that a price based on the 12-month trailing average of
4 Henry Hub prices is essentially a "straight Henry Hub" price and approval of straight
5 Henry Hub price will result in ENSTAR paying excessive prices for Cook Inlet natural
6 gas.⁸⁸ According to Tesoro, Cook Inlet natural gas is either used locally, used to
7 manufacture fertilizer for export along the Pacific Rim, or converted into LNG for export
8 to Japan,⁸⁹ and none of these uses is linked in any direct way to Henry Hub⁹⁰ pricing;
9 and therefore, a HHI price bears no logical relationship to the prices of Cook Inlet
10 natural gas.⁹¹ Tesoro stated that the only justification for using HHI pricing is as an
11 incentive for a commitment to explore for additional natural gas, such as in the Unocal
12 GSA.⁹² Tesoro asserted that because of the absence of an exploration obligation or
13 other undertakings on the part of Marathon, APL-5 lacks justification in support of the
14 proposed straight HHI pricing.⁹³ Tesoro is also concerned that the peaking and excess
15 volume price premiums to be paid by ENSTAR customers are excessive.⁹⁴

16 According to Tesoro, premiums for peaking gas are arguably built into the
17 HHI pricing structure, are reflective of seasonal supply and demand dynamics, and
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20 ⁸⁸ *Tesoro Alaska Company's Comments on Tariff Advice Letter 139-4 and Petition
to Intervene*, filed December 22, 2005, in TA139-4, at 3.

21 ⁸⁹ *Id.*

22 ⁹⁰ Henry Hub Index.

23 ⁹¹ *Id.*

24 ⁹² *Id.* at 5.

25 ⁹³ *Id.* at 6.

26 ⁹⁴ *Id.* at 3 and 7.

1 appear to be inappropriate as premiums above HHI pricing.⁹⁵ Tesoro said that the
2 propriety of these price adjustments for premium services should be investigated by the
3 commission.⁹⁶ Tesoro is also concerned with the ability of Marathon to resell third-party
4 natural gas to ENSTAR at a premium above its acquisition cost without any restrictions
5 or constraints.⁹⁷ According to Tesoro, APL-5 puts Marathon in the position of a gas
6 broker, providing it with the opportunity to purchase gas at lower prices from others and
7 sell that same gas to ENSTAR under APL-5.⁹⁸

8 Intervenor Trading Bay

9 Trading Bay Energy Corporation (Trading Bay) was granted intervenor
10 status in the Docket proceeding but did not participate at the hearing.⁹⁹ Trading Bay is
11 an Alaska business that has as its goal establishing an Alaska owned and operated oil
12 and gas exploration and production company.¹⁰⁰ The company complained that a
13 “[c]onsistent stick in the spokes” as it has sought to grow its business and produce oil or
14 gas, is the lack of opportunity to sell newly discovered gas into the existing
15 marketplace.¹⁰¹ Trading Bay asked that the commission take steps to require that a set

16 ⁹⁵*Id.*

17 ⁹⁶*Id.*

18 ⁹⁷*Id.* at 8.

19 ⁹⁸*Id.*

20 ⁹⁹Order U-06-2(2), *Order Granting Motion for Leave to Accept Reply Filed by*
21 *Tesoro, Denying Motion for Leave to Accept Reply Filed by Agrium, Affirming Electronic*
22 *Ruling Granting Intervention to Marathon and Denying Intervention to Agrium, Vacating*
23 *Electronic Ruling Denying Intervention to Tesoro, Granting Petitions to Intervene Filed*
24 *by Walker and Trading Bay, Rejecting Reply by Trading Bay, Affirming Bench Ruling*
25 *and Adopting Procedural Schedule, and Granting Motion to Adopt Orders Governing*
26 *Discovery and Confidential Discovery Material*, dated March 23, 2006.

¹⁰⁰*Comments by Trading Bay Energy Corporation*, filed in TA139-4 on
December 27, 2005, at 1.

¹⁰¹*Id.* at 2.

1 aside of at least 10 percent of the gas sold under APL-5 come from smaller independent
2 gas producers and that it be sold on the same terms as are enjoyed by the primary
3 seller.¹⁰² Sales by small producers to the ENSTAR market on the same terms as are
4 provided for in a primary seller contract will create economic incentive for exploration
5 and production companies to risk investment capital in gas projects in the Cook Inlet
6 Basin.¹⁰³

7 Comments by Non-parties

8 A number of interested individuals and entities commented on APL-5 after
9 issuance of our public notice. While these individuals and entities did not participate in
10 the public hearing, we consider their comments important to our review.

11 For example, C. Grey objected to the production and transportation costs
12 that would be paid to the producer.¹⁰⁴ Daniel Donkel urged broader competition and
13 asked that the RCA assure that competitors be given a fair share of the ENSTAR gas
14 market.¹⁰⁵ Gregory Micallef requested a 25 percent set aside gas market for smaller
15 producers to encourage new competition amongst major oil companies and mid sized
16 independents.¹⁰⁶ G. Scott Pfoff, the president of Aurora Gas, LLC, cited the
17 commission to two major areas of concern with regard to APL-5: (1) a potential
18 negative impact on exploration and (2) a negative impact on the Moquawkie Contract
19 that Aurora has with ENSTAR.¹⁰⁷ AARP asked that the gas pricing provision of APL-5

21 ¹⁰²*Id.* at 2.

22 ¹⁰³*Id.* at 3.

23 ¹⁰⁴E-mail from C. Gray to RCA, filed in TA139-4, December 12, 2005.

24 ¹⁰⁵Letter from D. Donkel to RCA filed in TA139-4, November 28, 2005.

25 ¹⁰⁶Letter from G. Micallef to RCA filed in TA139-4, December 23, 2005.

26 ¹⁰⁷Letter from G. Pfoff to RCA filed in TA 139-4, December 22, 2005.

1 be investigated including the appropriateness of the index to which the prices are to be
2 tied, and other price components.¹⁰⁸

3 Standard of Review

4 ENSTAR asked us to find that APL-5 is in the public interest and allow the
5 costs that ENSTAR incurs under the agreement to be recovered in ENSTAR's rates.¹⁰⁹
6 ENSTAR's focus in this proceeding was on supply. "ENSTAR's main focus is having a
7 secure supply of gas now and in the future." According to ENSTAR, that's the main
8 issue for its customers and Southcentral Alaska.¹¹⁰

9 We believe ENSTAR's position that supply is the "main issue" does not
10 give enough weight to the cost of that supply. ENSTAR ratepayers, not ENSTAR, bear
11 the cost of natural gas supplies that ENSTAR's obtains in its negotiations with the gas
12 producers.¹¹¹

13 The AG observed,

14 "[f]irst, to be consistent with the public interest, any proposed GSA must help
15 provide ENSTAR with a reliable supply of gas. And second, gas sold under
16 APL-5 must be 'reasonably priced.' Both requirements must be met, and a
finding of reliability does not trump the need for ENSTAR to also show any
proposed GSA is "reasonably priced".¹¹²

17 We adopt the Attorney General's observations as our standard of review
18 because it achieves the proper balance between the needs of the utility and the needs
19 of the ratepayers. We will approve APL-5 if we find that it achieves a reliable supply at
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22 ¹⁰⁸Letter from AARP to RCA, filed in TA139-4, December 22, 2005.

23 ¹⁰⁹ENSTAR's Issue Statement and Witness List, filed June 28, 2006, at 1.

24 ¹¹⁰T-8 (Dieckgraeff) at 26.

25 ¹¹¹Tr. at 205.

26 ¹¹²Comments of the Attorney General, filed in TA-139-4. December 22, 2005)

1 a reasonable price. Only if both of these factors are met can we find that APL-5 is in the
2 public interest.

3 Discussion

4 In the words of ENSTAR's witness Goldsmith, these are times of
5 "unprecedented market uncertainty" in Cook Inlet.¹¹³ Indeed, we cannot predict from
6 the record presented by the parties whether, in the next decade, Cook Inlet will continue
7 to export gas, as it has for almost 40 years, or whether it will import gas, or both. During
8 the latter years covered by APL-5, ENSTAR's customers could, for example, burn
9 exclusively local gas or a mixture of local gas and foreign LNG or even North Slope gas.

10 We realize from the record that ENSTAR's alternatives for gas supply
11 today in Cook Inlet are limited. The many transportation options and availability of
12 multiple suppliers that exist in the contiguous 48 states are not present in the Alaska
13 market. ENSTAR witness Izzo stated that from a long-term perspective there are three
14 other ways to bring gas to ENSTAR's pipeline system, coalbed methane, conventional
15 gas from interior basins, and import of LNG.¹¹⁴ On the possibility of North Slope Gas
16 from a spur line, Izzo stated, "[t]he earliest that North Slope gas might be available to
17 ENSTAR would be right around the time that APL-5 expires, approximately 2016, and
18 that's only if everything goes perfectly."¹¹⁵

19 ENSTAR witness Goldsmith testified that the concern over the fall in Cook
20 Inlet gas reserves led us to approve the Unocal and NorthStar contracts.¹¹⁶ Marathon
21 informed us that it has taken deliberate steps to prove up gas reserves in response to
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23 ¹¹³T-6 (Goldsmith) at 3.

24 ¹¹⁴T-1 (Izzo) at 16.

25 ¹¹⁵T-2 (Izzo) at 6.

26 ¹¹⁶T-5 (Goldsmith) at 18.

1 the perceived market signals given to gas producers with ENSTAR's Unocal and
2 NorthStar contracts.¹¹⁷ Marathon stated it spent substantial sums of money since 2002
3 which clearly demonstrates that Marathon "reacted in the same way as Unocal and
4 NorthStar to find and develop Cook Inlet gas."¹¹⁸ Goldsmith explained to us that new
5 fields have been discovered and brought into production and production companies that
6 are new to Cook Inlet and Alaska have been exploring for gas.¹¹⁹ ENSTAR states its
7 experience with paying higher market-based prices has resulted in Unocal finding over
8 130 Bcf of gas it committed to ENSTAR.¹²⁰ ENSTAR believes that unless new reserves
9 are discovered, it will soon not have enough Cook Inlet gas to meet the needs of the
10 community.¹²¹

11 ENSTAR's case in support of APL-5 is based on an assumption that
12 ENSTAR's current ratepayers should, by themselves, pay prices for natural gas high
13 enough to incent future exploration and development in Cook Inlet. Among the recitals
14 in APL-5 is one that reads:

15 WHEREAS, Buyer believes that it is in the best interest of its customers to
16 encourage and promote additional Gas exploration and development to
meet the Gas demands of the Cook Inlet in 2009 and beyond;¹²²

17 It is evident from that recital, as well as ENSTAR's testimony in support of APL-5,¹²³ that
18 ENSTAR's case hinges on the assumption that it would be acceptable for its ratepayers
19 to pay more for gas than others pay in the belief that paying extra would help Cook Inlet

20 ¹¹⁷T-9 (Webber) at 3.

21 ¹¹⁸T-10 (Webber) at 4-5.

22 ¹¹⁹T-5 (Goldsmith) at 17. .

23 ¹²⁰T-8 (Dieckgraeff) at 10.

24 ¹²¹T-1 (Izzo) at 3.

25 ¹²²APL-5, at 1.

26 ¹²³T-8 (Dieckgraeff) at 9.

1 exploration and development along. While it may be advantageous for a public utility's
2 shareholders to promote specific kinds of economic development, we cannot allow
3 ratepayers to bear the cost of this laudable goal alone.

4 Ratepayers should pay the going price in the regional market from which
5 they buy, a price that secures for them a gas supply with the appropriate swing they
6 need. They should not be required to pay a premium to achieve general economic
7 goals, although it might be acceptable under limited circumstances to acquire particular
8 supplies.

9 Ratepayers want gas at the lowest price they have to pay to get it. While
10 as Alaskans, they may prefer gas from nearby fields, which benefit the state and local
11 economies, as ratepayers, the price of gas is more important to them than its place of
12 origin. If foreign gas from a reliable source is cheaper, a public utility should not force
13 its captive ratepayers to pay for more expensive, Alaska gas. At this time, foreign gas is
14 not an option for ENSTAR or its ratepayers but, in the longer term, including many of
15 the years covered by APL-5, that option is viable.

16 The exploratory activity we believed that would lead to additional Cook
17 Inlet reserves as a result of our orders in Unocal and NorthStar has not materialized. In
18 the United States as a whole, the reserves-to-production ratio has historically been
19 about 10:1. In 1970 in the Cook Inlet, it was 30:1.¹²⁴ By 2002, the reserves-to-
20 production ratio had fallen to 10.7:1, close to the rest of the U.S. gas market.¹²⁵

21 ENSTAR stated that January 1, 2006, reserves compare unfavorably with
22 the Department of Natural Resources Cook Inlet reserves as of January 1, 2004.¹²⁶

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24 ¹²⁴*Id.* at 13.

¹²⁵T-5 at 15.

¹²⁶T-8 (Dieckgraeff) at 5.

