



## Memorandum

**TO:** Senator Gene Therriault, Chair, Legislative Budget and Audit Committee  
Representative Ralph Samuels, Vice-Chair, Legislative Budget and Audit Committee

**FROM:** Kenneth M. Minesinger  
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**DATE:** December 21, 2006

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

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### Introduction and Summary

This memorandum provides an update to our April 22, 2005 memorandum, which analyzed the antitrust and competitive issues raised by ownership of the Alaska natural gas pipeline by the major North Slope producers (BP, ExxonMobil, and ConocoPhillips, hereinafter jointly referred to as the “Producers”). This updated review specifically responds to various assertions made on behalf of the former Governor’s negotiating team (hereinafter the “Former Administration”), and other assertions by the Producers.<sup>1</sup> This update also addresses several developments that have occurred since we completed our prior memorandum, including the draft contract between the State and the Producers, new authority granted to the Federal Energy Regulatory Commission (“FERC”

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<sup>1</sup> In particular, we will respond to assertions made in: (1) the March 11, 2005 memorandum from Mr. Bradley S. Lui to the State of Alaska (“March 2005 Administration Memorandum”), which was included as Appendix J of the Fiscal Interest Findings published by the Former Administration; (2) the May 15, 2006 PowerPoint presented by Mr. Lui entitled “The Stranded Gas Fiscal Contract: Antitrust Issues” (“May 2006 Presentation to the Special Legislative Session”); (3) the July 13, 2006 PowerPoint presented by Mr. Robert H. Loeffler entitled “Access to Alaska Gas Pipeline and ‘Basin Control’” (“July 2006 Administration Presentation”); and (4) the August 3, 2006 letter on behalf of the Producers from Mr. Bradford G. Keithley to The Honorable Ralph Seekins (“August 2006 Producer Letter”).

or “Commission”) by the Energy Policy Act of 2005, and a federal court’s reversal of FERC’s Order No. 2004.

Counsel for the Former Administration and the Producers have contended that: (1) a Producer-owned pipeline would have the same incentive as an independent pipeline to ship third-party gas produced by smaller producers and explorers; (2) FERC regulations ensure that a Producer-owned pipeline would not discriminate against smaller producers and explorers; (3) virtually all pipelines in the United States are subject to the same sort of affiliate issues that would be presented by a Producer-owned Alaska pipeline; and (4) a Producer-owned pipeline would not violate the antitrust laws.

As discussed below, the antitrust and competitive analysis of the Former Administration and the Producers ignores well-established vertical market power principles, relies on erroneous factual assumptions, and does not address several of the key issues discussed in our prior memorandum. As a result, the Former Administration reached the wrong conclusion regarding the competitive problems associated with a Producer-owned pipeline. After reviewing the Former Administration’s analysis and having been informed of the key provisions of the draft contract, we continue to believe that a Producer-owned pipeline would raise significant vertical market power issues that, while not disqualifying, should at least be considered by the State in determining how to proceed.

Indeed, based on the scope and extent of the Producers’ ownership of the pipeline and control of the pipeline’s firm capacity rights and natural gas reserves in the State of Alaska, the project appears to present vertical market power issues that significantly exceed those on any other major natural gas pipeline in the U.S. Contrary to the Producers’ contention that “virtually all”

pipelines implicate these same concerns, this is a highly unusual fact pattern, presenting unique vertical market power problems. From both a competitive standpoint and in terms of maximizing the future development of Alaska's natural gas reserves, a Producer-owned pipeline would be inferior to an independent pipeline company project, all other factors being equal, because the Producers will have a disincentive to expand the line to its full potential and an incentive to restrict access by smaller producers and explorers. This conclusion is supported by the 1977 opinion of the U.S. Department of Justice ("DOJ") – which recommended a complete ban on producer-ownership of the pipeline – and more recent DOJ, Federal Trade Commission ("FTC") and Federal Energy Regulatory Commission ("FERC") cases and orders in analogous situations. The State's reported experience with the Trans-Alaska Pipeline System ("TAPS") oil pipeline also supports this analysis, and counsels in favor of adopting a new approach to avoid similar pitfalls. Similar to an analogous market power problem FERC identified in Order No. 2000, the State must be careful to avoid creating a pipeline ownership structure that fosters a *perception* of discrimination that could deter smaller producers and explorers from developing Alaska's gas reserves to their fullest potential. Indeed, failure to address the vertical market power issues could lead to a reduction in the number of competing producers, a reduction in the amount of Alaska's natural gas that will be produced, and control over the Alaskan natural gas production basin by the Producers as they force or encourage smaller producers/explorers to exit the market.

To be sure, some pipeline would clearly be better than none in terms of developing Alaska's natural gas reserves. Thus, we differ from the 1977 DOJ opinion in that we are not suggesting that the State should refuse to consider negotiating a contract with the Producers. Instead, we believe the State should take a "middle ground" approach, one which does not bar a

Producer-owned pipeline, but which also does not ignore the undeniable vertical market power issues associated with such a pipeline. Moreover, we believe smaller producers and explorers will likely raise these vertical market power issues in any FERC certificate proceeding involving a Producer-owned pipeline. While we do not doubt that FERC would authorize construction of a Producer-owned pipeline, we believe there is a significant risk FERC would impose certificate conditions to address the market power issues which the Producers would find unacceptable, leading to additional litigation, delay, and potential rejection of the certificate by the Producers. To avoid this problem, we strongly endorse any effort by the State to consider reforming the draft contract to address these issues in advance, and the option of opening the negotiations to include competing proposals by independent pipeline companies.

