Greenberg Traurig

Memorandum

TO: Senator Therriault
Representative Samuels
Joe Balash
Henry Webb
Bonnie Robson

FROM: Donald C. Shepler

DATE: April 22, 2005

RE: Competitive Analysis of Producer-Owned Alaska Natural Gas Pipeline

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At your request we have examined the competitive issues that might arise in the context of an Alaska natural gas pipeline if owned by the major North Slope producers. As you are aware, in 1977 the U.S. Attorney General recommended that such ownership be prohibited in implementing the Alaska Natural Gas Transportation Act ("ANGTA"). President Carter later forbade any producer ownership interest in the ANGTA pipeline. Recently, on January 28, 2005, those historical events were highlighted when the Chairman of the FERC wrote that the Commission would be mindful of competitive issues in reviewing any certificate application for a producer-owned line and noted that the antitrust concerns of the 1970's were "still valid and will be addressed" by the Commission.

Our analysis of the competitive issues is set forth in the accompanying memorandum by Ken Minesinger and Cecil Chung of Greenberg Traurig.[1] We conclude that the vertical integration arising from the largest North Slope producers also owning the only gas pipeline out of the state continues to raise serious competitive issues. Indeed, based on FTC precedent there is a significant chance that if the pipeline existed today the major producers would not be allowed to acquire it, largely because, and in contrast with an independent pipeline, the producer-owners would have the incentive and the ability to use their control over the pipeline to discriminate against rival producers and delay or defeat an expansion. Another concern relates

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[1] Mr. Minesinger, who is a past Chairman of the Antitrust Committee of the Energy Bar Association, has a unique combination of antitrust experience, having worked on numerous mergers involving major natural gas pipelines and other energy companies before the Federal Trade Commission ("FTC") and Department of Justice, and FERC experience, including several major FERC market power cases involving natural gas pipelines. Mr. Chung worked for years on the staff of the FTC -- the federal antitrust agency that typically reviews natural gas pipeline as well as many other energy sector mergers and acquisitions. While at the FTC, Mr. Chung investigated numerous energy industry mergers and acquisitions, including several natural gas pipeline transactions, and has continued to work on energy matters in private practice.

to the ability of producer-owners to raise rates on the pipeline, thereby raising the real cost to their competitors of doing business in Alaska. Such discrimination and delay could potentially cause competing producers to sell their leases at distress prices or even surrender their leases. Thus, an independent pipeline would be notably superior to a producer-owned pipeline from a competitive perspective.

We would anticipate that if the North Slope producers file for FERC approval of a pipeline the Commission would be required to address these competitive problems. This could well require that FERC adopt remedies that go beyond its existing regulations recently promulgated in Order No. 2005, and under Order No. 2004 (dealing with treatment of affiliates who own capacity on interstate pipelines).[2] These new remedies would likely include "structural" remedies which FTC and DOJ, and in some instances FERC itself, favor as a more effective means of preventing anticompetitive conduct than regulatory remedies. Such remedies could include: (1) partial divestiture to an independent pipeline; (2) establishment of an independent system operator, with the power to require expansions; and, (3) creation of an independent market monitor. FERC has adopted some of these remedies in electric utility cases, although these remedies would essentially be "new ground" in the context of a FERC pipeline certificate proceeding.

Although we deem it unlikely that FERC would refuse to certificate a producer-owned pipeline, we believe that a producer application would encounter moderate to significant delay compared to an application by an independent pipeline company due to litigation of the competitive and remedial issues identified above. This process could well result in conditions being imposed on the certificate that will be unacceptable to the producer-owners, who, in the end, may elect not to build the pipeline after all. An independently owned pipeline, by contrast, would face the same rate, tariff, design and environmental review processes at the FERC, but none of the competitive concerns that would give rise to such delay and risk that the pipeline will not be built.

[2] Order No. 2005—dealing with open season rules for an Alaskan pipeline—is the subject of rehearing petitions filed by the North Slope producers. Further, ChevronTexaco has filed an appeal of Order No. 2005 in the U.S. Court of Appeals for the District of Columbia Circuit (Case No. 05-1111).

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Memorandum

TO: Senator Therriault
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cc: Donald C. Shepler

FROM: Kenneth M. Minesinger
Cecil Chung

DATE: April 22, 2005

RE: Competitive Analysis of Producer-Owned Alaska Natural Gas Pipeline

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Introduction and Executive Summary

In 1977 the United States Attorney General warned that producer ownership of the Alaska natural gas pipeline would raise serious competitive concerns. You have asked us to address whether similar concerns exist today, and in particular whether ownership of the Alaska natural gas pipeline by a joint venture formed by the three major oil and gas producers in Alaska – BP, ConocoPhillips, and Exxon (the "Big 3") – would violate the federal antitrust laws or otherwise raise significant competitive issues. This memorandum concludes that the same or similar competitive issues identified by the Attorney General in 1977 continue to exist today and that time-consuming litigation regarding these issues and potential remedies is likely.

More specifically, a producer-owned pipeline would raise the following competitive issues, based on the available facts:

- A strong argument can be made that Big 3 ownership of the Alaska gas pipeline would raise serious competitive concerns, based on Federal Trade Commission

("FTC") and Department of Justice ("DOJ") consent decrees, and precedents of the Federal Energy Regulatory Commission ("FERC").

- For example, although we have not had the benefit of obtaining an expert economist's views on this subject, a significant risk exists that a pipeline owned by the Big 3 would have the incentive and the ability to discriminate against rival producers, including by delaying or defeating any pipeline expansion needed to serve rivals. An independent pipeline typically would not involve this or similar risks.

- FERC regulations that attempt to prevent this kind of anticompetitive conduct would not be dispositive in an FTC/DOJ antitrust analysis. Despite the existence of FERC regulation, the antitrust agencies have actively sought to prohibit anticompetitive mergers and activities in the energy industry, and have developed a strong preference for "structural" remedies such as divestiture over "behavioral" remedies such as FERC's "firewall" regulations. According to the antitrust agencies, a behavioral/regulatory remedy can be evaded and "does not eliminate the incentive and opportunity to engage in exclusionary behavior."[1]

- FERC is, nevertheless, highly relevant because a separate FTC or DOJ investigation is, while not inconceivable, unlikely, and any dispute over the competitive issues posed by Big 3 ownership of the pipeline would likely be addressed in a FERC certificate or complaint proceeding. FERC Chairman Wood has recently stated that FERC will fully consider antitrust concerns, and it is possible that FERC would make its certificate decision with input from the FTC or DOJ.

- Although it is possible FERC could decide that its existing regulations sufficiently protect against the exercise of market power (contrary to the what the Big 3 themselves have argued in other cases), based on the unique facts associated with the Alaska pipeline we think there is a not insignificant chance that FERC could be convinced to impose remedies that go beyond its existing regulations, including, by way of example:

  - divestiture of an undivided ownership interest to a third-party so that the Big 3 could not thwart an expansion, and each pipeline owner would be forced to compete against the other pipeline owners;

  - establishment of an independent operator of the pipeline system, thus taking operational control away from the Big 3; and

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[1] FTC Perspective on Competition Policy and Enforcement Initiatives in Electric Power, Prepared Remarks by William J. Baer, Bureau of Competition, FTC, before the Conference on the New Rules of the Game for Electric Power: Antitrust & Anticompetitive Behavior (December 4, 1997).

- establishment of a market monitor as a means of policing and deterring competitive abuses.

- Finally, although we believe it is unlikely that FERC would refuse to certificate a pipeline owned by the Big 3, smaller producers and perhaps others can be expected to ask to litigate the competitive issues raised by Big 3 ownership of the pipeline, and potential remedial solutions. These parties will likely urge FERC to solve these issues at the outset of the project – in contrast to the situation on TAPS, which some parties contend is infected with competitive problems similar to those discussed herein. As a result of such litigation, the potential exists for moderate or even significant delay in the FERC certificate process.

Background

Currently, the Big 3 hold 95 percent of Alaska's known natural gas reserves. The Big 3's reserves are concentrated in the Prudhoe Bay and Point Thomson production areas, and are adequate to support a pipeline with a capacity of approximately 4.5 Bcf/day. In addition, the total magnitude of the State's gas resources base is widely estimated to be many times the level of the known Prudhoe Bay and Point Thomson reserves. Third-party producers and explorers are seeking to develop these additional natural gas resources in competition with the Big 3. Currently, there is no pipeline that transports Alaska natural gas to the Lower 48 states, and it is anticipated that only one pipeline to the Lower 48 states will be constructed.

In addition to controlling most of Alaska's known reserves, the Big 3 also have a significant presence in natural gas sales markets in the Lower 48 states. According to one recent report, the Big 3 appear to account for 30-35 percent of the sales by natural gas marketers in the U.S. *See "E&P Firms Rule Revitalized Gas Wholesale Market,"* Gas Daily, at 1, 5-6 (March 14, 2005).

Also relevant to this memorandum are, in addition to FERC's existing regulations under the Natural Gas Act ("NGA"), the recently enacted Alaska Natural Gas Pipeline ("ANGPA") and the regulations FERC recently issued in Order No. 2005 pursuant to ANGPA. Because Don Shepler has previously summarized these authorities in detail, we will not do so here other than to note FERC has observed that "the tremendous size, scope, and cost of an Alaskan pipeline, the long lead-time needed for such a project, environmental sensitivities, and the competitive conditions that are unique to such a project warrant *special consideration and oversight.*" Order No. 2005 at ¶ 9 (emphasis added). In our view, any competitive analysis of the Alaska natural gas pipeline should account for the unique circumstances of this project.

Finally, the history of prior legislative efforts to encourage the construction of an Alaska natural gas pipeline also bears mention. As Don Shepler mentioned in his memorandum to you dated February 11, 2005, in passing the Alaska Natural Gas Transportation Act ("ANGTA") in the 1970s, Congress directed the President to choose an applicant from among three parties who were pursuing competitive proposals at the Federal Power Commission, and required the Attorney General to analyze antitrust issues relating to the proposals. In 1977, based on his review of the relevant facts and antitrust principles, President Carter's attorney general recommended that the Commission not issue a certificate to a producer-owned pipeline, as a producer-owned pipeline "would seek to restrict access and throughput to take monopoly profits." Report at page v. The Attorney General also concluded that "producer-ownership of the pipeline creates incentives to deny or impede . . . future capacity expansion", *id.* at 39-41, and that "it will be in the interest of producer-owners to resist future expansion and thus discourage future entry into Alaskan gas production." *Id.* at 43. Based on the Attorney

General's report, President Carter prohibited producer ownership in any ANGTA pipeline. In 1981, President Reagan waived the prohibition on producer ownership, but only on the condition that FERC consider the views of DOJ on the issue "and upon a finding by the [FERC] that the agreement [on producer participation] will not (a) create or maintain a situation inconsistent with the antitrust laws or (b) in and of itself create restrictions on access to the Alaska segment of the [proposed pipeline]."

Recently, on January 4, 2005, an Alaska state legislator brought the Attorney General's 1977 report and President Reagan's conditional waiver to FERC's attention, and sought guidance from FERC regarding whether antitrust concerns will prevent the North Slope producers from owning the Alaska gas pipeline. In a letter dated January 28, 2005, FERC Chairman Wood responded by stating that in acting on any application to construct an Alaska natural gas pipeline, FERC "will be mindful of the congressional and presidential pronouncements" discussed above. In addition, Chairman Wood emphasized that "it would be prudent to conclude that the antitrust issues which concerned Congress and the President over twenty years ago are still valid and will be addressed by our Commission in our proceedings."

Discussion

Ownership of the Alaska gas pipeline by the Big 3 raises two separate but related competitive issues. First, the collaboration among the Big 3 to form a joint venture to build the pipeline should be examined as an agreement among competitors, also known as a horizontal agreement. Second, the Big 3's ownership of the pipeline constitutes a vertical integration of the pipeline and shippers that will use the pipeline's transportation services, and for that reason

vertical merger analysis provides an important analytical tool. We address each of these issues below.

