From the desk of ***Richard A. Fineberg***
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June 11, 2008

Mr. John Larsen
Alaska Department of Revenue, Tax Division
550 W. 7th Ave., Ste. 500
Anchorage, AK 99501

Re: Comments on Dept. of Revenue Draft Transportation Regulations
(15 AAC 55.180 - 15 AAC 55.196; posted May 9, 2008 [2nd Draft])

Dear Mr. Larsen:

On May 9, the Alaska Department of Revenue (ADOR) posted revisions to draft regulations to implement the Legislature's November 2007 revisions to AS 43.55.150.[1] Based on review of the regulations (which closely follow the methodology ADOR outlined in the earlier draft, posted March 28) and information presented by others at the workshops on the proposed regulations in Anchorage April 8 and June 4, 2008, I believe that the complicated procedures proposed by ADOR are fatally flawed, and that these unduly complicated draft regulations:

- are unlikely to produce the reasonable cost estimates of pipeline costs contemplated by AS 43.55.150;
- contain provisions that are liable to perpetuate rather than correct oil pipeline tariff overcharges; and
- do not lend themselves to efficient implementation.

For these reasons, I recommend against adoption of the May 9, 2008 version of the revised draft regulations. I believe the workshop June 4 can accurately be described as a train wreck for this misguided proposal. In any event, the testimony ADOR received from knowledgeable practitioners in the pipeline ratemaking field suggests to me that the proposed draft regulations should be replaced by simplified ways to ascertain reasonable pipeline costs.[2]

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[1] Alaska Department of Revenue, Tax Division, "Request for Public Comments on Draft Transportation Regulations," May 9, 2008 (downloaded at http://www.tax.alaska.gov/programs/documentviewer/viewer.aspx?338; see also: proposed model for capital allowance for pipeline facilities [sample copy; untitled Excel workbook with three worksheets], http://www.tax.alaska.gov/programs/documentviewer/viewer.aspx?336).

[2] I monitored the June 4 workshop by teleconference but did not offer comments. By way of background: Although I consulted to the administration on the revisions to AS 43.55.150 last fall, I have not been actively engaged in the drafting of the approach to the regulations taken by ADOR since the initial interdepartmental drafting meeting in Anchorage in late January. The draft regulations promulgated March 28 and May 9 do not reflect concerns I raised at that meeting, or in memoranda prepared at request of the department on or about Feb. 12 and April 3, 2008.

Background

The revised transportation charges section of the "ACES" measure adopted in November 2007 enables ADOR to recoup state production tax revenue lost when pipeline companies file and charge excessive tariffs that do not reflect actual costs. According to ADOR, 2007 filed tariffs on the Trans-Alaska Pipeline System [TAPS] were more than $3.00 per barrel above the levels deemed just and reasonable by the responsible regulatory agencies, resulting in an estimated state production tax revenue loss of approximately $160 - $200 million. The statutory revisions to AS 43.55.150 passed by the Legislature Nov. 16, 2008 enable ADOR to close this loophole by reducing the costs imputed to pipeline tariffs filed with regulatory agencies when the producer or shipper on a pipeline is a subsidiary of a company owning a portion of that pipeline.[3]

A key to understanding what the revisions to AS 43.55.150 – and, consequently, the implementing regulations – are supposed to do is this: Three major North Slope producers own more than 95% of TAPS and control a roughly similar percentage of the oil shipped on TAPS. The November 2007 statutory revisions were designed to prevent companies that are, in effect, charging themselves for pipeline shipments, from overcharging themselves, thereby reducing production taxes and handicapping independent producers or shippers (who must pay those higher costs out of pocket).[4] Under the amended statute, ADOR is now empowered to determine reasonable costs and adopt the lower of actual costs (generally understood to be filed tariffs) or reasonable costs (to be determined by ADOR) when one of three conditions is found to exist.[5] The thrust of the amended statute was to revise the previously existing statutory language (which covers

[3] This description of the statute that the proposed regulations seek to implement is based on the presentation of the Palin-Parnell Administration during last fall's Special Session on production taxes. See: "Transportation Deductions," Nov. 2, 2007 (last update), Slides 7, 8 and 11 (http://www.gov.state.ak.us/aces/pdf/11-02-07%20Transportation%20Issues.pdf).