### **Discussion**

In our April 22, 2005 memorandum (a copy of which is attached hereto for your convenience, hereinafter referred to as the “April 2005 Memorandum”), we concluded that even though the construction of a new Alaska pipeline would be a positive development for Alaska and for the Nation’s energy resources, ownership of the pipeline by the Producers would raise significant competitive issues which could lead to time-consuming litigation at FERC and cause FERC to consider imposing various certificate conditions or remedies. Specifically, we concluded the Producers would have the incentive and ability to use their control of the pipeline to discriminate against smaller producers and explorers, including by resisting an expansion of the pipeline. We also concluded that these unique incentives associated with a Producer-owned pipeline could limit competition and the future development of Alaska’s natural gas resources,

even assuming the Producers could convince FERC to approve the project without conditions. We based our conclusions on several factors, including among other things (1) the 1977 DOJ opinion, (2) subsequent case law and consent decrees from DOJ, the FTC and FERC demonstrating that the vertical market power analysis in DOJ's 1977 opinion is still analytically valid, and (3) the unique fact situation presented.

Approximately one year following our memorandum, in a presentation dated May 15, 2006, the Former Administration indirectly responded to some of the points we had made. The Former Administration recognized that in 2005 the then-FERC chairman stated that the antitrust issues raised by DOJ in 1977 "are still valid".<sup>2</sup> However, the Former Administration concluded that a Producer joint venture to construct the Alaska natural gas pipeline would not violate the antitrust laws.<sup>3</sup> The Former Administration also concluded that FERC regulation will ensure that the Producers cannot and will not discriminate against third-parties.<sup>4</sup> Moreover, the Former Administration concluded the Producers will lack even the incentive to discriminate against their competitors, citing statistics which purportedly show the Producers as a group control only a small portion of the U.S. natural gas market.<sup>5</sup> In fact, the Former Administration even maintained the Producers would have the incentive "to encourage third party shipments", instead of an incentive to discriminate against third-party shipments.<sup>6</sup>

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<sup>2</sup> See the cover memorandum to the March 2005 Administration Memorandum at footnote 1.

<sup>3</sup> March 2005 Administration Memorandum at 4.

<sup>4</sup> *Id.* at 6-8.

<sup>5</sup> *Id.* at 8.

<sup>6</sup> *Id.* at 9.

As explained more fully below, the Former Administration’s conclusions directly conflict with well-established vertical market power principles applied by the DOJ, the FTC, and FERC, and are based on a mistaken view of the relevant facts.

**I. The Former Administration’s Analysis Focused on the Wrong Issues, and Virtually Ignored the 1977 DOJ Opinion.**

The Former Administration’s analysis hinges in substantial part on its conclusion that a Producer joint venture to build an Alaska natural gas pipeline would not violate the antitrust laws. But that is not the issue. As an initial matter, while antitrust and competitive principles are relevant, the applicable legal standard in a certificate proceeding to construct a new pipeline at FERC is not whether an antitrust violation has occurred or would occur. Enforcing the antitrust laws is the job of DOJ and the FTC; FERC does not enforce the antitrust laws. *Northern Natural Gas Co. v. FPC*, 399 F.2d 953, 961 (D.C. Cir. 1968). Rather, in determining whether a proposed pipeline project is in the “public convenience and necessity” and thus should be authorized under Section 7(c) of the Natural Gas Act, FERC must evaluate antitrust factors along with other public interest considerations. *Id.*; *City of Pittsburgh v. FPC*, 237 F.2d 741 (D.C. Cir. 1956). In performing its public interest analysis, FERC analyzes numerous factors, including, where appropriate, not only the narrow question of whether the antitrust laws would be violated but also the broader issue of the effect a particular proposal would have on competition and the impact of a proposal on the pipeline’s customers. *See, e.g., Southern Natural Gas Co.*, 72 FERC ¶ 61,322, at 62,386 (1995). Moreover, under the Alaska Natural Gas Pipeline Act (“ANGPA”), FERC is required to develop open season regulations (ultimately leading to a certificate) that “promote competition in the exploration, development, and production of Alaska natural gas.” (ANGPA §

103(e)(2)(B)). This requirement exists regardless whether a particular proposal violates the antitrust laws.<sup>7</sup>

By focusing on the narrow question of whether a producer joint venture in and of itself would violate the antitrust laws – something which neither the 1977 DOJ opinion nor our April 2005 memorandum ever asserted – the Former Administration constructed a “straw man” ignoring the relevant issues. Those issues include whether there is a significant risk that FERC, as part of its broad “public convenience and necessity” analysis under Section 7(c) of the Natural Gas Act, would impose conditions on the certificate authorizing construction of the pipeline that would be unacceptable to the Producers.

Searching for a technical violation of the antitrust laws also caused the Former Administration to misconstrue the 1977 DOJ opinion. As noted above, DOJ never concluded that a producer-owned pipeline would actually violate the antitrust laws. Yet DOJ continued to have very serious competitive concerns. Recall that DOJ concluded:

- “[P]roducer ownership or control of the transportation system could circumvent Federal Power Commission regulation of the pipeline....” [DOJ Opinion at iv-v.]
- “[M]onopoly profits could be taken by the integrated company by transferring some or all of the profits stemming from the transportation monopoly to the unregulated upstream production operations *through denial of access to non-owners and restricting downstream supply.*” [DOJ Opinion at iv-v.]
- “Because the producers’ market power “could be reduced by discovery and development of new fields by other producers, . . . *an integrated producer/pipeline owner would seek to restrict access and throughput to take monopoly profits.*” [Id. at v.]

