From the desk of ***Richard A. Fineberg***

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[Via E-Mail]

April 2, 2012

Senator Bert Stedman, Co-Chair
Senate Finance Committee
Room 520, State Capitol
Juneau, Alaska 99801

Re: Why CSSB 192(RES) Is Not Ripe for Consideration

Dear Senator Stedman:

The efforts of both the Senate Resources and Senate Finance Committee to make sense out of the complicated world of oil and gas taxation have been impressive and warrant the public's deep respect and gratitude. (I particularly appreciate your efforts to make sure the petroleum data you are looking at correlate meaningfully to the real world and are internally consistent.
Despite my respect for the impressive oversight work performed in both committees, I have reluctantly concluded that I cannot support CSHB 192(RES) tax rate changes at this time. In my estimation, there are still too many interlocking pieces missing from the petroleum policy puzzle, many of which have been identified by your diligent efforts. At this time, thanks to your efforts we recognize that we have trouble understanding how capital credits work; in this letter I focus on other factors that I believe also require legislative consideration and attention.

Before listing my reservations and recommendations on CSHB 192(RES), I will try to explain the significance of some of the problems I have identified by putting them in the context of North Slope petroleum development events; this exercise is based largely on my own experiences and documented from that history. I hope the background facts and observations I present in this letter will help you understand my reservations about CSHB 192(RES), as well as the dangers of trying to revise the tax system in a contentious situation, a short time frame and the absence of a credible data base.

Data Quantity v. Quality

I have been puzzled by Revenue Commissioner Bryan Butcher's frequent boasts that the Revenue Department has lots of tax data; surely the commissioner recognizes the difference between quantity and quality. Recent operating and capital expenditures ("OPEX" and CAPEX") demonstrate the importance of this distinction.

According to ADOR's unaudited estimates, since FY 2007 – the year that cost-based tax was instituted – unaudited North Slope operating and capital expenses have increased by 65%.[1] The increase in per-barrel capital construction costs – reported by ADOR at 80% over this five-year period – compared to operating expenses at 54%. Together, these unaudited expense figures outpaced the 53% West Coast oil price increase and the 20% transportation (pipelines plus tanker) cost increases (see Figure 1, Sheets 1 and 2, on the following pages).

Over this period, triennial comparisons are particularly revealing (see Figure 1, Sheet 2). CAPEX increases were particularly noteworthy:

- Between FY 2007 and 2009, a CAPEX increase of 51% compared to an oil price increase of 11%.
- Between FY 2008 and FY 2010, a CAPEX increase of 36% compared to a price DECREASE of 22%;
- Breaking the trend, between FY 2009 and 2011, CAPEX only increased 19%, compared to a price increase of 38%.

OPEX increases also outpaced oil prices in two out of three triennial comparisons -- twice by significant margins, including a 35% increase between FY 2008 and 2010, compared to the oil price decrease of 22%, noted above.

Overall, over this five-year period OPEX averaged a 54% increase, compared to the price increase of 53%, noted above. But the break in price trends for the FY 2008-2010 period, also noted above, suggests the importance of examining more closely what is happening on the North Slope

In sum:

- CAPEX increases have significantly outpaced oil prices since the switch to cost-based production tax;
- (2) annual OPEX figures do not appear to be tracking oil prices closely or consistently; and
- (3) the state has been unable to audit these expenses.

The anomalies in the unaudited field cost data the State is using suggest that these data need to be verified, analyzed and explained in order to identify the price level at which lowering production tax progressivity and tax caps will lead to increased oil production by improving competitiveness with other regimes.

Because the State compiles petroleum data on a fiscal-year basis, meaningful comparisons between these unaudited data and the calendar-year data used in company annual reports, industry-wide data and national economic reckonings cannot be made and trending of cost increases is therefore difficult to make.

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[1] These increases compare to cumulative inflation rates of approximately 6% (Gross Domestic Product) to 7% (Consumer Price Index) during this period.. ("Macroeconomic Indicators," *U.S. Budget for Fiscal Year 2012, Historical Tables*, pp. 211-212; and [CPI-U] Consumer Price Index – All Urban Consumers, U.S. Dept. of Labor, Bureau of Labor Statistics [ftp://ftp.bls.gov/pub/special.requests/cpi/cpiai.txt].)

Figure 1
(Sheet 1 of 2)

Fiscal Year	*Historical Production, Price and Cost Data*	*% Change v. Prior Year*	***% Change v. FY 2007***	*Source*
FY 2007 ADOR Data				
Production (bpd)	739,702			*Fall 2007 Revenue Sources*
ANS West Coast Price ($/bbl.)	$61.63			Book (Figure 4.6, p. 36)
Costs ($/bbl.)				
Transportation (P/l + Tanker)	$5.96			
OPEX	$7.71			
CAPEX	$5.84			
Total OPEX + CAPEX	$13.55			
FY 2008 ADOR Data				
Production (bpd)	715,950	-3.21%		*Fall 2008 Revenue Sources*
ANS West Coast Price ($/bbl.)	$96.51	56.60%		*Book* (Figure 4.7, p. 49)
Costs ($/bbl.)				
Transportation (P/l + Tanker)	$6.05	1.51%		
OPEX	$7.20	-6.61%		
CAPEX	$7.50	28.42%		
Total OPEX + CAPEX	$14.70	8.49%		
FY 2009 ADOR Data				
Production (bpd)	692,127	-3.33%	-6.43%	*Fall 2009 Revenue Sources*
ANS West Coast Price ($/bbl.)	$68.34	-29.19%	10.89%	*Book* (Figure 4.7, p. 34)
Costs ($/bbl.)				
Transportation (P/l + Tanker)	$6.48	7.11%	8.72%	
OPEX	$8.30	15.28%	7.65%	
CAPEX	$8.80	17.33%	50.68%	
Total OPEX + CAPEX	$17.10	16.33%	26.20%	
FY 2010 ADOR Data				
Production (bpd)	643,517	-7.02%	-13.00%	*Fall 2010 Revenue Sources*
ANS West Coast Price ($/bbl.)	$74.90	8.76%	21.53%	*Book* (Figure 4.7, p. 36)
Costs ($/bbl.)				
Transportation (P/l + Tanker)	$6.00	-7.41%	0.67%	
OPEX	$9.70	16.87%	25.81%	
CAPEX	$10.20	15.91%	74.66%	
Total OPEX + CAPEX	$19.90	16.37%	46.86%	
FY 2011 ADOR Data				
Production (bpd)	602,723	-6.34%	**-18.52%**	*Fall 2011 Revenue Sources*
ANS West Coast Price ($/bbl.)	$94.49	20.73%	**53.32%**	*Book* (Figure 4.6, p. 31)
Costs ($/bbl.)				
Transportation (P/l + Tanker)	$7.17	19.50%	**20.30%**	
OPEX	$11.90	22.68%	**54.35%**	
CAPEX	$10.50	2.94%	**79.79%**	
Total OPEX + CAPEX	$22.40	12.56%	**65.31%**	

