

Direct Testimony of

**John T. Durkin, Jr.**

in the matter of

**ILLINOIS COMMERCE COMMISSION**

**DOCKET NO. 07-0446**

CHICAGO PARTNERS  
A LIMITED LIABILITY COMPANY

140 South Dearborn Street  
Chicago, Illinois 60603

1 **Q1: Please state your name, business and address.**

2

3 My name is John T. Durkin, Jr. My address is Chicago Partners, Suite 1500, 140 S.  
4 Dearborn, Chicago, IL 60603.

5

6 **Q2: What is your position at Chicago Partners?**

7

8 I am a Vice President with Chicago Partners, an economics consulting firm that  
9 specializes in the application of economic theory to a variety of legal and regulatory  
10 issues.

11

12 **Q3: Please describe your education and professional experience**

13

14 I received my PhD. in economics from the University of Chicago in 1992. In addition to  
15 my position at Chicago Partners, I am also a lecturer at the Harris Graduate School of  
16 Public Policy Studies at the University of Chicago. My curriculum vitae, attached as  
17 Appendix A, describes my professional publications and previous experience.

18

19 **Q4: What is the purpose of your testimony?**

20

21 A4: I have been retained by counsel for Carlisle E. Kelly and other Thomas Pliura  
22 Interveners to consider whether the public benefits to the Southern Access Extension  
23 Project are sufficiently large that Enbridge should be granted the power of Eminent  
24 Domain (ED). I have also been asked to examine whether the opinions expressed by Dr.  
25 Cicchetti and Dr. Colwell support the granting of ED power to Enbridge.

26

27 **Q5: What opinions have you formed as a result of your analysis?**

28

29 A5: I have formed 3 main opinions

30

- 31       • The granting of ED will transfer surplus from Illinois landowners to Enbridge and  
32       will not enhance economic efficiency.
- 33       • Dr. Colwell’s analysis is incomplete. The “hold out” problem does not necessarily  
34       lead to inefficiency, and he fails to analyze whether the conditions necessary for  
35       inefficiency are satisfied in this case. Moreover, even if the threat of holding out  
36       did lead to inefficiency, granting ED power to Enbridge does not eliminate or  
37       even reduces inefficiency. Finally, his attempt to argue that there is a public need  
38       for the pipeline expansion is weak because he fails to draw a crucial distinction  
39       between public goods such as roads and a private pipeline.
- 40       • The analysis provided by Dr. Cicchetti is highly flawed on a number of different  
41       dimensions. His analysis of the benefits of the pipeline due to its effect on “price  
42       jumps” is inconsistent with basic economic principles and there are numerous  
43       errors in its implementation. His analysis of the other benefits of the pipeline is  
44       also inconsistent with economic principles.

45

46       **Q6: Please explain why granting eminent domain status transfers surplus from**  
47       **consumers to Enbridge.**

48

49       A6: Consumer surplus is the difference between how much consumers are willing to  
50       pay and how much they have to pay for the goods they buy. For goods purchased in  
51       discrete quantities like property, economists refer to the amount consumers are willing to  
52       pay as their reservation price. Reservation prices vary because consumers have different  
53       preferences. Any owner of a piece of property will have a reservation price that exceeds  
54       the market price and will have a non negative consumer surplus. For example, suppose  
55       that the market price for a particular type of property that has a fixed supply is \$100,000.  
56       Only those owners with reservation prices above \$100,000 will buy the property. A  
57       consumer willing to pay \$125k will have \$25k in consumer surplus.

58

59       Producer surplus is simply the difference between how much firms would have to pay to  
60       produce a given quantity of goods and how much they are willing to pay. For example,  
61       suppose a pipeline operator was willing to pay \$150k to buy a piece of property for a

62 project. If the pipeline operator has to pay only \$125k for the property, its producer  
63 surplus is \$25k.