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<sup>7</sup> Consistent with that requirement, the Commission’s regulations expressly contemplate that it will review the design of any proposed project and may require design changes to accommodate future expansions of the line. 18 C.F.R. §§ 157.36 and 156.37. Importantly, as discussed more fully below, the Producers have appealed those specific requirements.

- “[T]he case we are concerned with includes future efforts by other producers to enter the Alaskan field and consequential needs for expanded pipeline capacity (e.g., through looping) in the future. . . . [P]roducer-ownership of the pipeline creates incentives to deny or impede such future expansion.” [*Id.* at 39.]
- “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.]
- “The clean solution to the vertical integration problem is to place all pipelines in the position of the nonintegrated owner – prohibit producer ownership in the pipeline.” [*Id.* at 42.]

As these quotes make clear, DOJ’s opposition to producer-ownership of the pipeline in 1977 was predicated on the vertical market power problem created when large producers at the upstream stage of the natural gas supply chain integrate into the downstream pipeline transportation stage of the supply chain. DOJ’s opposition was not predicated on any assumption that such vertical integration would in and of itself violate any provision of the antitrust laws. Indeed, DOJ never discusses any specific provision of the antitrust laws or antitrust case law in its opinion. But DOJ was quite clearly concerned about vertical foreclosure – the incentive a producer-owned pipeline would have to try to use control over the pipeline to limit competition from rival producers and explorers. By focusing on the narrow question of whether a pipeline joint venture owned by the Producers would violate the antitrust laws, the Former Administration sidestepped the important competitive issues.<sup>8</sup>

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<sup>8</sup> We also would note the Former Administration failed to discuss an important way in which the implementation of a Producer joint venture could violate the antitrust laws. DOJ would be very concerned if the joint venture were used by the Producers to facilitate collusion. This collusion could take several forms. For example, any use of the joint venture to fix the price of natural gas sold through the pipeline would clearly violate the antitrust laws. Similarly, any use of the joint venture to divide markets – including through a joint, non-unilateral decision by the Producers not to construct or to delay construction of the pipeline in the first place – would also raise serious antitrust concerns. While these so-called “spill-over effects” could be addressed as a separate offense, if the proposed joint venture raises a significant likelihood of such potential abuses, then it would be prudent and more efficient for the State to address them now and insist on adopting structural safeguards.

The Former Administration also failed to address any of the post-1977 vertical market power cases which we discussed at length in our memorandum.<sup>9</sup> For example, in *Dominion Resources*,<sup>10</sup> 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. Specifically, the FTC was concerned Dominion could use VNG’s control over the natural gas pipeline network to raise the costs of entry and/or electricity production to new, competing generators by charging them discriminatorily high prices for natural gas or through other more subtle means of discrimination. As a result, the FTC required Dominion to divest VNG. The same vertical concerns expressed in *Dominion* have been relied on by the FTC, DOJ and FERC in numerous other cases, including in a merger case decided by FERC just last week where FERC was concerned that post-merger the company at issue could use its control over transmission to discriminate against rival generators and in favor of its affiliated generation.<sup>11</sup> These authorities demonstrate that, from both an antitrust and a FERC perspective, the underlying vertical market power theory relied on by DOJ in its 1977 opinion is still valid. Moreover, as we will discuss later in this memorandum, the vertical foreclosure concerns underlying the 1977 DOJ opinion are also supported by a number of the major rulemaking orders issued by FERC over the past twenty years, which are predicated in large part on the concern that a

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<sup>9</sup> See, e.g., the cases cited and discussed at pages 7-10 of our April 2005 Memorandum, including *Dominion Resources*, *infra*, *Shell/Texaco*, FTC File No. 971-0026 (1997), and *Detroit Edison*, FTC File No. 001-0067 (2001).

<sup>10</sup> FTC Dkt. No. C-3901 (1999).

<sup>11</sup> See *Aquila, Inc. and Mid-Kansas Electric Co., LLC*, 117 FERC ¶ 61,276, at P 38 (2006) (finding that, without mitigation, the combination of one company’s generation with another entity’s control of transmission could have a negative effect on vertical competition); see also *supra* footnote 9.

pipeline/transmission owner will use its control over pipeline/transmission facilities to discriminate against non-affiliated competitors and in favor of the pipeline/transmission owner's affiliates. Although we disagree with the 1977 DOJ's recommendation of a complete ban on producer-ownership, it cannot be reasonably disputed that the vertical analysis reflected in the 1977 DOJ opinion is based on well-established, widely accepted, and analytically sound competitive principles. Yet that is the direct implication of the Former Administration's stance.

## **II. The Former Administration Disregarded Facts and Other Precedent Demonstrating That A Producer-Owned Pipeline Would Have A Clear Incentive To Discriminate Against Smaller Producer/Explorers.**

A vertical market power problem exists when a company (or a group of companies through a joint venture) has the incentive and ability to use its control of a "bottleneck" asset such as a natural gas pipeline to discriminate against its competitors who need to use the asset to make competing sales of a commodity such as natural gas.<sup>12</sup> Despite this well-established principle, the Former Administration concluded, remarkably, that a Producer-owned pipeline would not have an incentive to discriminate against rival producers, and would have the same incentive to ship third-party gas as an independent pipeline. *See* March 2005 Administration Memorandum at 8 (asserting that "The Producers Would Have The Same Incentive To Allow Third Party Shippers To Ship on the Gas Pipeline As An Independent Owner."). The Former Administration's conclusion was

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<sup>12</sup> For example, 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)..

based on important factual errors and an apparent misconception about the natural gas business in general.