Figure 1
(Sheet 2 of 2)

TRIENNIAL INCREMENTAL COMPARISONS

Historical Production, Price and Cost Data

Triennial Increments	*Fiscal Year*		*% Change*	*Source*
FY 2007 - 2009 (ADOR Data)	*FY 2007*	*FY 2009*	*% Change*	
Production (bpd)	739,702	692,127	-6.43%	*Fall 2007 Revenue Sources*
ANS West Coast Price ($/bbl.)	$61.63	$68.34	10.89%	Book (Figure 4.6, p. 36);
Costs ($/bbl.)				*Fall 2009 Revenue Sources*
Transportation (P/l + Tanker)	$5.96	$6.48	8.72%	*Book* (Figure 4.7, p. 34)
OPEX	$7.71	$8.30	7.65%	
CAPEX	$5.84	$8.80	**50.68%**	
Total OPEX + CAPEX	$13.55	$17.10	26.20%	
FY 2008 - FY 2010 (ADOR Data)	*FY 2008*	*FY 2010*	*% Change*	
Production (bpd)	715,950	643,517	-10.12%	*Fall 2008 Revenue Sources*
ANS West Coast Price ($/bbl.)	$96.51	$74.90	**-22.39%**	*Book* (Figure 4.7, p. 49);
Costs ($/bbl.)				*Fall 2010 Revenue Sources*
Transportation (P/l + Tanker)	$6.05	$6.00	-0.83%	*Book* (Figure 4.7, p. 36)
OPEX	$7.20	$9.70	34.72%	
CAPEX	$7.50	$10.20	**36.00%**	
Total OPEX + CAPEX	$14.70	$19.90	35.37%	
FY 2009 - 2011 (ADOR Data)	*FY 2009*	*FY 2011*	*% Change*	
Production (bpd)	692,127	602,723	-12.92%	*Fall 2009 Revenue Sources*
ANS West Coast Price ($/bbl.)	$68.34	$94.49	**38.26%**	*Book* (Figure 4.7, p. 34);
Costs ($/bbl.)				*Fall 2011 Revenue Sources*
Transportation (P/l + Tanker)	$6.48	$7.17	10.65%	*Book* (Figure 4.6, p. 31)
OPEX	$8.30	$11.90	**43.37%**	
CAPEX	$8.80	$10.50	19.32%	
Total OPEX + CAPEX	$17.10	$22.40	30.99%	

Taxpayer Confidentiality: Blessing or Detriment?

Taxpayer confidentiality, a practice extolled by Revenue Department officials at the Resources Committee hearing Feb. 23, limits public review, obscures transparency and weakens the operations of checks and balances systems that are essential parts of good governance. This is not an abstract proposition. I documented the basis for the proposition that bad things can and do happen under the veil of confidentiality in a report I prepared as a consultant to the Alaska State House in 1990.[2] It took more than a decade for the effects of that misguided settlement to be recognized; those impacts were summarized in the recent Superior Court decision on TAPS property taxes, in which Judge Sharon Gleason noted that the 2002 RCA TAPS decision found that the 1985 settlement enabled TAPS owners to overcharge shippers by an estimated $13.5 billion dollars during the first 20 years of operations, through 1996. Judge Gleason also noted that the 1985 settlement that resulted in excessive tariffs had been approved by the Federal Energy Regulatory Commission at the urging of the State and the Federal Department of Justice.[3] (Another recent example of misinformation hidden behind the confidentiality shield that also involved TAPS will be discussed in the section on TAPS, below.)

Two confidentiality features of petroleum settlements are noteworthy: (1) the practice of allowing the industry to secure blanket confidentiality in various forums to conceal their information and (2) settlement agreements that require participants to remain silent about facts one party (or both) would prefer to hide from the public.

In the State-industry royalty litigation during the early 1990's, when the Department of Law failed to oppose the industry request for blanket or unreviewed confidentiality that protected, among other things, documents revealing BP's alleged sharp business practices (including "fraud and misrepresentation"), then-Superior Court Judge Walter Carpeneti issued an order denying industry confidentiality that concluded:

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[2] Richard A. Fineberg, *The 1985 TAPS Tariff Settlement: A Case Study in the Effects of Confidentiality on Information Available to Decision Makers (supplemental report to "Oil and Gas Revenue Disputes")*, Feb. 5, 1990. For a summary of the history of the 1985 TAPS tariff settlement, see the testimony I submitted to the House Finance Committee March 22 in opposition to the waiver of transparency requirements and the granting of confidentiality privileges that HB 9 would give to the proposed natural gas super-agency (copy attached to this letter).

[3] See: "Decision following Trial de Novo," in *BP Pipelines (Alaska), Inc., et al. and Fairbanks North Star Borough and City of Valdez (Appellants and Cross-Appellants) v State of Alaska Department of Revenue, et al. (Appellees),* Case No. 3-AN-06-08446 CI (Consolidated), Alaska Superior Court, Dec. 30, 2011 (2007, 2008 and 2009 Assessed Valuations of the Trans Alaska Pipeline System), ¶ 561-2 (reproduced by attorneys Robin Brena and Craig Richards, "Senate Resources Committee Presentations," Feb. 6-8, 2012, slides 26 and 27).