I. A Big 3 Joint Venture To Own The Alaska Gas Pipeline Should Not Raise Horizontal Competitive Concerns.

As a general proposition, the idea of forming a joint venture to construct a gas pipeline that will transport huge quantities of previously untapped gas supplies from a remote production region to a consumption area is undoubtedly pro-competitive when viewed in isolation. It is often necessary and in fact efficient for horizontal competitors to pool resources to undertake a project that would be too large or risky for a single company.[2]

Nonetheless, "who" participates in such collaboration, in "what ways", and under "what conditions and terms" remain important questions in determining the legality of the proposed joint venture. Moreover, even a legitimate horizontal joint venture often raises the so-called "spillover effects" issue. Unless carefully structured and monitored, anticompetitive effects could occur outside the joint venture's legitimate area of horizontal collaboration. An examination of such potential issues should not be put aside until after the joint venture is already in operation. In the present context, this means that even though the formation of the joint venture would generally be lawful, if possible the joint venture should be structured in such a way that does not give rise to the competitive issues identified in the 1977 Attorney General's report, including incentives by the Big 3 to resist expansion, deter entry, and encourage

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[2] In addition, sometimes what appears to be a legitimate, pro-competitive horizontal collaboration to offer a new product or service could be a carefully designed attempt to cover up an otherwise per se illegal output reduction or market allocation agreements by the joint venture partners. For purposes of this analysis we have assumed that the Big 3, under the guise of the joint venture, have not entered into a naked agreement to block construction or expansion of the pipeline or some other impermissible agreement not to compete.

competitors to abandon their leases and exit the market. We proceed to address those subjects in the next section.

II. A Big 3 Joint Venture To Own The Alaska Gas Pipeline Would Likely Raise Serious Vertical Competitive Concerns.

A. Vertical Merger Standards Currently Applied by the FTC, DOJ and FERC Echo the Concerns Expressed by the Attorney General In 1977 About a Producer-Owned Pipeline.

If the Alaska pipeline had already been built and then acquired by the Big 3 through a merger or acquisition, that would be considered a "vertical" merger, as it would combine a supplier (the pipeline) with certain of its customers (the producers who ship gas through the pipeline). As a result, our analysis begins with the vertical merger standards applied by the FTC and DOJ.

The federal antitrust enforcement agencies' vertical merger enforcement has gone through profound changes over the years. In the 1960's and 1970's, the agencies took an aggressive stance to block certain vertical mergers that would today easily pass muster as pro-competitive or competitively-neutral. In the 1980's and early 1990's, the agencies took a highly permissive attitude towards vertical mergers. In the recent past, however, the pendulum has swung back. Armed with modern theories of vertical merger analysis, such as a theory of raising rivals' costs ("RRC"), today's federal antitrust agencies have shown an increased level of attention to vertical mergers, especially involving those in the energy sector in the wake of deregulation in various aspects of gas and power businesses.

Currently, the FTC and DOJ have three principal concerns regarding vertical mergers. First, a vertical merger may give the merged firm the incentive and ability to foreclose rivals from competing, either by raising rivals' costs or through other forms of discrimination that may

harm rivals' ability to compete and either encourage them to exit the market or discourage potential rivals from entering the market. Second, a vertical merger may facilitate collusion. Third, a vertical merger may enable the merged firm to evade regulation.

Although most vertical mergers do not raise competitive concerns, in the past decade several transactions in the energy industry have been challenged by the FTC. For example:

- In *Dominion Resources*,[3] the FTC maintained that the acquisition of Virginia Natural Gas ("VNG"), the primary natural gas pipeline distributor in southeastern Virginia, by Dominion Resources, a major electric power generator in southeastern Virginia, would likely deter or disadvantage entry by independent power generation companies because Dominion could use VNG to raise the costs of entry and/or electricity production to new entrants. As a result, the FTC required Dominion to divest VNG.

- In *Shell/Texaco*,[4] the FTC found that Shell's proposal to form a joint venture with Texaco would have adverse vertical effects. Texaco owned the only pipeline carrying undiluted heavy crude oil to asphalt refineries in the San Francisco area, including Shell's refineries and refineries owned by third-parties that competed against Shell. The FTC alleged that the joint venture could raise rival asphalt refiners' cost of pipeline transportation, and therefore required a long-term fixed price supply agreement between the pipeline and the competing asphalt producers.

- In *Detroit Edison*, in order to address concerns that the acquisition of a major natural gas pipeline by a major electric generator could give the merged firm the incentive and ability to discriminate against competing generators, the FTC effectively required divestiture of an interest in the pipeline to an independent competitor, thereby essentially creating two independent, competing pipelines within one physical pipeline facility.[5]

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[3] FTC Dkt. No. C-3901 (1999).

[4] FTC File No. 971-0026 (1997).

[5] FTC File No. 001-0067 (2001). In addition to these and other mergers in the energy industry, the agencies also have challenged numerous vertical mergers in industries outside the energy industry. *See, e.g.*, Cytyc/Digene, FTC File No. 021-0098 (2002) (vertical merger abandoned after the FTC decision to block it in federal court; liquid Pap tests upstream and DNA-based test for the cervical cancer-causing HPV downstream); Cadence Design Sys., Inc., 124 F.T.C. 131 (1997); Time Warner Inc., 123 F.T.C. 171 (1997); Silicon Graphics, Inc., 120 F.T.C. 928 (1995); Alliant Techsystems, Inc., 941-0123 (1994); Eli Lilly & Co., 120 F.T.C. 243 (1995); Martin Marietta Corp., 117 F.T.C. 1039 (1994); United States v. MCI Communications Corp., 1994-2 Trade Cas. (CCH) ¶ 70,730 (D.D.C. 1994) (DOJ consent; upstream market for international telecommunication services in U.S. by MCI and downstream market for international telecommunication services in U.K. by British Telecom; raising rivals' costs and regulatory evasion concerns); AT&T/McCaw (DOJ consent; upstream market for cellular infrastructure equipment

Following the lead of the antitrust agencies, in recent years FERC itself has carefully scrutinized vertical mergers pursuant to its authority under Section 203 of the Federal Power Act to review mergers and acquisitions of jurisdictional electric facilities. FERC has focused particularly on transactions that involve a bottleneck transportation line, *i.e.*, natural gas pipelines or electric transmission facilities. Similar to the approach utilized by the FTC and DOJ, FERC's concern has generally been that a vertical merger of this type would give the merged firm the incentive and ability to use a natural gas pipeline or electric transmission facility to discriminate against rival electric generators. Numerous FERC orders, including its Merger Policy Statement, reflect FERC's concern about the potential for anticompetitive effects resulting from vertical mergers. *See, e.g.*, Inquiry Concerning the Commission's Merger Policy under the Federal Power Act: Policy Statement, Order No. 592, 61 Fed. Reg. 68,595 (1996), FERC Stats. & Regs. *Regulations Preambles January 1991-June 1996* ¶ 31,044 (1996), *order on reconsideration*, Order No. 592-A, *62 Fed. Reg. 33,341 (1997)*, 79 FERC ¶ 61,321 *(1997)*; *Oklahoma Gas and Electric Company, NRG McClain LLC*, 105 FERC ¶ 61,297 (2003); *Dominion Resources, Inc. and Consolidated Natural Gas Company*, 89 FERC ¶ 61,162 (1999); *San Diego Gas & Electric Company and Enova Energy, Inc., et al.*, 79 FERC ¶ 61,372 (1997), *order denying reh'g*, 85 FERC ¶ 61,037 (1998).

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and downstream market for cellular services; raising rivals' costs and increased anticompetitive coordination concerns; 1994); United States v. Tele-Communications Inc., 1994-2 Trade Cas. (CCH) ¶ 71,496 (D.D.C. 1994); Tele-Communications Inc., 119 F.T.C. 593 (1993); Atlantic Richfield Co., 113 F.T.C. 1050 (1990).

The scrutiny applied by the FTC, DOJ and FERC to vertical mergers over the past decade demonstrates that, in general, these agencies have the same concerns about vertical mergers that the Attorney General had in 1977 when he concluded that a producer-owned Alaska gas pipeline would create serious vertical issues. The common thread is the concern, then and now, that a bottleneck transportation facility could be used to foreclose rivals who depend on the facility to compete in selling various forms of energy, including electricity, oil and natural gas. Indeed, due to deregulation of many natural gas and electricity wholesale transactions, the recent vertical cases brought by the FTC, DOJ and FERC reflect a renewed concern that vertical mergers could cause increased prices for consumers and lead to less competition in deregulated markets if a transportation facility can be used to limit competition in those markets. Thus, any suggestion by the Big 3 that the basic principles on which the Attorney General relied in 1977 are outdated or no longer relevant would lack foundation, and would simply ignore the long line of recent vertical cases brought by these agencies.

B. Big 3 Ownership of the Alaska Gas Pipeline Would Raise Serious Competitive Concerns.

1. The Big 3 Would Likely Have the *Incentive* To Use the Alaska Gas Pipeline To Discriminate Against Rivals.

The challenge for the Big 3 will be to distinguish their situation from the numerous, recent cases in which the FTC, DOJ and/or FERC have identified vertical issues as a serious competitive concern, to explain why the concerns identified by the Attorney General in 1977 were either in error or no longer exist, and to demonstrate that the competitive problems which have allegedly occurred with regard to TAPS will not replicate themselves here. In analyzing this issue, we have assumed that only one pipeline will be constructed, that it will extend from

production areas in Alaska to a destination area or areas in the Lower 48 states, such as a market hub in the midwestern U.S., and that the Big 3 will hold the substantial majority of the pipeline's firm transportation rights and own approximately 95 percent of the gas reserves that initially will be transported through the pipeline.

Although we have not had the benefit of an expert economist's views, on its face the ownership of the Alaska pipeline by the Big 3 would appear to raise serious long-term competitive concerns. Indeed, FERC essentially said this already in Order No. 2005 (¶ 12): "we are well aware of the risks to competition imposed by a project that is owned or primarily sponsored by a small group." For competing producers, and perhaps for some downstream customers as well, there would be no realistic alternative to pipeline transportation of Alaska gas. Thus, whoever owns and controls the pipeline will have market power. A profit-maximizing firm should be presumed to pursue every possible lawful (and sometimes unlawful) means to maximize its profits, strengthen its competitive position in the marketplace, or weaken its rivals' competitive position. Having market power over the natural gas pipeline transportation segment of the overall natural gas business will further bolster the inherent incentive of the Big 3 to disadvantage their rivals in the production and sale of natural gas.

The Big 3 would vigorously dispute these conclusions. We have considered potential counterarguments that the Big 3 could offer, but none appears to satisfactorily address the competitive concerns created by their ownership of the pipeline.

For example, the Big 3 might argue that they lack market power in the downstream market for natural gas sales, and therefore lack any incentive to discriminate against rival sellers. In other words, the Big 3 would argue that they have such an insignificant share of the natural

gas sales market that they would lack any incentive to exercise market power over transportation, because the lost revenue from transportation would not be offset by increased gas sales revenue. To support this argument, the Big 3 would have to employ a broad definition of the market. Thus, they might argue that the entire United States and Canada, or the United States alone, constitute a single market and, under that market definition, they cannot possibly have market power in gas marketing and sales.