1 Reserves are lower by nearly the amount of production that occurred during the two-
2 year period, decreasing by 439.1 Bcf.¹²⁷

3 Despite ENSTAR's ratepayers funding millions of dollars in an "exploration
4 and development" incentive plan, Cook Inlet reserves have declined. No party
5 presented evidence that Henry Hub pricing resulted in more reserves for ENSTAR.
6 ENSTAR witness Goldsmith described supply curtailments that occurred in the winter of
7 2005-2006 and stated that those incidents suggested that the reserves-to-production
8 ratio is lower than it should be and that it is due to insufficient incentives to invest in new
9 reserves.¹²⁸

10 No party presented evidence to us that would suggest how much price
11 incentive ENSTAR ratepayers must pay to increase Cook Inlet reserves.¹²⁹ Marathon
12 witness Henning affirmed that no company ever made an investment exclusively off a
13 pricing signal.¹³⁰

14 We must reluctantly conclude, based on this record, that the now five year
15 old economic experiment promoted by ENSTAR in both the Unocal and NorthStar
16 contracts has not produced noticeable results. There have been no net reserves added
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19 ¹²⁷*Id.*

20 ¹²⁸T-5 (Goldsmith) at 19.

21 ¹²⁹We also cannot ignore the parts of this record that tell us that exploration (as
22 distinct from development of existing reserves) in Cook Inlet cannot be incentivized at
23 any price, that the possibility of a spur line from the North Slope trumps any monetary
24 effort ratepayers could make. And always in the back of producers' minds is the
25 possibility and expected price of imported LNG. ENSTAR offering a price above that
26 expected amount is unlikely to incent general exploration and development, although it
might elicit the desired behavior as to particular gas for which ENSTAR pledges to pay
its uniquely high price.

¹³⁰Tr. at 1466.

1 to Cook Inlet. In fact, what ENSTAR tells us today is that reserves replacement is not
2 keeping up with production.¹³¹

3 We note from the record there seems to be only one driver that spurs
4 substantial increases in Cook Inlet reserves—the export of LNG to Japan. Tesoro
5 witness Schlesinger stated, “[t]he export sale of Cook Inlet gas as LNG to Japan also
6 represents Marathon's primary alternative market for its gas sales.”¹³² Cook Inlet
7 reserves additions were reported in only 3 years between 1977 and 2004.¹³³ In 1986,
8 Cook Inlet reserves increased by 1,400 Bcf, in 1996 reserves increased by 955 Bcf, and
9 in 1997 by 439 Bcf.¹³⁴

10 Phillips Alaska Petroleum Gas Corporation and Marathon Oil Company
11 (the owners of the LNG plant) sell LNG to utility companies in Japan. On April 11, 1988,
12 two years after Cook Inlet reserves were increased by 1,400 Bcf, the LNG owners filed
13 an application with the Economic Regulatory Administration (ERA), requesting a fifteen-
14 year export license extension to March 31, 2004¹³⁵

15 Eight years later, on December 31, 1996, the owners of the LNG plant
16 filed an application requesting that the DOE extend their authorization to export LNG for
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22 ¹³¹T-8 (Dieckgraeff) at 5.

23 ¹³²T-19 (Schlesinger) at 8.

24 ¹³³T-5 (Goldsmith) at 16.

25 ¹³⁴H-2 at 71.

26 ¹³⁵H-60 at n.3 referencing DOE/ERA Opinion and Order No. 261, *Order Amending Authorization to Export Liquefied Natural Gas to Japan* (Order No. 261).

1 five years through March 31, 2009.¹³⁶ In 1996 and 1997, Cook Inlet reserves increased
2 by nearly 1,400 Bcf. The export license was extended through March 31, 2009.¹³⁷

3 We observe with interest this correlation between Cook Inlet reserves
4 growth and requests for extension of LNG exports¹³⁸ revealed in this record. The record
5 before us provides little more than speculation that the use of Henry Hub by one utility
6 provides sufficient incentive to result in Cook Inlet reserves growth.

7 Reliable Supply of Gas

8 ENSTAR stated that it applied the following criteria for new gas
9 purchases, (1) full requirements (if possible) (2) full swing, (3) fair price, (4) proven
10 reserves and (5) diversified supply.¹³⁹ ENSTAR stated its first priority is always to
11 obtain a reliable, long-term gas supply at the lowest possible price.¹⁴⁰

12 ENSTAR witness Izzo stated,

13 I see APL-5 as a bridge contract that will give ENSTAR a high level of supply
14 security during a very, very uncertain transition period. APL-5 provides us
15 with an assured supply at a reasonable, market-based price, provided by a
16 highly reliable and responsible supplier that ENSTAR has been able to trust
17 to meet its requirements for over 40-years."¹⁴¹

18 ¹³⁶H-60 at 2.

19 ¹³⁷H-60 at 57.

20 After taking into consideration all of the information in the record..., we find a
21 five-year extension of the authority.... to export LNG to Japan has not been
22 shown to be inconsistent with the public interest. In particular, the record
23 shows here is a sufficient regional supply of natural gas to satisfy local and
24 export demand through the extension period. Furthermore, we believe the
25 extension will continue benefits provided by the export to the Alaskan
26 economy, energy production, and international trade.

27 ¹³⁸T-5 (Goldsmith) at 16).

28 ¹³⁹T-7 (Dieckgraeff) at 11).

29 ¹⁴⁰*Id.* at 12.

30 ¹⁴¹T-2 (Izzo) at 7.

1 ENSTAR bears the burden of proving that this contract will provide that
2 high level of supply security. We test ENSTAR's statements against the record
3 compiled in this hearing.

4 ENSTAR believed that Marathon has committed to supply ENSTAR's
5 unmet requirements through 2016.¹⁴² It maintained that:

6 ENSTAR's most recent major gas supply contract, the Unocal contract was
7 not backed by proven reserves, but rather imposed an exploration obligation
8 on Unocal and it has been quite successful. As a result Unocal has found,
9 and is developing, significant new quantities of gas on which ENSTAR has
"first call". ENSTAR believes however that is prudent that the next layer of
gas supply be based on proven reserves."¹⁴³

10 This commitment is embodied in APL-5 contract at Section 2.3, Full Requirements
11 Supplier, which states. In part,

12 2.3 Full Requirements Supplier. The Parties acknowledge and agree that
13 Seller has made the Initial Annual Commitments in such amounts as are
14 necessary, in light of Buyer's current projections, to 'reduce Buyer's Unmet
15 Requirements .to zero (0) for each Contract Year beginning in Contract Year
2009 and ending in Contract Year 2016, and that, for those Contract Years,
Seller will be "Buyer's Full Requirements Supplier."¹⁴⁴

16 Section 2.7.4 of the Contract discusses the priority of ENSTAR's position
17 in relation to other of Marathon's gas sales contracts and states, in part,

18 2.7.4 Seller shall not commit to dispose of Gas from Seller's Proven
19 Reserves if such commitment would have a 'material adverse effect on
20 Seller's ability to meet the obligations of Seller under this Agreement. *Except*
21 *for Seller's Third Party Commitments*, Buyer has first call on Seller's Gas
22 delivered into the Cook Inlet Area necessary to meet Seller's obligations to
23 make Gas available to Buyer under this Agreement. Any agreement'
(including an amendment to Seller's Third Party Commitments or exercise of
an option under Seller's Third Party Commitments) made on or after October
14, 2005 by Seller to dispose of Seller's Gas from its Proven Reserves
during the Term of this Agreement must recognize that Seller has committed

24 ¹⁴²T-7 (Dieckgraeff) at 14.

25 ¹⁴³*Id.*

26 ¹⁴⁴H-1B at 9.

1 to make Gas available to Buyer under this Agreement and that Buyer has
2 prior call on that Gas to satisfy the obligations of seller to make Gas
available to Buyer.¹⁴⁵

3 A list of fifteen contracts or agreements between Marathon and third
4 parties are included at Exhibit E to the contract.¹⁴⁶ Several of the contracts appear to
5 be related to Marathon's LNG export activities as well as what appear to be gas supply
6 contracts with Agrium, Tesoro, Chugach Electric Association, XTO Energy, and others.

7 During the hearing we became aware that ENSTAR had not fully
8 evaluated the effect of Section 2.7.4 on its committed supplies from Marathon.¹⁴⁷

9 ENSTAR has relied on Marathon's representations "about not letting the
10 town to go dark while industrials operated"¹⁴⁸ and has required a reserves letter from
11 Marathon but has not yet fully evaluated it.¹⁴⁹ ENSTAR maintained that it takes a lot of
12 comfort from its 40-plus year relationship with Marathon.¹⁵⁰

13 ENSTAR stated that its criteria for new gas purchases are based on full
14 requirements, proven reserves, and diversified supply.¹⁵¹ We have established a
15 standard of review which requires that APL-5 provide a reliable supply of gas at a
16 reasonable price.

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¹⁴⁵H1-B at 12 (emphasis added).

¹⁴⁶H-1B, at 58.

¹⁴⁷Tr. at 151-157.

¹⁴⁸Tr. at 1016.

¹⁴⁹ Tr. at 1019.

¹⁵⁰Tr. at 1017.

¹⁵¹T-7 (Dieckgraeff) at 3.

1 We find that ENSTAR did not meet its burden of proof that APL-5 provides
2 a reliable supply of gas because it has not sufficiently reviewed possible commitments
3 of Marathon's reserves prior to bringing the contract to us for approval.¹⁵²

4 Were this the only deficiency in ENSTAR's case in support of APL-5, we
5 would be able to conditionally approve APL-5, subject to ENSTAR's submission of
6 further information curing this defect.

7 Our Unocal and NorthStar orders have been read too broadly by
8 ENSTAR.¹⁵³ We have not decided that Lower 48 market prices are a reasonable proxy
9 for Cook Inlet market prices under all circumstances and we certainly have not decided
10 that we will allow ENSTAR or any other public utility to pay Lower 48 market prices plus
11 transportation plus production taxes for all Cook Inlet gas.¹⁵⁴

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20 ¹⁵²*Id.* at 11 and Tr. 1016-1020.

21 ¹⁵³For example, Marathon's witness Henning testified that "[w]hen the
22 Commission approved the pricing provisions of the Unocal contract with ENSTAR, it
23 sent a clear price signal that the market for natural gas in Alaska would be linked with
24 the broader North American natural gas market." T-14 (Henning) at 12.

25 ¹⁵⁴Henry Hub prices have departed fundamentally from the basic economics of
26 Cook Inlet since the time of the Unocal contract and the NorthStar contract. Even if our
orders could reasonably be read to generally endorse Henry Hub prices, which we do
not believe they can, it would be necessary for us now, solely because of that
departure, to reexamine that policy decision.

1 ENSTAR has told us there is no other company that can provide what
2 Marathon offers to provide in APL-5.¹⁵⁵ Thus, there is no competition for this piece of
3 ENSTAR's gas supply.¹⁵⁶ Competition is what holds down price. In the absence of
4 competition, it is only our review that serves to hold down price. Marathon has every
5 incentive to negotiate for itself the highest price it believes ENSTAR would pay or we
6 would allow ENSTAR to pay. We must carefully assess the agreed-upon price.

7 The price in APL-5 is not a negotiated price. ENSTAR and Marathon
8 decided not to negotiate a price but rather to select an index and allow that index to set
9 the price of the contract, with add-ons for transportation and production taxes. A market
10 price is not a negotiated price. In that way APL-5 is like the Unocal and NorthStar
11 contracts and unlike the ENSTAR supply contracts that preceded the Unocal and
12 NorthStar contracts. Those legacy contracts contained negotiated prices, based on
13 market conditions in Cook Inlet. The negotiated prices of the legacy contracts are
14 adjusted annually according to an agreed upon index.

15 Evaluation of APL-5 Price

16 We evaluate the reasonableness of the pricing terms of APL-5 as a whole
17 rather than picking apart the elements and assessing the reasonableness of each
18 element separately, as we did with the Unocal and NorthStar contracts. We now
19 recognize that pricing terms are negotiated as a whole, that each element is adjusted

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21 ¹⁵⁵T-7 (Dieckgraeff) at 10.

22 ¹⁵⁶We are not certain there is any meaningful competition for ENSTAR's
23 business. The gas supply in Cook Inlet is largely tied up in long-term contracts. A
24 workably competitive environment for ENSTAR's supply would be one in which
25 producers sold gas on short-term contracts and there was common carrier storage
26 available to take care of ENSTAR's swing requirements. Only under those conditions
could small and large producers be on equal footing to compete for ENSTAR's
business.

1 and fine-tuned to counterbalance each other element of the contract to arrive at terms
2 the contracting parties can embrace. If we were to assess individual items with the
3 intent of conditioning our approval on a change in one or more individual elements, we
4 would be disturbing that balance.

5 We believe the fairer and wiser course is to approve or disapprove pricing
6 terms as a whole. We take the price of APL-5 and superimpose the changes Marathon
7 offered (none of which ENSTAR objected to) in response to some of the intervenors'
8 concerns and assess the resulting pricing terms as a whole. We cannot find that either
9 the original pricing terms of APL-5 or the pricing terms as revised by Marathon assure
10 that ratepayers will pay no more than a reasonable price for the gas bought for them
11 under APL-5.

12 The other Marathon contracts entered into evidence in this proceeding
13 (and given confidential status) demonstrate that the price of APL-5, at present Henry
14 Hub 12-month trailing average prices plus 25¢ for transportation plus production
15 taxes,¹⁵⁷ is a radical departure from the basic economics of Cook Inlet. ENSTAR has
16 not sufficiently justified that radical departure in this record.

