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April 2, 2004

Mr. Will Nebesky
Department of Natural Resources, State of Alaska
550 W. 7th Ave.
Suite 800
Anchorage, AK 99501

Re: Cook Inlet Natural Gas Royalty-In Kind (RIK) Sale

Dear Mr. Nebesky:

During a meeting with Governor Murkowski in July 2003, Marathon Oil Company ("Marathon") was advised that Agrium, Inc. ("Agrium") had petitioned the State of Alaska to provide it with so-called "royalty gas" *(Alaska's percentage share of natural gas produced from State lands in the Cook Inlet).* Since that meeting, Marathon has discussed this proposal with DNR staff, with the Governor's Chief of Staff, and others, to better understand Agrium's request, as well as share Marathon's concerns in regard to the proposed sale.

Recently, DNR issued a formal notice soliciting "expressions of interest" regarding a Cook Inlet royalty gas sale. Following is Marathon's response to that notice.

Section A of our response discusses the larger policy issues that must be examined before deciding to proceed with a Cook Inlet royalty gas sale. Section B relates to some of the specific details that must be worked out if, contrary to the recommendations in this letter, the State decides to proceed with a royalty gas sale.

A) SHOULD THE STATE HOLD A COOK INLET ROYALTY GAS SALE?

1) Natural gas volumes owned by the State are currently extracted and marketed by each producer on behalf of the State of Alaska. A significant portion of the State's Cook Inlet royalty gas is sold under long-term contracts; and many of these contracts, —approved by the Regulatory Commission of Alaska, serve the needs of *Alaskan* consumers (*e.g*, generating electricity at the Chugach and ML&P power plants, providing fuel for homes throughout Enstar's distribution system, etc).

2) The State currently enjoys the financial benefit of higher market value pricing for its share of natural gas production. If the State were to divert some or all of its royalty gas to a "preferred consumer", this would amount to a State subsidy, which over the long term, would distort markets, and hinder future industrial developments. Subsidizing an uneconomic plant would shift the economic burden to all other local consumers.

3) Redirecting the State's royalty gas to a private company undergoing economic difficulties would not create any new gas supplies. Rather, such an action merely diverts gas which otherwise would go to consumers who are just as deserving, if not more deserving than Agrium.

4) It is Agrium's own price expectations *(or more appropriately, their requirements for a low price)* which have put their natural gas supply at risk. As Agrium has stated publicly, they are competing in world markets for their nitrogen products sales. World-scale nitrogen producers depend on very low cost gas supplies *(often at a price less than $1 dollar per million cubic feet)* in order to remain competitive. The Cook Inlet enjoyed a long history of gas oversupply, which allowed Agrium and its predecessor to compete successfully in the world market. More recently, however, the natural gas market has tightened significantly, putting economic pressure on Agrium.

5) There are serious legal and commercial issues that the State must consider before proceeding with a Cook Inlet royalty gas sale. For example, diverting gas would materially disrupt most existing gas transportation and marketing contracts between gas producers and local consumers *(e.g., Chugach, ML&P and Enstar)*. In addition, with respect to future North Slope natural gas sales, the precedent set by such a diversion would increase the risks perceived by all potential buyers of Alaskan natural gas. Future sales of North Slope gas (either LNG or gas) could be adversely affected by a royalty gas sale if buyers feared there could be a future diversion of Alaska natural gas supplies.

6) This proposed royalty gas sale is fundamentally different than other contemplated uses of the State's royalty share of oil or gas. Using North Slope royalty oil which had not yet been put into commerce to promote development of Alaskan refineries, or using North Slope royalty gas to promote the development of a new gas pipeline, are both vastly different than diverting Cook Inlet royalty gas which has already been contractually committed to buyers.

7) The best solution to shortage is to progress policies that will encourage development of new gas supplies in the Cook Inlet. This is an area where Marathon Oil Company recognizes and strongly supports the recent efforts of the Governor. A stable regulatory and fiscal environment is critical to ongoing investment in Alsaka and, as such, changes to state policy must be carefully considered.

