REPORT OF THE ATTORNEY GENERAL REGARDING THE ACQUISITION OF YUKON FUEL COMPANY BY CROWLEY MARINE SERVICES.

I. Introduction.

In the fall of 2003, the Alaska Attorney General's Office became aware that Crowley Marine Services ("Crowley) made an offer to purchase all of the assets of Yukon Fuel Company ("Yukon"). Both Crowley and Yukon compete with each other for the sale, storage, and distribution of petroleum products in parts of Western Alaska. Concerns were raised by several individuals, communities, and businesses about the potential harm this transaction might have on the price of delivered petroleum products in the region. The Attorney General considered these concerns and began an informal review of the proposed transaction and its potential effects on competition for the sale and delivery of fuel in Western Alaska.

In response to this proposed transaction, the Alaska Village Electric Cooperative, Inc., ("AVEC") and members of the Western Alaska Fuel Group ("WAFG")[1] filed a complaint on November 19, 2003 in the Alaska Superior Court in Nome. The primary allegation in the complaint is that the transaction will eliminate the existing competition between Crowley and Yukon for the delivery of fuel, leaving Crowley with monopoly power over fuel prices in Western Alaska.

After filing the complaint, the parties to the lawsuit continued their request that the Attorney General initiate a formal investigation of the transaction to determine

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[1] Those six members are: (1) Inn Electric Cooperative, Inc.; (2) Kotzebue Electric Association, Inc.; (3) Naknek Electric Association, Inc.; (4) City of Nome d/b/a Nome Joint Utility System; (5) Nushagak Electric & Telephone Cooperative, Inc.; and (6) Unalakleet Valley Electric Cooperative, Inc.

whether it would violate Alaska's antitrust laws. In February 2004, the Attorney General held a meeting in Anchorage with the parties to discuss these concerns in more detail, and to determine whether the parties could take any action on their own to resolve the pending lawsuit. Following the meeting, the Attorney General decided further review by the state was warranted, and initiated a formal investigation to determine if the transaction would violate Alaska's antitrust laws.

II. Summary.

There are currently very few competing firms engaged in the sale of delivered petroleum products ("fuel") in Western Alaska. Some of the equipment and assets necessary for delivering fuel in this area is specialized. With the exception of small amounts of fuel delivered by air, all fuel is delivered by barge. Purchases by utility companies account for the majority of fuel sales. About 75% of all fuel in this region is purchased through the bidding process. Both AVEC and WAFG select the supplier of their fuel as a result of bidding. Once selected, the successful bidder usually enters a long term (two or three year) contract for supplying fuel.

In order for a competitor to bid on these contracts, it must have access to the necessary equipment and storage facilities to deliver fuel economically and profitably to the prospective customers. There are two primary components involved in the delivery of fuel by barge to a significant number of customers: (1) the barge, and (2) storage facilities. There are also two primary kinds of barges required to serve this market; (1) deep water (or "line haul") barges that can hold several million gallons of fuel, and (2) smaller barges capable of navigating shallow coastal and up-river locations, called "shallow draft" barges.

Most fuel delivered to Western Alaska locations originates from refiners in Anchorage. Bulk fuel is purchased by the barge company, loaded into line haul barges, then brought to Western Alaska for delivery to the customer. Some customers have storage tanks that can be accessed directly by a line haul barge. Other customers can only be reached by shallow draft barges. To make shallow draft deliveries, fuel must be transferred to a shallow draft barge directly from a line haul barge (called lightering), and it is then delivered directly to the customer, or stored in a storage tank for future delivery.

To maximize the efficiencies of delivering fuel, it is necessary for a competitor to own, or have access to, line haul barges, shallow draft barges, and storage facilities in key locations. Without all these elements, it is difficult to compete in this market. Currently, only Crowley and Yukon operate these kinds of assets in the immediate region. Thus, the proposed transaction creates a significant threat that Crowley would be the owner of all the assets necessary for delivering fuel in this market, and could exercise "market power" to increase prices.