First, the Former Administration contended that the Producers collectively have a current market share of less than 10 percent of the natural gas sales in the Lower 48 states, and are projected to have a market share of slightly more than 20 percent in 2015. *See* May 2006 Presentation to the Special Legislative Session at 4. The Former Administration's assumption about the Producers' current market share appears to be incorrect and based on data that significantly understates the Producers' sales of natural gas. Publicly available sales information demonstrates that the Producers have a North American market share of approximately 40 percent, about four times greater than the amount asserted by the Former Administration.<sup>13</sup> Moreover, the Former Administration should also have focused on the pipeline transportation of Alaskan gas to consumption areas and the ownership of the gas that will be transported out of Alaska. In other words, what is also crucial to the incentives issue is that the Producers will jointly own the pipeline and will collectively own approximately 90 percent or more of the natural gas that will initially be transported on the pipeline. That is an unusually high level, particularly on a pipeline of this size and scope.

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<sup>13</sup> *See Natural Gas Intelligence's* Rankings of the top North American Natural Gas Marketers for 2006 (ranking BP first and ConocoPhillips second among all marketers). It appears the Former Administration excluded third-party gas sold by the Producers from their market share calculation, but offered no reason to support that. *See* March 2005 Administration Memorandum at 8. Because the Producers presumably seek to make a profit on all gas sales they make, there appears to be no reason to exclude their sales of gas produced by third-parties. There also is no reason to expect their market share will go down in the future. In fact, based on the analogous experience with TAPS and other market trends, there is probably more reason to expect the Producers' market share to increase in the future. In any event, under the authorities discussed later in this memorandum, FERC's concern about discrimination in many instances does not depend on whether the vertically-integrated company has a large or small share of the downstream commodity market. Thus, the Former Administration's focus on the size of the Producers' market share in the Lower 48 states is somewhat misplaced, in addition to being factually incorrect.

A second factual misconception – which both the Former Administration and the Producers have asserted – is the claim that a Producer-owned Alaska pipeline does not present unique market power issues, and specifically that “*virtually all* interstate pipelines suffer from the same sort of affiliate concerns.” August 2006 Producer Letter at 3; March 2005 Administration Memorandum at 8. Their contention is simply incorrect. It is beyond any reasonable dispute that a Producer-owned Alaska pipeline would result in a situation where the pipeline’s marketing affiliates would hold a massive amount of the Alaska pipeline’s capacity, an amount that collectively far exceeds the amount of capacity (both in relative and absolute terms) held by *any* unregulated marketing affiliate on *any* other major pipeline in the U.S.<sup>14</sup> While it is certainly true that marketing affiliates hold capacity on other interstate natural gas pipelines, those situations appear to pale in comparison, as they typically involve smaller capacity holdings and/or smaller pipelines.

In this regard, there certainly are other pipelines in the U.S. that have or have had in the past a significant amount of producer-ownership, such as Entrega, Rockies Express and Alliance. However, those pipelines are readily distinguishable from the Alaska situation. Other producer-owned pipelines typically (1) involve a much smaller share of the natural gas produced in the production basin at issue, (2) are not the only pipeline which provides access to other producers from the relevant production basin, (3) have a significantly greater number of shippers with significant capacity holdings, and/or (4) to our knowledge, have not permitted the major producer-owner(s) to veto or restrict future expansions. Thus, on a smaller producer-owned pipeline, an

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<sup>14</sup> See Energy Information Agency statistics cited in Don Shepler’s August 18, 2006 memorandum at p. 4. This conclusion is based on our years of experience in the natural gas pipeline industry, and was confirmed by reviewing the Index of Customers filed at FERC by several major pipelines, including Transcontinental Gas Pipe Line, Texas Eastern, Tennessee Gas Pipeline, ANR Pipeline, El Paso Natural Gas Company, Northwest Pipeline, Columbia Gas Transmission, Colorado Interstate Gas Company, Florida Gas Transmission, and Southern Natural Gas Company.

ownership position of even 100 percent might not raise the same degree of competitive issues as would be raised by a Producer-owned Alaska pipeline. The unique facts of the Alaska situation, including the sheer size of the pipeline, the concentration of most of the natural gas reserves in the hands of only three producers, the absence of any other competing pipelines with access to the production basin at issue, and the ability of the Producers to veto an expansion, distinguish a Producer-owned Alaska pipeline from other pipelines owned in whole or in part by producers.

In short, these facts, along with economic analysis supporting prior DOJ, FTC, and FERC precedents in similar situations, compel the conclusion that a Producer-owned pipeline raises serious vertical market power issues. There are three related competitive problems that would likely arise, in one form or another. First, as the holders of the vast majority of the firm capacity on the largest-diameter natural gas pipeline ever constructed in North America, the Producers would have a tremendous incentive to favor their own marketing affiliates and to discriminate against competing producer/explorers, thereby increasing their control over the amount of natural gas shipped downstream. This discrimination could take subtle forms that are difficult for FERC to detect, including preferential access to information about the pipeline's operations and expansion plans. As the owners of virtually all existing natural gas reserves in Alaska, the Producers would have an incentive to use their ownership of the pipeline to limit pipeline access for competing producers and explorers – an incentive that would exist even if the Producers held *no* firm capacity rights on the pipeline.