64

65 In the absence of ED, the pipeline operator and the landowner would negotiate a price  
66 somewhere between the owner's reservation price, \$125k, and pipeline operator's  
67 willingness to pay, \$150k. The relative bargaining position of the two parties would  
68 determine the transaction price. The bargaining positions depend on such factors as any  
69 informational advantages one party has over the other and the availability of either buyer  
70 or seller substitutes. Independent of the agreed price, the transaction is efficient because it  
71 benefits both parties. If, instead, the owner's reservation price exceeded the buyer's  
72 willingness to pay, then there would be no transaction because the value of the property  
73 to the buyer would be less than the value to the seller, and that would be efficient.

74

75 Granting ED power to the pipeline operator has no effect on whether the transaction  
76 occurs as long as the operator's willingness to pay is greater than the landowner's  
77 reservation price. ED power simply gives the buyer the right to pay the market price, so  
78 the entire surplus goes to the seller. If, however, the transaction would not have occurred  
79 without ED, granting ED status not only transfers the surplus but it also reduces  
80 economic efficiency because the buyer values the property less than the owner.

81

82 Dr. Colwell himself makes this very point when he previously wrote:

83

84 The existing system of government takings might appear on the surface to be a  
85 benevolent one; taking can be only for a "public use," and "just compensation" is  
86 to be paid. However, the system is less than optimal. For example, anecdotal  
87 evidence suggests that owners rarely view prices at which they are forced to sell  
88 to the government as "just." More importantly, the system is subject to  
89 manipulation by politically powerful parties; examples exist nationwide of  
90 governmental units having condemned property not for schools or roads, but on

91           behalf of firms wishing to expand. While such a taking is not necessarily bad, it is  
92           inefficient if value in the new use is below value realized in the old use;<sup>1</sup>

93

94   **Q7:   Does your conclusion change if the buyer is seeking an easement rather than**  
95   **to purchase the property for its own use?**

96

97   A7:   Granting an easement for a pipeline reduces the value of the property. A property  
98   owner would be willing to grant the easement if compensated for the reduction in value.  
99   Each landowner, then, has an implicit reservation price for allowing an easement, and  
100   there is an implicit consumer surplus associated with not having a pipeline through one's  
101   property. ED power simply transfers that surplus to the pipeline operator and leads to  
102   inefficiency if the pipeline operator's willingness to pay for the easement is less than the  
103   property owner's consumer surplus from not having the easement.

104

105   **Q8:   Dr. Colwell's claims that when buyers need to assemble different properties**  
106   **ED "exists to solve the holdout problem." Does your opinion change if assembly is**  
107   **needed?**

108

109   A8:   No. There are two main problems with Colwell's analysis. First, the need for a  
110   buyer to assemble separate land parcels does not in and of itself create inefficiency. Dr.  
111   Colwell conducts no analysis of whether the conditions necessary for inefficiency are  
112   satisfied in this case. Second, even there is inefficiency, ED does not eliminate or even  
113   necessarily reduce the inefficiency.

114

115   There are two potential sources of inefficiency that exist when buyers need to assemble  
116   properties. First, property owners have a form of monopoly power when a buyer needs to  
117   assemble land parcels. With perfect information, sellers know that if the buyer cannot  
118   price discriminate it will be forced to pay the highest reservation price of all potential  
119   owners, and this forces buyers to offer all owners a price that is inefficient. The  
120   inefficiency arises because there are sellers whose reservation price is less than buyer's

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<sup>1</sup> Colwell, Peter F. "Privation of Assessment, Zoning and Eminent Domain." *ORER Letter*, Spring 1990.

121 willingness to pay, but those transactions do not occur because the owner can only offer  
122 one price. Second, if potential properties have different values to the buyer, then owners  
123 of more valuable property can capture a larger share of the surplus. This provides  
124 opportunities for individual owners to “hold out” in the hope that other owners will settle  
125 for a smaller share of the surplus.<sup>2</sup>