Additionally, Crowley and Yukon each own a fuel storage facility in Bethel. Crowley recently constructed a new 5 million gallon facility in Bethel which became operational in December, 2003. Yukon owns a 10 million gallon facility that has served Bethel and the surrounding area for over 20 years. Allowing Crowley to own both facilities would eliminate this newly created competition for fuel sales in and around Bethel.

The state approached Crowley and Yukon with these issues, and expressed serious reservations about approving the transaction unless Crowley was willing to sell sufficient assets to another competitor to address the state's antitrust concerns. The state expressed to Crowley its goal of maintaining a competitive marketplace for the delivery of fuel that was consistent with Alaska's antitrust laws. After months of review and investigation, the state and Crowley agreed on the terms of a Consent Decree the state believes complies with Alaska law. The main features of the decree are:

1. The buyer of the assets is Delta Western, one of the largest and most experienced barge companies on the West Coast.

2. Crowley will sell Delta Western two sets of tugs and barges that are capable of navigating the shallow coastal and up-river waters in Western Alaska. Coupled with Delta Western's other tugs and barges, this will allow Delta Western to compete effectively in this market.

3. Crowley will divest four million gallons of fuel storage capacity to Delta Western in Bethel. Because Crowley also plans to remove one million gallons of storage capacity from the Yukon facility in Bethel, this amount approximates the current level of competition in Bethel. The term of the divestiture extends to a potential of 30 years, with an initial term of 10 years plus four 5-year options.

4. Crowley must offer Delta Western an option to purchase or lease certain property Crowley owns in Bethel. The location of this property will allow Delta Western the opportunity to construct new fuel storage facilities in the future if competitive forces require expansion.

5. Crowley must offer Delta Western 29% of any additional storage capacity Crowley adds to its existing facilities in Bethel. This will allow Delta Western to grow along with Crowley.

6. Crowley must allow Delta Western and others access to fuel storage facilities in Nome, Kotzebue, and St. Michael. Access to storage at these locations will allow Delta Western to compete more effectively in and around these areas without the need to construct its own storage facilities.

By agreeing to these conditions, the state believes any legitimate concern about a reduction in competition for delivered petroleum products is resolved. The resulting competitive environment will prevent Crowley from charging monopoly prices, or exercising market power.

III. Alaska's Antitrust Laws.

Alaska's antitrust statutes, AS 45.50.562 - .596, are patterned after federal antitrust laws. These laws are aimed at stopping conduct that prevents or inhibits competition in the free marketplace. In the United States, unlike other countries, our policy of encouraging competition among free enterprise is based on the notion that consumers will benefit from lower prices, higher quality, and greater choice than under a system where capital ventures are controlled by the government. This national policy of competition has made the United States economy one of the strongest in the world.

A primary goal of the antitrust laws is to ensure that consumer choice is not unreasonably restricted since consumer choice is a powerful incentive for sellers to keep prices low and quality high. To ensure consumer choice, the antitrust laws set two basic requirements; (1) companies cannot agree to limit competition in ways that hurt consumers, and (2) a single company cannot monopolize an industry through unfair practices. These principles are set forth in general terms in both state and federal antitrust laws, and courts are left to decide on a case-by-case basis whether any particular conduct is unlawful.

Application of the antitrust laws, however, can be very complicated. It is not always obvious whether conduct is unlawful under these complex standards. For example, monopolies that form as a result of superior marketing efforts or a superior product may be completely lawful. A company that offers a new product in a market where no other comparable products have been sold before will have a monopoly until a competitor decides to enter the market and compete. The antitrust laws do not prevent someone from gaining market power if it is acquired through legitimate business practices.

Another basic principle of antitrust law is to prevent the illegal accumulation of market power in a single entity.[2] If one entity was able to obtain market power, it could control prices. The ability to control prices through illegal conduct is something state and federal governments try very hard to prevent. The role of the Alaska Attorney General in enforcing the state's antitrust laws is to review proposed transactions, like the Crowley/Yukon transaction, to make sure the resulting entity is not left with this kind of market power.

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[2] If a business has "market power" it has the ability to restrict competition or control prices. Thus, antitrust law does not distinguish between "how much" market power one business has. Any amount of market power is illegal.