However, any argument by the Big 3 that the market includes the entire U.S., or the U.S. and Canada combined, would conflict with numerous cases that rely on a much narrower market definition. In case after case involving the natural gas industry, the FTC has typically relied on a geographic market definition that includes all alternatives within a fairly local area, such as a 50-mile radius. *See, e.g., Southern Union/CMS Energy*, FTC File No. 031-0068 (2003) (consent order) (pipeline transportation of natural gas to certain consuming areas in Missouri and Kansas); *El Paso/Coastal*, FTC Dkt. No. C-3996 (2001) (consent order) (two separate product markets—natural gas pipeline transportation and long term firm transportation of natural gas; several distinct geographic markets—natural gas consuming areas in certain counties in central Florida; consuming areas in several distinct metropolitan statistical areas in New York; consuming area in certain counties in Indiana; certain producing areas in the central Gulf of Mexico; certain producing areas in the west central Gulf of Mexico); *El Paso/Sonat*, FTC Dkt. No. C-3915 (2000) (consent order) (three separate markets for natural gas transportation alleged: transportation out of the producing fields in the east-central Gulf of Mexico; transportation out of the producing fields in the west-central Gulf of Mexico; and transportation into gas consuming areas in certain portions of eastern Tennessee and northern Georgia); *FTC v. Questar Corp.*, No.

2:95CV1137S (D. Utah 1995) (Questar's proposed acquisition of Kern River; natural gas market in Salt Lake City, Utah; transaction abandoned). FERC has also relied on a similarly narrow geographic market definition in analyzing market power issues involving natural gas pipelines. *See, e.g., Koch Gateway Pipeline Co.*, 89 FERC ¶ 61,046 (1999).

The narrower market definition employed in these cases is logical because the market for the delivery and sale of natural gas is constrained by the physical limitations of production areas and gas pipelines. A gas pipeline that delivers gas to Portland, Maine simply does not compete in any real sense with a gas pipeline that delivers gas to, say, San Diego, California. Similarly, gas marketers with pipeline capacity rights on a pipeline that delivers gas to Chicago do not realistically compete, for the sales they make in the Chicago area, with gas sold by marketers at a distant location such as Miami, Florida. Thus, any attempt by the Big 3 to use a broad U.S./Canada market definition would conflict with established precedent and with the fundamental realities of the natural gas business.

If the downstream market is defined more narrowly to constitute the sale of gas in, for example, Chicago and other "Mid-Continent" areas, it seems likely that the Big 3 will have a sufficient market share to give them an incentive to use the Alaska gas pipeline to discriminate against rivals.[6] Ultimately, whether the Big 3 have market power (individually or collectively) in a relevant downstream gas sales/marketing market under accepted standards applied by the FTC,

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[6] In addition, it would be a mistake to think that there will be only one common consumption market served by the Alaska gas pipeline, even if the pipeline terminates at a single destination point. Actual pipeline interconnections to each local consumption market served along the route of the pipeline would determine how much gas from what producing areas could be available to consumers in a given area. While we have not undertaken a detailed analysis of what each of the potential relevant local consumption markets would look like, there likely would be some particular areas where the Big 3 or a member of the Big 3 have a substantial market share.

DOJ, or FERC is a fact-intensive question requiring an expert economic analysis. However, it is probably reasonable to assume that the Big 3, individually or collectively, have a major gas sales presence on Mid-Continent pipelines. Although a detailed factual investigation would be required to reach any final conclusion, it seems likely that further analysis will simply better define the extent of the Big 3's market share rather than demonstrate that the Big 3 lack a significant market share.[7]

Even if one ignores the precedents of the FTC and FERC and relies on a broad market definition, recent evidence indicates that the Big 3's market share would still be very substantial. According to one recent study, Amoco and Conoco are by far the largest natural gas marketers in the U.S. By one measure, the Big 3 appear to have a combined market share in the U.S. of approximately 30-35 percent. *See "E&P Firms Rule Revitalized Gas Wholesale Market,"* Gas Daily, at 1, 5-6 (March 14, 2005) (Source: company SEC filings). Given a market share of that size, at a minimum a plausible argument can be made that the Big 3 would have an incentive to discourage other producers in Alaska from engaging in robust production of additional gas, causing a deluge of new gas to enter the market and depress the price that the Big 3 can receive for their sales in the lower 48 states.

The Big 3 may also argue that they would have no incentive to discriminate against third-party gas producers because it will cost third-parties more to explore for and produce gas than it will cost the Big 3, who have established fields whose production costs are presumably lower. However, if the third-party gas producers are already cost-disadvantaged, then the potential harm

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[7] Because the Big 3's pipeline project involves multiple competitors at each level rather than a single upstream company and a single downstream company, for purposes of a comprehensive analysis of vertical issues their market shares should be aggregated both in the upstream Alaska natural gas exploration and production market and the downstream natural gas local marketing and sales markets.

from foreclosure from meaningful access to the pipeline would seemingly be even more serious, because it would take even less effort for the integrated firm to successfully raise rivals' costs by directly or indirectly denying access to the pipeline. By engaging in such exclusionary conduct, the integrated firm may lose some revenue in the short term. However, such short-term transportation service revenue shortfalls will be offset by the rivals' exit from the market or reduced competitiveness. In addition, exclusionary actions by the Big 3 would tend to further discourage new entry into the upstream exploration and production market, including a reduction in competition for new leases, thereby hindering the development of new production areas.[8]

Any argument by the Big 3 that they lack an incentive to discriminate would also directly conflict with FERC precedent regarding pipeline/affiliate relationships. FERC orders recognize the inherent incentive for a vertically integrated company to use transmission facilities to harm rivals in upstream or downstream markets. In Order Nos. 436 and 636, FERC encouraged, and then required, pipelines to offer open access transportation to third-parties because of the strong incentive for a pipeline to favor gas owned by the pipeline or its affiliate. In addition, in Order Nos. 497 and 2004, FERC issued a series of regulations that attempt to address the competitive concerns raised by vertical integration between pipelines and their gas marketing affiliates. Here, the Big 3 presumably would hold an atypically large percentage of the capacity on the Alaska gas pipeline, more than 50 percent and probably up to 75 percent.[9] On what would be the

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[8] *See, e.g.*, Atlantic Richfield Co., 113 F.T.C. 1050 (1990) (FTC alleged that the vertical merger involving chemicals would reduce the size of the merchant market for the upstream input product, making entry into that upstream market less likely and reducing the possibility of eventual deconcentration of that market).

[9] We assume that the State of Alaska and third-parties will hold approximately 25 percent of the firm capacity rights on the pipeline.

largest gas pipeline project constructed in the U.S., the Big 3's marketing affiliates would hold a huge amount of capacity compared to what marketing affiliates typically hold on other onshore pipelines. Although FERC has not placed a limit on the amount of capacity that can be held by any one shipper, *see, e.g., El Paso Natural Gas Co.*, 88 FERC ¶ 61,139 (1999), any suggestion by the Big 3 that this situation would not raise significant competitive concerns would strain credulity.

In addition, any argument by the Big 3 that a producer-owned pipeline would lack an incentive to discriminate against rivals conflicts with statements by the Big 3 themselves. It is well known that in numerous FERC proceedings the Big 3 have complained that the pipeline has an incentive to exercise market power to favor its marketing affiliate, including by discriminating against rival marketers and producers. To cite just one example, in a recent filing addressing a discounting issue, BP stated:

> The problem with affiliate capacity acquisition ... is related to the pipeline and its affiliate, in aggregate, accruing the ability to exercise market power. It relates to the combined incentive of the affiliate (once it has acquired capacity) and the pipeline to withhold capacity in order to drive up the delivered price of gas.[10]

The Big 3 also would have to address allegations by some that a similar anticompetitive situation has occurred on the TAPS oil pipeline. Independent producers have complained that the major producer-owners of TAPS have engaged in anticompetitive conduct causing the number of oil producers in Alaska to decline precipitously. *See, e.g.*, Protest and Complaint of Anadarko Petroleum Corp., filed in FERC Docket No. OR05-3, Dec. 16, 2004. Even Conoco itself made similar complaints—prior, that is, to becoming one of the TAPS owners (which

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[10] Initial Comments of BP America Production Co. and BP Energy Co., at 7, FERC Dkt. No. RM05-2 (March 4, 2005).

occurred when the FTC rejected the State's proposed remedy in the BP/Arco merger and required BP to divest Arco's entire interest in Alaska production to Phillips, and subsequently Phillips and Conoco merged). *See id.* at 12-13. The RCA also recently found that the TAPS owners have charged unreasonably high transportation rates for many years, over-recovering by $9.9 billion, and thereby raising rival producers' costs. The TAPS experience should, in effect, impose a higher burden on the Big 3 to demonstrate that their ownership of the Alaska gas pipeline will not (1) encourage exit by third-party producers and explorers, (2) discourage entry and reduce production by third-parties, or (3) cause other anticompetitive problems.

The Big 3's exclusionary conduct or discriminatory practices could take various forms. For example, they could propose an artificially high tariff for all shippers. This type of inflated tariff (in that it would be higher than it would have been in a competitive market with multiple alternative pipelines) will be "uniformly" applied to all producer-shippers and thus still considered "nondiscriminatory" in a technical sense. However, in reality it would raise only the independent, third-party producers' transportation costs. The marketing affiliates of the Big 3 would pay the same inflated tariff, but in the view of third-party producers' that would be just like "moving money from one pocket to the other" for the Big 3. Moreover, from the State's perspective, increased transportation rates would reduce wellhead prices, royalties and production taxes.

The Big 3 may argue that an independently-owned pipeline would have the same incentive to charge the high possible transportation rate. It is true that even an independent pipeline would have the incentive to maximize its profits. However, it would have a different set of incentives, opportunities and abilities compared with a producer-owned pipeline. There

would be no inherent structural incentive for an independent pipeline to favor its affiliates. In addition, in FERC rate cases an independent pipeline would face the prospective of litigating against a much stronger group of intervenors – the Big 3 themselves – and this adversity could produce a lower transportation rate.

The Big 3's exclusionary conduct could also take the form of subtle differences in quality of services that are not easily quantifiable and detectable. The Big 3 could try to delay interconnection to independent third-party producers' wells or otherwise offer less prompt and effective services. They could also attempt to use FERC procedures to delay third-parties' requests, thereby further increasing rivals' costs. *Cf. Oklahoma Gas and Electric Company, NRG McClain LLC*, 105 FERC ¶ 61,297, at ¶ 35 (2003) ("when utilities control monopoly transmission facilities and also have power marketing interests, they have poor incentive to provide equal quality transmission service to their power marketing competitors"). At a minimum, such subtle tactics would delay the process and weaken rivals' competitive position.

Even more troubling, a pipeline owned by the Big 3 could have a strong incentive to block an expansion of the pipeline, whereas an independent pipeline would have a clear incentive to build an economically justified expansion. The main way for an independent pipeline to increase profits would be to build an expansion, thereby increasing rate base on which to earn a return. Thus, an independent pipeline would plainly want to expand if third-party producers and explorers were willing to fund the cost of an expansion. By contrast, a Big 3 pipeline would face a different set of incentives. The Big 3 would have an incentive to control the amount of new gas delivered to the downstream consumption areas. A sudden flood of new gas could depress downstream price of gas in a given market. Thus, in deciding whether to

expand, the Big 3 pipeline would have to consider whether the increased profits from an addition to rate base would be offset by reduced profits in the gas sales markets.

FERC identified this potential problem in Order No. 637, where it addressed the concern that pipelines would refuse to expand in order to keep gas prices artificially high for the benefit of their marketing affiliates. FERC stated:

> [B]ecause of the possibility of affiliate abuse, the Commission will be particularly sensitive to complaints that pipelines, on which affiliates hold large amounts of transportation capacity, are refusing to undertake construction projects when demand for construction exists. In cases where such concerns are established, the Commission would need to take remedial measures. Depending on the circumstances, such remedies could include: requiring pipelines to put in taps to reduce capacity bottlenecks; requiring pipelines to build additional capacity when requested by customers willing to pay the costs of construction; limiting the rates at which the affiliate can release capacity; limiting the amount of capacity the affiliate can hold; or prohibiting the affiliate from holding capacity on its related pipeline.[11]

Delaying or thwarting an expansion would have a significant adverse impact on royalty revenues received by the State of Alaska, in two ways. First, it would result in less gas produced than would be the case if the pipeline expanded, thereby resulting in fewer royalty payments (which also would result if the Big 3 charged higher transportation rates, reducing netbacks in Alaska). Second, blocking an expansion would tend to keep the basin price of gas in Alaska lower than it would be if the pipeline were expanded, again resulting in lower royalties.[12] Thus, in addition to the potential that the vertical concerns created by Big 3 ownership of the Alaska

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[11] Order No. 637, at 31,287 (2000) (also stating that "there seems little indication that profits from scarcity exceed those that can be earned through construction, since pipeline construction applications have not noticeably declined").