> At the outset of this opinion, this court quoted the Supreme Court's observation in *Richmond Newspapers* that people do not demand infallibility from their institutions, but that it is difficult for them to accept what they are prohibited from observing. The "institutions" which the Supreme Court was referring to in that case were the courts. But there is another branch of government to which the quotation applies here: Where one of the parties to a lawsuit is the government, there is the additional public interest in assessing the work of the executive….the First Circuit held in Federal Trade Commission v. Standard Financial Management Corp., 830 F.2d 404, 410 (1st Cir. 1987),
>
> > The appropriateness of making court files accessible is accentuated in cases where the government is a party: in such circumstances, the public's right to know what the executive branch is about coalesces with the concomitant right of the citizenry to appraise the judicial branch.
>
> In accordance with the views expressed above,
> IT IS HEREBY ORDERED:
> 1. BP's First, Second and Third motions to maintain the protective order as to certain documents in the court records are denied.
> 2. The Clerk of Court is directed to unseal the documents and make them available for public review.
> 3. The temporary sealing order set out in Order 92-32 is withdrawn.
>
> DONE at Juneau, Alaska this 27th day of May, 1992.
>
> (Signed)
> Walter L. Carpeneti
> Superior Court Judge[4]

In sum, recognition of the public interest in access to relevant petroleum information needs to be more carefully balanced against the practice of granting industry the privilege of filing documents under seal on a blanket basis, without examination of the presumed need to hold this information confidential.

[4] "Memorandum Opinion and Order," in *ANS Royalty Litigation between State of Alaska et al. (Plaintiff) and ARCO Alaska, Inc., et al. (Defendants),* Case No 1-JU-77-847 Civil, Alaska Superior Court, Order No.. 92-71, May 27, 1992, p. 19 (denying motions by BP Exploration [Alaska], Inc. for continued in camera treatment of certain documents in court record; copy available from author's files). In this and other orders issued in this case, Judge Carpeneti favored the presumption of public access over the practice of granting the industry unreviewed blanket confidentiality for relevant documents (see, *e.g.*, Orders No. 91-66 [Sept. 13, 1991] and 95-44 [March 20, 1995]).

Implementing Regulations

ADOR's acknowledged difficulties implementing regulations should be considered as a subject worthy of legislative review, rather than an excuse for audit difficulties. Prior to and during the Special Session that passed ACES in 2007, I served as a consultant to the Governor on oil and tax issues. Working with ADOR, my efforts during that session were devoted primarily to helping create and explaining to legislators the TAPS tariff provision in the ACES bill (AS 43.55.150). This measure was designed to enable ADOR to use a lower deemed tariff for tax purposes if the industry's legal tariff defense continued to delay FERC and/or RCA tariff reductions. Instead of implementing this measure to correct a chronic problem crafted to help shippers and assure that excessive tariffs would not reduce state royalty and tax receipts, in 2008 ADOR promoted a regulatory Rube Goldberg framework that would have required over-charged shippers to re-invent the tariff wheel under a cumbersome, new framework at ADOR that would exacerbate rather than resolve the long-standing problem of tariff overcharges. The initial draft regulations were not implemented. The regulations dealing with the ACES changes to pipeline tariff calculations for tax purposes were implemented in April 2010.[5] While I can say that the regulations finally adopted to enact this measure appear to be more closely aligned with statutory intent, I have no information at this time as to how (or whether) these regulations are working to correct the TAPS overcharge issues described in the preceding section and discussed below. I would note, however, that if we seek independent development but TAPS is inhibiting that development, solving the capital credit conundrums will not suffice.

Putting the Audit Shop in Order

I was also disappointed last Monday with Commissioner Butcher's inability to tell the Legislature and the public when the Legislature – and the public – can expect the department to put its auditing shop in order. In this regard, I was heartened by Senator Hoffmann's clear statement of dissatisfaction with this situation. In my estimation, this problem underscores and complements the importance of the audit data infirmities discussed in the following two sections.

Facility Capacity and Charges

It appears to me that the state has failed to ensure that prospective independent explorers and developers who would operate on the North Slope are not handicapped by excessive facility charges and/or operating constraints that inhibit competition. For this reason, I was disappointed to learn that the current ADNR Division of Oil & Gas has shown little interest in North Slope facility

[5] 15 AAC 55. 180 – 15 AAC 55.193 (Register 194, July 2010).

sharing issues.[6] In my estimation, a key first step in the solution to this problem is the creation of a North Slope cost auditing program that can focus on facilities.

Audits and Petroleum Litigation Settlements

Confidentiality and audit issues come together on another important subject that demands attention as you assess State capacity to deal with management of petroleum development issues: Management of litigation and settlements. Auditing is critical to quasi-judicial settlement processes by which the Administration determines that taxes and royalty assessment, filing, payment and appeal practices are appropriate to changing economic conditions and meet the public interest by balancing the sometimes conflicting goals of maximizing revenue while encouraging appropriate development. These goals that are particularly difficult to accomplish when three companies hold a 95 percent hegemony on North Slope production and own a roughly similar share of TAPS.

I estimate that the State has obtained approximately $8.4 billion through petroleum litigation settlements.[7] According to *Revenue Sources Book* figures, the CBRF has received approximately $1.5 billion of this amount in the last five years, compared to less than $0.2 billion in the preceding five years.[8]

The dramatic rise in oil prices in recent years has greatly increased the financial interests at stake in the complementary relationship between industry profits and State revenue collections**.** The following figure adds data on the right-hand side to a chart I prepared for the April 2011 report I submitted to legislators) to depict the locus of this area of potential conflict in nominal, per-barrel terms.