A. Defining Markets.

The start of any antitrust investigation begins with determining what market is potentially affected by the alleged conduct. In this case, the state had to determine what markets would be affected by the sale of Yukon to Crowley. This is called the "relevant market." In general terms, the relevant market consists of two components: (1) a "product market" which consists of all the competing products sold by the merging companies plus any products that can be used as a reasonable substitute; and (2) a "geographic market" which consists of all the areas from which these products can be economically and profitably supplied.

In this case, the product market was determined to be "barge delivered petroleum products." The product market is not simply "petroleum products" because none of the competitors in this area actually own a source of fuel. Both Yukon and Crowley, for example, purchase all their fuel from a third party. The product is also not "barge services" because barge services by themselves are rarely purchased by customers. Fuel is typically purchased on a "delivered" basis.

There are no other reasonable substitutes for barge delivered petroleum products in this area. There are no roads that service Western Alaska, thus land transportation of petroleum is not possible. Some limited amounts of fuel are delivered by air. These deliveries are isolated, and not economical in large volumes. Other sources of energy, such as coal, hydro, and wind power, are also not economic alternatives to petroleum. None of the communities currently using petroleum products could quickly and economically switch to one of these alternative energy sources. Accordingly, the Attorney General defined the product market as “delivered petroleum products.”

The geographic market was more difficult to define. To determine the relevant geographic market, antitrust law requires that you include all places a customer could go to get the relevant product at competitive prices. Courts have frequently, and consistently, defined geographic markets for barge transportation as generally broad, and have found them to include all waterways where there is no physical barrier to barge movement.

The area affected most by the proposed transaction is Western Alaska. Fuel can be economically delivered to Western Alaska by barge, however, from locations outside of Western Alaska. For example, a barge company from as far away as Southern California could bid on contracts to supply AVEC, the WFAG, and other customers. If successful, the bidder could arrange to purchase fuel in Anchorage, lease (or buy) line haul and shallow draft barges, then arrange necessary storage space to deliver the fuel to customers. Economic and profitable deliveries, however, depend on a variety of factors, including the volume of fuel sold, and the cost to position equipment in Western Alaska to make deliveries. Complicating this analysis is the unique geography of Western Alaska. The experience and knowledge required to operate here is unique and challenging.

Antitrust economists hired by Crowley determined that profitable fuel deliveries could be made by using a single set of tugs and barges from Southern California if the seller could obtain at least 2.1 million gallons of delivered fuel sales.

This estimate considered the cost of bringing a shallow draft tug and barge from San Diego to Alaska.

The analysis done by an expert economist hired by the state suggests the minimum volume necessary for deliveries to be made from California is probably higher than the volumes calculated by Crowley's economist. But under either analysis, it was clear that at some volume, fuel could be profitably delivered to Alaska from locations as far away as California, including locations in Oregon and Washington State. There is about 90 million gallons of bulk fuel sales annually in Western Alaska. Considering these volumes, the state concluded the geographic market for supplying barge delivered petroleum products includes all of Western Alaska and the West Coast of the United States.

B. Competitors in the Market.

The next step in analyzing the potential competitive effects of the proposed transaction required the state to identify competitors currently participating in the relevant market, and the amount of "market power" held by each. Knowing the number of competitors and each competitor's share of the market is critical to understanding how the elimination of one competitor may impact competition among the remaining competitors.

For barge delivered petroleum, the Western Alaska market has been recently dominated by three competitors. When a market has few competitors, it is considered "highly concentrated." Crowley and Yukon have been the major competitors in recent years making bids on contracts to supply fuel in shallow-draft markets. Delta

Western and Crowley are the two dominant competitors bidding for contracts to supply fuel by line haul barge. Of all the barge companies actively operating in Western Alaska, Crowley is the only competitor with a mix of assets that allows it to serve both the shallow draft and line haul markets. Delta Western does not own any shallow draft barges in the Western Alaska region, and Yukon does not own any line-haul barges.