Within three days of the posted description of the purpose of the amendment to AS 43.55.150 summarized above, the second committee of referral in both chambers had inserted provisions designed to enable ADOR to accomplish this purpose into the production tax legislation that was being forwarded to the third and final committee of referral. (See: *Alaska Budget Report*, Nov. 5, 2007 ["S. Judiciary bill packs a punch against producers," pp. 2-3; and "Divided H. Resources Committee sends beefed-up bill to Finance," pp. 6-9.) Less than two weeks later, similar language to accomplish this purpose was incorporated into the production tax legislation passed by both houses and formerly adopted Nov. 16, 2007 (SCS CSHB2001[FIN] Am S, Section 53).

[4] Ibid. It is important to note that ADOR does not set pipeline tariffs and cannot reduce them; rather, this statute simply seeks to render the excessive tariffs inoperable when companies reduce production taxes by overcharging themselves. Independent producers would get the benefit of the higher tariffs they are forced to pay to the pipeline owners.

[5] The three conditions, each of which could require ADOR to determine the value of production using reasonable pipeline costs rather than actual costs (often equated with filed tariff costs), are: (1) if the shipper and the pipeline owner are affiliated; (2) if the tariff was not negotiated at arms length; or (3) if the transportation charge was unreasonable. (AS 43.55.150, Sec. 53, as revised in SCS CSHB2001[FIN] Am S, Section 53).

tanker transportation, as well as pipelines) to cover oil shipped on a pipeline when production and pipeline interests overlap. As noted above, the statute now applies to the vast majority of the oil shipped on TAPS – and on the smaller North Slope feeder lines.

The change in language between the identical versions of the proposed revision that were adopted by the second committees of referral during the Special Session and the final version adopted by both bodies demonstrate that the Legislature's intent was to capture production tax revenue from producers that benefit from excessive tariffs through overlapping pipeline interests without inflicting that production tax correction on the small percentage of oil produced in Alaska by companies that do not have an interest in the pipeline (or pipelines) that carry that oil.[6] Further, the final statutory language was crafted so as not to interfere with ADOR regulation of tanker costs.[7]

<u>Comments on Specific Provisions of Draft Regulations Posted May 9, 2008</u>

The following comments relate to specific provisions of the draft regulations posted May 9, 2008. If ADOR proceeds on this course, the new regulations should address these issues. However, in my estimation resolution of these issues in the May 9 draft regulations for these subjects alone will not cure the fundamental defects in the proposed regulations stated in the opening paragraph and discussed further in the background paragraphs of this letter.

<u>15 AAC 55.181(b)</u>

This subsection requires the producer to account for the effects of annual "true-up" adjustments to the pipeline owner's tariffs to account for differences between forecast and actual throughputs. But it is the pipeline owners who make these calculations. When the source or repository of the required information is the entity that owns and operates the pipeline, it seems rather Byzantine to make the producer responsible for these data. Moreover, the record on pipeline tariff regulatory proceedings is rife with examples of the industry's chronic failures to provide substantive cost and accounting information on its operations over extended periods. In light of this background, this provision must be regarded as grossly impractical.[8]

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[6] See fn. 3, above and CS HB2001[RES], Sections 48 and 49 (offered Nov. 6, 2007 and referred to the Finance Committee).

[7] Personal knowledge.

[8] This issue was raised in my April 3, 2008 memorandum to ADOR drafters (copy attached to these comments), but does not appear to have been addressed.

