**ALASKA STATE LEGISLATURE**
**HOUSE RESOURCES STANDING COMMITTEE**
March 5, 2007
1:01 p.m.

**MEMBERS PRESENT**

Representative Carl Gatto, Co-Chair
Representative Craig Johnson, Co-Chair
Representative Bob Roses
Representative Paul Seaton
Representative Peggy Wilson
Representative Bryce Edgmon
Representative David Guttenberg

**MEMBERS ABSENT**

Representative Vic Kohring
Representative Scott Kawasaki

**OTHER LEGISLATORS PRESENT**

Senator Fred Dyson
Senator Gary Stevens
Senator Gene Therriault
Representative Anna Fairclough

**COMMITTEE CALENDAR**

HOUSE BILL NO. 26
"An Act relating to aquatic farm permitting involving geoducks and to geoduck seed transfers between certified hatcheries and aquatic farms."

- MOVED CSHB 26(FSH) OUT OF COMMITTEE

PRESENTATION: INITIAL BRIEF OF THE FERC TRIAL STAFF

- HEARD

**PREVIOUS COMMITTEE ACTION**

BILL: HB 26
SHORT TITLE: GEODUCK AQUATIC FARMING EXEMPTION
SPONSOR(s): REPRESENTATIVE(s) SEATON

01/16/07 (H) PREFILE RELEASED 1/5/07

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|---|---|---|
| 01/16/07 | (H) | READ THE FIRST TIME - REFERRALS |
| 01/16/07 | (H) | FSH, RES |
| 02/02/07 | (H) | FSH AT 8:30 AM CAPITOL 124 |
| 02/02/07 | (H) | Heard & Held |
| 02/02/07 | (H) | MINUTE(FSH) |
| 02/05/07 | (H) | FSH AT 8:30 AM CAPITOL 124 |
| 02/05/07 | (H) | Heard & Held |
| 02/05/07 | (H) | MINUTE(FSH) |
| 02/07/07 | (H) | FSH AT 8:30 AM CAPITOL 124 |
| 02/07/07 | (H) | Moved CSHB 26(FSH) Out of Committee |
| 02/07/07 | (H) | MINUTE(FSH) |
| 02/08/07 | (H) | FSH RPT CS(FSH) 1DP 4NR |
| 02/08/07 | (H) | DP: SEATON |
| 02/08/07 | (H) | NR: LEDOUX, JOHANSEN, HOLMES, EDGMON |
| 02/23/07 | (H) | RES AT 1:00 PM CAPITOL 124 |
| 02/23/07 | (H) | Heard & Held |
| 02/23/07 | (H) | MINUTE(RES) |
| 03/05/07 | (H) | RES AT 1:00 PM BARNES 124 |

**WITNESS REGISTER**

JOHN KATZ, Deputy Associate Counsel for Energy Projects
Federal Energy Regulatory Commission
Washington, D.C.
POSITION STATEMENT: Reviewed the procedures of the case.

KATE GIARD, Chairman
Regulatory Commission of Alaska
Anchorage, Alaska
POSITION STATEMENT: During presentation related to the FERC case, answered questions.

CARMEN GENTILE, Attorney at Law
Bruder, Gentile & Marcoux, L.L.P.;
Counsel for Regulatory Commission of Alaska
Washington, D.C.
POSITION STATEMENT: Testified that the objective in the current FERC litigation is to protect the sovereignty of the state over the setting of rates for oil transportation within its jurisdiction.

STEVEN BROSE, Attorney at Law
Steptoe & Johnson L.L.C.;
Counsel of Record for the TAPS owners
Washington, D.C.
POSITION STATEMENT: Spoke as one of the counsel of record for the TAPS owners in the FERC proceeding.

PHILLIP REEVES, Assistant Attorney General
Oil, Gas & Mining Section
Criminal Division (Juneau)
Department of Law
Juneau, Alaska
POSITION STATEMENT: Testified that the state's brief seeks to correct the unjust discrimination and undue prejudice.

MARK HANLEY, Public Affairs Manager
Anadarko Petroleum Corporation
Anchorage, Alaska
POSITION STATEMENT: Discussed how Anadarko came to file a case on the interstate rate.