As noted earlier in the discussion of production cost anomalies, the State's practice of collecting and compiling petroleum information on a fiscal-year basis increases the difficulty of identifying and quantifying field cost trends that play a significant role in determining the future point at which "cost oil" line – the red, vertical line on the right-hand side of the chart on the following page – becomes the blue "profit oil" portion of petroleum revenue that will be split between the industry and the government entities. On the following chart it should also be noted that the brown annualized oil price line on the ADOR chart presented in February 2010 appeared to be declining, even though monthly oil prices had been rising steadily for over a year at that time. (That's why I extended the price line by adding the red arrow that points upward at the right side of the chart on the following page.)

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[6] See: testimony of Bill Barron, Director, Division of Oil & Gas, ADNR, at Senate Finance, March 27, 2012.

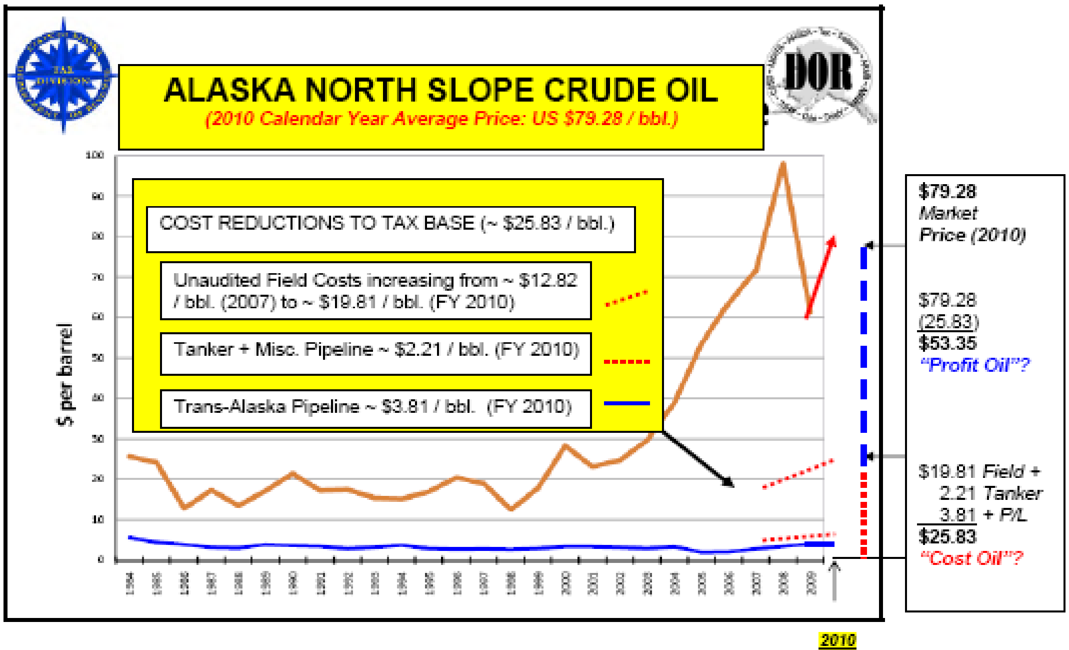
[7] For details of the first $6.8 billion, see: Richard A. Fineberg, "Securing the Take: Petroleum Litigation in Alaska," in *Caspian Oil Windfalls: Who Will Benefit?* [New York: Open Society Institute, 2003], pp. 53-69 [Chapter 3].

[8] *Fall 2010 Revenue Sources Book*, p. 90; *Fall 2011 Revenue Sources Book*, p. 92.

Figure 2

Alaska North Slope Crude Oil Prices and Cost Elements, 1984-2010

(Nominal Dollars)



Sources:

Oil prices and Tans-Alaska Pipeline (TAPS) tariffs (chart): Alaska Dept. of Revenue, Presentation to Senate Finance Committee, Feb. 16, 2010, and ADOR web site.

Field costs: Fall 2010 Revenue Sources Book, Fig. 4.7, and Oil and Gas Production Tax Status Report to the Legislature, Jan. 18, 2011 (Chart 4).

TAPS , Misc. transit (incl. feeder pipelines) and tanker costs: Fall 2010 Revenue Sources Book, Appendix Table B-2a.

– Research Associates, Ester, Alaska, January 2012 (data added to April 2011 Chart)

TAPS Issues

Although property tax payments on TAPS constitute a relatively small element of the TAPS tariff;[9] the decision rejecting the TAPS owners' contentions on TAPS property tax valuations for 2007 through 2009 announced December 30, 2011 – a follow-up to the judge's 2010 decision on TAPS valuation for 2006 – spotlighted many aspects of industry and state administrative abuse of confidentiality that continue today, often skewing public policy deliberations.[10] For example, in 2011

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[9] The annual pipeline property tax assessment takes place under the aegis of the State Assessment Review Board – an entirely separate venue from TAPS tariff rates, which are handled by the Federal Energy Regulatory Commission (FERC) and the Regulatory Commission of Alaska (RCA). The TAPS property tax is passed on to shippers as an element of the tariff.

[10] The Dec. 30, 2011 "Decision following Trial de Novo" (2007, 2008 and 2009 Assessed Valuations of the Trans Alaska Pipeline System) was the second in a consolidated case that followed Judge Sharon Gleason's 2010 judgment on the 2006 tax year ("Amended Decision Upon

the oil industry and the Governor implored the Legislature to adopt HB 110, cutting production taxes drastically, arguing that this measure was necessary immediately to induce investment necessary to prevent oil production from continuing to drop because cold temperatures at throughput levels already reached threatened to shut down the pipeline, as demonstrated by the temporary TAPS shutdown due to a small leak at Pump Station 1 on the North Slope in January 2011. However, documents classified as "highly confidential" – withheld from the first property tax trial and discovered in the second – revealed that as early as 2005 BP had conducted a "very low flow study" that concluded the pipeline could handle flows down to 135,000 bpd. This level was confirmed by a BP's 2010 follow-up study that concluded the heating at various locations along the pipeline "appears to be viable to an endpoint … of about 70,000 BPD for the portion of the pipeline operating from PS01 to North Pole, Alaska." [11]