17 The best proxy we have for the Cook Inlet market price for gas with the
18 same variable deliverability and swing required by ENSTAR is ENSTAR's own
19 WACOG. The WACOG, by its very nature, represents a diverse base of suppliers, both
20 willing and able to meet ENSTAR's deliverability and swing. ENSTAR's WACOG is also
21 comprised of a blend of legacy pricing based on proven reserves combined with the
22 exploration-driven Henry Hub, through Unocal. That WACOG is currently approximately
23 \$5.00 for calendar year 2006. The 2006 price of APL-5 (if in effect, which it is not) is

24 _____
25 ¹⁵⁷If ENSTAR were taking gas under APL-5 today the price of gas would be
26 \$7.50 plus production taxes. Tr. 924.

1 \$7.50 plus production taxes. The APL-5 price for proven reserves represents at least a
2 50 percent increase over ENSTAR's current WACOG. That is an unacceptable
3 divergence because ENSTAR is currently receiving supplies from both proven reserves
4 and exploration efforts at a much lower price.

5 ENSTAR has not sustained its burden to prove that the price of APL-5 is
6 reasonable. We reject APL-5 based on our conclusion that the price, to the extent that
7 it increases ENSTAR's WACOG, is not reasonable.

8 We give guidance to the contracting parties on what pricing terms we
9 might be able to accept. In doing so, we do not seek to interfere with future negotiations
10 or second-guess past negotiations. The APL-5 pricing terms are simply too divergent
11 from other prices in Cook Inlet. They must be conformed in some way to the realities of
12 the Cook Inlet market.

13 As evidenced in our earlier discussion, we have difficulty approving pricing
14 terms if the parties' goal in entering into those terms is to change the Cook Inlet market
15 by paying a higher price than is necessary to obtain the gas needed. We believe
16 ENSTAR should pay prices appropriate to the existing market, considering its
17 deliverability and swing requirements. ENSTAR is likely to need to pay a higher price
18 than other buyers in Cook Inlet because of those requirements but needs to create an
19 adequate record on which we can base our decision in support of that need.

20 The use of Henry Hub or another market index with or without discounts
21 requires the parties to justify use of the index for their contract and must reconcile use
22 of the market index with Cook Inlet market conditions. Assuming they do so, use of
23 such an index might be acceptable, but only if transportation and production taxes are
24 not added on and if there is a meaningful cap.

1 The record reveals that, generally, sellers pay transportation to the hub at
2 which gas is priced and buyers pay transportation away from the hub.¹⁵⁸ Whether
3 transportation should be added on to a hub market index price depends upon the
4 pricing point to which the market price index is applied. In this instance, the only points
5 which make sense under the configuration in Cook Inlet are the KPL junction (where a
6 number of pipelines, including ENSTAR's eastside pipeline, come together) and the
7 inlet to ENSTAR's westside pipeline in the Beluga River field.

8 The only reasonable alternatives to those points are the wellheads in each
9 field. We believe wellheads are inappropriate pricing points at which to apply a market
10 index. The evidence tells us that sellers pay transportation from the wellhead to the
11 hub.

12 We do not believe a reasonable price would include a transportation cost
13 added on to a price determined directly by a market index. Transportation was not
14 added on to ENSTAR's legacy contracts. The Unocal contract did provide that a fee
15 would be added on to the market price if gas was shipped through a newly constructed
16 pipeline. A transportation fee was also to be added on to the market index price in the
17 NorthStar contract. The Unocal and NorthStar contracts are distinguishable from the
18 current contract because the pricing terms in those contracts were approved as
19 exploration incentives. We would not allow a transportation fee to be added to a market
20 index price in APL-5.

21 There is no evidence in this record that buyers at Henry Hub or at any
22 other hub with a market index pay sellers' production taxes. Production taxes are a
23 normal cost of producing gas, like compressors, salaries, and office overhead. Market
24 prices are a function of supply and demand and have no relationship to costs of

25 _____
26 ¹⁵⁸T-13 (Elder) at 6-8.

1 production. ENSTAR did not provide any support for the tax add-on in APL-5 except to
2 say that the provision is in all its other contracts and that producers preferred it that
3 way.¹⁵⁹ Contrary to our decision in NorthStar, we now find on the basis of the existing
4 record in this proceeding insufficient justification to add production taxes on to market
5 index prices, which already compensate sellers for costs of production.

6 Prices established on Henry Hub might be acceptable in the presence of a
7 meaningful cap. Neither the \$15.00 cap nor the \$14.00 cap proposed protects
8 ratepayers from anything other than circumstances in Lower 48 markets that are so dire
9 as to be almost unimaginable. The devastating storms of 2005 resulted only in price
10 spikes to \$15.00. The yearly average for 2005 was in the \$9.00 range. We find that in
11 this market even a cap of \$9.00 does not ensure that ENSTAR's ratepayers will pay a
12 reasonable price when we see other buyers in Cook Inlet paying less than half that
13 amount. Even the Japanese utilities taking Cook Inlet gas pay \$2.00 less than this
14 \$9.00 cap at the receiving point in Japan. If a contract is priced to another market, there
15 must be a meaningful cap that prevents the price paid by ENSTAR's ratepayers from
16 diverging too far from the price paid by others in Cook Inlet unless that divergence is
17 due to and in proportion with differing deliverability and swing requirements.

18 We understand that the price of natural gas is rising, in step with crude oil.
19 There is evidence in the record that natural gas prices have been steadily increasing in
20 the Pacific Basin.¹⁶⁰ There is evidence in the confidential record that non-utility
21 contracts for gas supplies have been increasing. We are not opposed to recognizing in
22 APL-5 economically rational price increases that reflect the realities of Cook Inlet's gas
23 market.

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¹⁵⁹T-8 (Dieckgraeff) at 19.

25 ¹⁶⁰T-19, Ex. BSA-5.
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Conclusion

On the basis of the evidence in this record we conclude that ENSTAR has failed to meet its burden of proof that APL-5 achieves a reliable gas supply at a reasonable price. Accordingly, we reject the addition of TA139-4 as a base supply contract having the effect of increasing the current average cost of system gas supply as proposed by ENSTAR. We note, however, that ENSTAR's tariff allows it to add base supply contracts having the effect of decreasing the cost of system gas without our approval. We allow ENSTAR to add TA139-4 to its base supply under those limited conditions.

Final Order

This order constitutes the final decision in this proceeding. This decision may be appealed within thirty days of the date of this order in accordance with AS 22.10.020(d) and the Alaska Rules of Court, Rule of Appellate Procedure (Ak. R. App. P.) 602(a)(2). In addition to the appellate rights afforded by AS 22.10.020(d), a party has the right to file a petition for reconsideration as permitted by 3 AAC 48.105. If such a petition is filed, the time period for filing an appeal is then calculated under Ak. R. App. P. 602(a)(2).

ORDER

THE COMMISSION FURTHER ORDERS:

1. TA139-4, as presented by ENSTAR Natural Gas Company, a Division of SEMCO Energy, Inc., is rejected as discussed in the body of this order.
2. TA139-4, as presented by ENSTAR Natural Gas Company, a Division of SEMCO Energy, Inc., may otherwise go into effect immediately without further approval, provided it has the effect of decreasing the current average cost of system gas as per tariff Sheet No. 90, Section 708f.

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3. By 4 p.m., November 1, 2006, should ENSTAR Natural Gas Company, a Division of SEMCO Energy, Inc., choose to have TA139-4 take effect under Ordering Paragraph No. 2 above, it must file any revisions to its contract terms and perfect its supply commitments under Section 2.7.4 of APL-5.

DATED AND EFFECTIVE at Anchorage, Alaska, this 28th day of September, 2006.

BY DIRECTION OF THE COMMISSION
(Commissioners Dave Harbour and Mark K. Johnson, dissenting.)



Regulatory Commission of Alaska
701 West Eighth Avenue, Suite 300
Anchorage, Alaska 99501
(907) 276-6222; TTY (907) 276-4533

Appendix
ENSTAR Weighted Average Cost of Gas 2002 – 2006

2002				2003			
Contract	Price	Vol. BCF	Total \$ Millions	Contract	Price	Vol. BCF	Total \$ Millions
APL-4 ¹	2.46	21.0	51.67	APL-4	2.40	19.0	45.69
Beluga ²	2.43	3.0	8.01	Beluga	2.42	3.3	7.99
Moquawkie ³	2.99	1.3	3.84	Moquawkie	3.00	4.2	12.64
Unocal ⁴	-	-	-	Unocal	-	-	-
		25.6	63.52			26.5	66.32
Adjustments			0.28	Adjustments			1.14
Total Gas Costs			63.80	Total Gas Costs			67.46
Total Sales Volume (BCF)			25.46	Total Sales Volume (BCF)			26.38
Weighted Average Cost of Gas			2.5059	Weighted Average Cost of Gas			2.5575

2004				2005			
Contract	Price	Vol. BCF	Total \$ Millions	Contract	Price	Vol. BCF	Total \$ Millions
APL-4	2.69	17.0	45.68	APL-4	3.38	15.0	50.64
Beluga	2.78	2.1	5.83	Beluga	3.56	1.6	5.70
Moquawkie	2.98	2.9	8.70	Moquawkie	3.02	1.9	5.74
Unocal	4.74	5.3	25.31	Unocal	5.10	9.2	47.06
		27.4	85.51			27.7	109.15
Adjustments			(0.84)	Adjustments			(0.87)
Total Gas Costs			84.67	Total Gas Costs			108.28
Total Sales Volume (BCF)			27.20	Total Sales Volume (BCF)			27.54
Weighted Average Cost of Gas			3.1123	Weighted Average Cost of Gas			3.9321

2006			
Contract	Price	Vol. BCF	Total \$ Millions
APL-4	4.43	13.0	57.58
Beluga	5.12	1.1	5.64
Moquawkie	3.04	1.8	5.47
Unocal	6.49	10.7	69.32
		26.6	138.00
Adjustments			(6.00)
Total Gas Costs			131.99
Total Sales Volume (BCF)			26.39
Weighted Average Cost of Gas			5.0009

Source: Exhibit H-39, as corrected by RCA Staff

¹ APL-4 Gas Purchase Agreement with Marathon Oil Company, dated May 1, 1988, and approved by the Commission in U-88-49(6), dated July 20, 1989.

² Beluga Gas Purchase Agreement between Shell Western E&P, Inc. and Alaska Pipeline Company, approved by the Commission in docket U-83-2(6), dated June 3, 1983. The Commission approved an amended contract, Beluga Schedule 3, in U-92-7(3) dated December 7, 1992.

³ Moquawkie Gas Purchase Agreement with Anadarko Petroleum Corporation and Phillip's Alaska, Inc., dated May 16, 2000, and approved by the Commission in TA114-4, dated July 27, 2000.

⁴ Unocal Gas Purchase Agreement with Union Oil of California Inc., approved by the Commission in U-01-7 dated October 25, 2001.

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STATE OF ALASKA

THE REGULATORY COMMISSION OF ALASKA

Before Commissioners:

Kate Giard, Chairman
Dave Harbour
Mark K. Johnson
Anthony A. Price
Janis W. Wilson

In the Matter of the Gas Sales Agreement)
Between ENSTAR NATURAL GAS COMPANY,)
A DIVISION OF SEMCO ENERGY, INC. and)
MARATHON OIL COMPANY Filed as TA139-4)

U-06-2

CERTIFICATION OF MAILING

I, Natasha L. Odom-Brown, certify as follows:

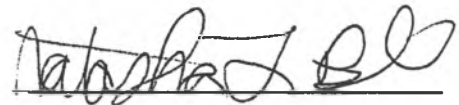
I am Administrative Clerk III in the offices of
the Regulatory Commission of Alaska, 701 West Eighth Avenue, Suite 300,
Anchorage, Alaska 99501. On September 28, 2006, I mailed
copies of

Order No. 15, entitled:

**ORDER REJECTING TA139-4 AS A BASE SUPPLY CONTRACT HAVING
THE EFFECT OF INCREASING THE CURRENT AVERAGE COST OF
SYSTEM GAS SUPPLY BUT ALLOWING TA139-4 TO TAKE EFFECT
IMMEDIATELY AS A BASE SUPPLY CONTRACT HAVING THE EFFECT OF
DECREASING THE CURRENT AVERAGE COST OF SYSTEM GAS SUPPLY
AND REQUIRING FILINGS**
(Issued September 28, 2006)

in the proceeding identified above to the persons indicated on the attached service list.

DATED at Anchorage, Alaska, this 28th day of September, 2006.



Regulatory Commission of Alaska
701 West Eighth Avenue, Suite 300
Anchorage, Alaska 99501
(907) 276-6222; TTY (907) 276-4533

**SERVICE LIST
U-06-2(15)**

**Page: 1 of 1
Date: 9/28/2006**

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STATE OF ALASKA

THE REGULATORY COMMISSION OF ALASKA

Before Commissioners: Robert M. Pickett, Chairman
Kate Giard
Mark K. Johnson
Anthony A. Price
Janis W. Wilson

In the Matter of the Tariff Revision, Designated as)
TA167-4, Regarding a Proposed Gas Sales) U-08-58
Agreement Between ENSTAR NATURAL GAS)
COMPANY, A DIVISION OF SEMCO ENERGY,) ORDER NO. 8
INC. and ConocoPhillips Alaska, Inc. and a)
Proposed Gas Sales Agreement Between)
ENSTAR NATURAL GAS COMPANY, A)
DIVISION OF SEMCO ENERGY INC. and)
MARATHON OIL COMPANY)

ORDER APPROVING GAS SALES AGREEMENTS, IF AMENDMENTS
REQUIRED IN THIS ORDER ARE FILED

BY THE COMMISSION:

Summary

We find that ENSTAR was prudent in its efforts to secure natural gas supplies. We approve the gas sales agreements at issue in this proceeding if ENSTAR files signed amendments to each contract in accordance with this Order.