KIP KNUDSON, External Affairs Manager
Tesoro Alaska Pipeline Company
Anchorage, Alaska
POSITION STATEMENT: Highlighted points in the brief important to Tesoro.

ROBIN BRENA, Attorney at Law
Brena, Bell & Clarkson, P.C.
Anchorage, Alaska
POSITION STATEMENT: Testified that the TSM was a bad deal for the state, resulting in rates that are twice what they should be.

JONATHAN IVERSEN, Director
Anchorage Office
Tax Division
Department of Revenue
Anchorage, Alaska
POSITION STATEMENT: Presented scenarios in regard to possible FERC rates.

JOYCE LOFGREN, Economist
Tax Division
Department of Revenue
Anchorage, Alaska
POSITION STATEMENT: During Department of Revenue's presentation, answered questions.

JOHN RUSH, Oil & Gas Revenue Auditor
Tax Division
Department of Revenue
Anchorage, Alaska

POSITION STATEMENT: During Department of Revenue's presentation, answered questions.

**ACTION NARRATIVE**

**CO-CHAIR CARL GATTO** called the House Resources Standing Committee meeting to order at 1:01:40 PM. Representatives Gatto, Johnson, Wilson, Seaton, Roses, and Guttenberg were present at the call to order. Representative Edgmon arrived as the meeting was in progress. Also in attendance were Senators Dyson, Stevens, and Therriault and Representative Fairclough.

HB 26-GEODUCK AQUATIC FARMING EXEMPTION

1:02:07 PM

CO-CHAIR GATTO announced that the first order of business would be HOUSE BILL NO. 26, "An Act relating to aquatic farm permitting involving geoducks and to geoduck seed transfers between certified hatcheries and aquatic farms."

1:03:02 PM

REPRESENTATIVE ROSES moved to report CSHB 26(FSH) out of committee with individual recommendations and the accompanying fiscal notes.

1:03:08 PM

REPRESENTATIVE GUTTENBERG objected for purposes of discussion. Representative Guttenberg said that it would be wonderful to have the opportunity to build another industry. However, placing the department and scientists in a position of proving a negative is of concern. He questioned the impacts of expanding the geoduck fishery into areas where geoducks aren't [naturally occurring]. He then withdrew his objection.

1:03:54 PM

REPRESENTATIVE WILSON objected for discussion purposes. She opined that there are many unknowns in this situation, such as in regard to sterile geoducks. She said that she has some reservations. She then withdrew her objection and noted that she won't be voting for the legislation.

1:04:22 PM

There being no further objection, CSHB 26(FSH) was reported from the House Resources Standing Committee.

PRESENTATION: INITIAL BRIEF OF THE FERC TRIAL STAFF

1:05:05 PM

CO-CHAIR GATTO announced that the next order of business would be a presentation regarding the initial brief of the Federal Energy Regulatory Commission (FERC) trial staff.

1:06:10 PM

JOHN KATZ, Deputy Associate Counsel for Energy Projects, Federal Energy Regulatory Commission, began by informing the committee that because this matter is under litigation, he can't really go into details about the case. He noted that the positions of commission staff are just that and not the position of the commission itself. Similarly, Mr. Katz specified that his remarks relate to his position, not that of the FERC or any of the commissioners. He then informed the committee that procedurally, in terms of the FERC's processing of this case, all the interested parties filed initial briefs that followed a long set of hearings before an administrative law judge. The parties can then file reply briefs in which they try to rebut the position of others, which are due March 21, 2007. The initial decision of the administrative law judge is expected in May. Once that is issued, the parties have 30 days to file briefs on exceptions, which essentially explain what they believe is wrong with the judge's decision. The parties have 20 days thereafter to file briefs opposing exceptions. The matter then goes before FERC, which doesn't have a set time table or deadline by which it must act on the administrative law judge's hearing. Once FERC issues its decision, it's subject to rehearing before FERC. Once parties have filed a request for rehearing, FERC issues an order of rehearing. At this point, the matter is eligible to go to the U.S. Court of Appeals.

