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VIA HAND DELIVERY

April 2, 2004

Commissioner Tom Irwin
Department of Natural Resources
550 West 7th Ave., Suite 1400
Anchorage, Alaska 99501

DEPARTMENT OF NATURAL RESOURCES
APR 0 2 2004
COMMISSIONER'S OFFICE
ANCHORAGE

Re: Request for Expressions of Interest
Royalty-in-Kind Sale of Natural Gas
Cook Inlet Area

Dear Commissioner Irwin:

ConocoPhillips Company and ConocoPhillips Alaska, Inc. (collectively "ConocoPhillips") appreciate the opportunity to comment on the Department of Natural Resource's evaluation of a sale of the state's Cook Inlet Royalty-In-Kind ("RIK") gas production. ConocoPhillips is a seller, buyer, and direct consumer of natural gas in the Cook Inlet market. ConocoPhillips understands that the state is considering whether it should sell its RIK gas and if so, whether it should sell the RIK gas via a noncompetitive sale, a competitive sale, or both. ConocoPhillips does not believe an RIK gas sale in the Cook Inlet market at this time is in the best interests of the state.

When RIK gas is to be disposed of by other than a competitive bid, the commissioner must consider several factors including the existence and extent of present and projected local and regional needs and the projected effects of the proposed transaction upon existing private commercial enterprise and patterns of investments. AS 38.05.183(e)(5); AS 38.06.070(a)(2),(8). ConocoPhillips understands that one focus for the state's evaluation of an RIK gas sale at this time is a noncompetitive sale for industrial feed gas purposes, including, potentially, a noncompetitive sale to Agrium, the owner of an export fertilizer manufacturing plant in Kenai. A review of some of the factors that must be considered in evaluating such a non-competitive sale shows that such a sale is not in the best interests of the state.

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In analyzing the present and projected local and regional needs, the commissioner will need to determine whether or not the volume of RIK gas available to the state in the Cook Inlet is sufficient to provide the kind of long-term, stable gas supply necessary for the proposed end use for a beneficial period of time. The RIK volume of gas available in Cook Inlet in the short-term will decline as existing production declines while the volumes necessary to maintain feed gas supplies for industrial operations or to meet the seasonal volumes of gas that a utility needs will not decrease. In other words, an RIK sale may provide an industrial or utility purchaser with a short-term period of ever-decreasing relief with little if any long-term benefit to the purchaser, and with little if any benefit to the state or local community. For example, Agrium has announced it may shut down the Kenai fertilizer plant in 2005 or 2006 if additional inexpensive gas sources do not materialize in the short-term.[1] The interest by Agrium in an RIK sale would seem to infer that such a sale might have an impact on the fertilizer plant's fate. However, the volumes of gas available through an RIK sale are unlikely to make a significant difference in the shut down timing of the plant in light of the decline of other gas available to the plant.

In the current Cook Inlet gas market situation, it is the evaluation of the projected effects on existing private commercial enterprise for a Cook Inlet RIK gas sale that offers the clearest reason that an RIK sale is not in the best interests of the state. An RIK sale in the Cook Inlet market at this time cannot avoid adverse impacts on other operations and utilities that depend on the use of royalty gas taken in value by the state. An RIK sale would simply shift the current tightness in the Cook Inlet gas market from parties whose current gas-short situations result from their own business decisions, to other parties who would be put into the same gas-short situations as a direct result of the state's RIK sale. In addition, the gas price in a noncompetitive sale would likely be lower than the price the state currently receives, resulting in lower revenues to the state.

An example of an operation that could be adversely impacted by an RIK sale and that illustrates how an RIK sale simply shifts the available gas supply from one party to another is the Kenai LNG plant. The primary source of ConocoPhillips feed gas for the LNG plant (ConocoPhillips supplies 70% of the feed gas, Marathon supplies 30%) is the North Cook Inlet Unit (NCIU).[2] If the state's royalty gas volume in NCIU (12.5% of the

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[1] Per Mr. William Boycott's presentation to the Resource Development Council on March 4, 2004, in Anchorage, regarding the Kenai fertilizer plant's situation and future. Mr. Boycott has also asserted that the plant's shut down will have a large economic impact to the Kenai Borough and the local Kenai economy. The size of the impact is debatable at this point as no impartial party with expertise has analyzed this potential in any depth and provided the results to the public.