15 AAC 55.193(b)(1)

This provision, at the starting point for ADOR pipeline cost calculations, defines "actual costs of transportation under AS 43.55.150(a)" as a "tariff that is on file with the Federal Energy Regulatory Commission or other regulatory agency having jurisdiction." This approach strikes me as inconsistent with the meaning and intent of the revisions to AS 43.55.150 that these regulations are supposed to implement. As discussed above, the purpose of the Legislature's revisions to AS 43.55.150 is to ensure that artificially high filed tariffs would not continue to significantly reduce production tax payments – as they have done (and continue to do) for most of the oil shipped from the North Slope on TAPS.[9]

15 AAC 55.193(n)

This proposed subsection states that the reasonable costs of pipeline transportation includes four elements: (1)"ordinary and necessary costs incurred," (2) *ad valorem* taxes, (3) an allowance for the cost of dismantlement, removal and restoration of the pipeline facility" (DR&R) and (4) a cost of capital allowance. The methods of determining reasonable costs presented for three of these four elements appear to be designed to produce results that will replicate or exceed filed tariffs, rather than test the merits of filed tariffs, thus contravening the stated purpose of the statute the regulations are supposed to implement. Comments on specific subsections follow.

15 AAC 55.193(n)(1)

Instead of providing directions for establishing reasonable costs in an efficient manner, the reliance on "ordinary and necessary" operating and maintenance costs sets in motion an administrative review of actual costs that is similar to a tariff proceeding and therefore redundant and liable to be inefficient; instead, this subsection should provide guidelines for making use of relevant information already gathered in regulatory proceedings or establishing a simplified formula for proxy costs that would provide a basis for determining reasonable costs without requiring an audit or full administrative hearing.

15 AAC 55.193(n)(3)

The inclusion of DR&R provisions embedded in a tariff should NOT be treated as a pipeline cost for the following reasons:

- It makes no sense to accept embedded pipeline tariff elements such as DR&R as reasonable costs for inclusion in tariff calculations when pipeline owners vigorously contend that individual tariff elements that

[9] For clarity this subsection should state that the term "actual" cost, often identified with filed tariffs, has limited or conditional application when the exceptions identified in AS 43.55.150(a) and (b) are found to exist. (This problem was also raised in my April 3, 2008 memorandum to ADOR).

were negotiated for the purpose of achieving a settlement do not represent true costs.

- As a reasonable cost proxy, the DR&R element is particularly suspect because it deals with future costs that cannot be determined with accuracy.
- This provision creates an incentive for the pipeline owner to force the shipper to give the pipeline owners what is, in effect, an interest-free loan that is also reducing state production taxes for the producer who owns an interest in the pipelines used to ship its own oil (or [say] the oil of an affiliate on a convenience exchange).
- The history of the TAPS DR&R provision demonstrates that inclusion of this item will provide pipeline owners an opportunity to collect substantial sums from shippers and hold that money on an interest-free basis for decades.

As stated in my April 3, 2008 memorandum, I believe that public policy is best served by escrow of DR&R collections. Moreover, those amounts reviewed periodically (say, every three or five years) to assure that the collection schedules reflect current understandings of costs, inflation and performance date. In any event, the difficulty that regulatory agencies have had establishing appropriate DR&R rates suggests that inclusion of filed tariff DR&R elements is no guarantee that tariff-based DR&R amounts represent actual costs.

<u>15 AAC 55.193(n)(4)</u>

This section applies the cost of capital model used for tankers to determine reasonable pipeline capital expenditures. As in the case of operating costs, this approach sets up a new administrative procedure that appears to be redundant to regulatory agency functions. Moreover, on June 4 a knowledgeable attorney suggested that the formulae included in the tanker capital model contains provisions that will result in significantly higher capital costs than the costs that would be derived from a tariff proceeding. ADOR presented no information indicating that the department had tested its cost of capital model to determine whether this is the case. (Instead, ADOR asked the questioning attorney to provide test results substantiating *his* concerns.)

Conclusions

For purposes of determining the basis price for production taxes in the overlap situation identified in the background paragraphs, the Legislature has instructed ADOR to use actual costs or reasonable costs, “whichever is lower,” leaving it to ADOR to devise a method for calculating reasonable pipeline costs.[10] From the standpoint of administrative efficiency, one might expect that ADOR would seek a simple and efficient alternative method to estimate reasonable pipeline. Indeed, in the initial stages of drafting the proposed regulations, there was discussion of

[10] AS 43.55.150(b) (Sec. 53, SCS CSHB2001[FIN] am [Ch. 1, SSSLA 2007]).

borrowing from existing oil or pipeline regulatory agency standards for this purpose.[11] But by the time the draft regulations emerged for public consideration, ADOR had devised a complicated set of procedures that is neither simple nor efficient.