Second, as marketers of a significant portion of the natural gas in the U.S., the Producers would have a strong incentive to control the “spigot” and prevent other producers from flooding the market with additional gas, thereby undercutting their existing U.S. sales. A central means by

which this could occur would be for the Producers to make it as difficult as possible for smaller producers and explorers to expand the pipeline. The Producers' actions thus far have only confirmed this concern, as the Producers have expended considerable resources at FERC and in the court of appeals to make it more difficult for a third-party to expand the pipeline. Given their large market share, there is every reason to expect the Producers to continue pursue an anti-expansion agenda in the coming years.

Third, the Producers would have an incentive to limit competition by reducing the number of competing producers and explorers, thereby achieving control over the production basin. By achieving "basin control", the Producers could limit the amount of gas produced, similar to the way they have appeared to have little enthusiasm thus far to build the pipeline itself. The Producers could achieve this by making it more difficult for smaller producers and explorers to gain access to the pipeline and to expand the line, and ultimately inducing them to leave the Alaska market altogether. This would harm the State by reducing efforts to develop Alaska's reserves. A similar situation has reportedly occurred on TAPS, where the number of competing producers has dwindled over time, as producers (including, ironically, Conoco itself) who do not have an ownership position in TAPS become discouraged by a perceived lack of equal access and eventually leave the State.<sup>15</sup> The State should take steps to ensure that history does not repeat itself on the gas pipeline.

Despite these serious competitive concerns, the Former Administration has even contended that the Producers would actually have "an incentive to encourage rather than discourage third party shipments on the Gas Pipeline." March 2005 Administration Memorandum at p. 8.

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<sup>15</sup> See, e.g., Protest and Complaint of Anadarko Petroleum Corp., filed in FERC Docket No. OR05-3, Dec. 16, 2004, at pp. 11-13.

According to the Former Administration, encouraging third-party shipments would provide the Producer-owners with an opportunity to recoup a portion of the cost and earn a return on their pipeline investment. *Id.* The Former Administration thus asserted that a Producer-owned pipeline would have the exact, *same* incentive as an independent pipeline company to operate and expand the pipeline system.<sup>16</sup>

As discussed above, the Former Administration's conclusions ignore well-established legal precedents, the 1977 DOJ opinion, and the unique incentives of the Producer-owners. It does not require any sophisticated economic analysis to conclude that the Producers' profits from unregulated commodity sales of natural gas would dwarf their profits from natural gas pipeline transportation charges where equity returns are limited by FERC regulation. The Producers would continue to make their natural gas-related profits largely through the production and sale of natural gas, not through the transportation of natural gas through a pipeline for others. As a result, the Producers will have an incentive to ensure that the pipeline does not facilitate their competitors' access to consumption areas in a way that would undermine their profits from commodity sales revenues.

This analysis is confirmed not only by the 1977 DOJ opinion and the substantial body of vertical market power case law which we cited in our prior memorandum, but also by a series of major FERC rulemaking orders over the past twenty years. Indeed, were the Former

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<sup>16</sup> March 2005 Administration Memorandum at 8 (asserting that "The Producers Would Have The Same Incentive To Allow Third Party Shippers To Ship on the Gas Pipeline As An Independent Owner."). In this regard, it is interesting to compare the Former Administration's faith in the Producers' incentive to *expand* the Alaska gas pipeline with the recent allegations that BP has failed merely to *maintain* the existing capacity of the TAPS oil pipeline. *See, e.g.*, "BP Executives Rebuked in Hill Appearance," Washington Post, Page D01 (quoting Representative Joe Barton as stating that if BP "can't do the basic maintenance needed to keep Prudhoe Bay's oil field operating safely and without interruption, maybe it shouldn't be operating the pipeline").

Administration correct that the Producers would have no incentive to discriminate, there would be absolutely no need for the regulatory scheme FERC has established to try and prevent such discrimination. In a series of landmark orders, FERC has taken several steps to increase competition in the natural gas industry, and specifically to combat the incentive that a vertically-integrated pipeline has to discriminate in favor of its own gas marketing and production affiliates and against competing non-affiliated gas marketing and production companies.<sup>17</sup> FERC has also observed that this incentive can lead to a variety of discriminatory actions, including action by the pipeline to “refus[e] to undertake construction projects when demand for construction [by non-affiliated shippers] exists,” in order to keep gas prices artificially high for the benefit of its marketing affiliates.<sup>18</sup>

The Former Administration’s claim that the Producers would have the same incentives as an independent pipeline company directly conflicts with the economic justification for these FERC precedents. Plainly, therefore, the Former Administration’s competitive analysis was fundamentally flawed and overreaching.

### **III. The Former Administration Also Failed To Properly Analyze A Producer-Owned Pipeline’s *Ability To Discriminate Against Smaller Producer/Explorers.***

The Former Administration also contended that even assuming for the sake of argument that the Producers would have an incentive to discriminate against third-party shippers, FERC

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<sup>17</sup> See, e.g., Order No. 497, FERC Stats. & Regs. ¶ 30,820, at 31,129 (1988) (stating that “pipelines continue to have economic incentives to show undue preferences toward their marketing affiliates, ...”); Order No. 2004-A, FERC Stats. & Regs. ¶ 31,161, at P 14 (2004); see also Order No. 2000, 89 FERC ¶ 61,285, slip op. at p. 66 (where the Commission found that “vertically integrated utilities have the incentive and the opportunity to favor their generation interests over those of their competitors. If a transmission provider’s marketing interests have favorable access to transmission system information or receive more favorable treatment of their transmission requests, this obviously creates a disadvantage for market competitors.”); see also generally FERC Order Nos. 436, 636, and 637.