Returning to tariff-related issues: One month before the first oil entered TAPS, on May 20, 1977 a BP memorandum stated that "All the TAPS owners should want to file the highest possible tariff except Sohio which may file lower because of its obligation to tender one-third of its production to BP Pipelines, and because it will have to make some wellhead sales." The memo listed the reasons the TAPS owners would benefit by filing high tariffs to reduce royalty and tax payments to the State and noted that Sohio "would earn the enmity of the other owners" if it cut tariffs.[12]

In 1996, Archie Dunham, then Chairman and CEO of Conoco, Inc., made this statement on why his company, then the only independent field operator on Alaska's North Slope, traded its properties to BP and left Alaska after a period of low oil prices in 1993:

> "We realized we had to have more focus, so we began selling, buying and exchanging properties. For example, we traded all our Milne Point properties in Alaska to BP and did the same thing in the North Sea. . . . It broke my heart to trade Milne Point, but we had to do it. All the value of that property was taken away from us in the pipeline tariffs. It was a valuable strategic lesson – just look at why the producers in the Caspian are so worried."
>
> – *Hart's Oil and Gas Investor*, August, 1996 (see following figure).

Reconsideration Following Trial De Novo," Oct. 26, 2010 [2006 Assessed Valuation of the Trans Alaska Pipeline System]).

[11] JTG Technology Consortium, "Report on TAPS Pipe Line Operation at Low Flow (Sections 1, Overview & Section 2, Executive Summary," May 2005 (prepared for BP [redacted]; Ex. Mun7-3000, "Decision Following Trial de Novo,"; Dec. 30, 2011), BP Pipelines, Inc., "Trans Alaska Pipeline System Very Low Throughput Mitigation Analysis," Aug. 16, 2010 ([redacted], p. 6 (Ex. Mun7-3020, "Decision Following Trial de Novo,"; Dec. 30, 2011). See also: "Decision Following Trial de Novo," Dec. 30, 2011, ¶¶ 406, 408, 412, 415, 416 and 430 and Robin O. Brena and Craig W. Richards, Senate Resources Committee Presentation, ¶¶ 65-74.

[12] "TAPS OWNERS' TARIFFS," memo from B.A. Lucas to F.K. Rickwood, May 20, 1977 (Confidential).

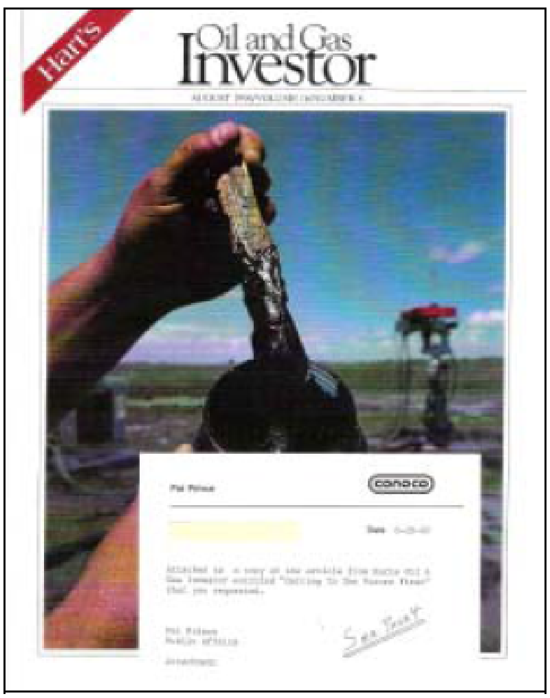
Figure 3

1996 Statement of Archie Dunham, Chairman and CEO, Conoco, Inc.:

It broke my heart to trade Milne Point, but we had to do it. All the value of that property was taken away from us in the pipeline tariffs. It was a valuable strategic lesson—just look at why the producers in the Caspian Sea are so worried.

"Getting to the Future First," *Hart's Oil & Gas Investor,* August 1996, p. 4

"Getting to the Future First," Interview with Archie Dunham, Chairman & CEO, Conoco, Inc. (8/96)



Hart's Oil and Gas Investor , August 1996 (copy provided by Conoco, Inc.).


GETTING TO THE FUTURE FIRST

In 1997, following up on Dunham's statement, I prepared and released a report, *The Big Squeeze: TAPS and the Departure of Major Oil Companies Who Found Oil on Alaska's North Slope*. The Department of Law downgraded the status of Mr. Dunham's statement to "reported," and rejected criticisms of the TAPS tariff settlement and antitrust issues. For example, the Attorney General's letter stated that the 1985 "Settlement Agreement cut TAPS tariff rates by more than 50 percent and provided greater tariff rate certainty to ANS producers" and that dismissed the report's antitrust concerns as "speculative," noting that "[n]either Conoco nor any other producer has ever raised these concerns with the State." [13]

While producers may not have raised antitrust concerns, at that time at least one shipper had filed an antitrust complaint against the TAPS owners and Alyeska. Independent tanker operator Maritime Endeavor had filed an antitrust case against Alyeska under Clayton and Sherman Antitrust Acts in May 27, 1997. In conjunction with its antitrust complaint, independent tanker operator Maritime Endeavor launched a state court quest for damages incurred because its tanker COVE ENDEAVOR, chartered to carry ANS crude, had been dry-docked for a two-year period due to Alyeska's arbitrary application of state oil spill response laws and therefore suffered damages in the amount of not less ten million dollars.[14] Maritime Endeavor prevailed on its charge in state court in 1998 and the federal antitrust case on the same set of facts never came to trial. Without access to confidential information, the public does not know the amount in damages the TAPS owners paid to make the antitrust case go away.[15]

At the time of the ARCO-BP merger deliberations in1999, Dunham was asked if he would bid on ARCO's North Slope properties. He replied that he wouldn't bring Conoco back to Alaska without an interest in TAPS. Phillips acquired ARCO's Alaska properties in 2000; the following year, Conoco merged with Phillips and Dunham's company returned to Alaska with Dunham serving as second in command at ConocoPhillips.