126

127 These potential sources of inefficiency suggest that, under certain conditions, a less than  
128 optimal amount of land may be purchased when assembly is required. However, Dr.  
129 Colwell has not made any attempt to establish whether those conditions are satisfied. For  
130 example, Dr. Colwell recognizes that if buyers can learn landowners’ reservation prices  
131 they can price discriminate and eliminate any inefficiency.<sup>3</sup> Even if landowners do not  
132 have an incentive to reveal their true reservation prices, buyers negotiate individually and  
133 can price discriminate. They also have different contracting options to induce buyers to  
134 reveal their reservation prices. For example, economists have suggested the buyers can  
135 use contingent contracts or options to buy to eliminate the inefficiency.<sup>4</sup> In addition, the  
136 ability of owners to demand the highest reservation price requires that they know the  
137 reservation prices of the other landowners. Dr. Colwell has failed to provide any  
138 explanation for why landowners know each other’s reservation prices, while buyers do  
139 not. Finally, the availability of substitute properties diminishes the ability of landowners  
140 to exploit market power or to “hold out”. Dr. Colwell has failed to establish that there are  
141 individual landowners that do not have close substitutes available.

142

143 Most importantly, granting ED status does not solve the holdout problem. The solution to  
144 the holdout problem would be to pay owners their reservation prices. ED eliminates the  
145 monopoly and hold out problem, but it replaces them with another form of inefficiency.  
146 Under the same conditions in which purchases without ED are too low, the purchases  
147 with ED are too high. Dr. Colwell recognizes this when he wrote:

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<sup>2</sup> See Munch, Patricia. “An Economic Analysis of Eminent Domain.” *Journal of Political Economy* 84 (June 1976): 473-498.

<sup>3</sup> Op. Cit., Colwell, page 5.

<sup>4</sup> Op. Cit., Munch. Also Colwell has suggested that another method for inducing landowners to reveal their reservation price is to have their taxes property taxes based on their self assessment of the property’s value. Op. Cit, Colwell.

148

149 The government, in an attempt to optimize its position (rather than society's),  
150 condemns [a] quantity ... of property if it intends to pay the market value-based  
151 "just compensation;" at [that quantity] ... the government's marginal cost equals  
152 its marginal benefit. However, that quantity of land is too great an allocation, in a  
153 social sense, to the new activity;<sup>5</sup>

154

155 As described above in the case of the purchase of a single property, ED leads to  
156 inefficiency because it allows buyers to purchase properties that are worth more to the  
157 landowner than they are to the buyer. Even landowners who would have sold without ED  
158 are worse off with ED because their consumer surplus is transferred to the buyer.

159

160 **Q9: Dr. Colwell argues that road building is the kind of activity that is deserving**  
161 **of eminent domain status. From an economic standpoint, does it matter what type of**  
162 **activity receives ED power?**

163

164 A9: No. From an economic standpoint, road building is different from other activities  
165 because roads are examples of public goods. Roads are non rival goods in that one  
166 person's use of the road does not prevent another person from using the same road. This  
167 means that a private road company would not be able to charge enough to achieve the  
168 socially optimal level of roads, so governments often step in and subsidize road  
169 production or build the roads themselves.

170

171 In this setting, the fact that ED leads to excess purchases can offset the inefficiency  
172 caused by the non rival nature of public goods. However, ED is an inefficient method of  
173 subsidizing road production because it forces property owners to bear a burden of the  
174 subsidy that is disproportionate to their use of the road. Thus, even though there is a  
175 public need for roads, ED is an inefficient way of satisfying that need.<sup>6</sup>

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<sup>5</sup> Op. Cit, Colwell, page 5.

<sup>6</sup> The same conclusions apply to private goods that have positive external effects. Private firms would not provide the socially optimal level of production of goods with positive external effects, so there is a role for

176

177 **Q10: Do pipelines differ from roads in any way that should affect whether**  
178 **Enbridge should receive ED power?**

179

180 A10: No. Dr. Colwell's arguments suggesting that pipelines are "similarly deserving of  
181 the power of eminent domain"<sup>7</sup> is difficult to follow. It isn't clear whether he believes  
182 they are similar because pipelines and road both require network assemblage or because  
183 pipelines and roads are public goods.

184

185 In either case, he is wrong. While both require network assemblage, neither, as argued  
186 above, requires ED. Also, pipelines are not public goods and there are no positive  
187 externalities from pipeline production, so there is no reason why Enbridge cannot capture  
188 all of the benefits from their investment in the pipeline. Even if the pipeline benefits  
189 consumers, the value of those benefits is exactly equal to the benefits Enbridge gets from  
190 selling the oil.