[12] Experience on other pipelines shows that, when an expansion is constructed, the price of gas in the basin rises, all other things being equal. *See, e.g.*, Direct Testimony filed by Kern River Gas Transmission Co. in its pending FERC rate case, FERC Dkt. No. RP04-274 (explaining that Rockies gas prices increased and the Rockies to California basis spread narrowed significantly after the in-service date of Kern River's major expansion to California).

gas pipeline would have adverse effects on downstream consumption markets, they would also adversely impact Alaska.

In sum, if the Big 3 own the Alaska gas pipeline, the pipeline is likely to have a strong incentive to discriminate against third-party explorers and producers. This will likely discourage entry and encourage exit by the Big 3's rivals, reducing competition for the exploration and production of Alaska natural gas. Even the perception that a Big 3-owned pipeline would discriminate against rivals could discourage entry and encourage exit. In contrast, an independently-owned pipeline would not present any of these potential problems, assuming its marketing affiliate does not contract for a significant amount of capacity, and thus would be a competitively superior option to a Big 3 pipeline.

2. The Big 3 Would Likely Have the *Ability* To Use the Alaska Gas Pipeline To Discriminate Against Rivals.

Assuming that the Big 3 would have an incentive to discriminate against rivals, the remaining question in a vertical analysis is whether the Big 3 would have the ability to foreclose rivals and raise rivals' costs. Absent FERC regulation, the answer would almost certainly be yes, because the Big 3 would control the only gas pipeline shipping gas from Alaska, and perhaps the largest gas pipeline serving the destination points accessed by the pipeline. Indeed, natural gas pipelines are heavily regulated precisely because they have and presumably would exercise market power in the absence of regulation.

The Big 3 may argue that various aspects of FERC regulation, such as the ban on affiliate preferences, the requirement that the Alaska gas pipeline be properly sized, the ability of FERC to require expansion of the Alaska gas pipeline in certain circumstances, and the limit on charging more than a "just and reasonable" rate, would prevent a Big 3-owned pipeline from

exercising market power. Viewed strictly from an FTC/DOJ antitrust perspective, the Big 3's reliance on FERC regulation as a defense would be unlikely to succeed. In numerous merger cases involving regulated pipelines and other regulated entities, the FTC and DOJ have required divestitures even though regulation by FERC or by some other agency would arguably have deterred the merged firm's ability to exercise market power. For example, in the Dominion case discussed *supra*, the FTC required Dominion to divest its natural gas pipeline because of the potential the pipeline could be used to discriminate against rival electric generators, even though the pipeline was heavily regulated by the state public utilities commission. Similarly, in one gas pipeline merger case after another, the FTC has required pipeline divestitures despite the fact that the pipelines would have been heavily regulated by FERC after the merger.[13]

These precedents also reflect the strong preference of the antitrust enforcement agencies for structural remedies such as divestiture over behavioral, regulatory remedies. The FTC and DOJ prefer structural remedies over regulation because of the possibility that regulations can be evaded and due to the cost of policing regulatory-type remedies.

In this regard, lengthy FERC proceedings themselves would further weaken independent producers' competitive position. For example, loopholes and ambiguous language in FERC's Order No. 2005 would give the Big 3 ample opportunities to defeat or delay pro-competitive attempts to expand the pipeline. *See, e.g.*, Order No. 2005 at ¶ 123 (deferring decision on whether to approve rolled-in rate treatment for any expansion until the specific facts of a proposed expansion can be reviewed—and litigated). While the proceedings are ongoing, the

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13 *See supra* (discussion of market definition in gas pipeline cases at the FTC).

Big 3 could continue to employ their subtle yet effective strategic behavior to raise their rivals' costs and further weaken their rivals' competitive position.

In sum, strictly from an antitrust perspective, the fact that FERC would regulate the Big 3-owned pipeline would not completely solve the potential vertical problems caused by Big 3 ownership.[14] However, because the competitive issues will likely arise in the context of application by a Big 3 joint venture for a FERC certificate to construct an Alaska gas pipeline, perhaps in conjunction with a competing application by an independent gas pipeline company, we proceed in the next section to address the issue of what remedies are available at FERC to address the competitive issues raised by a producer-owned pipeline.

III. Potential Remedies To Address Vertical Concerns Posed by Producer-Ownership of the Alaska Natural Gas Pipeline

Although it is likely that a pipeline owned by the Big 3 would have the incentive and ability to foreclose rival producers, the fact that a producer-owned pipeline would raise serious competitive issues does not automatically mean that Big 3 ownership of the pipeline would violate the antitrust laws. Big 3 ownership may be necessary to get the pipeline built, which would be a more competitive result than if no pipeline is constructed. Still, for the reasons discussed above, an independent pipeline would be a competitively superior result over a producer-owned pipeline, and as a result the State may want to support and encourage an independent pipeline alternative in FERC proceedings and in Stranded Gas Act negotiations. If, however, the only alternative is a producer-owned pipeline, the question that must be addressed

[14] In fact, FERC itself has sometimes recognized that its regulations are not always effective in preventing discrimination. *Oklahoma Gas and Electric Company, NRG McClain LLC*, 105 FERC ¶ 61,297, at ¶ 35 (2003).

is what remedies or mitigation measures FERC could adopt to address the vertical market power problem created by Big 3 ownership.[15]

A. FERC Can Select From a Broad Range of Remedies, Including Remedies That Go Beyond its Existing Regulations, To Address the Unique Situation Posed by a Producer-Owned Pipeline.

In an ordinary certificate proceeding, FERC would simply decide whether to issue a certificate based on the facts presented and would apply its existing regulations to any pipeline constructed under the certificate authority. It typically would not impose unique remedies on an ordinary pipeline.

The Alaska natural gas pipeline, however, will not be an ordinary pipeline, as Congress and FERC have recognized. Not only will it constitute the single largest gas pipeline project ever constructed in the U.S.—a fact that in and of itself might call for special treatment—but Big 3 ownership would create a unique vertical integration problem. The ownership by the Big 3 marketing affiliates of up to 75 percent of the pipeline's firm capacity rights would probably surpass the amount of capacity held by marketing affiliates on any other onshore gas pipeline in the U.S. The Big 3 also will own the vast majority of gas that will flow through the pipeline. Given the distinct incentive that a producer-owned Alaska pipeline would have to discriminate against rivals, and ANGPA's directive that FERC ensure access to the pipeline by third-party producers, FERC may strongly consider remedies that go beyond what it would consider in an ordinary pipeline certificate case. This possibility is strengthened even further by the perception by some that Big 3 ownership of the gas pipeline would make third-party producers vulnerable to

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[15] A danger exists that if there is no viable independent pipeline alternative, the Big 3 could simply refuse to build the pipeline if FERC requires any of the following remedies. Thus, from a negotiating standpoint, it would seemingly be very important to maintain at least the appearance of a viable independent pipeline alternative.

the sorts of abuses that have allegedly occurred on TAPS. In the following discussion we briefly discuss some of the remedies that third-party producers, consumer interests, and others could propose at FERC to address the unique circumstances posed by Big 3 ownership.[16] FERC could impose one or more of these remedies.

1. Divestiture

It may be possible to require the Big 3 producers to sever their relationships with the upstream and further downstream affiliates through some form of divestiture or similar remedy. In other words, it may be possible to create a truly independent Alaska natural gas pipeline company. Even though the initial funding and personnel for the pipeline joint venture could come from the Big 3 producers, based on a pre-determined schedule, they could be required to spin it off or otherwise dispose of their financial interest. The FTC has used this method in the past.[17] Moreover, FERC has recognized divestiture and similar remedies as an appropriate, yet rare, option in unique situations. *See, e.g.*, Order No. 497, FERC Stats. and Regs. ¶ 30,820, at 31,129 (1988) ("the Commission reserves the right to consider and impose such remedies as divorcement and divestiture in specific cases where the circumstances demonstrate they are required"); *see also* Order No. 637, at 31,287 (stating that where appropriate FERC could

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[16] It is possible that the Big 3 would contend that these remedies are not permitted under the Act. That issue is beyond the scope of this memorandum.

[17] *See, e.g., Valspar Corporation*, FTC Docket No. C-3478 (1993) (coating resins for paints; divestiture of overlapping assets to a new independent corporation to be formed). The key difference between this method of spin-off and the more traditional method of selling a company to an existing company is that the former creates a new independent company. Alternatively, it can be viewed as divesting an overlapping business to the merging firm's shareholders. While the shareholders might be initially the same, management teams will be different. Moreover, Section 8 of the Clayton Act that deals with interlocking directorate situations would apply if the same individual attempts to sit on two competing firms' boards.

prohibit an affiliate from acquiring capacity on its affiliated pipeline). Because divestiture would eliminate the vertical concerns posed by Big 3 ownership of the gas pipeline, divestiture is the "cleanest" remedy available. However, it is possible the Big 3 would refuse to go forward with the project if they could not own the pipeline. Thus, other remedies must also be considered.

2. Partial Divestiture Through Creation of an Undivided Interest Pipeline

Another option is to allow the Big 3 producers to own the pipeline but as an undivided interest pipeline. In this case, each owner would be free to market its own share of the capacity. Thus, while physically there will be only one pipeline, from a competition perspective, it would be like having three separate, "virtual" pipelines competing against one another, with separate tariffs, separate rate schedules, and separate management and marketing employees.

If this option is pursued but the Big 3 are the only undivided interest owners, then it may not result in any material improvement of the competitive situation that would otherwise exist. Indeed, it would essentially replicate the situation that exists on TAPS, which at least arguably has not resulted in a vibrant competitive landscape in Alaskan oil exploration and production. The Big 3 would have common incentives, and tacit coordination of their activities would be a distinct possibility.

The real value in this option – and an improvement over the TAPS model – is if a third-party, such as the State of Alaska or an independent pipeline company, also acquires an undivided interest, with equal rights to expand the pipeline (and that cannot be vetoed by the Big 3). The State of Alaska or an independent pipeline company could play a pivotal role, akin to a maverick, disruptive competitor, possibly frustrating any attempt by the Big 3 to thwart pipeline expansion or otherwise foreclose upstream or downstream rivals. The FTC required the creation

of a similar "pipeline within a pipeline" in order to address vertical competition problems created by the merger of a gas pipeline and an electric generator in Michigan. *See, e.g., Detroit Edison, supra.* FERC has certificated similar undivided interest pipelines in the past, *see, e.g., Kern River Gas Transmission Co.*, 50 FERC ¶ 61,069 (1990), and requiring the Big 3 to divest an undivided interest in the pipeline would be consistent with FERC's past view that it has the power to require divestitures if necessary to address vertical problems.[18]

3. Establishment of an Independent System Operator

FERC has sought to encourage, and even require, vertically integrated electric utilities to transfer their transmission facilities to an independent system operator ("ISO"). FERC has relied on the ISO remedy to address the vertical integration problem that exists where an electric transmission provider's generation affiliates utilize a large percentage of the provider's transmission capacity. Through the creation of an independent operator, FERC seeks to ensure that transmission capacity will be operated and allocated in a way that does not discriminate against non-affiliates.