During the first decade of this century, state and federal TAPS tariff decisions have consistently confirmed past tariff overcharges under the 1985 TAPS

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[13] "Re: *The Big Squeeze*" (letter from Alaska Attorney General Bruce Botelho to Jim Sykes [Executive Director, Oilwatch Alaska]), Nov. 7, 1997, p. 3.

[14] See: "Jury Demand," Maritime Endeavor Associates, L.P. Plaintiff, v. Alyeska Pipeline Service Company, *et al.*, Defendants, United States District Court, Juneau, Case No. J97-010 (HRH), May 27, 1997, pp. 36-37; and "Complaint," Maritime Endeavor Associates, L.P. Plaintiff, v. Alyeska Pipeline Service Company, Defendant, Alaska Superior Court, First Judicial District, Case No. 1JU-95-1141 Civil, May 31, 1995, pp. 1-22.

[15] See: "Memorandum of Decision and Order," Maritime Endeavor Associates, L.P. Plaintiff, v. Alyeska Pipeline Service Company, Defendant, Alaska Superior Court, First Judicial District Case No. 1JU-95-1141 Civil, Sept. 30, 1998, pp. 1-22; and "Stipulation and Order for: Vacation of September 30, 1998 Memorandum of Decision and Order and Dismissal of Action with Prejudice," Case No. 1JU-95-1141 Civil, Feb. 17, 1999, pp. 1-2.

Settlement Methodology (TSM).[16] Conservatively estimated, the permitted TAPS tariff overcharge of $13.5 billion during the first 20 years of North Slope operations calculated by RCA, noted earlier, enabled the pipeline owners to make an extra $19,000 per hour in current nominal dollars at State expense between 1977 and 1996 – the result of reduced royalty and production tax payments, which are based on a netback price that subtracts shipping costs from the daily market price of a barrel of oil.[17] The RCA decision for the 1997-2000 period found that the TAPS owners had overcharged, on average, by 57% and ordered reduced tariffs for that period. However, refunds for the first 20 years were not at issue (RCA had to determine the 1977-1996 rates to calculate the 1997-2000 rates at issue, but the refunds were not attainable). Although RCA and FERC employed different methodologies, both cut tariffs significantly, to a base rate of approximately $2.00 per barrel.[18] The TAPS owners continue to increase their tariffs annually and litigation over current tariffs takes place at FERC and RCA over two separate issues: the tariff itself and charges incurred for the TAPS electrification and automation makeover (originally known as Strategic Reconfiguration), whose costs tripled over original (2003) estimates.

Without acknowledging the historical evidence and continued current indications that the TAPS owners consistently file high tariffs, at a May 2006 briefing a Department of Law pipeline tariff consultant Brad Lui assured legislators, “Arguably, a producer-owned pipeline, the theory, anyway, would have a greater incentive to control costs because ... it's coming directly out of their pockets." In introducing Lui, the Attorney General mentioned that this antitrust specialist had

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[16] See, for example: “Order Rejecting 1997, 1998, 1999 and 2000 Filed TAPS Rates; Setting Just and Reasonable Rates; Requiring Refunds and Filings; and Outlining Phase II Issues” (In the Matter of Amerada Hess Pipeline Corporation, *et al.,* and the Protest by Tesoro Alaska Petroleum Company of the 1997 and 1999 Tariff Rates, etc.), Regulatory Commission of Alaska, Docket No. P-97-4, Order No. 151, Nov. 27, 2002 (upheld by Alaska Superior Court [2006]); “Opinion” (Appeal from the Superior Court), Alaska Supreme Court, No. 6231, Feb. 15, 2008; and “Opinion and Order on Initial Decision” (BP Pipelines [Alaska], *et al.*, State of Alaska v. BP Pipelines (Alaska), Anadarko Petroleum Corporation v. TAPS Carriers, *etc.*), Federal Energy Regulatory Commission, Docket Nos. ISO5-82-002, *etc.*, June 20, 2008.

[17] TAPS carried an estimated 11.2 billion barrels of oil during its first 20 years of operation. A tariff overcharge of $13.5 billion in nominal 2012 dollars represents an average overcharge of $1.20 per barrel over this period ($13.5 / 11.2 = $1.20). Estimating state revenue take during this period at 25%, over this period, the overcharge reduced state royalty and severance tax collections by roughly $3.4 billion at $0.30 per barrel (11.2 billion x $0.30 = $3.36 billion); spread over a 20-year period, this amount equals roughly $19,000 per hour in nominal dollars ([$3,336,000,000] / [20 * 365 * 24] = $3,360,000,000 / 175,200 = $19,178).

[18] See: Richard A. Fineberg, *“Federal Energy Regulatory Commission (FERC) and State Supreme Court Confirm TAPS Overcharges, Hand Pipeline Owners Their Sixth Successive Defeat Since 2002,”* July 1, 2008.)

been involved in almost every tariff rate challenge filed by the state.[19] One could hardly ask for a better example of the distinction between theory and practice.

CSSB 192(RES)

The inherent uncertainties with which you have been struggling combine with the existing problems I have enumerated to tip the scales against changing tax rates at this time, The bright side of this picture is that your excellent work during this session has identified many problems that still need to be addressed. By elevating these issues from work-around issues to priority status, it is my hope that you will be able to enlist industry support to improve the State revenue management system in order to generate the information necessary for informed debate. In any event, here are my comments on the major provisions of CSSB 192(RES):

- **Lowering Progressivity (progressive rate of 0.35% per dollar increase, changing to $0.1% at $101.43 PTV and capped at 60%).**
  In part due to weakness of the unaudited field cost data used in this analysis (see Figure, Sheets 1 and 2, above), along with other basic data and systemic problems, discussed above, I find it difficult to accept the proposition that ACES progressivity is a principal factor inhibiting Alaska North Slope development that must be addressed immediately. Rhetoric aside, a strong case for this change simply has not been made. In light of the data infirmities you and your colleagues have identified through Senate's excellent committee work, to get a firm handle on causes and effects of ACES progressivity and the pluses and minuses of possible fixes, I recommend keeping the existing system in place until you fix the sources of data problems.

