

Stranded Gas and PPT: Update and Observations

By RICHARD FINEBERG

June 6, 2006
(State Legislature Special Session Ends June 8)

Update

For the second time in one month, as the Legislature approaches the end of its session June 6, the fate of the production profits tax (PPT) was in doubt.

During the Legislature's regular session, which ended May 9, the governor linked the petroleum fiscal regime reforms, including a long-term freeze on changing the terms, to pending natural gas pipeline negotiations. At the same time, he refused to release the draft gas line contract arrangements he had negotiated with the major North Slope producers. Meanwhile, the industry unleashed a lobbying blitz in Juneau and an aggressive statewide television advertising campaign. When the House and Senate couldn't agree on the PPT terms at session end, the governor immediately called the Legislature back into a special session.

Concurrently, the governor was forced to release the carefully guarded draft gas line contract May 10 and the petroleum fiscal regime overhaul took a back seat to gas line deliberations. The industry obligingly turned down its advertising campaign as administration officials and their consultants began a carefully staged eleven-day lecture series for the Legislature on the gas line project.

At center stage was the draft Alaska Stranded Gas Fiscal Contract. When released May 10, the draft contract was 352 pages long and was accompanied by a 306-page Fiscal Interest Findings (*FIF*) document. The draft contract was not complete. An additional 105 pages were released May 24. By that time, administration officials were holding a series of informational public meetings at various locations around the state at which they were taking oral testimony.

The governor reintroduced his PPT proposal, which called for a 20 percent tax rate and 20 percent credits and deductions to reduce the tax base. Again he indicated that changes to that proposal could cause the industry to walk away from the gas line deal. He also tendered a series of bills for implementing the gas line.

As legislators, their consultants and interested members of the public struggled to understand the complicated gas line proposal, deliberations were continuing on the PPT. The Senate raised the tax rate to 22.5 percent, added a mild escalating factor to raise the tax bite as oil prices increased and sent it back to the House. The House raised the base rate to 23.5 percent, increased the escalator and put a floor on the tax at low prices. When the Senate failed to concur in the House amendments June 6, a conference committee to reconcile the differences was appointed.

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Observations

Until the draft Alaska Stranded Gas Fiscal Contract and the supporting Fiscal Interest Findings (*FIF*) were released, this writer's recent research and reporting on state fiscal policy dealt primarily with oil-related issues.¹ With the release of the draft contract and the *FIF*, new articles posted on this site deal with selected aspects of the draft gas line proposal, as well as the oil-related issues previously discussed. The materials in this section are offered to illuminate specific aspects in both areas of the current policy deliberations.

The articles and communiqués on the following pages are not intended to represent a comprehensive analysis of the voluminous materials that the administration has released since May 10. Rather, the communiqués posted in this section focus on issues whose importance, in this writer's estimation, has been confirmed by review of the recently release of the draft contract and the *FIF*. Foremost among these issues are:

- failure to deal with TAPS tariff issues;
- the potential of the draft gas contract and the switch to a cost-based tax regime to create fertile ground for new litigation while restricting access to regulatory and court venues for dispute resolution;
- observations on the negotiating process; and
- shortcomings previously identified in the Alaska Department of Revenue's estimation of industry earnings from its Alaska operations (discussed in previously posted articles).

¹ The articles posted previously on this web site are still available. These include: [April 23, 2006 report](#) on the Alaska Department of Revenue's short-term fiscal model (prepared for the *Alaska Budget Report*); an [April 30, 2006 commentary](#) on the state's deliberations on petroleum fiscal regime change; and a May 4, 2006 report to the Alaska Public Interest Research Group and a May 7, 2006 perspective for the *Fairbanks Daily News-Miner* (at pages 4-16 and 2-3 of the [May 10, 2006 Juneau Update](#)). In addition, see the following: [1990 report](#) on the effects of confidential information on the 1985 TAPS settlement and a 2003 book chapter on [Alaska's petroleum litigation experience](#).