To our knowledge, FERC has never required a natural gas pipeline to transfer control of its pipeline facilities to an independent operator. However, because the Big 3 presumably will hold up to 75 percent of the Alaska pipeline's firm capacity rights, and will own most of the gas to be shipped through the pipeline, a plausible argument can be made that FERC should impose an ISO-type remedy on any pipeline owned by the Big 3, to address the unique vertical issues presented.

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[18] *See* Order No. 497, *supra.* Note that this option, which appears to dovetail with the State of Alaska's potential interest in owning part of the pipeline, will tend to minimize coordinated interaction as well.

Under this option, in essence, the Big 3 producers would own a passive ownership interest. To be most effective, the ISO should be given the power to propose capacity expansion and given the power to override any of the Big 3 producers' objections as long as certain pre-determined conditions are met. For instance, if the ISO secured a firm commitment from independent producers with newly discovered reserves that would justify a capacity expansion project, then the Big 3 producers would have to agree to capacity expansion. It also probably would be necessary to have a provision on admitting a new passive investor who is willing to share the cost of such capacity expansion, particularly in the event the Big 3 are unwilling to expand.

Obviously, the issue of expansion also would raise the controversial issue of rolled-in versus incremental rate treatment. How to resolve that issue – and numerous other details – would need to be addressed as part of proposing any ISO-type remedy.

4. Establishment of a Market Monitor

In FERC cases involving ISOs, FERC has also approved the establishment of a market monitor, as part of the ISO structure. One drawback of this remedy may be introducing yet another regulatory regime, in addition to FERC. On the other hand, appointing a market monitor or trustee to periodically audit the Big 3-owned pipeline for any anticompetitive behavior, and to investigate complaints and suspicious activities, could act as a useful constraint on the Big 3's abuse of market power over the pipeline transportation business. This option probably is most effective when it is used in conjunction with other checks and balances provided by the FERC's regulatory regime. One advantage of this option is that the market monitor would indirectly be funded primarily by the Big 3 by including the cost of the market monitor in the pipeline's

transportation rates. This would reduce the amount of costs that rivals would have to spend policing the Big 3's conduct, and essentially would require the Big 3 to pay part of the cost of monitoring their own behavior.

5. Other Potential Remedies

Other potential remedies could be considered, although those addressed here appear to have significant drawbacks. For example, in theory FERC could require the Big 3 to agree in advance on the terms under which they would expand the pipeline, including the circumstances in which they would agree to rolled-in rate treatment. However, unless the Big 3 made a blanket commitment to expansion and rolled-in rate treatment, it is difficult to see how this option could be implemented because of the myriad of different potential capacity expansion scenarios. Whether an expansion would make economic sense, and what rate treatment is appropriate, would depend on numerous factors that would be difficult to predict in advance.

Another option would be to require the Big 3 to provide "most favored nation" rate protection to third-party shippers. However, this could be rendered meaningless for the same reason that FERC's non-discrimination requirements would not prevent the Big 3 producers from charging a uniformly-inflated tariff or otherwise engaging in subtle forms of strategic behavior to raise their rivals' costs.

B. A Significant Potential for Delay Exists.

You have asked us to address whether the competitive issues raised by a producer-owned pipeline could delay the project, either because of a delay caused by FTC or DOJ review, or by protracted litigation at FERC. It is unlikely, but not inconceivable, that the FTC (or DOJ, although the FTC is the antitrust agency that typically reviews natural gas pipeline transactions)

would undertake a separate investigation and thereby delay the project. However, the FTC (or DOJ) may decide to express their position to FERC in context of a certificate proceeding or to Alaska in context of the Stranded Gas Act process. In the FERC context, this would fulfill the spirit of the Reagan directive that required FERC to consult with DOJ about antitrust issues raised by producer-ownership of any gas pipeline certificated under ANGTA. In addition, the FTC, as part of its competition advocacy program, often shares its views with other federal agencies such as the FERC or state agencies on a formal or informal basis. Thus, it may still be the case that the FTC will have an opportunity to share its non-binding views.

A significant potential for delay exists at FERC. It would not be surprising if third-party producers (such as Anadarko), competing pipelines, or consumer interests protest any certificate application by the Big 3 by raising the competitive concerns addressed in this memorandum, particularly in light of Chairman Wood's recent letter stating that the antitrust concerns which concerned Congress and the President over twenty years ago are still valid and will be addressed by FERC. This could cause a producer application to experience significant delay compared with an application by an independent producer. The competitive issues that a third-party could raise, including potential remedies to address those issues, would require FERC to conduct either a "paper" hearing or set the case for an evidentiary hearing before an ALJ. Although we believe a paper hearing is more likely in view of the goal of expedited treatment that Congress expressed in the Act, some precedent exists for setting these types of issues for hearing in somewhat analogous electric merger cases at FERC. *See, e.g., OG&E, supra.* In any event, even a paper hearing to litigate vertical competitive issues could take significant time (6-12 months),

depending on the number of filings and FERC's ability and willingness to deal with the issues expeditiously.

Conclusion

As discussed above, numerous and recent FTC, DOJ and FERC precedents indicate that the competitive concerns expressed by the U.S. Attorney General in 1977 about a producer-owned Alaska natural gas pipeline remain valid today. A significant risk exists that a pipeline owned by the Big 3 would have the incentive and ability to discriminate against rival producers, thwarting expansion of the pipeline, reducing competition for leases, and ultimately reducing royalties and taxes for the State of Alaska. A potential for significant delay at FERC also exists in order to litigate these competitive issues and to address whether FERC should impose a unique remedy due to the special circumstances posed by Big 3 ownership of the pipeline. In contrast, an independent pipeline typically would not present these or similar risks.

ExxonMobil AGIA Testimony
Senate Judiciary Committee 4-14-07

SENATE JUDICIARY COMMITTEE:
Chairman: Hollis French
Vice-Chair: Charlie Huggins;
Members: Senators Lesil McGuire; Bill Wielechowski; Gene Therriault

INTRODUCTION
Good afternoon Chairman French, Vice-Chair Huggins and members of the Senate Judiciary Committee. My name is Bill McMahon. I am the Commercial Manager in the ExxonMobil Alaska Gas Development group, a position I have held since November 2000. I am involved in the effort to commercialize ExxonMobil's gas resources in Alaska.

ExxonMobil has been in Alaska for over 50 years and has been a key player in Alaska's oil industry development. We hold the largest working interest at Prudhoe Bay (36.4%) and our current net production in Alaska is approximately 150,000 barrels per day.

We have benefited from our involvement in the State of Alaska, and we believe that Alaska has benefited from this long-term relationship as well.

Commercializing Alaska's North Slope gas will allow us to continue this mutually beneficial relationship for another 50 years or more. Let me emphasize that ExxonMobil wants a successful gas pipeline project and we want to move it forward.

EXXONMOBIL READY TO PROGRESS PROJECT

The Alaska Gas Pipeline project is important to Alaska, to our nation, and to ExxonMobil. The Project has the potential to generate billions of dollars in revenues for the State of Alaska, the U.S. federal government, and Canada, and could provide a stable and secure source of clean energy for Alaska and North America for decades to come. For ExxonMobil, the project has the potential to add over 1 billion cubic feet per day (EM share) of gas sales, which would be more than a 10% increase to our current worldwide daily gas production. Given the significant impact this project could have on our business, we strongly support efforts to advance a pipeline project and we are ready to work with Governor Palin and her cabinet and with the Legislature to move the project forward.

As an illustration of our commitment, EM has spent more than $180 million studying ways to commercialize Alaska gas. Since the 1970's we have evaluated LNG, gas to liquids and gas pipeline alternatives. Based on these studies we have determined that a Producer gas pipeline project will result in the best value for the State, the Producers and the nation. It is important for me to say ExxonMobil is aligned with the Governor, the legislature and the people of Alaska regarding the overall objective—we are committed to moving the Alaska Gas pipeline project forward.

GENERAL FEEDBACK ON AGIA

ExxonMobil embraces the concept of competition all over the world and is ready to participate in a fair market based competition. We understand the overarching goal of AGIA is to create open competition but due to the prescribed conditions included in AGIA it will not achieve this goal. A prescriptive bidding process will not allow the flexibility needed for individual applicants to weigh the risks associated with this basin opening mega-project and propose what is necessary to manage these risks.

It is important that AGIA allow applicants to define how they could achieve the State's objectives rather than prescribing specific requirements that must be met. To ensure the best result, AGIA should establish broad key objectives and allow applicants flexibility in meeting those objectives and in defining the requirements that are necessary to make the project commercially viable. If you were to amend AGIA to make it objective driven, it would result in an open competition, maximizing the number of applicants and allowing those applicants to propose innovative solutions.

As such, we suggest AGIA be modified to establish an objective driven process – define the state's broad objectives, request proposals as to how applicants intend to meet or not meet those objectives, evaluate the proposals and then select the one that best serves Alaska's needs. If none meet the State's overall objectives then you can always reject them or opt to negotiate with the party that most closely meets your needs.

To understand why it's important to use broad objectives as opposed to prescribing specific requirements it is helpful to review project risks and issues surrounding its development that will have to be addressed by an applicant.

PROJECT RISK / PRODUCER CAPABILITIES

Because there is a perception this is "simply" a gas treating / gas pipeline project, the tendency exists for many to underestimate the size, magnitude and risks associated with this undertaking. The Alaska Gas Pipeline Project is a world-scale undertaking with significant risks. In fact, the Project would be the largest private investment in North America – significantly larger than most "model" worldwide oil and gas "mega" projects. There is not really another project that compares.

Because of this size, many factors impact commercial viability.

First there is cost:

Our previous estimate of $20 billion ($2001) is now substantially higher. Since 2001, steel prices have nearly doubled. Industry and construction labor costs are experiencing hyperinflation. In addition, world-wide mega-projects are placing pressure on pricing and availability of global materials, and skilled manpower.

Next there is gas price:

Despite recent increases, natural gas prices remain highly volatile. The price of natural gas before 2000 was less than currently estimated gas treating and transportation costs.

Finally, there are many other risks.

These include cost overruns, schedule delays, construction conditions, and regulatory and State fiscal uncertainties. It is also important to note that project investments would have to be made over a period of 10 or more years before gas flows down the pipeline and is sold at the marketplace.

With size comes complexity, and an even greater premium on getting the design concept, contracting and marketing plans right...and then executing these plans efficiently and effectively. Most importantly, size also amplifies the consequences of poor execution. If a mistake is made on this project it would cost us all dearly.

The State of Alaska cannot anticipate how individual applicants will view these risks or how they may address them. Establishing a set of rigid prescribed terms will not allow the flexibility needed for individual applicants to weigh and manage those risks.

HOW PIPELINES ARE FINANCED AND WHO BEARS PROJECT RISKS

It is also important to understand how pipelines are financed which is a key reason why AGIA should allow flexibility in proposing upstream terms. Commercially-sound oil, gas, and pipeline projects traditionally have been able to obtain financing if they have strong sponsors with proven track records and the financial strength to both provide sponsor equity and to backstop key project commitments. For the Alaska gas pipeline project, key project commitments take the form of firm, long-term gas transportation commitments. Firm transportation commitments are binding obligations made by companies to pay for the cost of reserving a quantity of gas capacity as shippers on a pipeline over a specified period of time, typically many years. These commitments are made during an "open season", which, according to FERC Order 2005 for the Alaska gas pipeline, is a period of at least 90 days during which any and all prospective gas shippers can make binding commitments for a specific volume of transportation capacity.

Financial institutions generally require substantial, long-term, firm transportation commitments to provide funding for a gas pipeline project. These commitments must be provided by creditworthy shippers. In this case, the shippers will be the Producers, and, directly or indirectly, the State or the State's shipper. These firm transportation commitments are substantial, in the tens of billions of dollars and must be paid whether the shipper making those commitments actually transports gas through its reserved capacity. The shipper is also required to pay this commitment regardless of the price of gas in the market place.