We establish a floating market-based price cap for the natural gas supplies under each gas supply contract as described in Appendix D and E. We require the use of these price caps for as long as natural gas is exported from Cook Inlet or there are ongoing activities leading to the export of natural gas. Additionally, we do not approve any aspect of Section 2.4(b) of the Marathon GSA that is inconsistent with our directive that future ENSTAR GSAs shall be unbundled as to volume and price to remove the limitation on third party suppliers contained in Section 2.4(b).

1 We acknowledge the approval of these contracts with the pricing terms is
2 a compromise of different positions of the parties. By virtue of approving the pricing
3 tiers we accept that ENSTAR's swing profile is more difficult to meet than a flatter swing
4 profile and that tier pricing is justified. We do not, by virtue of our approval, find that
5 pricing or volume increments within the tiers are appropriate for future contracts. We
6 are merely accepting that tier pricing appears to be a reasonable first step to unbundling
7 ENSTAR's future contracts.

8 We find that the producers of natural gas in Cook Inlet have the ability to
9 exercise market power and were able to do so in their negotiations with local buyers of
10 natural gas. Market power arises from the particular circumstances of supply and
11 demand in Cook Inlet. Producers own the liquefied natural gas (LNG) plant and are
12 themselves the alternative buyer of the gas. Relatively inelastic consumer demand for
13 natural gas, particularly when combined with tightening supply, allows producers to
14 more easily force prices higher. Absent the unequivocal need on the part of ENSTAR
15 consumers for natural gas in the wintertime, producers would not have market power
16 and there would be much less need for regulatory intervention.

17 We have some of the tools for addressing this situation. Other agencies
18 have additional tools. Based on our record, we believe that U.S. Department of Energy
19 and the State of Alaska could have done a better job in ensuring that local needs were
20 met at reasonable pricing terms before the LNG export license was extended. Approval
21 of the LNG export license weakened ENSTAR's negotiation position and conversely
22 gave the Cook Inlet producers an opportunity to exercise market power.

23 We also require that ENSTAR unbundle all future natural gas contracts in
24 volume and in price.

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Background

ENSTAR filed a tariff advice letter, TA167-4, in which it requested approval of two proposed GSAs.¹ The proposed GSAs are between ENSTAR and ConocoPhillips and between ENSTAR and Marathon.² ENSTAR requested inclusion of the GSAs in Section 708 of its tariff as base supply contracts and requested inclusion of all costs related to the GSAs in the calculation of its gas cost adjustment. We suspended TA167-4, opened this docket for further investigation, and scheduled a public hearing.³

The Attorney General, Regulatory Affairs & Public Advocacy (AG) elected to participate in this proceeding.⁴ We granted⁵ the petitions to intervene filed by Fairbanks Natural Gas, LLC (FNG);⁶ Aurora Power Resources, Inc. (Aurora Power);⁷

¹TA167-4, filed April 11, 2008 (H-1).

²*Id.*; H-1, Attach. A, ConocoPhillips Contract, *Gas Sales Agreement Between ConocoPhillips Alaska, Inc. and Alaska Pipeline Company* (H-2); H-1, Attach. B, Marathon APL-6 Contract, *Gas Sales Agreement Between Marathon Oil Company and Alaska Pipeline Company* (H-3).

³Order U-08-58(1), *Order Suspending TA167-4, Inviting Petitions to Intervene, Requesting Participation by the Attorney General, Addressing Timeline for Decision, Establishing Procedural Schedule, Designating Commission Panel, and Appointing Administrative Law Judge*, dated May 12, 2008 (Order U-08-58(1)), as corrected by *Errata Notice to Order U-08-58(1)*, dated May 23, 2008.

⁴*Notice of Election to Participate and Entry of Appearance*, both filed May 21, 2008.

⁵Order U-08-58(5), *Order Granting Petitions to Intervene Filed by Fairbanks Natural Gas, LLC; Aurora Power Resources, Inc.; Chugach Electric Association, Inc.; and Homer Electric Association, Inc. and Alaska Electric and Energy Cooperative, Inc.*, dated June 12, 2008.

⁶*Petition to Intervene by Fairbanks Natural Gas*, filed May 20, 2008.

⁷*Petition to Intervene of Aurora Power Resources, Inc.*, filed May 21, 2008.

1 Chugach Electric Association, Inc. (Chugach);⁸ and Homer Electric Association and
2 Alaska Electric and Energy Cooperative, Inc. (together, HEA).⁹ We allowed HEA to
3 withdraw as a party from the docket before the scheduled hearing.¹⁰ FNG withdrew its
4 prefiled testimony before the hearing but did not request withdrawal as a party.¹¹

5 We held a public hearing that began on July 28, 2008, and continued
6 through August 13, 2008. FNG did not participate in the hearing.¹² The parties¹³ filed
7 post-hearing briefs.¹⁴

8 ENSTAR requested a decision regarding the GSAs by October 31, 2008.¹⁵
9 Both GSAs may be terminated if approval does not occur by October 31, 2008.¹⁶

10 ENSTAR filed a notice of amendment to testimony and pleadings on
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12

13 ⁸*Chugach Electric Association, Inc.'s Petition for Leave to Intervene*, filed
14 May 21, 2008.

15 ⁹*Petition for Permission to Intervene of Homer Electric Association, Inc. and
16 Alaska Electric and Energy Cooperative, Inc.*, May 21, 2008.

17 ¹⁰Order U-08-58(7), *Order Granting Homer Electric Association, Inc. and Alaska
18 Electric and Energy Cooperative, Inc.'s Motion to Withdraw from Docket*, dated
19 July 25, 2008.

20 ¹¹*Final Witness List of Fairbanks Natural Gas*, filed July 21, 2008.

21 ¹²Prehearing conference, dated July 28, 2008, Tr. at 23; Public hearing, dated
22 July 28, 2008 (Vol. II), Tr. at 30.

23 ¹³The parties at hearing were ENSTAR, the AG, Chugach, and Aurora Power.

24 ¹⁴*ENSTAR's Initial Post-Hearing Brief*, filed August 22, 2008 (ENSTAR
25 Post-Hearing Brief); *Attorney General's Post-Hearing Brief*, filed August 29, 2008 (AG
26 Post-Hearing Brief); *Chugach Electric Association, Inc.'s Post-Hearing Brief*, filed
August 29, 2008 (Chugach Post-Hearing Brief); *Aurora Power Resources, Inc.'s
Post-Hearing Brief*, filed August 29, 2008 (Aurora Post-Hearing Brief); *ENSTAR's Post-
Hearing Reply Brief*, filed September 5, 2008 (ENSTAR Post-Hearing Reply Brief).

¹⁵H-1 at 2.

¹⁶H-2 (ConocoPhillips GSA) at 22 (§10.1(b)); H-3 (Marathon GSA) at 35 (§11.3).

1 October 15, 2008, a short two weeks before its requested decision date of
2 October 31, 2008.¹⁷ The hearing in this matter concluded on August 13, 2008, and the
3 final post hearing brief, ENSTAR's reply, was filed on September 5, 2008. The AG¹⁸
4 and Chugach¹⁹ filed motions to strike ENSTAR's notice of amendment. We explicitly
5 did not consider ENSTAR's notice, amended testimony, or pleadings in reaching our
6 decision in this order. Accordingly, we decline to rule on the motions to strike or the
7 propriety of ENSTAR's notice of amendment at this time.

8 Discussion

9 Overview of TA167-4 Gas Sales Agreements

10 ENSTAR is required by its tariff to file for advance approval any new base
11 supply contract that will increase its current average cost of system gas.²⁰ ENSTAR
12 base supply contracts that decrease the current average cost of system gas become
13 effective immediately without our prior approval.²¹

14 The GSAs with ConocoPhillips and Marathon (Producers) provide for
15 deliveries of natural gas starting in 2009 and continuing through 2013.²² ENSTAR
16 states that it will no longer have an unmet requirements supplier beyond 2008 and that

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20 ¹⁷Notice by ENSTAR Natural Gas Company of Amendment to Testimony and
Pleadings, filed October 15, 2008.

21 ¹⁸Motion to Strike, filed October 16, 2008.

22 ¹⁹Chugach Electric Association, Inc.'s Motion to Strike Notice by ENSTAR
23 Natural Gas Company of Amendment to Testimony and Pleadings; or, in the
Alternative, Motion to Reopen Record, filed October 20, 2008.

24 ²⁰ENSTAR's Tariff Sheet No. 90, § 708(f).

25 ²¹*Id.*

26 ²²H-1 at 1; H-2 (ConocoPhillips GSA) at 23; H-3 (Marathon GSA) at 28-29.

1 the GSAs are necessary to fill a gap in its gas supply portfolio beginning in 2009.²³ The
2 two GSAs combine to provide 37.8 Bcf²⁴ of natural gas over their terms.²⁵

3 The GSAs provide committed volumes that, combined with ENSTAR's
4 other GSAs, meet 100 percent of ENSTAR's projected needs for 2009 and 2010.²⁶
5 ENSTAR plans to develop storage and utilize gas storage facilities to meet its peak
6 seasonal fluctuations beginning in 2011.²⁷ ENSTAR views these relatively short term
7 GSAs as a bridge to the future that will include storage and a possible supply of natural
8 gas from the Brooks Range.²⁸

9 ENSTAR requests approval of the GSAs as base supply contracts under
10 its tariff and for inclusion of all costs related to the GSAs in the calculation of its gas cost
11 adjustment.²⁹ ENSTAR's tariff advice letter, TA167-4 (Exhibit H-1), the ConocoPhillips
12 GSA (Exhibit H-2), and the Marathon GSA (Exhibit H-3) are attached to this order as
13 Appendices A, B, and C, respectively.

14 ConocoPhillips GSA

15 The ConocoPhillips GSA provides for an expected total volume of
16 approximately 12.1 Bcf over the five-year term of the agreement.³⁰ Gas delivered under
17 the GSA is divided into three tiers for pricing purposes described as a Base Tier, a
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20 ²³H-1 at 2, 4.

21 ²⁴Bcf means one billion standard cubic feet.

22 ²⁵*Prefiled Direct Testimony of Eugene N. Dubay*, filed May 28, 2008 (E-1) at 4.

23 ²⁶H-1 at 4.

24 ²⁷*Id.*

25 ²⁸E-1 (Dubay Direct) at 6-7, 41-42.

26 ²⁹H-1 at 1.

³⁰E-1 (Dubay Direct) at 16; H-1 at 5; H-2 (ConocoPhillips GSA) at 34.

1 Seasonal Tier, and a Needle Peak Tier.³¹ The Base Tier contains gas used throughout
2 the year and is approximately 64 percent of total gas consumption.³² The Seasonal Tier
3 includes increments above the Base Tier which ENSTAR purchases during October
4 through April.³³ The Needle Peak Tier is used on the coldest winter days and is
5 approximately five percent of overall demand.³⁴

6 Pricing under the ConocoPhillips GSA is based on an Energy Price
7 derived from the twelve-month trailing average of the daily median prices at five West
8 Coast and Canadian trading locations.³⁵ The "basket" of trading locations is a variation
9 on the Cook Inlet Composite Index (CICI), proposed by the AG's expert Arlon Tussing in
10 Docket U-06-2.³⁶ The trading locations are TCPL Alberta (AECO-C); Northwest,
11 Canadian Border (Sumas); PG&E Malin; PG&E City Gate; and SoCal Gas.³⁷ Base Tier
12 volumes are priced at the Energy Price, Seasonal Tier volumes are 125 percent of the
13 Energy Price, and Needle Peak Tier volumes are 150 percent of the Energy Price.³⁸
14 The price will be adjusted quarterly.³⁹

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³¹E-1 (Dubay Direct) at 17; H-2 (ConocoPhillips GSA) at 10.

³²E-1 (Dubay Direct) at 17.

³³*Id.*

³⁴*Id.*

³⁵*Id.* at 18-19.

³⁶*Id.* at 18-19. Docket U-06-2 is titled *In the Matter of the Gas Sales Agreement Between ENSTAR NATURAL GAS COMPANY, A DIVISION OF SEMCO ENERGY, INC. and MARATHON OIL COMPANY Filed as TA139-4.*

³⁷*Id.*; H-1 at 5; H-2 (ConocoPhillips GSA) at 40.

³⁸H-1 at 5; H-2 (ConocoPhillips GSA) at 15.

³⁹E-1 (Dubay Direct) at 21; H-2 (ConocoPhillips GSA) at 12.