1:09:01 PM

CO-CHAIR GATTO surmised then that it's likely that the matter [won't go to the U.S. Court of Appeals] until the end of the year.

MR. KATZ said that's a likely timeframe. He pointed out that the FERC doesn't have a statutory deadline so [the timing]

depends on the complexity of the matters raised before the FERC as well as the time it takes FERC staff to prepare a draft order and the FERC to review it. Mr. Katz noted that there are five commissioners [in Washington, D.C.] and they issue orders acting as a body. By way of background of the case, Mr. Katz related that in 1985 there was a FERC-approved settlement of an ongoing TAPS case. He explained that when the FERC approves a settlement, it applies a different standard than if it were acting itself under a statute. Therefore, the FERC reviews whether the settlement is fair and reasonable. If the FERC is determining a rate case, as it is in this instance, it's required by the Interstate Commerce Act to determine whether the rates are just and reasonable. The aforementioned is done on a cost-base rate process, which is very complex. In this case, the settlement has been in place for a number of years and one party made a filing suggesting that the rates in question weren't just and reasonable and requested that cost-base rates be set. The FERC is in the process of doing so in this proceeding. Mr. Katz related that in the brief of FERC staff it was indicated that the position taken by the state was consistent with what FERC staff believed to be the correct procedure. He mentioned that the brief also mentions the [Regulatory Commission of Alaska (RCA)], its rates, and how those relate to the interstate rates.

1:11:46 PM

REPRESENTATIVE GUTTENBERG related his understanding that the settlement is a larger issue itself. He asked if it's Mr. Katz's opinion that the state received a fair deal on this settlement.

MR. KATZ answered that the state would have to make that judgment call.

1:13:11 PM

KATE GIARD, Chairman, Regulatory Commission of Alaska (RCA), related that she believes it will be helpful for the committee to speak with the RCA's FERC counsel, Mr. Gentile, who represented the RCA in this matter. She then offered to answer any questions of the RCA.

1:14:10 PM

CARMEN GENTILE, Attorney at Law, Bruder, Gentile & Marcoux, L.L.P., Counsel for Regulatory Commission of Alaska, stated that

[the RCA] has one objective in the current FERC litigation: to protect the sovereignty of the state over the setting of rates for oil transportation within its jurisdiction. The RCA didn't seek out this case, rather it was thrust on the RCA by the TAPS carriers. Without speculation regarding motivation, Mr. Gentile opined that the carriers were upset that the TAPS settlement was being challenged. Furthermore, the carriers give the impression of attempting to strike out in every direction in order to maintain the settlement arrangement that they have, which they perceive to be to their advantage. The tool that the carriers are using to encroach on the state's jurisdiction is Section 13(4) of the Interstate Commerce Act (ICA). He explained that the aforementioned provision originated in legislation that was under the jurisdiction of the Interstate Commerce Commission (ICC) and mainly applied to railroad traffic. Basically, Section 13(4) created, in extraordinary circumstances, an ICC right to override a state regulatory determination. The aforementioned could only be exercised in extraordinary circumstances, he emphasized. Congress was clear in its recognition that the state had paramount authority over intrastate rates. Congress permitted the federal override only in circumstances of clear discrimination and circumstances when the state's rate was so low that it created a burden on interstate commerce. The Supreme Court, in its interpretation of Section 13(4), has maintained the state's regulatory authority over intrastate rates was to be respected. He noted that the state's regulatory authority could only be overturned in the following circumstances: when detailed findings were made to illustrate that discrimination existed, there were unfair advantages conferred on intrastate shippers, or in circumstances in which the state's rates were so low that they weren't making a fair contribution to the carriers' overall cost.