To get fuel to its smaller barges, Yukon contracts with other companies for the delivery of fuel by line haul barge. Recently, Yukon has contracted with Sirrius Maritime, Inc., a Seattle-based barge company, to deliver fuel by line haul barge to specific locations in Western Alaska where it is then loaded onto Yukon's storage facilities or barges. Sirrius does not have any other customers in Western Alaska.

There are no other "active" competitors supplying bulk fuel by barge to Western Alaska. Thus, this transaction would eliminate one of the three barge companies operating in Western Alaska, and eliminate the only other current competitor for shallow draft barge deliveries. This reduction in competition raises serious concerns, but is not entirely determinative of the actual competitive impact caused by this transaction. Because the fuel market is a "bidding market" all potential bidders must be considered as potential competitors, regardless of whether they have actually made any historic sales of fuel in the market.

C. Market Power.

Once the competitors in a market are identified, the "market power" of each competitor must be assessed. Market power is defined as the ability to raise prices or exclude competition. The most common basis for predicting a firm's ability to raise prices in the future is to calculate its historic percentage of sales in the relevant market. There are exceptions to this approach, however, when future sales are not dependent on past percentages, but are determined by independent events. In a bidding market, like the Western Alaska fuel market, past performance is not a good indicator of market power. Future sales depend on future bids, not past sales. Market power also cannot be inferred from high percentages of past sales in markets that are characterized by low entry barriers, as discussed more fully below. A firm with 100% of sales cannot profitably overcharge if doing so would simply attract new competition lured by the higher-than-competitive prices.

Because all competitors in a bidding market have an equal chance of winning future bids, each is assigned the same amount of market share. Even if a company makes no sales in one year, it still has an equal share of the market along with companies that made significant sales. The antitrust law requires consideration of these other "potential" or "uncommitted" competitors. These are competitors who are not currently participating in the market, but would likely enter the market in a timely manner if prices rose above competitive levels. This "threat" of competition is a strong deterrent to active competitors, and acts to keep prices from reaching monopoly levels. Thus, all potential bidders are assigned an equal share of the market.

D. Entry Barriers.

Federal regulators have often approved mergers and acquisitions that have left only one competitor in the market when evidence showed a strong likelihood that other competitors could easily enter the market. A merger or acquisition is not likely to create or enhance market power if entry into the market is so easy that market participants could not profitably maintain a price increase above pre-merger levels. Entry into a market is considered "likely" if it would be profitable at pre-merger prices, and those prices could be secured by the new entrant. In addition, to be "sufficient" under antitrust guidelines, the assets required for entry must be available so that entrants can respond fully to new sales opportunities.

To determine which potential competitors are likely to enter the market in response to a price increase, the barriers to entering the market must be identified. Entry barriers are defined to include potential obstacles that a new competitor would have to overcome that the current competitors did not have to deal with. Examples of entry barriers include new governmental regulations that impose new requirements (i.e. permits) that current competitors did not have to comply with. Another barrier could be the ownership of a necessary resource by an incumbent firm (such as land or a manufacturing plant) that a new competitor cannot obtain. If access to these necessary components are constrained, or controlled by the existing competitors, new competition is not likely to happen.

Applying these principles to the Crowley/Yukon transaction, the state identified the following as potential entry barriers. There is some reasonable debate about whether any of these items, standing alone, would prevent a potential competitor from entering the market. But taken together, these items present significant obstacles to anyone looking to compete in this market.

1. Shallow draft barges. The state's research showed that shallow draft barges are not readily available. Although there are some used shallow draft barges on the market, most are not suitable for use in Alaska waters without significant retrofitting. One of the largest barge brokerage firms in the world, Markon International, Inc., lists several shallow draft barges for sale on its web page. A competitor could acquire one of these barges and invest in the necessary modifications, but the cost to do so would approach over 50% of the cost of a new barge. New shallow draft barges can be built for as little as $1 million, and Crowley is currently completing construction of a state-of-the art barge for approximately $3 million. The building process takes less than one year to complete.

Regardless of the cost, any investment in a shallow draft barge would not be profitable unless the buyer could obtain sufficient fuel sales to warrant the investment. Shallow draft barges are designed for a specific purpose, and cannot be used for a broad range of tasks. There are a few river systems in the U.S. where these assets can be deployed, including, for example, the Columbia River and the Mississippi River systems. However, the Attorney General remains concerned that these shallow-draft vessels are not as freely available as, for instance, line-haul barges, and the market for shallow draft barges is limited.