1 Marathon GSA

2 The Marathon GSA, also called APL-6, provides for an expected total
3 volume of approximately 25.6 Bcf over the five-year term of the agreement.⁴⁰ Gas
4 delivered under the GSA is divided into six tiers for pricing purposes described as Base
5 Load Gas, Seasonal Peak Tier 1 Gas, Seasonal Peak Tier 2 Gas, Needle Peak Gas,
6 Storage Gas up to 1.0 Bcf, and Storage Gas in excess of 1.0 Bcf.⁴¹ ENSTAR states
7 that the tier structure and rationale behind the tier structure is “essentially similar” to that
8 in the ConocoPhillips GSA.⁴² Base Load Gas plus Seasonal Peak Tier 1 Gas are
9 consumed year-round, the Seasonal Peak Tier 2 Gas is consumed during October
10 through April, and Needle Peak Gas is consumed on the coldest days during November
11 through March. Storage gas will be taken during the summer months and injected into
12 storage.⁴³

13 Pricing under the Marathon GSA is based on an Energy Price derived
14 from the twelve-month average of the daily median of the midpoint prices at three
15 natural gas trading locations.⁴⁴ The “market basket” of trading locations contains two
16 locations that overlap with the ConocoPhillips GSA and seeks to dampen volatility
17 through geographic diversity.⁴⁵ The trading locations are Chicago Citygate, PG&E
18 Citygate, and SoCal Gas.⁴⁶ Base Load Gas volumes are priced at 98 percent of the
19 Energy Price, Seasonal Peak Tier 1 Gas is 105 percent of the Energy Price, Seasonal

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21 ⁴⁰E-1 (Dubay Direct) at 25-26; H-1 at 7; H-3 (Marathon GSA) at 45-49.

22 ⁴¹*Id.* at 25-27; H-1 at 7; H-3 (Marathon GSA) at 15-24.

23 ⁴²E-1 (Dubay Direct) at 26.

24 ⁴³*Id.* at 27; H-1 at 7.

25 ⁴⁴E-1 (Dubay Direct) at 26; H-1 at 7; H-3 (Marathon GSA) at 24-25.

26 ⁴⁵E-1 (Dubay Direct) at 26; H-1 at 7.

⁴⁶E-1 (Dubay Direct) at 26; H-1 at 7; H-3 (Marathon GSA) at 24-25.

1 Peak Tier 2 Gas is 115 percent of the Energy Price, Needle Peak Gas is 130 percent of
2 the Energy Price, Storage Gas up to 1.0 Bcf is 98 percent of the Energy Price, and
3 Storage Gas in excess of 1.0 Bcf is 88 percent of the Energy Price.⁴⁷ The GSA includes
4 an "S-curve" price dampening mechanism" that dampens volatility through adjusting the
5 Energy Price upward if the market basket value is below \$6.00 and adjusting it
6 downward if the index basket value is above \$8.50.⁴⁸

7 Positions of the Parties

8 ENSTAR states that it needs gas supplies beginning in January 2009.⁴⁹ It
9 asserts that the Energy Price provisions, made up of a "basket" of trading locations are
10 reasonable and that the tier pricing provisions are reasonable additions to the base
11 Energy Price and reasonably reflect the value of peaking gas supplies and storage.⁵⁰ It
12 claims that the proposed terms for the GSAs advocated by the AG and Chugach are not
13 available in the Cook Inlet market and that the Producers have no obligation to accept
14 contract terms dictated by the commission.⁵¹ Finally, ENSTAR argues that the
15 contracts meet the test of "overall reasonableness in the current market."⁵²

16 The AG argues that the ConocoPhillips GSA and the Marathon GSA are
17 the result of excessive Producer market power and contain unreasonable price terms
18 and unreliable gas supplies.⁵³ However, the AG does not recommend rejection of the
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20 ⁴⁷H-1 at 7; H-3 (Marathon GSA) at 24.

21 ⁴⁸E-1 (Dubay Direct) at 28; H-1 at 7; H-3 (Marathon GSA) at 24.

22 ⁴⁹ENSTAR Post-Hearing Brief at 4-7.

23 ⁵⁰*Id.* at 11-12, 14-15.

24 ⁵¹ENSTAR Post-Hearing Brief at 12-3.

25 ⁵²*Id.* at 7-11.

26 ⁵³AG Post-Hearing Brief at 7-13.

1 GSAs.⁵⁴ Instead the AG asks that we limit the price under the GSAs with the composite
2 index that was proposed by the AG's expert witness in Docket U-06-2, Arlon Tussing.⁵⁵
3 Tussing did not participate in the current proceeding. The AG's witness in this
4 proceeding, Cristina Klein, adopted Tussing's proposed index and recommends its use
5 in this docket.⁵⁶ The AG also asks that we state that approval of these GSAs is not
6 "precedent," that ENSTAR gas storage should be addressed in a separate docket, and
7 that ENSTAR should absorb some costs of the GSAs.⁵⁷

8 Chugach argues that the GSAs are unreasonable and should be
9 disapproved.⁵⁸ It claims that we can help ENSTAR manage 2009 without these
10 GSAs.⁵⁹ It suggests that we open a separate docket to address ENSTAR storage and
11 that we "tell" the State of Alaska, Department of Natural Resources (DNR) and the
12 United States of America Department of Energy (DOE) that local utilities need gas
13 under contract before LNG export is authorized.⁶⁰ Finally, it requests guidance on
14 reasonable natural gas pricing for Cook Inlet.⁶¹

15 Aurora does not oppose approval of the ConocoPhillips GSA and the
16 Marathon GSA.⁶² It requests our identification of attributes for acceptable future
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19 ⁵⁴AG Post-Hearing Brief at 2, 20.

20 ⁵⁵*Id.* at 15-17.

21 ⁵⁶*Id.* at 15-17.

22 ⁵⁷*Id.* at 18-19.

23 ⁵⁸Chugach Post-Hearing Brief at 2-13.

24 ⁵⁹*Id.* at 13-16.

25 ⁶⁰*Id.* at 16-19.

26 ⁶¹*Id.* at 19-20.

⁶²Aurora Post-Hearing Brief at 1-2, 20.

1 GSAs.⁶³ Attributes Aurora suggests are shorter terms, unbundled services including
2 deliverability and storage, and unbundled price.

3 Standard for Evaluation

4 We have articulated a standard for our evaluation of ENSTAR GSAs on
5 several previous occasions. Although there have been variations, we have consistently
6 looked to the public interest while considering whether ENSTAR acted in a prudent
7 fashion, whether the terms of the GSA at issue are reasonable,⁶⁴ and whether the GSA
8 ensures reliable and reasonably priced-utility service.⁶⁵ Accordingly, we evaluate the
9 ConocoPhillips and Marathon GSAs to determine whether approval is in the public
10 interest. We consider whether ENSTAR's decision to enter into the GSAs was prudent.
11 We consider whether the future gas supplies provided by the GSAs are reliable.

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13 ⁶³Aurora Post-Hearing Brief at 3-18.

14 ⁶⁴AS 42.05.431(a).

15 ⁶⁵Order U-83-2(6), *Order Approving Gas Supply Contracts and Related Tariff*
16 *Revisions*, dated June 3, 1983, at 6-8; Order U-88-49(6), *Order Approving Contract,*
17 *Exchange Agreement, and Gas Cost Adjustment; Subject to Conditions and*
18 *Modifications*, dated July 20, 1989, at 5, as corrected by *Errata Notice to Order No. 6,*
19 *dated August 1, 1989; Order U-01-7(8), Order Conditionally Approving TA117-4 (Gas*
20 *Sales Agreement) and Requiring Filing*, dated October 25, 2001, at 4, as corrected by
21 *Errata Notice to Order No. 8, dated December 21, 2001; Order U-96-108(12)/*
22 *U-03-84(7), Order Conditionally Approving Gas Sales Agreement, Inclusion of Costs of*
23 *Gas Sales Agreement in Gas Cost Adjustment, and Homer Area Surcharge; Denying,*
24 *Without Prejudice, the Request to Amend Service Area; Vacating Previous Filing*
25 *Requirement; and Requiring Filings*, dated March 23, 2004, at 6, as corrected by *Errata*
26 *Notice to Order U-96-108(12)/U-03-84(7), dated April 8, 2004; Order U-06-2(15), Order*
Rejecting TA139-4 as a Base Supply Contract Having the Effect of Increasing the
Current Average Cost of System Gas Supply but Allowing TA139-4 to Take Effect
Immediately as a Base Supply Contract Having the Effect of Decreasing the Current
Average Cost of System Gas Supply and Requiring Filings, dated September 28, 2006
(Order U-06-2(15)) at 22-23, as corrected by *Errata Notice to Order U-06-2(15), dated*
March 8, 2007; Order U-06-2(17), *Order Granting Reconsideration in Part; Denying*
Reconsideration in Part; and Revising Order U-06-2(15), dated December 29, 2006, at
2.

1 We are guided by AS 42.05.431(a). Under that subsection, we are required to
2 determine whether the GSAs or particular terms within the GSAs are unjust,
3 unreasonable, unduly discriminatory, or preferential when viewed in the context of Cook
4 Inlet which is unique among regional natural gas markets in the United States.

5 Prudency of Entering into GSAs

6 ENSTAR is a natural gas transmission and distribution utility that services
7 127,000 residential, commercial, industrial, and electric power generation customers.⁶⁶
8 ENSTAR has asserted and presented evidence that without new gas supply contracts it
9 faces a gas shortage beginning January 1, 2009.⁶⁷ ENSTAR acted in a reasonable
10 fashion to negotiate these GSAs.⁶⁸ We are convinced, based on the testimony, that
11 ENSTAR negotiated the best contracts it was able, given its urgent need for gas and its
12 position in relation to the Producers.⁶⁹ We find that ENSTAR acted in a prudent fashion
13 in entering into the ConocoPhillips and Marathon GSAs.

14 Reliable Supply

15 The AG questions the reliability of the supplies provided under the
16 ConocoPhillips GSA by highlighting Section 2.3(h) of the GSA which states that
17 deliveries to ENSTAR may be reduced if the State of Alaska (State) elects to take its
18 royalty in kind.⁷⁰ Additionally, the AG argues that ratepayers are at risk due to the lack
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20 ⁶⁶*Prefiled Direct Testimony of Mark William Slaughter*, filed May 28, 2008 (E-6) at
21 2-3.

22 ⁶⁷H-1 at 3; E-1 (Dubay Direct) at 4; E-6 (Slaughter Direct), MWS-2; Public
23 hearing, August 5, 2008 (Vol. VIII), Tr. (Slaughter) at 1273-1274.

24 ⁶⁸Public hearing, dated August 6, 2008 (Vol. IX), Tr. (Klein) at 1416-1417.

25 ⁶⁹Vol. II, Tr. (Dubay) at 99; Vol. IV, Tr. (Dubay) at 423; E-1 (Dubay Direct) at
26 12-14, 21, 27.

⁷⁰AG's Post Hearing Brief at 13; Vol. II, Tr. (Dubay) at 127-129.

1 of a requirement that Marathon deliver Needle Peak gas beyond 2010,⁷¹ or that
2 ConocoPhillips deliver Needle Peak gas beyond the first quarter of 2011⁷² and the
3 attendant need for ENSTAR to develop appropriate storage before those times.⁷³

4 ENSTAR argues that the GSAs provide for a reliable gas supply.⁷⁴
5 ENSTAR testified that the gas storage and peak shaving term within the ConocoPhillips
6 GSA will help ensure the reliability of ENSTAR's gas supply.⁷⁵ ENSTAR provided
7 testimony that it has purchased gas from Marathon for over forty years with no supply
8 disruptions.⁷⁶ Further, ENSTAR provided testimony that it is confident in
9 ConocoPhillips' ability to supply the volumes contracted under its GSA.⁷⁷

10 We find that the term in the ConocoPhillips GSA allowing a reduction in
11 deliveries to ENSTAR if the State elects to take its royalty in kind is not in the public
12 interest. This provision creates the potential for an impact in the gas supply relied upon
13 by ENSTAR and its customers. However, we will not require removal of the term. As
14 discussed below, there is sufficient evidence in the record to find that gas supplies
15 under the GSAs are reliable even with the inclusion of the offending term.

16 The DOE, Office of Fossil Energy recently granted the Producers' request
17 to export LNG from Cook Inlet to Japan or one or more countries on either side of the

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20 ⁷¹H-3 (Marathon GSA) at 17, 47-48.

21 ⁷²H-2 (ConocoPhillips GSA) at 11.

22 ⁷³AG's Post-Hearing Brief at 13; R-1 (Klein) at 62-68; Vol. II, Tr. at 142-145.

23 ⁷⁴ENSTAR'S Initial Post-Hearing Brief at 15-16.

24 ⁷⁵Vol. II, Tr. (Dubay) at 146.

25 ⁷⁶Vol. III, Tr. (Dubay) 366-368; Vol. VIII, Tr. (Slaughter) at 1252-1253.

26 ⁷⁷*Id.* at 369-370; *Id.* at 1251-1252.