To: (Legislator [Name Withheld])/ From: Richard A. Fineberg / June 2, 2006
Re: TAPS Tariffs, the PPT and the Draft Stranded Gas Fiscal Contract

In case you missed it in the pandemonium as the gas train tries to leave the station: my condensed summary of the relationship between TAPS tariffs and PPT (attached) ran as an op-ed in the *Anchorage Daily News* and the *Juneau Empire* May 24. Here is the one-page summary of TAPS issues you requested.

The fundamental issue raised here is that the state, through the PPT, is giving up revenue (“sharing the risk”) through tax credits and deductions. A primary purpose is to promote exploration by independent developers. But nowhere (to the best of my knowledge) has the administration reckoned the fact to the extent that TAPS tariffs are excessive, we are handicapping those independents. As demonstrated in [worksheet 1](#) and [worksheet 2](#) posted and discussed on my web site, the RCA, I and many other observers believe that handicap (compared to the three major TAPS owners, who control approximately 95% of North Slope production and own a similar share of the pipeline) is nearly \$4.00 per barrel.

Put otherwise: If we give up \$4.00 per barrel in credits and deductions to both the independents and the “Big Three,” the independents will still be handicapped by \$4.00 per barrel, compared to the majors. Since the administration is counting on exploration to come up with the final one-third (18 TCF) of the gas necessary to keep the gas pipeline full (and, therefore, hopefully, profitable), this appears to be a significant defect in the draft Alaska Stranded Gas Fiscal Contract.

In addition to the TAPS disincentive summarized above, in my May 19 note to Johnny Ellis, I raised two broader concerns about TAPS. I will repeat them here, with quick reference links to material I have posted:

- Substantive: Correct reckoning of oil pipeline costs – and profits – will materially affect the results of petroleum fiscal regime overhaul, but the amounts at issue – and their implications have either been obscured or ignored altogether. (Note that due to confusion created by the manner in which ADOR’s short-term model treats pipeline tariffs, the results summarized in my [April 23 report](#) to the *Alaska Budget Report* on the ADOR model understate the amount by which ADOR has understated industry profits.)
- Reflexive: the fact that this important issue never made it onto the administration’s table or the Legislature’s radar screens raises questions in my mind about the quality of the administration’s policy development and review process. This omission is particularly surprising when two of the administration’s consultants – one of its top negotiators and his colleague, the administration’s antitrust consultant -- also manage TAPS tariff matters in DC for the state.

In conclusion: Based on my experience on the administration side, I believe that from a broad policy standpoint, there are ominous similarities between the 1985 TAPS tariff negotiations and the Alaska Stranded Gas Fiscal Contract negotiations. For example:

- This package is being sold on the need for certainty;
- we are being asked to accept a package without “nitpicking” the details;
- [confidentiality and delayed release](#) of key information make review difficult;
- we are creating a new very complicated system with many inter-related moving parts in an era of high oil prices – exactly the circumstances that condemned us to two decades of [litigation](#) that was necessary to obtain approximately \$1.00 out of every \$6.00 we received during the first quarter-century of North Slope operations (of which TAPS was only one example).

For additional information on litigation and TAPS tariff issues, see the articles and reports hyperlinked in the [April 30 article](#) posted on my web site and the background information on the [“Trans-Alaska Pipeline System: Economics”](#) page.

If you need additional information on any of these points, please let me know.

Excessive pipeline tariffs hurt Alaska

By RICHARD FINEBERG

Published: May 24, 2006

The governor insists that the Legislature must accept the complicated new oil and gas production tax he negotiated with the three major North Slope producers. He says the Legislature's failure to approve those terms as part of the even more complicated 352-page natural gas pipeline contract will kill the gas deal.

This sounds more like extortion than negotiation.

Under the proposed agreement, the new oil tax terms cannot be changed for 30 years. When experience demonstrates that the petroleum fiscal system requires a major overhaul every decade or so, we should not lock in an untested new system for three decades.