1:18:10 PM

MR. GENTILE said that the question is whether Section 13(4) has ever been used with respect to oil transportation, to which he said no. The provision was chiefly aimed at railroads. Whether Congress really intended the provision to apply to oil transportation is dubious, he opined. The aforementioned was pointed out to the administrative law judge in the briefs that were submitted for her consideration. Mr. Gentile said that [the RCA] has also pointed out to the judge that basically the TAPS carriers have failed to submit any evidence supporting a claim under Section 13(4) to reduce the state rates. The evidentiary deficiencies were of two kinds. First, the carriers

didn't submit any cost of service evidence, but rather the carriers' evidence was hypothetical evidence based on the TAPS settlement which uses hypothetical costs. He noted that the carriers submitted two other technical analyses that were also predicated on hypothetical costs. Mr. Gentile said that [the RCA] told FERC that unless actual cost of service evidence was submitted, there was no way FERC could determine that the rates were too low or discriminatory. He opined that all participants in the proceedings, save the TAPS carriers, agreed with the RCA's position. Mr. Gentile then highlighted that [the RCA] contended that the carriers hadn't submitted any evidence to illustrate any burden on interstate commerce.

1:21:10 PM

MR. GENTILE explained that he has made the aforementioned contentions in the hearing and has defended the sovereignty of the Alaska process and the integrity of the RCA's ratemaking process in its Order 151. Of particular importance is that the carriers, through the TAPS settlement, collected accelerated depreciation over a number of years. In ratemaking, the more depreciation is taken, the smaller the investment base because the accumulated depreciation is subtracted from the rate base. The carriers asked not to recognize that historical actual depreciation, which puts them in the position of seeking a double recovery. He noted that he hasn't made any contentions regarding the interstate rates, but has pointed out to FERC that considering the interstate rates the RCA appropriately took into account these depreciation recoveries. The matter, in terms of the initial brief, has now been submitted to the administrative law judge. The RCA will submit reply briefs March 21st. As indicated earlier, all of the parties in the case, except the carriers, support the State of Alaska's position. Mr. Gentile opined that the administrative law judge was sensitive to the RCA's views, and therefore he is optimistic that the administrative law judge will write a favorable decision. He concluded by relating that this case will likely go to the courts for final resolution.

1:24:10 PM

CO-CHAIR GATTO inquired as to how the rates the state is paying would be impacted if the decision was made that the producers have to charge a lower rate to the complainants.

MS. GIARD related that the aforementioned question will likely be answered by Anadarko Petroleum Corporation (Anadarko) and

Tesoro Alaska Company (Tesoro) during its presentation. The RCA wouldn't have a position on the impact of interstate rates and the rate the RCA has deemed just and reasonable.

1:25:12 PM

REPRESENTATIVE GUTTENBERG requested more explanation of the earlier reference to double recovery.

MS. GIARD again said that the answer would be better presented by Anadarko and Tesoro as it's a component of the interstate case.

1:26:06 PM

STEVEN BROSE, Attorney at Law, Steptoe & Johnson L.L.C.; Counsel of Record for the TAPS owners, clarified that he isn't appearing today to discuss the merits of the issues in the FERC case or to argue in favor of the TAPS owners' position in the case. The TAPS owners have submitted a detailed legal brief that defends the rates as lawful under the governing standards and in compliance with the TAPS settlement agreement. Therefore, it's appropriate to allow the FERC decision makers to rule on the issues based on the arguments in that brief and those filed by the other party. He specified that his comments will focus on the procedural status of the case and how it can be expected to unfold going forward. With regard to the FERC proceeding, that case relates to the TAPS interstate tariff rates. The TAPS interstate tariff rates are the rates for service on TAPS for barrels that travel the full distance to Valdez and are loaded on tankers for destinations outside of Alaska. The interstate rates at issue in the FERC case are for the years beginning 2005. The TAPS intrastate tariff rates, which are the rates for service to destinations within Alaska, apply to a relatively small portion of the total TAPS volumes. Those rates were the subject of the separate proceeding before the RCA, which ordered a rate reduction that's resulted in lower intrastate rates than interstate rates at issue in the FERC case. However, one must keep in mind that the RCA decision is still subject to active litigation. In fact, it's currently under consideration by the Alaska Supreme Court.