1 Pacific Rim (DOE Order).⁷⁸ The DOE found that Cook Inlet contains adequate supplies
2 to meet domestic utility demand through at least the first quarter of 2011.⁷⁹ In its
3 application to the DOE, ConocoPhillips and Marathon provided information that there
4 were 1,726.4 Bcf of "proved and probable natural gas reserves in Cook Inlet" as of
5 January 1, 2006.⁸⁰ The State agreed with the Producers that Cook Inlet natural gas
6 resources are more than adequate to satisfy the requested export volumes and utility
7 demand in Southcentral Alaska during the export period.⁸¹ Both of the GSAs contain a
8 requirement for the Producers to curtail the delivery of gas to the LNG facility to the
9 extent necessary to meet their obligations under the GSAs.⁸² Further, both Producers
10 committed to undertake new drilling efforts in their settlement agreement with the State
11 of Alaska.⁸³

12 The ConocoPhillips GSA explicitly recognizes ENSTAR's priority, subject
13 to existing commitments, for delivery of natural gas.⁸⁴ Both GSAs require the Producers
14 to demonstrate on a yearly basis that they have proven and risked probable reserves
15 sufficient to fulfill their commitments to ENSTAR.⁸⁵ No party presented evidence that

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17 ⁷⁸*Order Granting Authorization to Export Liquefied Natural Gas from Alaska*,
18 FE Docket No. 07-02-LNG (June 3, 2008) (H-37) at 70. (The entire record before the
19 DOE in FE Docket No. 07-02-LNG was incorporated into evidence in this docket. Public
20 hearing, August 8, 2008 (Volume XI) Tr. at 1795-1796.)

21 ⁷⁹H-37 at 58-59.

22 ⁸⁰*Application for Blanket Authorization to Export Liquefied Natural Gas*,
23 FE Docket No. 07-02-LNG (January 10, 2007) (H-20) at 10.

24 ⁸¹*Prefiled Testimony of Cristina M. Klein*, filed June 24, 2008 (R-1), CMK-5 at 7
25 (§1(c)).

26 ⁸²H-2 at 12 (§2.3(i)); H-3 at 23 (§2.4 (c)).

⁸³R-1 (Klein), CMK-5 at 6, 9-10.

⁸⁴H-2 at 12 (§2.3(i)).

⁸⁵*Id.*; H-3 at 23 (§2.7).

1 Cook Inlet contains insufficient reserves or that either Producer lacks access to
2 sufficient reserves to meet the volume commitments presented in these GSAs.

3 Based on the evidence presented in this record we find that the future gas
4 supplies provided by the ConocoPhillips GSA and the Marathon GSA are reliable.
5 However, we reserve the right to revisit the reliability of gas supplies under these GSAs
6 if the Producers fail to follow through on the commitments made in the GSAs and during
7 the course of the DOE proceedings.

8 Statutory Authority

9 AS 42.05.431(a) states in part:

10 When the commission, after an investigation and hearing, finds that a rate
11 demanded, observed, charged, or collected by a public utility for a service
12 subject to the jurisdiction of the commission, or that a classification, rule,
13 regulation, practice, or contract affecting the rate, is unjust, unreasonable,
14 unduly discriminatory or preferential, the commission shall determine a just
15 and reasonable rate, classification, rule, regulation, practice, or contract to be
16 observed or allowed and shall establish it by order.

17 ENSTAR is a public utility that provides service subject to our
18 jurisdiction.⁸⁶ The ConocoPhillips and Marathon GSAs, if approved, will affect the rates
19 charged by ENSTAR.⁸⁷ Therefore, we are required by statute to determine whether the
20 GSAs are unjust, unreasonable, unduly discriminatory, or preferential, and if so,
21 determine terms that are just and reasonable, and establish them by order.

22 Preliminary Issues

23 During the course of these proceedings, it became apparent that we must
24 address two foundational issues that affect our analysis of the reasonableness of the
25 GSAs. The first issue is whether it is appropriate to price Cook Inlet natural gas used

26 ⁸⁶See ENSTAR's Certificate of Public Convenience and Necessity No. 4.

⁸⁷H-1 at 1.

1 locally at consumption area prices, as the GSAs do. The second issue is whether the
2 Producers entering into the GSAs with ENSTAR have market power in the Cook Inlet
3 natural gas market that would cast doubt on the reasonableness of all or portions of the
4 GSAs.

5 Cook Inlet Natural Gas Production

6 Vast quantities of natural gas were discovered in Cook Inlet by petroleum
7 companies exploring for oil.⁸⁸ Natural gas is currently produced in Cook Inlet and has
8 been produced in Cook Inlet for forty years.⁸⁹ A majority of the gas produced over those
9 forty years was converted to LNG or manufactured into fertilizer and exported out of the
10 Cook Inlet area.

11 Today, fertilizer is no longer produced in Cook Inlet. However, LNG
12 continues to be exported to Japan and will be exported to Japan until March 31, 2009.
13 At that time, a two-year extension of ConocoPhillips' and Marathon's export license will
14 take effect and LNG will be exported to Japan and/or one or more other countries on
15 either side of the Pacific Rim, according to the DOE order. The natural gas produced in
16 Cook Inlet and not exported is used for oil and gas production purposes and for electric
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20 ⁸⁸E-1 (Dubay Direct) at 7; E-4 (Carpenter Direct) at 9; Ex. H-29, *Economic
Analysis of Kenai LNG Export* (H-29) at 4-1.

21 ⁸⁹E-4 (Carpenter Direct) at 9-13 (history of natural gas discovery and production
22 in Cook Inlet), 18 (gas production by owner in Cook Inlet); E-4 (Carpenter Direct),
23 PRC-4 at 27-28 (natural gas supply in Cook Inlet); Public hearing, July 31, 2008 (Vol.
24 V), Tr. at 813 (Carpenter); Public hearing, August 11, 2008 (Vol. XII), Tr. at 1965
25 (Gibson); Vol. II, Tr. at 66 (Gibson); See H-2 (ConocoPhillips GSA); H-3 (Marathon
26 GSA); H-20 at 18-25 (natural gas exploration, development and supply in Cook Inlet);
H-29 at 4-1 (RD Report natural gas exploration and development); H-37 (DOE Order) at
45-47 (natural gas reserves in Cook Inlet).

1 and gas utility purposes.⁹⁰ The quantities to be sold under the ConocoPhillips and
2 Marathon GSAs are among the quantities used locally.⁹¹

3 The evidence presented in this record indicates that in 2007, the reserves-
4 to-production ratio for Cook Inlet was approximately 10:1.⁹² This means that without the
5 development of additional reserves, proven and probable reserves will be exhausted in
6 ten years.⁹³ By its nature, a reserves-to-production ratio is calculated for a production
7 area. A reserves-to-production ratio of around 8:1 to 10:1 is typical in Lower 48
8 states.⁹⁴ We find that the reserves-to-production ratio in Cook Inlet is in the same range
9 as is typical for Lower 48 production areas.

10 The need for natural gas in the Cook Inlet area has always been able to
11 be satisfied by Cook Inlet production. No natural gas has ever been imported into the
12 Cook Inlet area. Further, Cook Inlet is unique as the home of the only plant in the
13 United States that liquefies natural gas and ships it out of the immediate area as LNG.⁹⁵
14 In fact, as previously stated, LNG from Cook Inlet is exported outside of the United
15 States.⁹⁶ We find that Cook Inlet is a natural gas production basin.

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18 ⁹⁰E-1 at 8-9 (Dubay Direct); E-4 (Carpenter Direct) at 13-14; R-1 (Klein), CMK-2;
19 Vol. V, Tr. at 711-712 (Carpenter); Vol. VIII, Tr. at 1331-1332 (Klein).

20 ⁹¹H-2 (ConocoPhillips GSA) at 8 (definition of Receipt Point) and 36 (location of
21 Receipt Points); H-3 (Marathon GSA) at 13 (definition of Receipt Point(s)) and 58-60
(Exhibit C, location of Receipt Points).

22 ⁹²E-4 (Carpenter Direct) at 11.

23 ⁹³*Id.*

24 ⁹⁴H-29 at 4-4 to 4-5.

25 ⁹⁵Vol. V, Tr. at 774 (Carpenter); Public hearing, August 7, 2008 (Vol. X), Tr. at
26 1606 (Leitzinger).

⁹⁶H-37 (DOE Order) at 70.

1 Cook Inlet Market Power

2 ConocoPhillips, Marathon, and Union Oil Company of California, a division
3 of Chevron (Union), control the vast majority of the natural gas supplied in Cook Inlet.⁹⁷
4 Of these three, ConocoPhillips and Marathon are the two largest.⁹⁸ ConocoPhillips and
5 Marathon own the Kenai LNG export facility.⁹⁹ Therefore, the Cook Inlet market is
6 vertically integrated with the Producers as their own best customers through the
7 medium of sales to the LNG export facility.

8 ENSTAR's witness Carpenter, in earlier proceedings before the Federal
9 Energy Regulatory Commission (FERC), defined market power as:

10 [T]he power to raise price profitably above the competitive level (defined as
11 marginal cost) and not lose so many sales in the process that the price
12 increase must be rescinded. Courts have defined market power as "the
13 power to control prices or exclude competition."¹⁰⁰

14 In this docket, Carpenter agreed during cross-examination by the AG with a definition of
15 market power which stated in part "when one buyer or seller in a market has the ability
16 to exert significant influence over the quantity . . . of goods and services traded, or the
17 price at which they are sold."¹⁰¹ These definitions are consistent with the definition of
18 market power provided by Professors Samuelson and Nordhaus in the academic

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21 ⁹⁷R-1 (Klein) at 22; E-4 (Carpenter Direct) at 18.

22 ⁹⁸E-4 (Carpenter Direct) at 18.

23 ⁹⁹*Id.* at 17 (Carpenter Direct); H-20 (DOE Application) at 4; H-37 (DOE Order) at
24 14.

25 ¹⁰⁰H-44 at 10 (internal citation omitted).

26 ¹⁰¹Vol. V, Tr. at 610-611. (AG quoting a definition of market power from
Economist.com).

1 textbook *Microeconomics*.¹⁰² We reviewed ENSTAR's GSAs and the record in this
2 proceeding with these definitions of market power in mind.

3 As a gas utility ENSTAR requires a supply of natural gas for its very
4 existence. The AG presented testimony from its witness, Cristina Klein (Klein), that the
5 Producers in Cook Inlet have considerable or substantial market power.¹⁰³ Klein quoted
6 and affirmatively agreed with the State's observation in front of the DOE that "[t]he
7 Lerner Index approximation of basin price and cost indicates a degree of exerted
8 monopoly power is present at current price levels."¹⁰⁴ Eugene Dubay, the Senior Vice
9 President and Chief Operating Officer of ENSTAR's parent corporation, stated, "[W]e're
10 -- we're in a fairly constrained market and using again, my poor rental car analogy, at
11 least the [P]roducers here even though they -- they know to some extent they've got us
12 by the throat, are only asking for [sic] us what lots of other companies are paying in a
13 liquid market."¹⁰⁵ Under questioning from Commissioner Price, Carpenter, ENSTAR's
14 expert witness, stated, "[u]nder those circumstances [circumstances in Cook Inlet] the
15 [P]roducers definitely have market power. I've never -- I've never said they don't have
16 significant bargaining leverage. But it's the reality of the market. It's the reality under
17 which these contracts are negotiated."¹⁰⁶

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21 ¹⁰²Samuelson and Nordhaus, *Microeconomics*, Thirteenth Edition, McGraw-Hill,
22 Inc., 1989 at 631 ("The degree of control that a firm or group of firms has over the price
and production decisions in an industry.").

23 ¹⁰³R-1 (Klein) at 22-23.

24 ¹⁰⁴*Id.*

25 ¹⁰⁵Vol. IV, Tr. at 423.

26 ¹⁰⁶Vol. V, Tr. at 794.

1 ENSTAR issued a request for proposals (RFP) on February 1, 2007,
2 seeking long-term gas supply contracts to fill its projected need beginning in 2009.¹⁰⁷
3 ENSTAR requested supply proposals by March 19, 2007.¹⁰⁸ Only ConocoPhillips and
4 Marathon responded to the RFP.¹⁰⁹ The ConocoPhillips GSA was entered into on
5 April 10, 2008,¹¹⁰ and the Marathon GSA was entered into on April 11, 2008.¹¹¹ No
6 supplier would agree to fill the role of unmet requirements supplier for ENSTAR, and no
7 supplier would meet ENSTAR's full deliverability needs beyond the first quarter of
8 2011.¹¹²

9 Union, ENSTAR's current unmet requirements supplier, did not submit a
10 response to ENSTAR's RFP. Further, Union has supplied only the volumes required
11 under its contract with ENSTAR and has not provided any discretionary additional
12 volumes allowed under the contract.¹¹³

13 Certain terms that were agreed to by ENSTAR give us concern and
14 provide evidence of an excessive degree of control over the terms of the GSAs by
15 ConocoPhillips and Marathon. These terms include the limitations on the ability for
16 third-party producers to supply gas to ENSTAR found in the Marathon GSA; the
17 requirement for ENSTAR to develop storage to successfully provide service to its
18 customers inherent in both the ConocoPhillips GSA and the Marathon GSA; and the
19 explicit contractual control over ENSTAR's participation in this proceeding by

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21 ¹⁰⁷E-1 (Dubay Direct), END-1 at 1.

22 ¹⁰⁸*Id.*, 1 at 2.

23 ¹⁰⁹*Id.* at 13; H-1 at 2.

24 ¹¹⁰H-2 (ConocoPhillips GSA) at 4.