A very important element of that regime -- oil pipeline profits -- has been omitted from consideration. This oversight is significant because excessive trans-Alaska oil pipeline system tariffs, or shipping charges, handicap independent shippers. The benefactors are the three major producers, which own 95 percent of the oil line.

The Regulatory Commission of Alaska ruled in 2002 that the state's 1985 tariff settlement agreement with Alyeska Pipeline Service Co., the consortium of oil companies that operates the pipeline, allowed them to overcharge in-state oil shippers by approximately 57 percent from 1997 to 2000. The RCA calculated that if it had jurisdiction over interstate shipments, and if the commission's findings applied back to the start of the pipeline in 1977, it would mean Alyeska had overcharged shippers almost \$10 billion over 20 years. Those overcharges would have reduced state royalty and severance tax payments by approximately \$2 billion.

According to the RCA, a tariff of \$1.96 per barrel allows Alyeska to recover all costs, along with a reasonable profit.

RCA tariffs apply only to in-state shipments of oil. The Federal Energy Regulatory Commission sets rates for more than 90 percent of pipeline shipments. Today at FERC, Alyeska, still using the 1985 settlement formula, charges approximately \$3.98 per barrel -- more than twice the RCA tariff.

If the RCA is correct in its rate determination, it means Alyeska overcharges are putting independent shippers at a price disadvantage of almost \$4 per barrel -- the almost \$2-per-barrel overcharge in shipping costs, plus the fact that the pipeline owners are profiting \$2 from the same overcharge to nonowners. The state loses about \$0.30 per barrel because of excess pipeline tariffs.

And when oil prices are low, pipeline tariffs become increasingly important.

In 1993, for example, Conoco -- the only company other than a major pipeline owner ever to build and operate a North Slope field -- left the state during a period of low oil prices. BP acquired Conoco's Milne Point field and immediately began expanding it. Conoco president Archie Dunham later said: "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."

Without correcting the oil pipeline overcharge problem, the tariff handicap for independents will continue -- while giving the pipeline's owners excess profits.

Meanwhile, the administration is renegotiating the pipeline tariffs, but past negotiations have failed. But delay creates precisely the uncertainty that oil industry and Murkowski administration representatives decry.

Postponement also ignores the history of the pipeline tariff agreement that the RCA, this writer and many others believe stifled competition and cost the state billions of dollars. Ironically, the Department of Law and its consultants advocated the tariff settlement, like the current gas line deal, to end uncertainty.

The law firm that represented the state in the pipeline tariff settlement and has handled pipeline tariff issues in Washington, D.C., for the past two decades now assists the administration in gas pipeline negotiations. Despite the fact that the state began protesting pipeline tariffs at FERC in 2003, last week that law firm's Brad Lui told legislators, "Arguably, a producer-owned pipeline, under theory, anyway, would have a greater incentive to control costs because ... it's coming directly out of their pocket."

So much for legal theory.

Oil pipeline tariffs exemplify the many problems that require careful consideration in the reformulation of petroleum fiscal policy. But it is difficult to focus on the important details of a complicated contract while negotiating with a loaded gun pointed at your head.

Richard Fineberg, an independent petroleum analyst from Ester, helped formulate and execute state oil and gas policy as an adviser to former Gov. Steve Cowper during the late 1980s.

Note: The Daily News incorrectly identified Alyeska Pipeline Service Co. as a party to the 1985 tariff agreement and the RCA rate case. In fact, the TAPS owners -- not their wholly-owned subsidiary, Alyeska-- were the legal entities involved in the tariff agreement and the subsequent rate cases. At this writer's request, the Daily News ran a correction the following day.. -- RAF

To: (Legislator [Name Withheld])/ From: Richard A. Fineberg / June 2, 2006
Re: Grynberg Cases on Gas Valuation

Dear Legislator:

While at OMB during the late 1980s I was active in setting up an oil and gas litigation policy review group and, after leaving state service, in 1990 I reported to the Legislature on North Slope litigation issues. In 2003 I reviewed Alaska's petroleum litigation experience for the book, *Caspian Oil Windfalls: Who Will Benefit?* Based on this background, I offer the following observations:

Dr. Roger Marks of ADOR assures me, based on the reduced payments to the Constitutional Budget Reserve Fund in recent years, that the Alaska's past petroleum litigation problems are a thing of the past. I regard Dr. Marks' assurance as a classic example of the propensity of economists to treat assumptions as reality, as in the classic joke in which the economist, trapped on a life raft with a tin of sardines but no means to open it. (The economist saves his colleagues from starvation by assuming a can opener.)