- **Rewarding Increased Production**
  Four factors militate against implementing this proposal at this time:
  (1) When a field is in decline without additional investment, determining the decline rate from which to measure that increase could be difficult, particularly when the industry that manages the fields would stand to profit from the reduced tax on a steeper decline.
  (2) Apart from measuring difficulties, from a policy standpoint I question whether it is necessary to offer a tax incentive when producers boast, if I recall correctly, that their expenditures have postponed and/or ameliorated the decline rate.
  (3) The major legacy fields are profitably operated by vertically integrated firms that serve established markets. Because this production has an off-book value for the major producers, it would be inappropriate to increase their profitability as if these were stand-alone investments.

[19] Testimony of Brad Lui (Morrison & Foerster, Washington, DC), May 15, 2006 (at Juneau Civic Center).

(4) Regarding new fields, we are already incentivizing this effort with capital credits; when we have heard from informed consultants that our tax system is already too complicated, I think the utility of this proposal is subject to question.

- **Establishing a Gross Minimum Tax**
  While I believe past production history demonstrates the wisdom of raising the floor on the production tax on major producers at low oil prices in order to stabilize funds for the delivery of government services, I must ask: do we have the cost data necessary to account for the different investment positions and downstream rewards realized by the smaller participating investors in the major fields?

- **Decoupling Oil from Gas**
  The importance of decoupling is clear in view of the volatility of natural gas pricing and the lower market value of natural gas, compared to oil. To facilitate North Slope natural gas development so that potential in-state natural gas users can benefit from the economies of scale that come with gas export, I favor removing the uncertainty associated with impending decoupling with all deliberate speed.

  I salute your past pioneering work on this question and recommend moving forward as soon as you can conclude that the proposed method of decoupling will not inhibit the necessary fixes on both the oil and the natural gas side of the production picture.

  However, in view of the field cost and other basic data and systemic problems discussed above, I do not favor splitting the production tax into two separate, non-deductible taxes (a gross progressive severance and a flat-rate, cost-based component) for three reasons: (1) as a practical matter, in view of the basic data and systemic problems discussed above, I do not think the trade-offs can be accurately quantified at this time; (2) a gross tax component runs contrary to the rationale for establishing a progressive production tax (*i.e.*, to make the production tax responsive to changing economic conditions); and (3) introduction of this dual production tax would run counter to fundamental goals of State policy considerations such as (a) simplifying the State revenue collection structure (as recommended by consultants) and (b) understanding that system's operations (through, for example, five-year look-back and look-forward data runs),

- **Petroleum Information Management System (PIMS)**
  While working at OMB during the late 1980's, I helped set up an inter-agency review system designed to bring the petroleum litigation activities under control. Unfortunately, the mini-cabinet we set up by executive order turned out to function as a lobbying platform for the industry – an unfortunate example of unintended consequences and that well-known maxim, be careful what you wish for. With this experience in mind, I recommend that you add statutory language that will:

(1) strengthen the statutory proposal by specifying the primary information problems that PIMS should fix (hopefully, some of the problems discussed in this letter will find their way into the intent language;

(2) strengthen PIMS reporting schedules and requirements, including required public reports at specified intervals, with each member who dissents on major policy decisions enabled to report publicly on the reasons for dissent;

(3) strengthen public disclosure requirements v. confidentiality; and

(4) include a public advisory board that meets regularly and includes select Legislature and general public representatives.

For two months I have followed your efforts with admiration for your steadfast dedication to a measure twice, cut once policy. I hope the information I have shared in this letter will encourage you to continue along this path. As a practical matter, I do not believe the unaudited fiscal year price and production data we use for petroleum policy analysis provides sufficient information for establishing trends and identifying the effects on differently endowed and situated major and independent producers and explorers of proposed changes to the State's petroleum fiscal regime. I am attaching for your information a copy of my testimony to House Finance March 22 on HB 9, which contains additional information on confidentiality issues.

Closing with thanks for your excellent efforts and your kind attention, I am

Sincerely,

Richard A. Fineberg

Att: Testimony on CSHB 9 (Version \K), March 22, 2012

Cc: Sen. Lyman Hoffman (Co-Chair)
Sen. Dennis Egan
Sen. Johnny Ellis
Sen. Lesil McGujire
Sen. Donald Olson
Sen. Joe Thomas
Sen. Joe Paskvan
Sen. Tom Wagoner
Sen. Bill Weilechowski
Sen. Hollis French
Sen. Gary Stevens

ATTACHMENT

Testimony on CSHB9 (Version \K), March 22, 2012

Before the House Finance Committee

Richard A. Fineberg

Testimony on CSHB9 (Version \K), March 22, 2012 *

Richard A. Fineberg
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P.O. Box 416
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Thank you for the opportunity to testify on HB9.   I appreciate the intent of the sponsors of this bill – to try once again to move North Slope natural gas from its remote location to where it is needed, despite the economic challenges that keep that resource stuck in the ditch. However, based on six and one-half years at OMB in the 1980's participating in administrative, legislative and judicial branch interactions split evenly between budget and oil and gas policy, plus prior journalism and subsequent consulting opportunities to observe our oil and gas development struggles, I believe HB9 was fundamentally misguided from its inception and legislative tinkering to alter its thrust at this late date is not going to turn this sow's ear into a silk purse for anybody except the major North Slope producers.