Pipeline investors use these firm transportation commitments from shippers to show creditors they have capacity confirmed over a sufficient duration to secure financing and must rely on the financial strength of the companies backing the transportation commitments to secure project financing. Thus, the development costs and the associated over-run risk are ultimately borne by the shipper via this commitment. In other words, shippers must make long-term ship or pay transportation commitments and agree to pay transportation and treating rates that are based on the ultimate cost of the pipeline and treating facilities. The only information known in advance of making these commitments will be a projection based on each project entity's initial estimate of costs.

For that reason, the parties taking the risks need to be able to manage those risks. The Producers, as shippers, cannot make firm transportation commitments during an open season unless they are confident the gas pipeline project can be built cost effectively and operated on a long-term, commercially viable basis, including being competitive with other sources of gas supply. This is especially true for a project of this magnitude.

The existing prescriptive terms will preclude leaseholders from being able to make a conforming proposal which would deny the state the opportunity to even consider terms from the parties who hold the largest stake in the project's successful development.

IMPORTANCE OF STATE / PRODUCER ALIGNMENT AND BENEFITS OF THE PRODUCER PROJECT

Let me now talk about the importance of alignment between the State and the Producers and the benefits of a Producer project.

Maximizing the value to the State of Alaska and the resource holders means selecting the right design concept for this mega-project and then executing the project to deliver the lowest possible cost.

On a mega-project of this size and magnitude, project construction and operating experience should be a significant consideration. Only a limited number of companies have demonstrated the capabilities and financial strength to effectively participate in and manage world-scale mega-projects.

The Producers have mega-project experience on numerous projects world-wide and have demonstrated success in meeting project objectives. For example, ExxonMobil operates in nearly 200 countries and territories and on every continent except Antarctica. We are the world's largest non-government producer of both oil and natural gas. ExxonMobil's global project development company is unique within industry. This global development company leads the industry in project cost and schedule performance. Nearly 90% of ExxonMobil projects with costs greater than $1 billion are delivered within 15% of estimated costs at the time of project funding and nearly 80% of those were delivered within 15% of the funding schedule. ExxonMobil's superior performance was independently validated in a report (dated September 21, 2005) published by Sanford C. Bernstein and Co. On the topic of project delays, the report stated "ExxonMobil came out on top of this analysis, with the lowest slippage rates, despite undertaking some of the largest projects. We believe this to be a direct result of its highly competent internal development company, which assumes full responsibility for monitoring a new project from idea to profit." Combining our capability with BP and ConocoPhillips will provide the best chance of delivering a successful project.

The Producers also have Arctic experience in Alaska and throughout the world. ExxonMobil's arctic experience is extensive - over 40 years – with developments in multiple types of arctic environments. Large projects with significant complexity are what we do and we are extremely qualified to take on this work.

Our successes in Arctic environments are the result of a long-term commitment to technology development which has played an important role in the advancement of oil and gas development in Alaska. ExxonMobil believes innovation is the key to meeting the world's energy challenges. Technology is the lifeblood of our industry, and it always has been. We are the leader in our industry in technology development. In 2006, we spent $730 million on technology development and we have spent more than $3 billion since 2002.

In addition, ExxonMobil has demonstrated world-class leadership in safety, health and environmental performance. ExxonMobil is a leader in operating efficiency and a pacesetter in operating safety. Our total recordable incident rates for employees and contractors are substantially below the average of US Petroleum Industry benchmark of participating American Petroleum Institute companies. We believe a company's commitment to the highest standards of safety, health and environmental care manifests itself in superior performance in all aspects of its operations.

In addition to our operational excellence, ExxonMobil has the financial strength to make this mega-project a reality. ExxonMobil has consistently maintained one of the strongest financial positions of any company in the world. We are one of just a few public companies to maintain the highest credit rating from Standard and Poor's (AAA) and Moody's (Aaa), and we have done so for each of the last 88 years. Our unparalleled access to financial resources gives us the flexibility to pursue opportunities worldwide throughout the economic cycle with the knowledge that they can be financed. Host governments recognize this strength and its importance as they look to develop their resources and economies. As an example of that strength, ExxonMobil's project financing experience exceeds $30 billion in value for recently completed and ongoing activities. Our efficient management of large scale project financings is a critical piece in the overall success of ExxonMobil's project implementation record.

It is important to remember that the Alaska gas pipeline project is a basin-opening project that will benefit the State and the oil and gas industry in Alaska. Basin-opening projects throughout the world have progressed and been successful when there is alignment between the host government and the leaseholders. The Producers and the State both want a pipeline project to commercialize the known ANS gas resources and open the basin to gas exploration. So, at a very high level we are aligned.

We believe a Producer gas pipeline project will result in maximum value to the State and the Producers. The reason is the Producers and the State have maximum incentive to control costs. Low capital and operating costs, which result in lower treating and transportation costs, and access to premium market price, result in higher netback value on gas. It should be noted that the State will receive the majority of its revenue from the value of gas sales via revenue received under its lease royalty agreements and from production taxes, which are valued based on the netback received from the gas.

Third-party owners do not share the same incentives in that they actually benefit from increased capital costs.

Based on the demand for workers that this project will generate, Alaskans are obviously key to successful project execution. Both the State and the Producers want Alaskans to

benefit from the many job opportunities that will exist. When you consider carefully the options available, a Producer pipeline will provide maximum value to the State of Alaska.

We believe that financial strength, experience and the ability to get the job done should be critical components of any evaluation of proposals.

IMPORTANCE OF PREDICTABLE AND DURABLE FISCAL TERMS

For us to progress the project and mitigate its inherent risks, we will need some things from the State. Let me discuss the importance of predictable and durable fiscal terms for the upstream participants. Because of the nature and magnitude of the risks associated with this project – tens of billions of dollars of financial commitments, unprecedented cost and scope, potential for construction delays, as well as the inevitable risks associated with the commodity price of gas - fiscal terms that are predictable and durable are necessary. This is a common thread for all of our mega-project investments in basin opening developments. In all such cases, we are willing to take geologic risks, we are willing to take cost risks, and we are willing to take commodity price risks, but we cannot take the risk of fiscal terms changing. Let me expand on this important concept further. The first two risks, geologic and cost risk are risks for which we have developed an industry leading expertise to manage. This is what we do day after day at EM. Market risk is inevitable in a commodity business such as oil and gas and we manage that by attempting to ensure that we deliver those products into the highest value market at the lowest cost. Fiscal risk, however, is of a completely different nature and wholly outside of our control. We must have agreements that will allow us to develop this mega-project under predictable and durable terms, so that we can make an adequate investment decision. If fiscal terms can be changed in the future, then we are not able to make a well founded investment decision on behalf of our shareholders.

The Alaska Gas Pipeline Project will require massive investments to be made over a period of many years before any revenue is generated from those investments. As a result, increases in taxes on oil and gas related activities during the life of the project could significantly impact the commercial viability of the project and offset the benefits of taking on a project of this magnitude. Because fiscal terms could be modified under the proposed AGIA legislation, it does not provide the fiscal stability necessary to ensure a commercially viable project.

Development of a predictable and durable fiscal framework means that the terms agreed between the Producers and the State recognize the magnitude and risks associated with the project; balance State and Producer needs; and provide for the calculation of total State take in a transparent and predictable manner.

AGIA should allow market participants to put forward their best proposal on what is required to make the project viable, thereby creating a competitive process that will allow the State the opportunity to consider those proposals that have the best chance of actually delivering on the promise of an Alaska gas pipeline.

ADDITIONAL FEEDBACK ON AGIA

I would like to now give some specific feedback on AGIA which is based on the conclusions and principles I've mentioned. I will also outline some additional thoughts on how AGIA should be modified to provide the best chance of a successful result. For example, alignment between the State and the leaseholders is essential to a basin opening project of this magnitude. Therefore, establishing the right approach going forward is the most important activity for the project at this time. It is important that AGIA bring together the upstream and the midstream and provide for an integrated proposal. Let me expand on this point. The upstream and midstream at some point in time will have to come together. The reason is simple – the upstream pays for the midstream. When I say upstream I mean the revenue generated from sale of the gas and liquids from the pipeline project. To be able to calculate the revenue from the upstream we must have clarity on the taxes and royalty from our oil and gas operations and the taxes and royalties must be set at a level that makes the project viable. In order to ensure a viable project from the outset, we believe this must be done at the beginning. At a minimum, any proposal should demonstrate how a successful open season would be achieved.

As I discussed previously, with regard to upstream terms, the proposed upstream inducements would require significant modification to ensure a commercially viable project is obtained. It would be better to leave that issue open for now and allow an applicant to make a proposal to address those terms.

AGIA also prescribes activities that must be completed within a specific timeframe or date certain. Setting arbitrary target dates is not consistent with good project management practices. Further, milestones are not necessary if the project is commercially viable. The Producers' builder will progress the project at the maximum prudent pace, consistent with the industry proven "gate" process for project development.

In general, AGIA lacks specifics on key fiscal terms and other requirements. To address these gaps, AGIA gives commissioners broad authority to adopt additional requirements and establish regulations. Not knowing the requirements now creates significant uncertainty.

Finally, because of the complexity and risk associated with this project, the parties must have an efficient and impartial means of handling disagreements when they arise. We believe project related agreements should provide for binding neutral arbitration as the mechanism for resolving disputes. Binding neutral arbitration is widely utilized in U.S. and international commercial agreements and is not a new concept with the State of Alaska. Arbitration is the method used to resolve disputes under the State's Royalty Settlement Agreements. In addition, Alaska courts have recognized a strong public policy in favor of arbitration.

REACTIONS TO COMMITTEE AMENDMENTS

We also note that the House Oil & Gas Committee and the Senate Resources Committee made a number of amendments to AGIA. While substantial work needs to

be done to make AGIA truly objective, several of the proposed changes moved in the right direction, including making the state's entire capital contribution a bid variable, beefing up evaluation criteria, recognizing the need to include terms in a contract and requiring legislative approval of any license award. Unfortunately, steps were also taken that will likely limit the number of potential bidders by eliminating any confidentiality protection for a licensee's proprietary and trade secret data and imposing new prescriptive terms such as requiring any bidder to forego its legal rights to challenge an improper award. What we have at this stage is an AGIA bill that remains too prescriptive to solicit the quality market based bids necessary to move the project forward.

CONCLUSION

In closing, I would like to reiterate that ExxonMobil is committed to moving the gas pipeline project forward. Our company possesses the financial strength and project experience required to make this project a success. We are ready to work with the Administration and the Legislature to establish a framework that recognizes the integrated nature of the project and mitigates the risks I've discussed to allow the project to progress. We would suggest AGIA be amended to include a broad objective driven framework that sets out what the State wants to achieve. AGIA should allow each applicant to propose how best to meet those objectives and to identify what is required from the State to advance the project. This process will secure more viable applications, create more competition and afford the State the opportunity to secure the most value. We are ready to participate in a competitive, open and transparent process under the approach I've outlined.

Thank you for your attention and for the opportunity to address this important topic today. I look forward to addressing your questions.

RESPONSE TO QUESTION FROM SENATOR THERRIAULT ON POLITICAL RISK

Western democracies all have broadly diversified economies and when there is a need for more tax revenue, those governments have many options available to them as to how best to raise the needed additional revenue. For example, in the United States, changing the rate of personal income tax is often the vehicle that is selected. There is no need to target a particular industry.

We need fiscal predictability in Alaska for exactly the same reason that we insist on fiscal stability in these other political jurisdictions. The temptation to target the predominant industry to provide additional revenue is always there and fiscal stability provisions prevent these other host governments from responding to that temptation.