<sup>18</sup> Order No. 637, at 31,287 (2000).

regulation “should preclude any effort by the Producers to favor their shipper affiliates to the detriment of non-affiliated shippers.” March 2005 Administration Memorandum at 8. According to the Former Administration, due to FERC regulation, “the Producers could not discriminate in favor of their own affiliates in order to give their shipping affiliates a competitive advantage vis-à-vis a non-affiliated shipper or to place non-affiliated shippers at a competitive disadvantage to the affiliated shippers.” *Id.* Thus, the Former Administration contended that FERC regulation would prevent the Producers from restricting smaller producers’ access to the pipeline or to an expansion of the pipeline in the future.

**A. The Antitrust Agencies Prefer Structural Remedies Over Regulation.**

The Former Administration was correct to point out that FERC has *attempted* to prevent discrimination by vertically integrated pipelines. However, the Former Administration’s total reliance on and complete faith in FERC regulation is inconsistent with established antitrust and competitive principles. As we explained in our April 2005 Memorandum, the antitrust agencies have actively sought to prevent anticompetitive mergers and conduct in the natural gas pipeline industry and in other regulated industries, despite the existence of pervasive regulatory schemes designed to prevent anticompetitive conduct from occurring. Simply put, the antitrust agencies doubt that regulation will always work, and believe that regulated companies will seek and sometimes find ways to evade regulatory proscriptions against undue discrimination. Accordingly, the antitrust agencies have a preference for “structural” remedies such as divestiture over “behavioral” remedies such as FERC’s anti-discrimination regulations, precisely because a regulatory scheme can be evaded and “does not eliminate the incentive and opportunity to engage

in exclusionary behavior.”<sup>19</sup> The Former Administration did not address this part of our April 2005 Memorandum.

In addition, the Former Administration has claimed that the regulatory scheme which exists today is more pervasive now than it was in 1977 when the DOJ recommended a ban on producer ownership. *See* March 2005 Administration Memorandum at 6. Again, this disregards what the DOJ said in 1977.<sup>20</sup> The DOJ specifically considered the fact that Section 13(a) of the Alaska Natural Gas Transportation Act (“ANGTA”) required the Alaska pipeline to provide open and non-discriminatory access to third-party shippers – similar to what FERC’s current regulations now seek to achieve. 1977 DOJ Opinion at 39. Despite the fact that ANGTA sought to prevent producers from using the pipeline to discriminate against competitors, DOJ nevertheless recommended that producer-ownership be banned because it would still be in the interest of vertically-integrated producer-owners to prevent third-parties from obtaining equal access to the pipeline, and the regulations would be difficult to enforce effectively. *Id.* The 1977 DOJ opinion’s refusal to rely on the regulatory scheme also reinforces what we have said about the antitrust agencies’ general view that regulations can be evaded, and their preference for structural remedies.

#### **B. Recent Regulatory Developments Do Not Cure the Problem.**

In addition, the Producers and the Former Administration have tried to bolster their arguments by pointing to FERC’s new anti-market manipulation rules, its new civil penalty

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<sup>19</sup> *See* our February 2005 Memorandum at 2 (quoting *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)).

<sup>20</sup> It also ignores the fact that, despite pervasive FERC regulation of TAPS, the competitive situation on TAPS has, according to some, deteriorated over time.

authority, and the “Standards of Conduct” regulations established by FERC in Order No. 2004 as evidence that anticompetitive conduct by the Producers would not occur. *See, e.g.*, August 2006 Producer Letter at 3; July 2006 Administration Presentation at 14-20. These assertions, however, again fail to refute the fact that the antitrust agencies typically prefer structural remedies because of the problem of regulatory evasion. Moreover, the argument by the Former Administration and the Producers – that the existence of FERC regulations will ensure discriminatory conduct does not occur – again overreaches. Extensive rules and regulations exist in numerous areas of our economy, including, for example, securities regulations, environmental regulations, regulations prohibiting the manipulation of commodities trading, and even clear antitrust prohibitions against various forms of anticompetitive conduct. Yet, it is an unfortunate fact that, despite those rules and regulations and significant penalties and other potential remedies for violating them, companies (including the Producers themselves) sometimes violate and evade the applicable rules and regulations.<sup>21</sup> There is no reason to expect regulations and associated penalties will be any more effective in this situation. Indeed, given the unique facts presented here – 90 percent (or more) Producer ownership of Alaska’s known reserves, an unprecedented amount of pipeline capacity rights held by Producer marketing affiliates, etc. – there is every reason for the State not to place complete faith in a regulatory scheme that will have to be constantly policed by FERC and the State, and even then will likely be unable to prevent all anticompetitive conduct.<sup>22</sup>

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<sup>21</sup> *Cf.* “BP Faces Civil Enforcement Action: [CFTC] to recommend charges for trading violations in 2002”, *adn.com/Anchorage Daily News*, Dec. 15, 2006; “BP Woes Deepen With New Probe: Public, Political Pressure May Rise As Inquiry Looks Into Possibility Of Manipulation In Gas, Oil Prices,” *The Wall Street Journal Online*, Page C1, August 29, 2006.

<sup>22</sup> In addition, were the Producers to control gathering, processing or treatment facilities which must be used prior to entering the FERC-regulated pipeline, such control would give them an additional,

It also should be noted that the Court of Appeals for the District of Columbia Circuit recently vacated Order No. 2004. *National Fuel Gas Supply v. FERC*, Case No. 04-1183 (D.C. Cir., Nov. 17, 2006). From a strictly antitrust perspective that places more faith in structural remedies than in regulatory schemes such as Order No. 2004, this development does not have great significance, although it does remove, at least for now, an additional (albeit insufficient) “line of defense” against anti-competitive conduct. In addition, on remand FERC may be able to come up with a new rationale to justify the regulatory scheme adopted in Order No. 2004, or design a new set of regulations that seeks to achieve the same objectives. Still, the D.C. Circuit’s rejection of Order No. 2004 further undermines one of the main arguments cited by the Former Administration and the Producers in favor of a Producer-owned pipeline.