On cursory review of Articles 24 through 26 and Exhibit A of the draft Stranded Gas Fiscal Contract, I find them woefully inadequate for deal with the circumstances the state is liable to be facing.

Based on my experience, I anticipate that the run-up in petroleum prices and the shift to a profits-based production tax are liable to combine to create a repeat of the situation that condemned the state to two decades of litigation caused in large part by the industry's legitimate aggressive pursuit of shareholder interests. Under these circumstances, I think it likely that it will require a renewed round of extended litigation to ensure that the state is correctly compensated for the value of its resources. I am therefore concerned that the draft Stranded Gas Fiscal Contract terms substitutes what appears to be a weak and ineffective arbitration process for the court and administrative safeguards through which the state gained approximately one dollar for every five dollars the industry paid during the first quarter century of North Slope operations.

Dr. Marks further assures me that value or market price issues are no longer a problem for Alaska revenue collectors. Based on the False Claims Act suits of Jack Grynberg, head of an independent, Denver-based oil and gas company, again I marvel at the insouciance of the economic perspective. According to a May 31 report on National Public Radio, Mr. Grynberg contends that producers cheat resource owners by underpricing natural gas produced from federal lands by approximately 30 percent. According to NPR, Mr. Grynberg claims to have identified a dozen ways that this is done. A knowledgeable natural gas engineer tells me that he is aware of examples of with the practice for reducing natural gas value described in the NPR story on Mr. Grynberg.

I have attached a transcript of the NPR story on Mr. Grynberg; I think you will find it interesting. if you want to see a front-page *Denver Post* article on Mr. Grynberg's long-running litigation wars or his 57-page False Claims Act complaint against ExxonMobil, please let me know.

Sincerely,

Richard A. Fineberg
P.O. Box 416
Ester, AK 99725

Phone/Fax: (907) 479-7778
Web Page: <http://www.finebergresearch.com>

NPR's Morning Edition

(Accessed June 3, 2006 at <http://www.npr.org/templates/story/story.php?storyId=5441272>)

Business

Independent Oilman Takes on Oil Giants

by Jeff Brady

Morning Edition, May 31, 2006 · Jack Grynberg is the oilman other oilmen love to hate. The veteran oil driller has filed a series of lawsuits claiming that the oil industry is systematically defrauding the government of royalty payments. Grynberg has been in court for years trying to prove his case.

(Listen logo.)

Transcript by R.A. Fineberg:

Steve Inskip: From NPR News, it's Morning Edition, I'm Steve Inskip. A Colorado man says petroleum companies owe the U.S. government \$400 billion and he's spending millions of his own fortune to prove his point.. Jack Grynberg says dozens of companies have been stealing natural gas from wells drilled on federal land. He's filed a lawsuit, and soon a Wyoming judge will decide if that case will be allowed to continue. NPR's Jeff Brady has this profile of Grynberg and his lawsuit.

Jeff Brady: Jack Grynberg works out of a cluttered, corner office in a Denver suburb. From the looks of it, you'd never know he's made a lot of money discovering oil and gas deposits all over the world. The décor is a bit dated and the hallways are lined with files and papers sitting on the floor. Frankly, it looks a bit like a war zone, and in some ways it is. But the battlefield is the courtroom.

Jack Grynberg: "Well, I guess you can say I've been a fighter ever since I was a kid. I'm a Holocaust survivor. At the age of 12, I carried a gun in the forests of Belarus, with the partisans, fighting the Nazis.