1:28:32 PM

MR. BROSE explained that in the FERC proceeding the TAPS owners are defending the interstate tariff rates that each of the owners filed with FERC in compliance with the agreed upon rate

methodology provided in the TAPS Interstate Settlement Agreement. The aforementioned agreement is a binding, long-term contract entered into in 1985 by the State of Alaska and the TAPS owners to settle a lengthy and complex litigation regarding the TAPS tariffs. The terms of the settlement represented compromises on both sides. The agreement was presented to FERC, which approved it, and was subsequently approved by a federal court of appeals in 1985 and 1986. The agreement has established a ceiling on TAPS rates since that time. Mr. Brose highlighted that the agreement could terminate as early as the end of 2008, if a new agreement is not reached by the TAPS owners and the state in the interim. Tesoro, a TAPS shipper at the time, wasn't a participant in the interstate settlement and Anadarko has never been a TAPS shipper and only produced its first barrel in Alaska that was shipped by others through TAPS some 15 years after the settlement agreement.

MR. BROSE stated that the principle issue in the FERC case is whether the TAPS interstate rates since 2005 satisfy the ICA requirement that they be just and reasonable. The just and reasonable rate standard, he explained, is intended to ensure that the pipeline rates are fair to both the ratepayers, the shippers who are the direct customers of the pipeline, and the pipeline's investors. The case was tried over the course of about two and a half months before an administrative law judge. The record presented included written testimony of some 35 witnesses, the majority of which were sponsored by the TAPS owners, and totaled nearly 7,000 pages of transcript with more than 800 exhibits. Mr. Brose then reviewed the course of the case as laid out earlier by Mr. Katz. When the administrative judge issues her recommended decision, participants can take exception to that decision in briefs to be filed with the FERC commissioners. He emphasized that the decision of the FERC commissioners will reflect FERC's position, which he expected will be appealed to a federal appeals court by either side.

1:31:24 PM

MR. BROSE highlighted the importance of understanding that in reaching the substantive decisions in the case, neither the administrative judge nor FERC are bound to adopt or give special consideration to the position of the FERC trial staff. Furthermore, it can't be presumed that the administrative judge or the FERC commissioners agree with the staff's view. History has shown many times when the FERC trial staff position hasn't been adopted by either the hearing judge or the FERC commissioners. In the TAPS case, the FERC trial staff's brief

presents the views of a single participant in a large and complex proceeding. The trial staff often sponsor witnesses and cross-examine the witnesses of other parties in a case. In this case, the trial staff elected to do neither of the aforementioned. He noted that six other briefs with widely varying positions were submitted at the same time of the staff's brief. Responsive briefs are due by all participants by March 21st. Under FERC's rules, trial staff isn't permitted to communicate about the case with the decision makers other than through briefs and other on-the-record submissions. Mr. Brose related his belief that the large number of complex legal issues involving matters of contract, statutory interpretation, as well as regulatory policy are properly entrusted to the current process before FERC. However, one must remember that the TAPS owners are vigorously defending the lawfulness of their rates and opposing the positions of those who have presented against them. He offered to provide the committee with the other briefs filed in the case, including those of in-state refiners other than Tesoro.

1:33:25 PM

MR. BROSE then related that the TAPS owners wish to emphasize the procedural status of the case as it stands today. Mr. Brose reiterated that a range of views have been presented to the administrative law judge in the form of initial briefs. However, none of those, including that of the FERC trial staff is entitled to any special deference. In conclusion, Mr. Brose said:

> The case is in the very early stages of its decision-making process, not even the initial recommended opinion by the administrative law judge has yet been issued, and an ultimate decision will not be announced [for] some time, maybe quite some time in the future, and perhaps not even until after exploration of the settlement agreement itself. The staff brief and the positions of Anadarko and Tesoro that you've heard about today are not determinative of any outcome. And we believe it's premature to even speculate on the precise outcome of the case before a final resolution is reached.

1:34:34 PM

SENATOR GENE THERRIAULT, Alaska State Legislature, related that he has been struck by the fairly strong language used in the

brief. Furthermore, the individual who wrote the brief is an individual who is charged with understanding such issues, but doesn't have "a dog in the fight" except that [FERC] may make an argument for the preservation of the precedent it set in the past. He asked if Mr. Brose could comment on that. He also inquired as to Mr. Brose's view of the language, "to agree with that particular opinion would abrogate decades of FERC precedent."