Rather than devising a system to check tariff results and provide an efficient alternative determination in the event that overlapping interests have caused that process to fail in its objective of securing just and reasonable shipping rates, ADOR now appears to be promulgating a complicate, new methodology that appears to supplant pipeline tariff procedures. Comments at the June 4 workshop by attorney Robin Brena suggest that, apart from being radically inefficient, specific mechanisms in the proposed procedures are liable to ensure that the ADOR approach to "reasonable" costs will result in higher cost levels than existing tariff methodologies.[12] If this is turns out to be the case, the proposed regulations will have turned the purpose of revisions to AS 43.55.150 on its head.

My comments, based on more than three decades of experience observing state and federal and tax collection and pipeline ratemaking activities, suggest that the complicated procedures proposed by ADOR are fatally flawed, and that these unduly complicated draft regulations:

- are unlikely to produce the reasonable cost estimates of pipeline costs contemplated by AS 43.55.150;
- contain provisions that are liable to perpetuate rather than correct oil pipeline tariff overcharges; and
- do not lend themselves to efficient implementation.

For these reasons, I recommend against adoption of the May 9, 2008 version of the revised draft regulations.

Thank you for your consideration.

Sincerely,

Richard A. Fineberg

Att: Draft Regulations (April 3, 2008 Memorandum)

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[11] Two standards discussed by ADOR were federal Minerals Management Service pipeline regulations and Regulatory Commission of Alaska "safe harbor" provisions; neither were considered applicable to this situation.

[12] The comments of Mr. Brena, who has successfully challenged excessive pipeline tariffs on behalf of independent shippers at the Regulatory Commission of Alaska and has secured similar preliminary decisions at the Federal Energy Regulatory Commission, deserve serious consideration.

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To: Marcia Davis, Deputy Commissioner, ADOR
Roger Marks
Rob Mintz
John Larsen
Antony Scott

April 3, 2008

Re: Draft Regulations for AS 43.55.150 (Transportation Costs) – 15 AAC 55.180 - 195

I. General Comments

The intent of AS 43.55.150, as enacted, is to rely on filed tariffs only for independent shippers (for whom the filed tariff is an actual cost, even if that tariff includes pseudo-costs that do not represent real cash outlays). A principal problem with filed tariffs has been the industry's insistence that the result of a tariff established by negotiated settlement is a package of elements, none of which mean anything outside of the settlement. This legerdemain has created a framework from which industry has profited mightily, while its lawyers argue that items embedded in a filed settlement tariff cannot reliably be isolated for determination of actual costs.

It follows from this understanding that the Department of Revenue regulations should not create forward-looking regulations that rely on filed tariff elements unless required to do so by circumstance or statute. In view of the industry's steadfast opposition to efforts to isolate costs (rejected by the RCA and Alaska courts), I believe these regulations should establish the principle of using filed tariff elements, but only for the limited purpose of calculating past tariff amounts actually collected. Calculations that look forward should utilize current estimates of that life and should be revisited every three years to bring current tariff collection rates into line with current conditions by incorporating updated estimates regarding factors that include (1) life of line, (2) remaining throughput, (3) anticipated capital investments, (4) inflation rates, (5) interest rates and (6) industry rates of return.

The fact that current-year collections of TAPS DR&R prescribed in the 1985 TAPS settlement are now denied by the RCA supports the conclusion first stated by the APUC staff expert in 1987: that the DR&R collection schedule adopted in the 1985 TAPS tariff settlement allowed over-collection. Unfortunately, because the TAPS DR&R collection schedule was front-loaded, the RCA's eventual correction of the 1985 settlement only stops collection of the last 1% of total DR&R collections. The over-stroked pre-collection of DR&R has already put an off-book windfall of more than $1.5 billion in the hands of the industry. Documents filed at FERC support the contention that if the pipeline is dismantled at the end of the current lease (circa 2030), the difference between the industry's rate of return on the pre-collected cash will result in a tax-paid surplus of at least $15 billion over the anticipated costs of DR&R.