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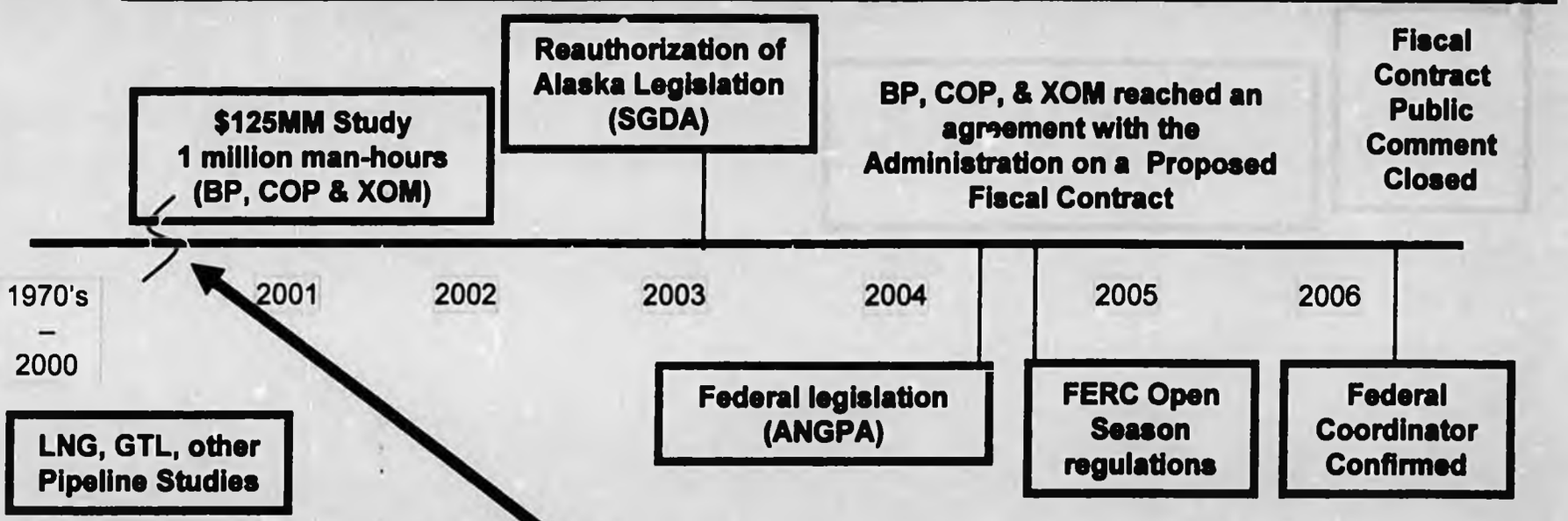
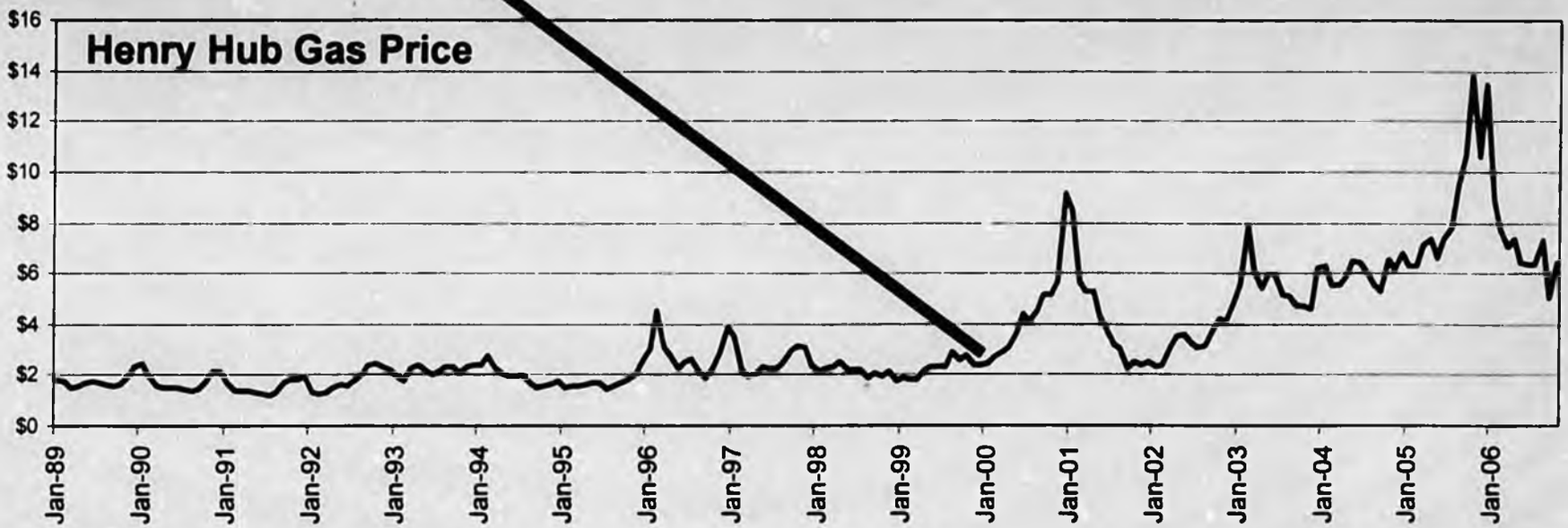
Senate Judiciary Committee
April 14, 2007

Wendy D. King
ANS Gas Development Team

Alaska Gas Pipeline Project





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What makes the Alaska Project Different?

Source: ConocoPhillips Internal Resources

Alaska Gas Pipeline will be much larger / more difficult than other US/CAN pipelines. Size brings additional risk.

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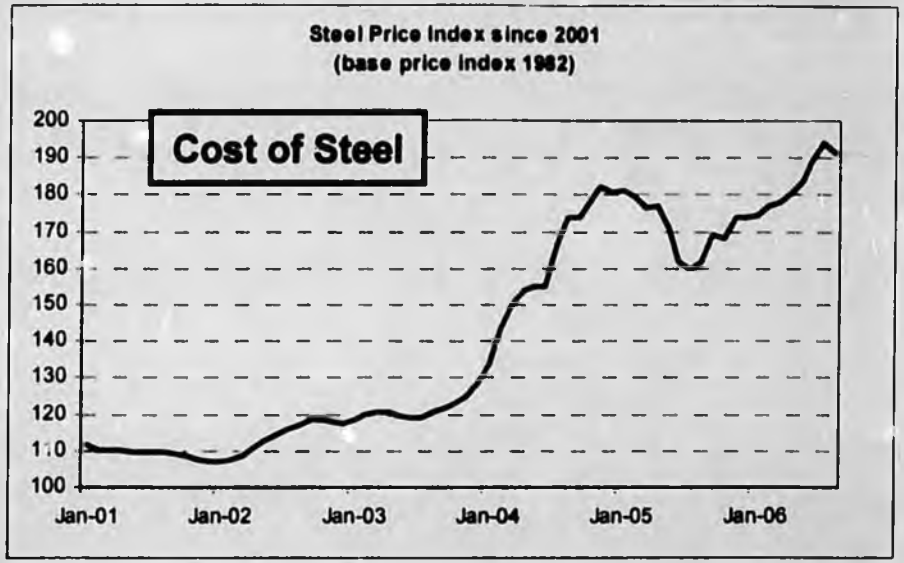
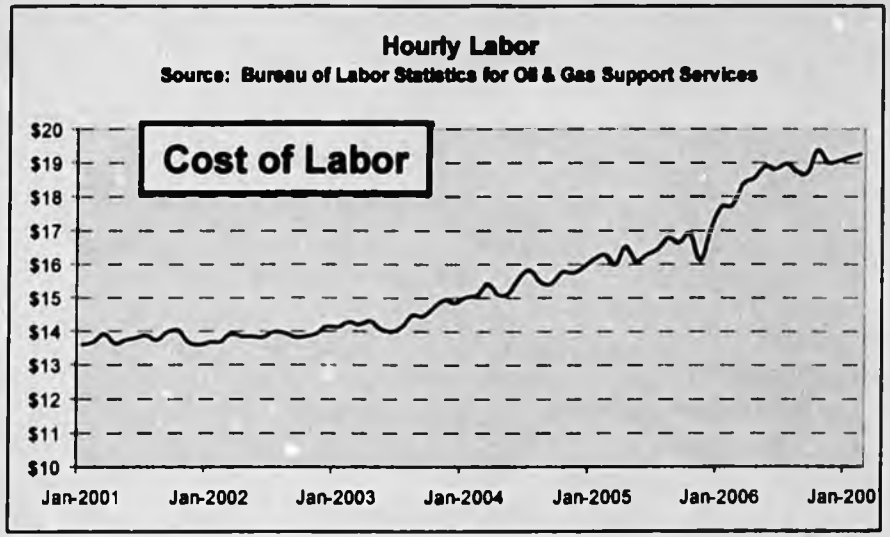
Alaska Gas Pipeline Project Risks

- **Cost**
  - Since 2001, steel prices have nearly doubled
  - Labor costs continue to rise
  - Previous $20 billion cost estimate would be significantly higher today
- **Prices**
  - Natural Gas Supply & Demand
  - Volatility
- **Other Risks and Uncertainties**
  - World-scale logistics
  - World-scale material procurement
  - Labor availability
  - Weather
  - Reserves and Deliverability





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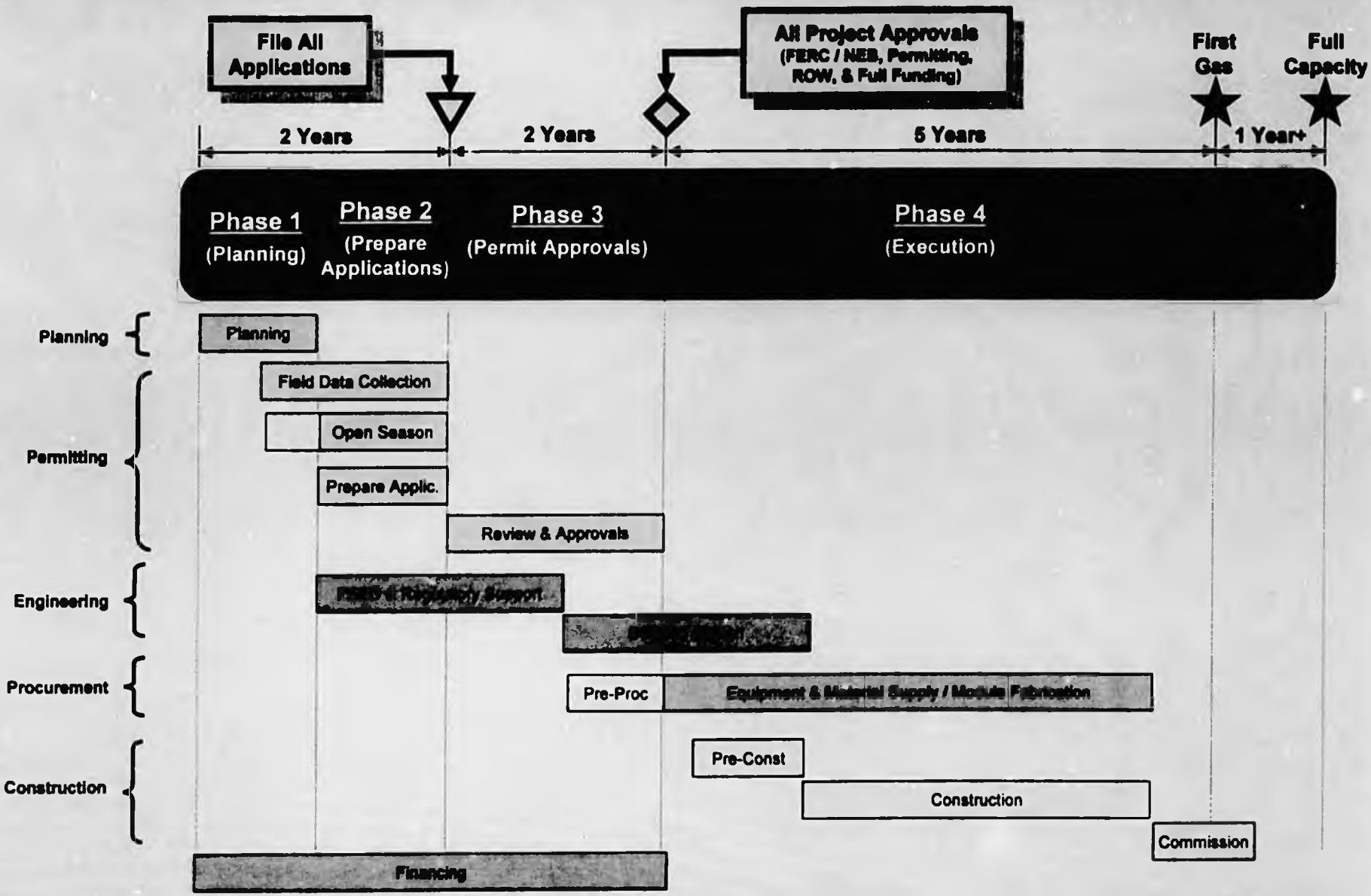
Success Case Project Timeline