As I understand it, HB9 would attempt to get the gas line off high-center by giving an Alaska Housing Finance subsidiary – an entity without the seasoning of a natural gas portfolio – extraordinary powers to make deals while removing important government safeguards designed to protect the public interest – provisions that would – and, in my estimation, should – provide for the necessary of accountability through public disclosure (transparency) and checks and balances. One example is taxpayer confidentiality. HB9, including draft version K before you, endows the Alaska Gasline Development Corporation – and, I believe, its successors – with unusual powers this area.

On February 23, the Senate Resources Committee learned that the Department of Revenue believes that taxpayer confidentiality is a good thing. In extolling the putative virtues of taxpayer confidentiality before Senate Resources Feb. 23, the Commissioner of Revenue and the Deputy Director of the Tax Division neglected

* *Revised*

to consider the possibility that by limiting the number of persons who are permitted to look at these complex data. I am here to tell you that confidentiality creates a political circumstance in which very bad things can and do happen. Experience demonstrates that when we fail to ensure these safeguards, we lose.

Last month, for example, Senate Resources also confirmed that during the first two decades of North Slope and TAPS operations, the owners of TAPS overcharged shippers by 13.5 billion dollars, compared to the established rate-making methodology. This is a matter of public record, unrefuted to my knowledge. The Senate has not focused on tariff issues, but I can offer a few quick estimates on the economic costs, derived directly from the generally accepted figures figures. During that period, I estimate that TAPS shipped 11.2 billion barrels. Overcharges therefore amounted to approximately $1.20 per barrel. While the shipper-owners simply pocketed the overcharge themselves as an internal transfer, for two decades the overcharges:

- Handicapped the small percentage of independent shippers who paid the excess tariff out of pocket, and
- Cost the state at least $3.4 billion through reduced royalties production tax and state income tax.

Put otherwise, in rough terms, for the first two decades of North Slope and TAPS operations the state lost approximately $19,000 per hour due to tariff overcharges. These figures are conservatively estimated and only through 1997; the RCA was not able to reach a decision on the tariffs through 1997 until 2002 and it took four more years to prevail in state court. The FERC, which has responsibility for approximately 90% of TAPS shipments is also working on tariff issues but has taken longer still, following behind the RCA.

It is also a matter of record that the state had assured FERC that the 1985 settlement would produce a just and reasonable shipping charge. Why did the state enter into a tariff settlement that worked out so badly? Why did we give up refunds in hopes of lower tariffs that we never got? Based on first-hand experience, I can offer two answers:

- (1) Industry stonewalling behind the veil of
- (2) Confidentiality.

You can find documentation for the bad things that happened behind the veil of confidentiality in a February 1990 report I prepared for the House Speaker Sam Cotton and his majority leader in February 1990. In this report you will find more than a dozen examples of delays (2), opacity (6), omissions (7) and misinformation (5) in the administration presentations on the pending TAPS settlement. A major piece of information on the settlement available to legislators and Executive Branch policy-makers prior to settlement highlighted the difficulty of collecting refunds and failed to mention a unanimous 1978 U.S. Supreme Court decision that established the right of shippers – and, presumably, the State – to collect any refunds due from TAPS litigation. The 1978 Supreme Court decision on TAPS also escaped mention in the major post-settlement hearings on the settlement, March 18-19, 1985. Later in the year, behind the veil, the governor was also misinformed as to the benefits of the settlement. [1]

Before the first barrel of oil entered TAPS in 1977, preparation for tariff litigation had begun. When the first tariffs were filed, almost every informed state and federal observer believed the tariffs were excessive. Eight years later, the state suddenly changed course and decided to settle the ongoing litigation, concerned congressmen sent a letter to the U.S. Attorney General in opposition and tried to figure out what was going on. At a hearing in Washington on the proposed

[1] Richard A. Fineberg, *The 1985 TAPS Tariff Settlement: A Case Study in the Effects of Confidentiality on Information Available to Decision Makers (supplemental report to "Oil and Gas Revenue Disputes")*, prepared under contract for the Alaska State Legislature, Feb. 5 1990. (This report led to a House bill improving settlement practices that passed both houses but died in the final minutes of the session when the clock ran out as the House was preparing to concur in the Senate amendments; for a narrative history of this episode, see: Richard A. Fineberg, "Only minutes from rescue, HB 541 drowned in special interests," *Anchorage Daily News*, June 3, 1990, p. G-1).

settlement in June 1985, Rep. Norman Sisisky of Virginia commented, "This one Congressman thinks FERC is derelict in its duty." Turning to the Alaska Department of Law Assistant Attorney General advocating the settlement, he said:

> **"**To Alaska now. Isn't the real problem that they stonewalled you? They stonewalled you and you gave in? They used the power of the corporate treasury, of the courts, to absolutely stonewall anything that happened? Isn't that really what happened?"[2]

I submit that we are in a similar position where the three major North Slope producers hold production rights to North Slope natural gas, except that natural gas is genereally worth much less than oil on a Btu basis, making the transportation cost of shipping natural gas a significantly larger share of its market price.

The argumentation over North Slope investment returns demonstrates that whatever else it has done, ACES has not lived up to its name (Alaska's CLEAR and Equitable Share). If we wish to encourage investment by independent explorers and potential producers – a wise idea on the downside of the Prudhoe Bay decline curve – two of the best things we can do is focus on (1) audits so that we know and understand the actual costs of North Slope facility operations and (2) assuring just and reasonable shipping costs. Independents have to pay both. Thirty-three years later, it is time to live up to the U.S. Supreme Court presumption that Alaska stands in the shoes of the shippers.[3]

By its failure to solve fundamental policy problems while elevating confidentiality, eliminating transparency, eroding checks and balances and eviscerating judicial review, in my estimation this bill is a recipe for disaster.

Thank you for your attention and hard work.

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[2] U.S. House of Representatives Committee on Small Business, *H.R. 245 and Trans-Alaska Pipeline System Tariffs* (Washington, D.C.: Government Printing Office, 1985), p. 157.

[3] United States Supreme Court, *Mobil Alaska Pipeline Co. v. United States, et al.*, 56 L Ed 2nd 591 (1978), p. 596 (footnote 6).