191

192 **Q11: Will the expansion project lead to lower prices for Illinois consumers?**

193

194 A11: No. For commodities like refined petroleum products with relatively low transport  
195 costs, local prices are determined primarily by national and international supply and  
196 demand factors. If prices differed significantly across suppliers, then suppliers would  
197 have an incentive to ship their product to the higher price areas. Moreover, a significant  
198 fraction of local consumption of refined products is provided by refineries in the Gulf  
199 Coast.<sup>8</sup> Exhibit 1 plots Illinois and Regional weekly average retail gasoline prices.  
200 Exhibit 2 plots weekly regional and national prices. Changes in Illinois prices are highly  
201 correlated with changes in regional and national prices.

202

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the government to subsidize production of these goods. However, it is still inefficient to grant ED to firms with positive external effects in order to finance the subsidy.

<sup>7</sup> Testimony of Peter F. Colwell, Illinois Commerce Commission Docket No. 07-0446, Oct., 5 2007, page 8.

<sup>8</sup> North American Crude Supply and Demand Study for Enbridge Energy Partners, Southern Access Pipeline Project, December 2006, page 17.

203 Moreover, even if local gasoline prices were determined by gasoline supply, the Southern  
204 Access Extension Project expansion project would impact local prices if it impacted local  
205 crude or refined supply. However, Enbridge's recent announcement that it plans to extend  
206 its pipeline to carry 400,000 bpd from southern Illinois to Houston suggests that the  
207 Southern Access Extension Project will have no impact on local crude supplies.<sup>9</sup>  
208 Moreover, even if local crude supply did increase, there is no evidence that local  
209 refineries have the ability to increase local refined supply without increased investment.<sup>10</sup>

210

211 This means the only way local prices would be impacted by the Southern Access  
212 Extension Project would be if it impacted national or international prices by raising world  
213 supply. However, the expansion project has a trivial impact on world supply because it  
214 simply makes it cheaper for Enbridge to transport crude over 175 miles. Because the  
215 share of world crude oil demand moving through Enbridge's pipeline is less than .5%,<sup>11</sup>  
216 this reduction in costs would have no impact on international prices.

217

218 **Q12: Dr. Cicchetti's claims that the expansion will reduce price jumps and provide**  
219 **substantial benefits to Illinois consumers. Is his analysis reasonable?**

220

221 A11: No. Dr. Cicchetti's analysis is flawed on many dimensions and is without merit. I  
222 will describe only the most significant flaws.

223

224 First, Dr. Cicchetti's analysis is based on the claim that the expansion project will add  
225 400,000 bpd to world supply. As noted above, the expansion project has no impact on  
226 world supply.

227

228 Second, Dr. Cicchetti implicitly assumes that all of the crude flowing through Enbridge's  
229 pipeline will be added to what he calls "spare capacity". For a commodity like crude oil,  
230 the standard definition of spare capacity used by economists is production capacity that is

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<sup>9</sup> *The Globe and Mail*, "Enbridge, Exxon move ahead on pipeline bid", December 19, 2007.

<sup>10</sup> Testimony of Neil K. Earnest, Illinois Commerce Commission docket no. 06-0470, pages 15-16.

<sup>11</sup> Testimony of Charles J. Cicchetti, Illinois Commerce Commission docket no. 06-0470, page 7.

231 not being used because price is less than marginal cost. Dr. Cicchetti invents his own  
232 definition for spare capacity:

233

234 Spare Capacity means the available wells are known, rigs are in place or readily  
235 available, but for operational or other reasons, some potential crude oil production  
236 in being shut in (*i e.* not in current production) despite marginal costs being less  
237 than current market prices.<sup>12</sup>

238

239 Since individual profit maximizing firms without market power would not withhold  
240 supply if price exceeded marginal costs, it must be, as Dr. Cicchetti recognizes,<sup>13</sup> either a  
241 government agency or government regulated entity that is withholding the supply. Dr.  
242 Cicchetti provides no analysis of who these government agencies are or how they  
243 determine how much to hold in “spare capacity”. Thus, there is absolutely no reason to  
244 believe that this expansion project will add 400,000 bpd to world’s “spare capacity”.