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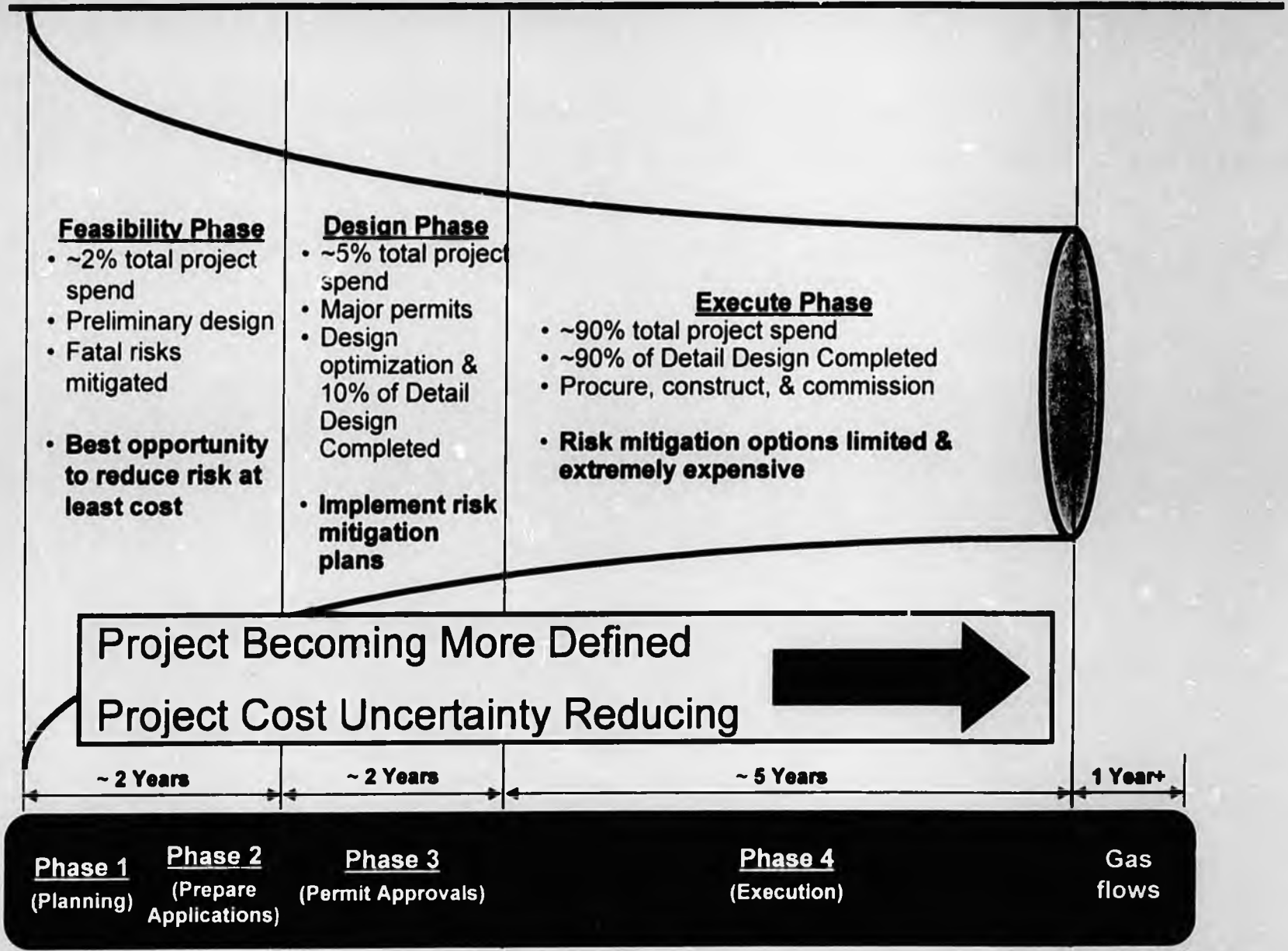
Front End Loading and Cost Estimates



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Why an Open Season?

- Why shipping commitments?
  - Shippers agree to ship gas, or pay demand charges for fixed term
    - Allows pipeline company to repay its debt and obtain a return on its equity contribution
  - Commitments allow pipeline company to obtain financing – the commitments serve as collateral for the financing

- Why is Open Season critical?
  - Allows open access to pipeline
  - Demonstrates no discrimination
  - Required by ANGPA – Sec. 103(e)
  - Establishes the demand for capacity, which impacts size, design, and cost of the pipeline
  - Also supports determination of whether project is viable commercially and can get financing

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Proposed AGIA

Initial Concerns:

- AGIA structure hinders competition and creative alternatives
  - Licensed Project Assurances clause creates significant barriers to alternatives and competition
  - State could pick the wrong winner and be tied up for over a decade
  - AGIA 'bid requirements' are too narrow, prescriptive, and could result in subsidization that may not even be in the State's interests
- Resource terms not adequately addressed - clearly 'not a negotiation'
  - Long term firm shipping commitments are key to a successful pipeline project

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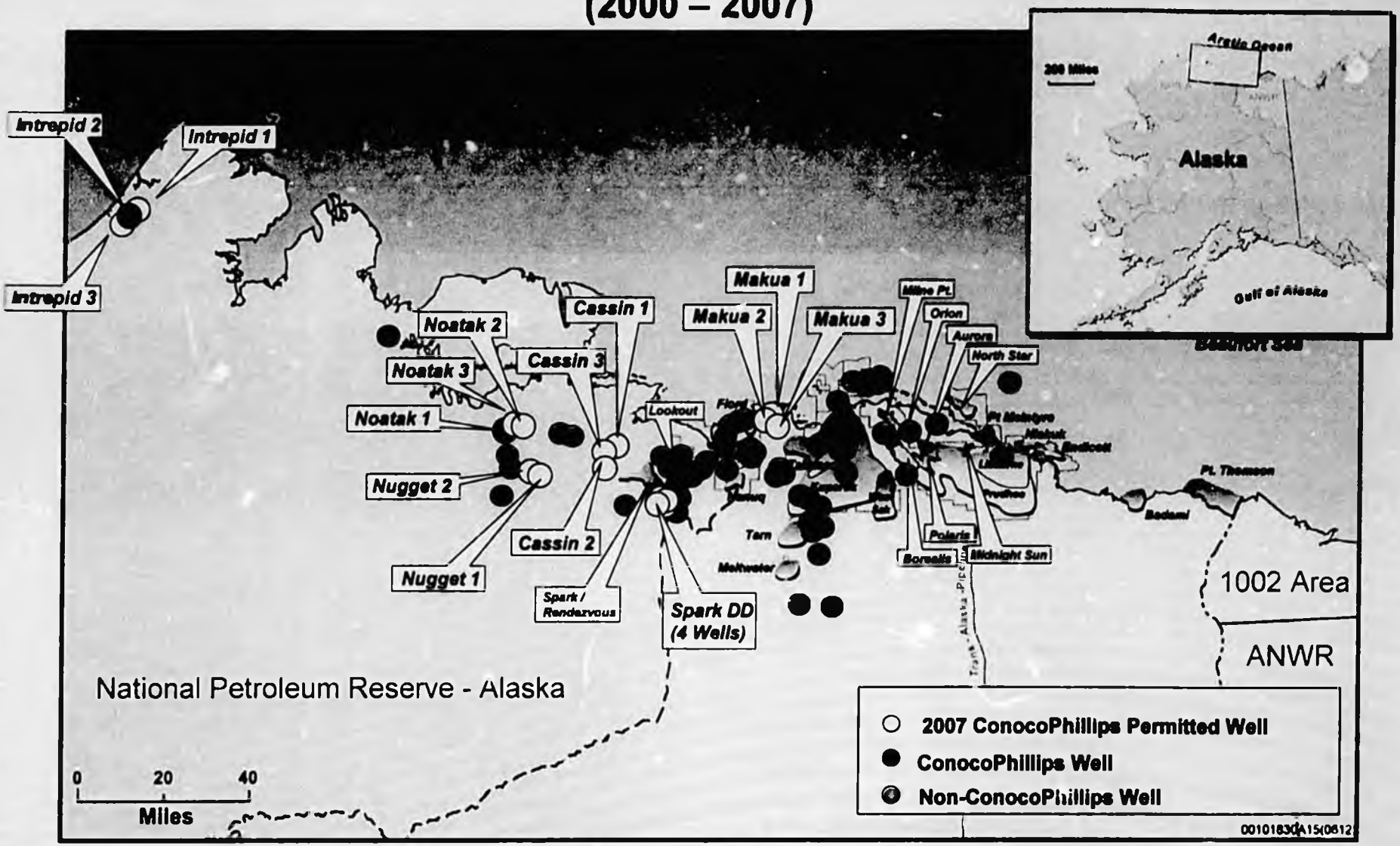
ConocoPhillips Exploration on North Slope

(2000 – 2007)



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Order 2005 on Rolled-in Rates

"In conclusion, to provide guidance to potential shippers in advance of the initial open season that is the subject of this rule, the Commission intends to harmonize both objectives (rate predictability for initial shippers and reductions of barriers to future exploration and production) in designing rates for future expansions of any Alaska natural gas transportation project. It is consistent with our guiding principle that competition favors all of the Commission's customers, as well as with the objectives of the Act, ***to adopt rolled-in treatment up to the point that would cause there to be a subsidy of expansion shippers by initial shippers, if any subsidy were to be found.***"

– page 44, 18 CFR Part 157, Order No. 2005, 2/9/05

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ANS Exploration Potential

	Acres	Range (5 – 95%)	State Royalty?	State Taxes?
State lands* (onshore & offshore)	15 million	24 – 45 TCF unassociated	Yes	Yes
Private lands* (mostly native)		3 – 6 TCF associated		Yes
Federal onshore				
ANWR (1002 Area)	19 million (1.5 million)	0 – 20 TCF	Shared Federal Royalty	Yes
NPRA	23 million	39 – 83 TCF	Shared Federal Royalty	Yes
Federal OCS				
Beaufort Sea		1 – 72 TCF		
Chukchi Sea		10 – 210 TCF		

** Includes Foothills acreage*

Source: USGS assessments for State (2005), ANWR (1998), NPRA (2002), Chukchi (2006), Beaufort (2006)

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Suggested Changes to AGIA

- Convert AGIA 'bid requirements' to 'bid variables'
  - Allow proposals to include other commitments and inducements
  - Allow resource-owner applicants to propose packages with resource terms
  - Foster greater quantity and quality of proposals

- Amend exclusivity provisions to protect Alaska's options
  - Avoid treble damages which might penalize Alaska for prudent actions
  - AGIA impairs State's ability to agree resource terms in the future
  - State coordinator/streamlined permitting should be available to any project
    - Similar structure to Alaska Natural Gas Pipeline Act (ANGPA)

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