25 ¹¹¹H-3 (Marathon GSA) at 6.

26 ¹¹²E-1 (Dubay Direct) at 14; E-2 (Dubay Reply) at 39.

¹¹³E-1 (Dubay Direct) at 13; E-6 (Slaughter Direct) at 6.

1 ConocoPhillips and Marathon, neither of whom filed a petition to intervene to participate
2 on its own behalf.

3 The Marathon GSA contains a provision that ENSTAR states "allow[s]
4 increased access by independent producers to the ENSTAR market" ¹¹⁴ However,
5 the term may be viewed as a restriction on ENSTAR's ability to procure gas from a
6 third-party supplier, rather than an opportunity for such a third-party supplier. ¹¹⁵ The
7 provision states that it accommodates purchases of up to 0.5 Bcf from a new supplier to
8 begin in 2011. ¹¹⁶ However, the third-party supplier must meet all levels of deliverability
9 described under the GSA, meaning Base Load Gas, Seasonal Peak Tier 1 Gas,
10 Seasonal Peak Tier 2 Gas, and Needle Peak Gas. ¹¹⁷ Marathon is no longer required to
11 provide Needle Peak Gas in 2011. ConocoPhillips only provides Base Load Gas after
12 the first quarter of 2011. Therefore, the small third-party supplier must provide a higher
13 level of deliverability than the two largest suppliers of natural gas in Cook Inlet if it seeks
14 to supply relatively small amounts of gas to ENSTAR. It is doubtful that an independent
15 supplier can provide a higher level of deliverability than Marathon itself is willing to
16 provide. This provision is unreasonable on its face, is evidence of Marathon's ability to
17 exclude competition, and is evidence of an excessive degree of control over the terms
18 of the GSA by Marathon. We note that this provision may be inconsistent with our
19 requirement that all future ENSTAR contracts shall be unbundled as to volume and
20 price. To the extent that Section 2.4(b) of the Marathon GSA is inconsistent with our
21 directive, we do not approve the inconsistent aspect of the provision.

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23 ¹¹⁴E-6 (Slaughter Direct) at 12.

24 ¹¹⁵H-3 (Marathon GSA) at 22-23 (§2.4(b)).

25 ¹¹⁶H-1 at 8; H-3 (Marathon GSA) at 22 (§2.4(b)).

26 ¹¹⁷H-3 (Marathon GSA) at 23 (§2.4(b)).

1 The GSAs contain terms that allowed ConocoPhillips and Marathon to
2 exert a significant degree of control over ENSTAR during these proceedings. Neither
3 ConocoPhillips nor Marathon became a party to this docket. Neither ConocoPhillips nor
4 Marathon filed a petition to intervene in this docket. Under the terms of its GSA:

- 5 • ConocoPhillips was affirmatively “not obligated” to file a petition to
6 intervene in this docket;
- 7 • ENSTAR was required to provide copies of all pleadings in this docket
8 to ConocoPhillips;
- 9 • ENSTAR was required to seek approval for filings that may include
10 content that would impact ConocoPhillips’ business in Cook Inlet; and
- 11 • ConocoPhillips could have objected and prevented ENSTAR from
12 using content that would affect ConocoPhillips’ business.¹¹⁸

13 Both GSAs allow the Producers to terminate the agreements if they
14 determine that discovery requests are “unduly burdensome,” while ConocoPhillips may
15 terminate its GSA if it decides that discovery requests are “not relevant to the
16 proceeding.”¹¹⁹ These provisions provide evidence that ConocoPhillips and Marathon
17 possess the ability to exert significant influence over the terms of any sale of natural gas
18 to ENSTAR.

19 ENSTAR describes the difficulty in meeting its full deliverability for all
20 levels of demand and the consequences that may ensue in its prefiled testimony.¹²⁰
21 The difficulty in meeting deliverability relates to the large differential between ENSTAR’s
22 peak demand on the coldest day in the winter and its lowest demand during the
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24 ¹¹⁸H-2 (ConocoPhillips GSA) at 21-22 (§10.1(a)).

25 ¹¹⁹H-2 (ConocoPhillips GSA) at 22 (§10.1(b)); H-3 (Marathon GSA) at 35 (§11.3).

26 ¹²⁰E-1 (Dubay Direct) at 9-11; E-6 (Slaughter Direct) at 5.

1 summer.¹²¹ The consequences of failure to meet full deliverability could include service
2 interruptions during the coldest time of the year.¹²² Yet, neither GSA will provide
3 ENSTAR with full deliverability for all levels of demand beyond 2010. This shortcoming
4 requires ENSTAR to obtain and implement storage prior to that time. While ENSTAR
5 plans to do so, it has no concrete strategy in place at this time.¹²³ The deliverability tiers
6 of the GSAs were developed in order to meet the Producers' desired efficiency range.¹²⁴
7 The Producers' implicit refusal to provide ENSTAR with gas at full deliverability
8 throughout the length of the GSAs, and the GSAs' inherent requirement for ENSTAR to
9 develop and implement storage by 2011, is evidence that ConocoPhillips and Marathon
10 exerted significant influence on the deliverability terms of the GSAs.

11 We find that ConocoPhillips and Marathon have market power over
12 ENSTAR in the Cook Inlet natural gas market. Further, we find that the GSAs that
13 ENSTAR has submitted for approval in this docket contain terms that are affected by
14 the Producers' exercise of their market power.

15 The finding that the Producers have market power over ENSTAR, and our
16 earlier finding that Cook Inlet is a production area, in and of themselves do not require
17 any particular action on our part in relation to the GSAs. However, the findings do affect
18 our evaluation of whether the GSAs or particular terms within the GSAs are unjust,
19 unreasonable, unduly discriminatory, or preferential when viewed in the context of Cook
20 Inlet, which is unique among United States regional natural gas markets.

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22 ¹²¹E-6 (Slaughter Direct) at 5.

23 ¹²²E-1 (Dubay Direct) at 10.

24 ¹²³*Id.* at 41-42; *Errata to Reply Testimony of Eugene N. Dubay*, filed
25 July 21, 2008 (E-2) at 39.

26 ¹²⁴E-6 (Slaughter Direct) at 7; H-2 (ConocoPhillips GSA) at 10-11; Public hearing,
dated August 4, 2008 (Vol. VII), Tr. at 1076 (Slaughter).

1 GSA Price Terms

2 The parties presented widely varied viewpoints on the reasonableness of
3 the pricing terms of the GSAs. ENSTAR presented evidence that the price terms are
4 reasonable.¹²⁵ Regarding the ConocoPhillips GSA, ENSTAR stated, "The price was
5 arrived at through arm's length negotiations. The Company agreed to this price
6 because it is a reasonable market-based price for the value of natural gas in Cook
7 Inlet."¹²⁶ Regarding the Marathon GSA ENSTAR similarly stated, "From the Company's
8 perspective, I would also emphasize that this is a market-based price, negotiated at
9 arm's length in the market in which ENSTAR must buy its gas supplies. It is the price
10 that ENSTAR was required to pay to induce [Marathon Oil Company] to commit the gas
11 to ENSTAR with all of the positive elements that the contract includes."¹²⁷ ENSTAR
12 asserts that it is not realistic to expect it to obtain GSA terms that are not available in the
13 market.¹²⁸ ENSTAR argues that the tier pricing provisions are reasonable and reflect
14 the value of deliverability and seasonal swing services compared to the value of similar
15 services such as storage.¹²⁹ ENSTAR acknowledges that there is some seasonal
16 fluctuation due to demand built into the Energy Price.¹³⁰ ENSTAR states that based on
17 its forecasts its calculations show that under the ConocoPhillips GSA, the tier structure

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20 ¹²⁵E-1 (Dubay Direct) at 18-28; E-2 (Dubay Reply) at 26-30; E-4 (Carpenter
21 Direct) at 5-9, 32-47; *Prepared Reply Testimony of Paul R. Carpenter*, filed
22 July 14, 2008 (E-5) at 5-9.

23 ¹²⁶E-1 (Dubay Direct) at 19.

24 ¹²⁷*Id.* at 27.

25 ¹²⁸E-2 (Dubay Reply) at 9.

26 ¹²⁹E-4 (Carpenter Direct) at 4, 43-47; Vol. IV, Tr. at 499-501 (Dubay).

¹³⁰Volume II, Tr. at 160 (Dubay).

1 will add in the range of \$0.95/Mcf¹³¹ to \$1.24/Mcf to the Energy Price for 2009.¹³²
2 Similarly, it states that based on its forecasts the Marathon GSA tier structure will add in
3 the range of \$.75/Mcf to \$.88/Mcf to its Energy Price for 2009.¹³³ ENSTAR claims that
4 the tier additions are not excessive when compared to benchmarks for storage services
5 in Lower 48 markets.¹³⁴

6 The AG presented evidence in support of his argument that the pricing
7 provisions of the GSAs are not reasonable.¹³⁵ The AG claims that a reasonable price
8 for Cook Inlet gas with full deliverability would be "the CICI market index proposed by
9 [the Regulatory Affairs and Public Advocacy Section of the Department of Law] and
10 used in the COP [ConocoPhillips] GSA. . . ."¹³⁶ The "CICI market index" proposed by
11 the AG is composed of the same trading hubs utilized by the ConocoPhillips GSA to
12 calculate an Energy Price.¹³⁷ The AG states that these trading hubs are reasonable
13 because one, TCPL Alberta, AECO-C, "would be the first liquid point for Alaska gas
14 flowing south by pipeline."¹³⁸ And, "The other four hubs have a closer regional affinity to
15 Alaska than East Coast or Midwest hubs, and/or they are locations where Alaska LNG
16 might someday be shipped."¹³⁹ The AG claims that the tier pricing provisions within the

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19 ¹³¹Mcf means one thousand standard cubic feet.

20 ¹³²E-4 (Carpenter Direct) at 45.

21 ¹³³*Id.*

22 ¹³⁴*Id.*

23 ¹³⁵R-1 (Klein) at 30-41.

24 ¹³⁶*Id.* at 41.

25 ¹³⁷*Id.* at 31, 41.

26 ¹³⁸*Id.* at 41.

¹³⁹*Id.* at 41.

1 GSAs are unreasonable.¹⁴⁰ Further, the AG asserts that the Energy Price under the
2 GSAs is a yearly average that already includes costs for storage and seasonal swing.¹⁴¹
3 The AG advocates for pricing provisions that average out to the CICI median price with
4 discounts for base gas and adders for peaking gas.¹⁴² However, the AG acknowledges
5 that ENSTAR had limited bargaining power and that ENSTAR needs the gas provided
6 by the GSAs.¹⁴³ Therefore, the AG recognizes that public policy may require approval
7 of the GSAs.¹⁴⁴

8 Chugach offered testimony that ENSTAR failed to present a compelling
9 economic justification for the pricing provisions of the GSAs.¹⁴⁵ Chugach also
10 presented testimony that the price provisions of the GSAs are unreasonable.¹⁴⁶
11 Chugach presented testimony suggesting that production basin indices are more
12 appropriate pricing proxies for the Cook Inlet than trading hub and city gate indices.¹⁴⁷
13 Chugach also presented testimony that ENSTAR's weighted average cost of gas
14 (WACOG) may be an "attractive" price for sellers.¹⁴⁸

15 ENSTAR responded to Chugach's testimony claiming that production area
16 prices are inappropriate for Cook Inlet as there is consumption as well as production in
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19 ¹⁴⁰R-1 (Klein) at 42-48.

20 ¹⁴¹Vol. IX, Tr. at 1450 (Klein).

21 ¹⁴²R-1 (Klein) at 43.

22 ¹⁴³Vol. VIII, Tr. at 1325 (Klein).

23 ¹⁴⁴Vol. IX, Tr. at 1394 (Klein).

24 ¹⁴⁵C-1 (Leitzinger) at 3-27.

25 ¹⁴⁶C-3 (Gibson) at 3-23.

26 ¹⁴⁷*Id.* at 8-11.

¹⁴⁸*Id.* at 13-17.

1 Cook Inlet.¹⁴⁹ However, as noted by Chugach, there is generally consumption in a
2 production basin.¹⁵⁰ Further, ENSTAR's witness Carpenter acknowledged during cross-
3 examination that there is consumption in Lower 48 production areas.¹⁵¹

4 We stated in Order U-06-2(15) that the use of a market index to set the
5 price terms for an ENSTAR GSA may be acceptable.¹⁵² However, the use of the
6 market index must be justified and reconciled with Cook Inlet market conditions.¹⁵³ We
7 also stated that a GSA may not add costs for transportation or production taxes over
8 and above the index price.¹⁵⁴ Further, we stated that the use of an index requires "a
9 meaningful cap."¹⁵⁵

10 The Union contract was intended to be an exploration contract, with a
11 price Union represented it needed to explore and develop additional resources for the
12 local utility market, and, specifically, for ENSTAR. Union's unwillingness to provide
13 additional volumes to ENSTAR, discussed above, is further evidence supporting our
14 conclusion in Order U-06-2(15) that attempts to justify the prices in an ENSTAR GSA
15 through asserting the need to provide an exploration and development incentive in Cook
16 Inlet have not been fully realized.¹⁵⁶

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20 ¹⁴⁹E-5 (Carpenter Reply) at 35.

21 ¹⁵⁰Vol. XII, Tr. at 1976 (Gibson).