Similarly, the Producers themselves are currently challenging in the D.C. Circuit FERC’s order (Order No. 2005) promulgating regulations governing the construction of the Alaska natural gas pipeline. Order No. 2005 included, among other things, the explicit proviso that FERC would review the design of the pipeline to ensure it could accommodate future “low cost” expansions. Although those regulations do not go far enough to ensure future access to capacity by smaller producers and explorers, they are better than nothing. In defending the contract with the Producers, the Former Administration cited the regulations promulgated by Order No. 2005 as another reason not to fear any competitive problems. July 2006 Administration Presentation at 22. Yet the Producers are currently seeking to undermine those regulations in the D.C. Circuit. Even if their currently pending appeal is ultimately unsuccessful, they may have a later right to appeal any FERC order that, *inter alia*, imposes any design change conditions on a certificate. Thus, their

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*unregulated* means by which to attempt to discriminate against their rivals and thereby discourage the full development of Alaska’s natural gas resources.

current court challenge fairly illustrates that any effort to rely on regulation to control anticompetitive behavior by the Producers may be subject to frequent challenge, litigation, and efforts to evade such regulation by the Producers in the future.

**IV. The Former Administration Also Failed To Consider Sufficiently the Risk That Smaller Producer/Explorers Will Abandon Efforts To Develop Alaska's Natural Gas Reserves Due to a Perception of Discrimination.**

In addition, there is a substantial risk that smaller producers and potential explorers will not trust the regulatory scheme to protect them from discrimination, and will simply conclude that investment in developing Alaska's natural gas resources is not worth their time, effort or financial commitment. As documented in Mr. Shepler's August 18, 2006 memorandum to the Legislature, several smaller producers, including Anadarko Petroleum Co., Tesoro Corporation, BG Alaska E&P, and Shell Exploration and Production, have expressed concerns about non-discriminatory access to and expansion of any natural gas pipeline owned by the Producers. The comments and concerns of these smaller producers indicate that even if the Former Administration and the Producers believe the regulatory scheme can be trusted to ensure non-discriminatory access, smaller producers and explorers may not.

This risk is significant because FERC itself has recognized the serious competitive problems that can occur merely when new entrants merely *perceive* they will be discriminated against by a vertically-integrated transmission company. In Order No. 2000, in an analogous context involving vertically-integrated electric utilities which owned regulated transmission lines and electric generation plants used to generate power flowing through the transmission lines to customers, FERC said the following:

[W]e continue to believe that perceptions of discrimination are significant impediments to competitive markets. Efficient and competitive markets will

develop only if market participants have confidence that the system is administered fairly. Lack of market confidence resulting from the perception of discrimination is not mere rhetoric. It has real-world consequences for market participants and consumers. . . . Fears of discriminatory curtailment may deter access to existing generation or deter entry by new sources of generation. . . .<sup>23</sup>

Moreover, FERC itself has expressed concern that its anti-discrimination regulations are difficult to administer and enforce. In Order No. 2000, FERC stated:

[W]e are increasingly concerned about the extensive regulatory oversight and administrative burdens that have resulted from policing compliance with standards of conduct. The use of standards of conduct is not the best way to correct vertical integration problems.<sup>24</sup>

Because of these concerns, FERC endorsed a structural remedy in Order No. 2000, whereby electric utilities would transfer operational control of their transmission assets to an independent organization, which would have no incentive to discriminate against others.

By virtue of its jurisdiction over the production of natural gas within its borders, the State has an opportunity to help ensure that perceptions of discriminatory treatment do not hinder the development of Alaska's natural gas reserves. For example, instead of relying on FERC regulation to address the vertical market problem inherent in a Producer-owned pipeline, the State could require as a condition of any gas contract with the Producers that the pipeline either be owned or operated by an independent entity that would lack any incentive to discriminate against new entrants, and that the pipeline be expanded on reasonable terms.<sup>25</sup> Moreover, as a condition to Producer-ownership of the pipeline, the State could require the Producers to forego any ability to

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<sup>23</sup> Order No. 2000, at p. 69. According to some, a similar situation exists on the TAPS oil pipeline, in which smaller producers have exited the market due to perceptions of discrimination in connection with the operation of TAPS. *See, e.g.*, Protest and Complaint of Anadarko Petroleum Corp., filed in FERC Docket No. OR05-3, Dec. 16, 2004, at pp. 11-13.

<sup>24</sup> Order No. 2000, at pp. 67-68.

<sup>25</sup> We discussed a variation of this option at pages 26-27 of our April 2005 Memorandum.

veto an expansion. In addition, and similar to concerns the Legislature voiced in its comments to FERC regarding the regulations governing the Alaska natural gas pipeline, the State can also ensure that the contract contains appropriate protections that ensure any pipeline will be designed to accommodate future entrants and expansions on reasonable terms.

If these sorts of competitive issues are not addressed as a threshold matter in the contract with the Producers, the distinct possibility exists that similar competitive issues will be raised years later at FERC in any certificate proceeding the Producers file seeking FERC authorization to construct the project (and potentially in other future FERC litigation as well). Although we agree with the Former Administration that FERC is unlikely to deny certification of a Producer-owned pipeline based on these concerns, that is not the issue. The question is not whether certification would be denied, but instead (1) whether FERC could impose conditions on the certificate that the Producers would find unacceptable such that they would refuse to proceed with the project, sending the State back to “square one” years down the road, and (2) whether Producers could evade FERC’s regulations and discriminate against rivals in the future, assuming they construct the pipeline at all.