The current competitors, furthermore, had to obtain shallow draft barges to participate in this market, so the state's reliance on this obstacle is not fully supported by the antitrust law. Nonetheless, these barges are necessary assets to competition that only Crowley and Yukon have ready access to.[3] These considerations generate some concern about the willingness of a new competitor to enter this market.

2. Storage facilities. If the proposed transaction were allowed to proceed with no conditions, Crowley would own nearly all of the fuel storage facilities in Western Alaska, including all of the fuel storage facilities inland from the coast used for up-river deliveries. Of significant importance are the two facilities in Bethel. These facilities require heightened attention because there is current competition in the Bethel market for fuel that is directly tied to ownership of these facilities. There is an extremely limited opportunity for new competitors to build a storage facility in Bethel because there is a scarcity of suitable land, and the market simply does not justify adding additional storage capacity for the reasonably foreseeable future.

Storage facilities outside Bethel present less of a concern, but are still important. There appears to be fewer limitations on the ability to construct new facilities in necessary locations along the West Coast of Alaska. Historically, the common practice in the area has been for owners of these facilities to allow access to storage capacity by other competitors at a reasonable rate. Still, if one competitor owned all the necessary storage facilities, it could exercise control over its competitors in a harmful way. This presents some concerns for new competitors looking to compete in this market. It bears note, however, that the storage facilities in these other areas have not historically faced immediate competition, and that Crowley's acquisition will not consolidate competing resources.

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[3] The state's research showed there was a readily available supply of tugs and line-haul barges.

3. Knowledgeable barge pilots. State and federal regulations require licensed pilots to have knowledge of the waters to be navigated. The coastal and river waterways in Western Alaska offer some of the most challenging navigation anywhere in the world. The only way to gain the experience required to operate shallow draft equipment in some of these remote waterways is to log hours of time with an experienced pilot. New competitors looking to operate shallow draft barges would need to locate and hire knowledgeable mariners with the requisite experience navigating the shallow waters of Western Alaska.

The current competitors had to face this obstacle as well, so any argument about finding qualified pilots as a "barrier to entry" in antitrust terms is subject to reasonable debate. This is particularly so in view of the ability of any new entrant to hire away pilots from Crowley or other incumbent barge companies operating around the State. Nonetheless, coupled with the other barriers to competition, this presents another potential deterrence to new market entrants.

Courts addressing entry barrier issues consistently agree that barge markets are typically open to new entry. While the State is unwilling to rely on this market mechanism entirely to resolve its concerns in this case, it is equally true that any monopoly "gouging" by Crowley would probably cause other barge companies to enter or consider entering the Western Alaska fuel market.

IV. Analyzing the Crowley/Yukon Acquisition.

Considering the above, the state's analysis of the Crowley/Yukon Acquisition involved a preliminary assessment of market power based on a proper definition of the relevant market, followed by an analysis of mitigating factors, such as the ease of entry into the market. Applying these principles to Crowley and Yukon, the attorney general concluded that the transaction, if allowed, would violate Alaska's antitrust laws that prohibit mergers or acquisitions if the effect of the merger will "substantially lessen competition." The Attorney General reached this conclusion based on the following three assessments:

1. Crowley could obtain monopoly power over nearly all fuel sales in Bethel. At the very least, there would be a significant lessening of competition in Bethel if Crowley were to own both of the existing fuel storage facilities in Bethel. The total volume market demand for fuel, coupled with the limited availability of land prevents a new competitor form entering this market easily and timely.

2. Crowley would obtain ownership of all other fuel storage facilities required for deliveries to some locations, particularly areas served by shallow draft barges. Obtaining control over these necessary assets for a significant portion of the market presents a dangerous probability that Crowley could exercise market power over fuel prices.