245

246 Third, part of Dr. Cicchetti’s empirical analysis estimates the effect of spare capacity on  
247 price jumps. However, since his notion of spare capacity is essentially not measurable, he  
248 uses the traditional measure of spare capacity, unused production capacity.<sup>14</sup> Since the  
249 expansion project will have no effect on production capacity, his empirical analysis is  
250 meaningless. It tells us nothing about how the expansion project would impact price  
251 jumps.

252

253 Fourth, even if Illinois consumers benefited from the Southern Access Extension Project,  
254 Dr. Cicchetti has provided no explanation for why Enbridge cannot capture these  
255 benefits. If the expected net present value of benefits to Illinois consumers was \$407  
256 million, then Enbridge would not need ED status as long as the cost of the project without  
257 ED is less than \$407 million.

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<sup>12</sup> Testimony of Charles J. Cicchetti, Illinois Commerce Commission docket no. 06-0470, page 12.

<sup>13</sup> Testimony of Charles J. Cicchetti, Illinois Commerce Commission docket no. 06-0470, page 11.

<sup>14</sup> Testimony of Charles J. Cicchetti, Illinois Commerce Commission docket no. 06-0470, page 14.

259 **Q12: Dr. Cicchetti claims there will be local benefits to importing oil from Canada**  
260 **rather than relying on imports from South America or the Middle East. Do these**  
261 **claims have any merit?**

262

263 A12: No. Dr. Cicchetti's claims are vague and the logic is difficult to follow. He seems  
264 to be implying that supplies from Canada will less likely be subject to supply disruptions.  
265 Without explaining why he simply asserts that this will provide benefits in the form of  
266 improved regional security, improved balance of payments and increased regional  
267 investment.

268

269 Consider first the claim that relying on liquid petroleum from Canada makes either  
270 Illinois or the US less subject to supply disruptions.<sup>15</sup> As I stated previously, local prices  
271 are determined by national and international factors. A supply disruption in one part of  
272 the world has an impact on local prices independent of the source of the imports. For  
273 example, suppose the US was not relying at all on OPEC countries and that OPEC  
274 countries reduced their exports to zero. The countries supplying the US would switch part  
275 of their supply to those countries previously buying from OPEC, so prices in all parts of  
276 the world would rise. In other words, as long as the unstable parts of the world supply a  
277 relatively large share of crude oil, it does not matter whether you are importing oil from  
278 those parts of the world or more stable parts of the world. You are equally subject to  
279 supply disruptions.

280

281 His claim about national balance of payments is similarly difficult to follow.<sup>16</sup> It is not at  
282 all clear what a national balance of payments gain is let alone whether that is something  
283 desirable or whether it is impacted by importing oil from Canada rather than another  
284 country.

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<sup>15</sup>Testimony of Charles J. Cicchetti, Illinois Commerce Commission docket no. 07-0446, page 9.

<sup>16</sup> Testimony of Charles J. Cicchetti, Illinois Commerce Commission docket no. 07-0446, page 10.

286 He also claims that the pipeline will benefit the regional economy by causing additional  
287 investment and increased employment<sup>17</sup>, but he provides no estimate of the amount of  
288 additional investment or the number of new jobs. Even if he could, he would need to  
289 establish that these investments would not have occurred without the Southern Access  
290 Extension Project.

291

292 **Q13: If there is no public need, is it your opinion that should Enbridge be**  
293 **prevented from expanding its pipeline?**

294

295 A13: No. One of the most fundamental principles of economics is that if there are no  
296 distortions or externalities social welfare rises when firms maximize their profits. In other  
297 words, if it is profit maximizing for Enbridge to expand its pipeline without ED, then  
298 Enbridge should be allowed to do so as long as there are no negative externalities from  
299 the expansion project.

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<sup>17</sup> Testimony of Charles J. Cicchetti, Illinois Commerce Commission docket no. 07-0446, pages 11-12.

300 **RESPECTFULLY SUBMITTED THIS THIRTY FIRST DAY OF DECEMBER,**  
301 **2007**

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CHICAGO PARTNERS, LLC