TAPS DR&R history calls into question the proposed DR&R terms I have deleted from the proposed 15 AAC 55.195 in item number 4, below. As I have argued repeatedly, DR&R costs and collections should not be based on negotiated tariff filings; nor should they be locked in decades prior to the actual event through a one-size-fits-all model. Rather, DR&R collections should be escrowed and whatever DR&R formula is adopted should lend itself to updating every three years (or so) to assure that the collections reflect and meet changing conditions. This conceptual approach to DR&R reduces the danger that investors in the proposed natural gas pipeline could borrow from the TAPS playbook, using protracted natural gas pipeline negotiations to arrive at DR&R terms that would produce unreasonable windfall results for the pipeline owners; I leave it to the drafters to create a DR&R framework that will integrate this conceptual approach with the rest of the proposed package.

Because the proposed 15 AAC 55.193 parallels the existing 15 AAC 55.191 in structure, the pipeline tariff portions remain difficult to locate. To facilitate review and discussion of the proposed regulations, a sheet that identifies the pipeline tariff-related subsections by number and briefly summarizes each might be useful.

<u>II. Specific Changes</u>

1. Draft Regulations, pp. 2-3:

15 AAC 55 is amended by adding a new section to read:

15 AAC 55.181. Comparison of actual and reasonable costs of transportation for oil and gas produced after June 30, 2007. . . .

(b) If a filed tariff for pipeline transportation <u>**is used to determine actual costs and that tariff**</u> includes a variable tariff methodology to correct for the differences between (1) forecast costs and throughput amounts used in calculating a rate for an earlier year, and (2) the actual costs and throughput amounts for that earlier year, the <u>**[producer] carrier**</u> shall <u>**[account for the effect] provide the producer with data that enable the producer to show the effects**</u> of those <u>**prior-year**</u> mathematical adjustments <u>**[in the comparison] on the calculation**</u> of <u>**current-year**</u> actual <u>**and reasonable**</u> costs of transportation <u>**[and reasonable costs of transportation]**</u> under AS 43.55.1560(b), using a method . . . .

Comment: The purpose of this provision is to enable persons working with the tariff to compare annual tariffs on a per-barrel basis. When an adjustment factor is *included in the calculation, the inter-year comparison is not meaningful. It is the responsibility of the tariff filer – not the producer or shipper – to isolate the annual "true-up" factor so that meaningful annual tariff data can be developed.*

2. Draft Regulations, p. 4:

15 AAC 55 is amended by adding a new section to read:

15 AAC 55.193. Calculation of costs of transportation for oil and gas produced after June 30, 2007. (a) Costs of transportation are the ordinary and necessary costs incurred to transport the oil or gas from the point of production to the sales delivery point.

(b) Actual costs of transportation under AS 43.55.150(a) are

(1) if transportation of oil or gas is by a regulated carrier, **<u>[the] a</u>** tariff **<u>[on file with the Federal Energy Regulatory Commission or other] that is accepted by the Regulatory Commission of Alaska or other regulatory agency having jurisdiction and</u>** which is applicable to **<u>[that] the</u>** transportation of the oil or gas by the carrier, from the point where that oil or gas is tendered into the facilities of the carrier to the point where it is delivered from the facilities of the carrier; . . . . .

Comment: See my introductory comments on filed tariffs, above, and my memoranda of Feb. 12 and Feb. 20. (Note also: As a matter of style and consistency, I have substituted RCA for FERC.)