22 ¹⁵¹Vol. V, Tr. at 707-708 (Carpenter).

23 ¹⁵²Order U-06-2(15) at 34.

24 ¹⁵³*Id.*

25 ¹⁵⁴*Id.*

26 ¹⁵⁵*Id.*

¹⁵⁶*Id.* at 24-27.

1 Meaningful Price Cap

2 The price that ENSTAR pays for natural gas is passed on to its
3 ratepayers. Residential customers need gas for space heating purposes and their
4 demand is fairly inelastic.¹⁵⁷ For the price terms of ENSTAR's GSAs to be reasonable,
5 or for the cap on a market index to be meaningful, they must bear some relationship to
6 the characteristics that exist in Cook Inlet. We find that it is in the public interest to
7 place a dynamic market-based cap on the burden ratepayers are required to bear. For
8 this cap to be meaningful, we tie it to production-area market prices. This is appropriate
9 given the unique nature of Cook Inlet as a production area that exports a significant
10 amount of its natural gas beyond its immediate geographic boundaries and is home to
11 the only LNG export plant in the United States. The cap is necessary to protect the
12 public interest given the market power over ENSTAR that is held by the Producers.

13 Based on the record presented in this proceeding, we find that a
14 ConocoPhillips GSA Price Cap and a Marathon GSA Price Cap based on the El Paso,
15 Permian Basin; Panhandle, Tx.-Okla.; El Paso, San Juan Basin; Kern River, Opal Plant;
16 and TCPL Alberta, AECO-C trading locations will provide a meaningful and appropriate
17 cap for price terms in ENSTAR's GSAs with ConocoPhillips and Marathon.¹⁵⁸ The Price
18 Cap shall be calculated based on the twelve month trailing average of the trading
19 locations and is further explained in Appendix D and Appendix E to this order. The
20 ConocoPhillips Price Cap and the Marathon Price Cap include production taxes and
21 royalties.

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24 ¹⁵⁷Vol. V, Tr. at 638 (Carpenter).

25 ¹⁵⁸See Ex. H-45, *Production Prices vs. Consumption Prices* (H-45); *Prefiled*
26 *Direct Testimony of Suzanne L. Gibson*, filed June 24, 2008 (C-3) SLG-3.

1 The trading locations were selected because they are net producing
2 locations and export gas beyond their immediate geographic vicinity.¹⁵⁹ They are
3 located in the United States and Canada with geographic diversity to dampen risk. The
4 trading locations are transparent with daily trading volumes.¹⁶⁰ These factors work
5 together to provide a meaningful cap that will help to ameliorate any unreasonable price
6 terms within the GSAs. Correspondingly, the ConocoPhillips Price Cap and the
7 Marathon Price Cap also recognize the need for the Producers to earn market based
8 rates.¹⁶¹

9 Based on our review of the pricing information provided by ENSTAR we
10 find that, with one modification, the calculations embodied in the tier structure for base,
11 seasonal and needle peak gas in the Marathon GSA, is a more accurate representation
12 of seasonal price fluctuations than the calculations embodied in the tier structure
13 proposed by the ConocoPhillips GSA.¹⁶² We do require a minor modification to the
14 price structure for Base Load Gas and Seasonal Peak Tier 1 Gas in the Marathon GSA
15 (§3.1(a)) for purposes of calculating the Marathon Price Cap. Base Load Gas and
16 Seasonal Peak Tier 1 Gas are used year-round, and gas from both tiers is taken every
17 day of the contract year.¹⁶³ Therefore it is unreasonable to segment these tiers and
18 unreasonable to charge a 5 percent premium for a portion of this year-round gas. We
19 require the Marathon GSA Price Cap to be calculated such that Base Load Gas and
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21 ¹⁵⁹E-5 (Carpenter Reply) at 39; C-3 (Gibson Direct) at 9; H-45; Vol. III, Tr. at
22 208-209 (Dubay); Vol. V, Tr. at 714, 717 (Carpenter); Vol. XII, Tr. at 1975-1977
(Gibson).

23 ¹⁶⁰See C-3 (Gibson Direct), SLG-3.

24 ¹⁶¹See E-1 (Dubay Direct) at 33; Vol. III, Tr. at 208-209 (Dubay).

25 ¹⁶²See H-68 (Carpenter work papers, excel spreadsheet).

26 ¹⁶³E-6 (Slaughter Direct) at 8.

1 Seasonal Peak Tier 1 Gas are priced at 100 percent of the Energy Price. We are
2 allowing tier additions in the calculation of the Price Caps to recognize the need to
3 compensate the Producers for services such as meeting quality specifications and
4 transporting gas to ENSTAR's system.¹⁶⁴

5 We find that the floating market-based caps based on production area
6 trading locations are an appropriate limit and price signal for ENSTAR GSAs given the
7 current market conditions. The ConocoPhillips Price Cap and the Marathon Price Cap
8 shall remain in effect as long as natural gas is exported from Cook Inlet or there are
9 ongoing activities leading to the export of natural gas.

10 Tier Pricing

11 We find that storage costs are embedded in the tiers. Therefore, the value
12 of storage is hidden and difficult to analyze. Further, we find that the evidence shows
13 that the tier demarcations were Producer-efficiency driven and then retroactively
14 superimposed on ENSTAR's seasonal demand profile.¹⁶⁵ However, we recognize that
15 ENSTAR's forecasts indicate a need for the gas supplied by these GSAs in 2009. We
16 find that the pricing tiers in these GSAs are the beginning of unbundled pricing of supply
17 to ENSTAR. While imperfect, the tiers are an interim step to achieve unbundled rates.
18 We require the next GSAs filed by ENSTAR for our approval to be fully unbundled,
19 including pricing for storage. We explicitly do not endorse the tier structure in either of
20 the current GSAs; however in the absence of storage, some seasonal differential pricing
21 may be appropriate. In light of the forecasted immediate need for gas and the very tight
22 deliverability constraints in Cook Inlet, and provided that the GSAs are amended to
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24 ¹⁶⁴See E-5 (Carpenter Reply) at 35.

25 ¹⁶⁵E-6 (Slaughter Direct) at 7; H-2 (ConocoPhillips GSA) at 10.

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1 incorporate the ConocoPhillips Price Cap and the Marathon GSA Price Cap,
2 respectively, we do not find the tier structures unreasonable.

3 ConocoPhillips Quarterly Price Adjustment

4 The AG expressed concern that the quarterly price adjustment contained
5 within the ConocoPhillips GSA¹⁶⁶ presented the potential for rate shock.¹⁶⁷ In response,
6 ENSTAR presented testimony that the quarterly adjustment would dampen any
7 potential swings in pricing.¹⁶⁸ Further, the AG acknowledged that the volumes subject
8 to the quarterly adjustment are small and the potential impact would not be
9 significant.¹⁶⁹ We do not find that the quarterly price adjustment term in the
10 ConocoPhillips GSA is unreasonable.

11 Public Interest

12 We find that the public interest is served through ENSTAR's entering into
13 GSAs with terms that are not unreasonable and which reflect the characteristics of the
14 Cook Inlet natural gas production area. We find that ENSTAR acted in a prudent
15 fashion to enter into the ConocoPhillips and Marathon GSAs and that the future gas
16 supplies provided for under the GSAs are reliable. We find that the public interest
17 requires a floating market-based cap on the price terms of the GSAs that reflects the
18 Cook Inlet's unique status as a production area that exports natural gas beyond its
19 immediate geographic area and outside of the United States. The ConocoPhillips GSA
20 Price Cap and the Marathon GSA Price cap are required to help militate against the
21 market power and resultant imbalance in bargaining power held by the Producers over
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23 ¹⁶⁶H-2 (ConocoPhillips GSA) at 15 (§3.3).

24 ¹⁶⁷R-1 (Klein) at 48-49.

25 ¹⁶⁸Vol. II, Tr. at 168-170 (Dubay).

26 ¹⁶⁹Vol. VIII, Tr. at 1348-1351 (Klein).

1 ENSTAR. We find that approval of the GSAs, with the conditions described in the order
2 above, is in the public interest. We require ENSTAR to amend the GSAs to incorporate
3 the appropriate Price Cap.

4 Involvement of Other Government Agencies

5 Evidence presented in this record has made clear that it is the State of
6 Alaska, Department of Natural Resources (DNR), which has the ability to require and
7 approve plans of development by natural gas producers.¹⁷⁰ Further, DNR has the ability
8 to influence exploration and development at the time the Producers appear before the
9 DOE to request an extension of their export authorization.¹⁷¹ It is the United States of
10 America Department of Energy (DOE) which has the ability to place conditions on the
11 Producers' authorization to export natural gas. Our role in the regulatory regime is to
12 review the ENSTAR GSAs presented in this docket in order to hold utility prices to a
13 reasonable level.¹⁷²

14 In the recent proceedings before the DOE, DNR and the State Attorney
15 General, on behalf of the State as a resource owner,¹⁷³ entered into a settlement
16 agreement with ConocoPhillips and Marathon that resulted in the State's unconditional
17 support for the Producers' export application.¹⁷⁴ As a part of the settlement agreement,
18 ConocoPhillips and Marathon committed to act in good faith, in their sole discretion, to
19 complete gas supply agreements with ENSTAR that we would find approvable.¹⁷⁵ The

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21 ¹⁷⁰Tr. at 1826-28 (Hosie).

22 ¹⁷¹See e.g., Tr. at 1893-94 (Dubay); CMK-5 at 1, 6, 9-12.

23 ¹⁷²Order U-06-2(15) at 32.

24 ¹⁷³The Attorney General, Regulatory Affairs & Public Advocate was not a party to
25 the settlement agreement.

26 ¹⁷⁴CMK-5 at 1-2.

¹⁷⁵CMK-5 at 8.

1 recent authorization to export LNG allows the Producers to export up to 98.1 Bcf of LNG
2 between April 2009 and March 2011.¹⁷⁶ In contrast, the ConocoPhillips GSA and
3 Marathon GSA combine to provide 37.8 Bcf of natural gas to local ratepayers through
4 ENSTAR, a local utility. As explained above, we have concerns about the GSAs and
5 are able to approve them only after amendment to incorporate a Price Cap. Based on
6 our review of the record, we find that the DOE's decision to extend the Producers'
7 export authority negatively impacted ENSTAR's negotiating position and the resulting
8 terms of the ConocoPhillips GSA and the Marathon GSA. We recognize that the LNG
9 export facility is a benefit to the State of Alaska as a whole and that the export of LNG
10 stimulates exploration and development of new reserves. However, it is in the best
11 interests of local utility ratepayers to require the Producers to finalize contracts with
12 local utilities before receiving authorization to export natural gas. Therefore, we request
13 that DNR require the Producers to provide completed gas supply agreements, which we
14 have approved, with local utilities before supporting any future export applications from
15 the Producers. Additionally, we request that DOE require the Producers to provide
16 completed gas supply agreements, which we have approved, with local utilities before
17 granting future applications for authorization to export LNG.

18 Final Order

19 This order constitutes the final decision in this proceeding. This decision
20 may be appealed within thirty days of the date of this order in accordance with
21 AS 22.10.020(d) and the Alaska Rules of Court, Rule of Appellate Procedure
22 (Ak. R. App. P.) 602(a)(2). In addition to the appellate rights afforded by
23 AS 22.10.020(d), a party has the right to file a petition for reconsideration as permitted
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¹⁷⁶H-37 (DOE Order) at 70.
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1 by 3 AAC 48.105. If such a petition is filed, the time period for filing an appeal is then
2 calculated under Ak. R. App. P. 602(a)(2).

3 **ORDER**

4 THE COMMISSION FURTHER ORDERS:

5 1. The *Gas Sales Agreement Between ConocoPhillips Alaska, Inc. and*
6 *Alaska Pipeline Company*, filed with TA167-4 on April 11, 2008, is approved, subject to
7 filing of an amendment that incorporates the ConocoPhillips GSA Price Cap described
8 in this order.

9 2. By 4 p.m., December 1, 2008, ENSTAR Natural Gas Company, a
10 Division of SEMCO Energy, Inc. shall file an amendment to the *Gas Sales Agreement*
11 *Between ConocoPhillips Alaska, Inc. and Alaska Pipeline Company*, filed with TA167-4,
12 that incorporates the ConocoPhillips GSA Price Cap described in this order.

13 3. The *Gas Sales Agreement Between Marathon Oil Company and*
14 *Alaska Pipeline Company*, filed with TA167-4 on April 11, 2008, is approved, subject to
15 filing of an amendment that incorporates the Marathon GSA Price Cap described in this
16 order; and subject to the further exception that any aspect of Section 2.4(b) of the
17 agreement that is inconsistent with our directive that future ENSTAR gas sales
18 agreements shall be unbundled as to price and volume is not approved.

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4. By 4 p.m., December 1, 2008, ENSTAR Natural Gas Company, a Division of SEMCO Energy, Inc. shall file an amendment to the *Gas Sales Agreement Between Marathon Oil Company and Alaska Pipeline Company*, filed with TA167-4, that incorporates the Marathon GSA Price Cap described in this order.
DATED AND EFFECTIVE at Anchorage, Alaska, this 31st day of October, 2008.

BY DIRECTION OF THE COMMISSION



Regulatory Commission of Alaska
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