3. Crowley would obtain ownership of all the shallow draft barges currently used and available in Western Alaska for deliveries to shallow coastal and up-river locations. This would eliminate existing competition in areas where Crowley and Yukon currently compete for shallow draft deliveries. Although new competitors could purchase barges for use in these areas, there are significant obstacles to doing so.

The fact that Crowley would be in control of nearly all the assets currently used for barged delivered fuel, and would be the overwhelmingly dominant player, cannot be ignored. This alone presents serious concerns to the Attorney General.

V. The Remedy.

After concluding the transaction would violate Alaska's antitrust laws, the state was faced with only two options: (1) block the transaction, or (2) enter a consent decree that requires the parties to take affirmative steps to eliminate the potential for competitive harm. There are risks associated with each option. If the state filed a lawsuit to stop the transaction, Crowley and Yukon could litigate against the state to get the transaction approved. Crowley and Yukon argued vigorously that the transaction did not violate any state or federal antitrust laws, and the parties are confident they could get the transaction approved, without conditions, by a court.

The risk with a consent decree is that its terms may not adequately prevent the exercise of market power. Even though the Attorney General carefully reviewed the transaction, no one can predict the future. Events may occur that were not contemplated, or market conditions may change in ways not anticipated by a consent decree. Even so, the attorney general always retains the authority to take steps in the future if the intent and goal of a consent decree is not followed.

It is also important to recognize there are benefits that flow to the economy as a whole from mergers and acquisitions, and there are potential benefits to the economy of the state that can result from this merger. Here, Crowley will consolidate resources into a single firm that will be of a scope and scale sufficient to improve fuel delivery service and reliability, and also at a potentially lower cost due to the resulting efficiencies. Crowley's strong economic commitment to Alaska's maritime markets also ensure that a responsible owner will operate these resources, which is important for environmental and economic reasons. While the Attorney General is deeply committed to preventing anticompetitive conduct in the state's markets, the state is equally committed to promoting the benefits of economic activity.

Given the nature of this transaction and all the information reviewed by the state and its expert, the Attorney General decided to enter a consent decree that required Crowley to take certain steps to alleviate the concerns identified by its investigation. Those include:

1. Divesting significant amounts of storage capacity to a competitor under terms that position the competitor as tantamount to the owner of the capacity of that facility.

2. Selling at least two sets of shallow draft tugs and barges to a buyer willing and able to compete in the shallow draft market.

3. Making space available in key storage facilities on a non-discriminatory basis to any competitor who wants it.

4. Making land available in Bethel to a competitor for the purpose of constructing a new fuel storage facility.

5. Requiring the divestiture to a competitor of 29% of any additional storage capacity added by Crowley to the Bethel facility.

6. Finding a buyer for these assets with the economic ability and required experience to compete effectively in this market.

A consent decree was crafted with these goals in mind. After several weeks of negotiation, Crowley agreed to the terms of the decree. Providing all the terms are complied with, the attorney general believes the transaction will satisfy Alaska's antitrust law, and will encourage continued competition in the market for barge delivered petroleum.

VI. Further Proceedings and Opportunity to Comment.

The consent decree has been filed in the Superior Court in Nome, the same court in which the pending lawsuit is located. The consent decree must be reviewed and approved by the court before it is effective.

In addition to review by the court, Crowley and Yukon must file a notice with the Department of Justice and the Federal Trade Commission that describes the transaction. These federal agencies will have an opportunity to review the transaction for antitrust violations, and may decide to initiate their own investigation.

Finally, any interested person can file an "exception" to the consent decree with the court in Nome. An exception must be filed with the court within 60 days of filing the consent decree. These exceptions can be mailed to the Nome Superior Court, Box 1110, Nome, Alaska, 99762. The court will consider these comments and objections when deciding to approve or disapprove the consent decree.

VII. Conclusion.

The Attorney General believes the proposed transaction, as modified by the conditions set forth in the consent decree, is lawful under applicable Alaska (and federal) law, the federal antitrust merger guidelines, and the judicial decisions that interpret these laws and guidelines. Under the proposed consent decree, the Attorney General believes the transaction will benefit consumers in Western Alaska by maintaining strong competition, and securing reliable sources of barge delivered fuel by reputable competitors.