All consumers would prefer low prices. But in times of scarcity, higher prices have the salutary effect of encouraging companies to invest in exploration and development activities, which is the only way to bring new natural gas supplies to market. The recent increases in Cook Inlet exploration and drilling activities have been driven by companies willing to risk capital, primarily because of the incentive provided by higher natural gas prices.

In conclusion, Marathon believes free markets are best able to allocate scarce natural gas supplies. The alternative is to force the State to make some very difficult decisions. Higher market prices not only provide incentives to drill new wells, but they also encourage conservation. Experience has shown that a market-based approach provides the fastest solution to shortages.

B) IF THE STATE DECIDES TO PROCEED WITH A ROYALTY SALE, HOW SHOULD IT BE DONE? WHAT PROBLEMS DOES IT CREATE?

1) Detailed bidding procedures must be worked out in advance, and those procedures must disclosed be to all prospective bidders. Once received, the evaluation of these royalty gas bids must be non-discriminatory and open to audit. All bidding parties must have suitable credit worthiness to protect the State of Alaska.

2) A royalty sale should avoid non-monetary consideration, since such valuations tend to be very subjective, with the benefits accruing to only a small minority of Alaskans. However, if non-monetary consideration is allowed, then how would it be measured against all-cash bids? Who would make this measurement?

3) Payment for royalty gas should be transparent, should consider the credit rating of the buyer, and should be paid promptly, with payment terms comparable to those required throughout the industry. If allowed at all, non-monetary payments should have strict performance requirements as well.

4) If the objective of a royalty gas sale is to provide Agrium with low-priced natural gas, a royalty sale may not result in the desired outcome. It is very possible that under today's market conditions, natural gas prices resulting from this sale could be much higher than current Cook Inlet values, reflecting the scarcity of the natural gas resource. While that would certainly benefit the State, it would not be the outcome Agrium has been seeking.

5) Not to be ignored are the serious, practical, transportation and logistical problems this proposal would create. Aggregating and redirecting royalty gas from each of 25-odd fields and various pipelines in the Cook Inlet to Agrium's plant, would be a complex undertaking. Neither Agrium nor the State presently have the resources to identify, measure, and transport these volumes on a daily basis.

6) In consideration of these logistical and legal problems, at least one year should be allowed to prepare for such a sale. Sufficient time should be allowed for producers to amend their contracts with existing buyers, or to take other defensive measures to prevent default on existing contracts. Gas consumers may similarly need to have time to amend their contracts. Prospective royalty buyers also would need time to get new gas pipeline transportation contracts in place.

7) Just as it will require time for the Cook Inlet to prepare for any proposed royalty gas sale *(see #6 above)*, the sale should be of sufficient duration so as not to create further market shocks associated with its termination. As such, a term of two years is suggested.

8) If the State decides to hold a royalty gas sale, all producers must bear an equal burden. Discrimination between Cook Inlet producers and fields should not be permitted. Royalty sale volumes must not allow some producers and/or consumers to avoid any volume losses due to royalty gas sales, while other producers and/or consumers bear the full impact.

9) Marathon will expect to be allowed to participate in any proposed royalty gas sale.

CONCLUSION-

Marathon believes the concept of devoting the State's royalty gas to a private company *(even if suffering economically)* is ill conceived; sets dangerous precedents; and is fraught with practical difficulties.

For all these reasons, Marathon believes it is in the best long term interests of the State of Alaska, as well as the residents of Anchorage, the MatSu Valley, and the Kenai Peninsula who are the primary consumers of Cook Inlet gas production, to refrain from providing State royalty gas to Agrium. Instead, the State should continue and expand its efforts *(which are already showing progress)* to encourage development of new natural gas supplies in the Cook Inlet. That solution will best preserve jobs, maximize the State's revenues from gas royalties, maintain optimum efficiency of Alaska's gas pipeline system, ensure that local businesses will remain competitive, and preserve markets *(both domestic and international)* for future natural gas production.

Thank you for your consideration of our comments. We look forward to continuing the dialog and we look forward to answering your questions.

Sincerely,

John Barnes,

bjv
Cc: Mike Menge, Office of the Governor
James Clark, Office of the Governor

by email
by fax
by certified mail