Brady: This is how Grynberg typically introduces himself, but he quickly turns to the bulk of his life in the oil and gas industry. For most of those decades, he's been in the courtroom as much as he's been in the field. Grynberg claims that the petroleum industry has a habit of stealing from well owners like himself.

Grynberg: Litigation is the only way to do it, in the United States, in a free, democratic society. There's no other way.

Brady: You're not well liked in some parts of the industry, are you?

Grynberg: Who, me? That's understatement. I think I'm hated.

Brady: Grynberg's success in court is mixed, but he has won multi-million-dollar settlements. Most of the cases are against the pipeline companies that transport gas from wells to the market. Those companies measure the volume and heating content of the gas and then send a check to the well owner. But Grynberg says they under-measure both of those things.

Grynberg: They steal approximately 30 percent of the natural gas produced.

Brady: Grynberg has compiled a list of more than a dozen ways that he claims the pipelines steal gas. For example, he says companies put unnecessary bends in pipes and other obstructions just before the point where a probe measures how much heat the gas can produce. He says that pushes the heavier hydrocarbons toward the wall of the pipe and the probe in the middle can't measure them. The heating content of the gas appears lower than it is and the well owner is paid less. Many of these wells are on federal land and Grynberg says he tried to warn the government, but no one would listen.

Grynberg: I said, these guys are stealing from you. We're studying it; call back. Call back: We're still studying. Don't call us, we'll call you. That was in the winter of '92.

Brady: A few years later, Grynberg filed a case under the False Claims Act. It allows individuals to file a lawsuit on behalf of the government. If Grynberg is successful, the False Claims Act allows him to keep a portion of the money. Think of him as a corner office bounty hunter. And in this case, we're talking about a lot of money.

Grynberg: Thirty-five billion dollars, subject to triple damages, subject to mandatory penalties. They all add up to over \$400 billion dollars.

Brady: And the False Claims Act allows the person who reports it to get somewhere between 15 and 30 percent. I think you would automatically become the richest person in the world.

Grynberg: I don't think so, but I intend to give it to charity.

Brady: Grynberg later modified that statement. He would recover his legal costs first; he claims to have spent \$20 million so far. And he'd use some of the money to do more oil and gas exploration. That is, if he ever saw any money at all. The resolution of the case likely is a long way off. Patrick Burns (sp?) is with the False Claims Act Legal Center.

Patrick Burns: "Mr. Grynberg is essentially David engaged in a war not with one Goliath, but with an army of Goliaths."

Brady: Look at the list of defendants. Shell, Unocal, Conoco, Kerr-McGhee.

Burns: The oil companies have unlimited resources to put into litigation, slowing down discovery. They can hire law firm after law firm.”

Brady: And so far, that’s exactly what they’ve done. Grynberg filed his lawsuit in 1997. Nine years later, the court hasn’t even begun to weigh the merits of his arguments. So far both sides are still fighting over whether Grynberg has the right to file the case, and whether the law suit even qualifies under the False Claims Act. The defendants and their lead attorney wouldn’t comment for this story. NPR also contacted academic experts and industry consultants, but they also declined do comment., some citing Grynberg’s litigious history as a reason. Grynberg says he can hold on as long as the companies want to drag this out. If he dies, he says his children will take over the case. Jeff Brady, NPR News, Denver.

Lawmakers need to provide independent analysis of gas deal

By Dermot Cole

GAS CONTRACT: During the 11 days of presentations about the proposed gas line contract, the lawyers, consultants and executives of the Murkowski administration worked hard to sell the deal.

What was missing was independent analysis by people not connected to the agreement.

It was all pro, no con.

When a legislator asked about weaknesses in the contract, Murkowski consultant Pedro van Meurs sidestepped the question. He wasn't about to identify shortcomings.

"No contract is perfect," he said. "Everything is a balance."

He said his job was to explain all the details so "the Legislature can judge what the weaknesses and the strengths are, because that is often a very personal judgment, how you feel about those things."

Most of our legislators are not experts in petroleum finance, law, accounting or geology. To produce the right result for Alaska, the experts hired by our state need to be forthcoming with their opinions about strengths and weaknesses in this agreement and they must discuss the issues in public.