We believe that both of these risks are significant. In part, this conclusion is based on the recent experience with FERC’s proposed Alaska pipeline regulations, where FERC made several material changes to the proposed regulations over the Producers’ objections and in response to issues raised by the Legislature and by smaller producers.<sup>26</sup> Given that FERC was persuaded to modify its proposed regulations, it seems logical to assume FERC could be persuaded to impose conditions regarding access and expansion on a Producer-pipeline certificate. Although we are not

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<sup>26</sup> As noted above, the Producers have appealed Order No. 2005 and are asking the D.C. Circuit to invalidate significant portions of the order.

predicting this will occur, there clearly is a significant chance that it could based on this recent experience.

This conclusion is also directly informed by the unique circumstances of this case. On the largest pipeline ever constructed in North America, the three major Alaska natural gas producers would control more than 90 percent of the known reserves needed to fill the pipeline, and would collectively hold firm capacity rights that significantly exceed what any unregulated marketing affiliate holds on any major pipeline in the U.S. We also face a situation where FERC has recognized that the concerns that led DOJ to recommend an outright ban on producer-ownership in 1977 are “still valid” today. Moreover, well-established precedent at FERC, DOJ and the FTC confirms that the antitrust concerns about vertical integration which informed the 1977 DOJ opinion are more valid than ever. In similar situations the DOJ and FTC have refused to rely solely on regulation as a solution to the problem. Similarly, recent FERC precedent indicates even FERC itself does not believe that a regulatory scheme is always sufficient to deter the perception that a vertically-integrated transmission owner will discriminate against rivals, which in and of itself can deter new entrants from developing new sources of energy. In these unique circumstances, we believe there is a significant risk FERC would impose a remedy in the certificate proceeding which the Producers would refuse to accept.

The prudent approach, therefore, is to deal with this issue now, in drafting any contract between the State and the Producers, rather than waiting to find out years later whether the Producers will accept a FERC certificate that may contain unacceptable conditions or, even if they do, finding out years later that the Producers are able to evade FERC regulation and limit and/or discourage competition. Building such protections into the contract would clearly protect the

State's interests more than the alternative. If, in response to a draft contract which fully protects the interests of the State and smaller producer/explorers, the Producers refuse to proceed with the project, that merely will confirm the wisdom of addressing these issues up front, and that the dangers of vertical integration of which the DOJ warned in 1977 continue to exist. In that event, the State would then have the ability to consider other options to facilitate the development of an Alaska natural gas pipeline.

### **Conclusion**

As documented herein, the Former Administration failed to address several of the central points we raised in our April 2005 Memorandum. The Former Administration's failure to address these points does not, however, invalidate them. Nor does that failure change the simple fact that a Producer-owned Alaska pipeline would present a unique vertical market power problem in the natural gas pipeline business, one which the "still valid" 1977 DOJ opinion warned should not be permitted. This problem, while not disqualifying, should be addressed up front, if possible, by negotiating a contract with the Producers that guarantees non-discriminatory access to and expansion of the pipeline on reasonable terms, and/or by opening up the project to competitive bids by independent pipeline companies. Requiring the Producers to participate in a competitive process with an independent pipeline project should provide the State with additional options, assuming good faith participation by all parties. Failure to address the problematic competitive issues now will merely defer such issues to a subsequent FERC certificate proceeding. There, although FERC almost surely will authorize construction of a Producer-owned pipeline, it is likely that smaller producer/explorers will raise the vertical integration issues discussed herein. In

addressing those issues, there is a significant risk FERC would impose certificate conditions that the Producers will find unacceptable. Moreover, even if the producers accept such conditions and build the pipeline, there is a substantial risk of actual or perceived regulatory evasion which will discourage smaller producers and explorers from fully developing Alaska's natural gas resources. The better course, therefore, is to address the vertical market power issues well in advance of any FERC certificate proceeding.

**ATTACHMENT**

**(APRIL 22, 2005 MEMORANDUM)**



**Memorandum**

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

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.”<sup>1</sup>
- 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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<sup>1</sup> 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.<sup>2</sup>

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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<sup>2</sup> 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*,<sup>3</sup> 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*,<sup>4</sup> 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.<sup>5</sup>

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<sup>3</sup> FTC Dkt. No. C-3901 (1999).

<sup>4</sup> FTC File No. 971-0026 (1997).

<sup>5</sup> 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.*, Cytoc/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.<sup>6</sup> 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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<sup>6</sup> 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.<sup>7</sup>

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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<sup>7</sup> 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.<sup>8</sup>

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.<sup>9</sup> On what would be the

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<sup>8</sup> 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).

<sup>9</sup> 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.<sup>10</sup>

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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<sup>10</sup> 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.<sup>11</sup>

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.<sup>12</sup> Thus, in addition to the potential that the vertical concerns created by Big 3 ownership of the Alaska

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<sup>11</sup> 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”).

<sup>12</sup> 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.<sup>13</sup>

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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<sup>13</sup> *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.<sup>14</sup> 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

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<sup>14</sup> 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.<sup>15</sup>

**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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<sup>15</sup> 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.<sup>16</sup> 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.<sup>17</sup> 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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<sup>16</sup> 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.

<sup>17</sup> *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.<sup>18</sup>

### **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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<sup>18</sup> *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.