[2] It should be noted that, should the state determine to sell RIK gas, ConocoPhillips in its capacity as an owner of the Nikiski LNG plant is not likely, in the face of the apparent tightness in the Cook Inlet gas market, to be eligible to purchase state RIK gas for that purpose because the LNG is exported from the state. AS 38.05.183(d) provides that royalty gas taken in kind cannot be sold or otherwise exported from the state unless the commissioner determines that the royalty gas is "surplus to the present and projected intrastate domestic and industrial needs." These comments therefore are not submitted by a party who is a potential competitor for the RIK gas, but rather a party who will be unavoidably adversely impacted by any RIK gas sale from the fields in which it owns interests.

field's production, currently taken in value) were to be diverted away from the LNG operation for an RIK sale, ConocoPhillips would likely need to find supplemental sources of gas. This could have negative economic ramifications to the LNG operation, which, like the fertilizer plant, is an industrial operation in the Kenai area employing local residents, supporting local businesses, and paying state and local taxes.

The Beluga River Unit ("BRU") is an example of a field where an RIK sale from that field would have a negative impact upon utilities as well as industrial operations. On cold days, the BRU produces at maximum offtake to supply both industrial and gas and electric utilities servicing customers in the Anchorage, Kenai, Matanuska-Susitna Valley and Fairbanks areas. Should the RIK gas not be available to supply these contracts, the industrial and utility customers could be short of their gas requirements. At the very least, directing BRU gas away from the utilities decreases the ultimate amount of gas available to supply the utility contracts over the long-term.

ConocoPhillips also understands it has been asserted that the fertilizer plant is a "safety valve" for Cook Inlet gas exploration and that gas exploration will end in Cook Inlet if the fertilizer plant operation is not available to absorb gas found in excess of utility company requirements.[3] As far as ConocoPhillips is aware, no company has announced that it is conducting exploration to supply gas for customers that require large volumes of low priced gas. New gas contracts presented to and approved by the Regulatory Commission of Alaska in recent years for Enstar clearly signal that the driver for gas pricing in Cook Inlet is the ability to realize gas prices competitive with other areas in the U.S. (i.e., Henry Hub pricing formulas), not the lower prices needed by large industrial users. The most likely scenario is that any gas supply surplus would be short-lived and the longer-term incentive for exploration would still exist. Given the long lead-time required to realize production from an exploration program, it is unlikely that exploration would be significantly impacted by the shutdown of the fertilizer plant.

In the event the state were to elect to sell its RIK gas in a competitive sale, the effects would be much the same as if the gas were sold in a non-competitive manner. ConocoPhillips could suffer negative business consequences if royalty gas is diverted from the LNG operation and the local utilities could see gas supply shortfalls. Should the gas be resold to the utilities, the cost of gas to the utilities would likely increase resulting in higher prices to their customers.

In summary, a noncompetitive sale of the state's Cook Inlet RIK gas at this time to a gas-short business has the net effect of the state being the agent to force the transfer of that problem to the utilities and other industrial gas consumers in Cook Inlet with very little likelihood that there will be any overall benefits. In addition, a noncompetitive sale would most likely reduce royalty revenue to the state. While a competitive sale may yield

[3] Mr. William Boycott's presentation to the Resource Development Council on March 4, 2004, in Anchorage.

a better price for the state's royalty gas than the current average royalty in value (which includes both new and old contract pricing), such a sale has the potential to have many of the same negative impacts as a non-competitive sale. Consequently, ConocoPhillips believes that it is not in the best interests of the state for the state to pursue an RIK sale of Cook Inlet gas at this time.

Should the state pursue an RIK gas sale in spite of the negative impacts, ConocoPhillips requests that state provide at least 12 months notice after the issuance of a final decision not subject to further appeal before implementing a sale, to allow the producers and consumers to make commercial arrangements, if possible, to adjust to the resulting shortfall in their supplies.

Should you have any further questions, please call me at 263-4348.

Sincerely,

Scott Jepsen

J. Scott Jepsen

cc: K.O. Meyers, ATO 2100 - ConocoPhillips Alaska, Inc.
D. Jones, ATO 2100 - ConocoPhillips Alaska, Inc.
J. P. Griffin, ATO 2100 - ConocoPhillips Alaska, Inc.