During a review of the constitutionality of locking in oil and gas taxes, Attorney General David Marquez mentioned that a lawmaker had asked him, "What's the other side to all of this?"

Marquez didn't address the other side because "I was asked to give an opinion that would support the constitutionality" of the contract and explain the administration's reasoning.

He said the other sides of that issue "will be vigorously argued over the rest of the summer."

We can hope for thoughtful deliberations, but that will be tough because the gas pipeline is already the dominant issue in the governor's race.

The Murkowski administration has created a Web site with thousands of pages about the proposed gas line contract. These documents are accessible to anyone and I'm glad they've been made available.

Fairbanks Daily News-Miner, May 28, 2006 (Continued)

But informed debate among Alaskans requires a different type of communication and a different type of presentation than we've had so far.

It's not enough for the governor to declare that it's a "terrific" contract and expect everyone to stand up and cheer.

What's missing from the administration presentations and the thousands of pages is a clear catalog of the concessions our state is being asked to make in this agreement.

The provisions of the contract are so complicated that those of us who are not trained in law, economics, government regulation and oil company accounting, will find it impossible to figure out what tradeoffs are proposed.

The men and women who represent us in the Legislature are in the same position.

The state enters contracts all the time, but that word is inadequate to describe what is proposed in this document.

It's not like a deal to build a road or put up a building where everyone knows the ground rules. Instead, this is an agreement to create a new and unique relationship between the state and the oil companies, changing everything from taxes and regulatory powers to rules on sovereignty and the settlement of disputes.

It would make the state a business partner with the major oil companies, a partner with a minority interest and limited powers.

Before proceeding on this course, we must have a thorough understanding of what the new relationship would mean for Alaska's future.

In his closing comments to the legislators who attended the 11-day presentation in Juneau, Revenue Commissioner Bill Corbus said "the contract needs to be looked at as a whole, as anyone can nitpick any particular section or issue."

"Keep in mind that negotiating a deal, such as this contract, requires give and take in order to reach an agreement that's acceptable to all parties," he said.

Contrary to his comments, it is essential that the Legislature review this contract down the placement of the last comma.

Far from nitpicking, it's the only way to determine who's giving, who's taking and how much.

Fairbanks Daily News-Miner, May 28, 2006 (Continued)

Just about everyone in Alaska wants to see a gas pipeline. But to build a consensus on this agreement that will last beyond the next election, Alaskans must see the complete picture of tradeoffs and benefits.

Oil analyst Richard Fineberg has researched and written about the oil industry in Alaska for more than 30 years, both as a private citizen and a government employee. He makes a good point in saying that those who negotiate a deal tend to fall in love with it and can't be objective about its shortcomings.

That's why it will fall to the Legislature, not the Murkowski administration, to provide the independent analysis Alaskans need on this contract.

Independent experts with no vested interest need to review all aspects of this agreement. A second, third or fourth opinion may be required.

This work by consultants has already started under the Legislative Budget and Audit Committee, chaired by Sen. Gene Therriault, and it should continue for as long as it takes.

I expect there will be great pressure on lawmakers to act on this contract before the election, but that has everything to do with the election and nothing to do with the contract.

There have already been ads saying, "WORK BEGINS 90 DAYS AFTER CONTRACT SIGNING." The 90-day figure refers to early planning. A decision on whether to actually build a gas pipeline would not be made for at least four years.

Those pushing for immediate action on a new relationship that is supposed to last for nearly a half-century would do well to remember the advice playwright William Congreve offered three centuries ago: "Married in haste, we may repent at leisure."

Because of questionable assumptions and choices made long ago in haste, the state spent many years and hundreds of millions of dollars fighting over words and phrases in oil leases and tax legislation.

Under this gas line document, the state would give up its right to sue, so that part of legal history won't repeat itself, leaving Alaskans with the right to scream.

The Legislature should err on the side of caution in acting on this measure. If that means the work has to continue after the election, so be it.