3. Draft Regulations, p. 8:

(6) if transportation of oil or gas is by a nonregulated pipeline facility that is owned or effectively owned, in whole or in part, by the producer of that oil or gas, the sum of the following, allocated to that oil or gas in the proportion that the volume of that oil or gas bears to the total volume of fluids transported by the pipeline:

(A) a cost of capital allowance that includes depreciation and a return on investment, as provided in 15 AAC 55.195(d);

(B) the reasonable operating and maintenance costs for the pipeline facility<u>**[, which are determined by multiplying the projected actual annual amount of direct operating and maintenance costs for the pipeline facility by 112 percent]**</u>; for purposes of this subparagraph, direct operating and maintenance costs are only those costs necessary to physically operate and maintain the pipeline facility;

(C) ad valorem taxes associated with the pipeline facility.

Comment: At this time, do we have nonregulated pipelines that are allowed a profit element, or is the proposed 15 AAC 55.193(6)(B) in this draft creating a new class of pipelines? In any event: What criteri distinguish a pipe carrying fluid within a field (generally treated as a cost of production), from a pipeline (which qualifies for a transportation deduction and therefore, if carrying oil from state lands, creates both a royalty and tax deduction)? See discussion of need for pipeline definitions in my Feb. 12, 2008 memo (<u>n.b.</u> footnote 4 of that memo).

4. Draft Regulations, pp. 14-15:

(n) Except as provided under (o) of this section, the reasonable costs of pipeline transportation for oil under AS 43.55.150(b) are the sum of the following, allocated to the producer's oil in proportion to the number of barrel-miles transported:

(1) the ordinary and necessary direct costs incurred by the carrier to prudently operate and maintain the pipeline facility, except that items that are not direct costs for purposes of this paragraph include items described in AS 43.55.165(e) (3), (4), (6) – (10), (12), (13), <u>**(15),**</u> (16), (19), <u>**(20)**</u> and (21);

(2) a reasonable allowance for overhead expenses that are directly related to operating and maintaining the pipeline facility; the allowance is _____ percent of the costs allowed under (1) of this subsection;

(3) ad valorem taxes associated with the pipeline facility; **and**

(4) **[if specifically approved in an applicable tariff on file with a regulatory agency having jurisdiction, the allowance for the cost of dismantlement, removal, and restoration of the pipeline facility; and**

(5)] a cost of capital allowance for depreciation of and a return on investment prudently made in the pipeline facility, as provided in 15 AAC 55.195(j).

(o) If a tariff rate for pipeline transportation has been adjudicated as just and reasonable by the Regulatory Commission of Alaska or another appropriate regulatory agency having jurisdiction, the tariff rate establishes the reasonable cost of the pipeline transportation for the three calendar years immediately following the end of the test period set by order of the regulatory agency for use in determining the tariff rate. For purposes of this subection, the test period is the period whose actual costs and throughput amounts were used as the basis of the adjudicated tariff rate.

Comments:

(1) As discussed above, the documentary record clearly establishes that DR&R sums embedded in the filed TAPS tariffs and collected on an accelerated basis have resulted in hefty over-collection. Further, the regulatory agency track record on DR&R at FERC and the RCA indicates that the agencies have separated DR&R from basic ratemaking proceedings and been unable to sort through and resolve DR&R issues in a timely manner. In light of this history, the omission of AS 43.55.165(e)(15) from the proposed 15 AAC 55.193(n)(1)(15) and the language of the proposed 15 AAC 55.193(n)(4) – granting filed tariff DR&R costs – makes little sense. I believe DR&R collections should be escrowed and the collection rate should be reviewed every three years to make sure the collection rate is consistent with changing conditions. (See my summary discussion of DR&R issues above, and in my Feb. 20 memo, item 1.B., p. 2.)

> *(2) When the state has taken a hard line on allowing deductions for field refineries, I do not understand why the state would grant deductions for pipeline operators to build refineries.*

5. Draft Regulations (select minor typographical issues):

Check indentation and correct as necessary on pages 6 and 9::

Page 6: paragraph beginning with "(4)."

Page 9: paragraph beginning with "(d."

On Page 14, the letter "(l)" should not be italicized.

On Page 15, in subsection "(o)" insert the missing letter "s" in "subsection."