MR. BROSE related that [the TAPS owners] will be responding to the FERC trial staff brief on March 21st. He said he anticipated pointing out many instances in which the staff's brief is inconsistent with settled FERC policy. He recalled that the FERC trial staff wasn't one of the supporters of the TAPS settlement agreement at the time, but he said he wouldn't speculate the extent to which such is effecting positions today. In further response to Senator Therriault, Mr. Brose related that Mr. Dennis Melvin, Director of the Legal Division, has been with FERC for quite some time. In fact, Mr. Melvin and Mr. Brose were both [with FERC] when the original case resulted in the TAPS settlement agreement in 1985.

1:37:44 PM

MR. BROSE, in response to Co-Chair Gatto, clarified that his comments were that FERC staff was in disagreement. In further response, Mr. Brose informed the committee that the FERC commissioners approved the TAPS settlement agreement. Along the way briefs were submitted to FERC. He recalled that FERC staff was not among the parties actively supporting the TAPS settlement agreement, which was supported by the TAPS carriers, the State of Alaska, and the U.S. Department of Justice.

1:38:34 PM

CO-CHAIR GATTO surmised that once FERC has an agreement among the parties, it essentially withdraws and doesn't object.

MR. BROSE expressed the need to distinguish between the staff and the commissioners, who certainly don't have to accept a settlement agreement among the parties. The FERC staff, as a participant in the case, is entitled to present whatever views it wants with respect to whether the agreement should or shouldn't be accepted.

1:39:19 PM

SENATOR THERRIAULT clarified, "That acceptance was not an admission by the commissioners themselves that the underlying settlement would hold up to scrutiny under FERC rules on whether the resulting tariff was just and reasonable."

MR. BROSE noted his agreement, adding that it was accepted as an uncontested settlement as fair and reasonable in the public interest rather than the language "just and reasonable".

1:39:51 PM

PHILLIP REEVES, Assistant Attorney General, Oil, Gas & Mining Section, Criminal Division (Juneau), Department of Law (DOL), began by relating that he is DOL's manager of the case for the state's position. Mr. Reeves explained that the current FERC litigation consolidates state protests of the 2005 and 2006 TAPS rates on the grounds of unjust discrimination and undue prejudice and protests of Anadarko and Tesoro that the rates aren't just and reasonable. Therefore, the state's protests are on substantially different legal grounds than that of Anadarko Petroleum and Tesoro. Mr. Reeves stated:

> The state's protest is grounded in the TAPS settlement agreement. The settlement agreement expressly provides that, "Not withstanding any other provisions of the agreement, rates charged are subject to legal prohibitions on unjust discrimination and undue prejudice." The state's protest, therefore, is actually seeking to enforce a specific term of the settlement agreement. One of the main reasons that we are on such a different legal path than Anadarko and Tesoro is Anadarko and Tesoro are now parties to the settlement agreement. In so far as rates are filed in conformance with the settlement agreement, the state, as a party to that agreement, will not protest them. But, as I've said, here we have an express term that is actually included in the TAPS settlement methodology. The methodology by which the annual rates are calculated, this is the final term of the methodology and it says, "Not withstanding any other term, the rates charged cannot violate legal prohibitions on unjust discrimination and undue prejudice." Those legal prohibitions are found in the Interstate Commerce Act and it's under the Interstate Commerce Act that oil pipelines are regulated.

1:42:48 PM

MR. REEVES continued:

> The state is not here requesting a specific amount of dollar damages, it's simply requesting a correction of the unjust discrimination and undue prejudice in accord with ICA Sections 2 and 3. We seek to have the interstate rates lowered to a level at or near the intrastate rates, to within a zone of reasonableness determined by the commission, based on the fact that the TAPS carriers are charging substantially divergent rates for essentially the same service, the service of shipping oil from Pump Station 1 on the North Slope to Valdez. I know that there were questions regarding calculations of what could possible refunds be, what could the dollar amount in issue in this case be. The calculation of the total amount of potential refunds is subject to a lot of variables: annual throughput, the amount of the rate reduction that might be ordered for each year of the protest, the percentage of the state's interest through royalties and production taxes in the oil. I understand that you've requested that the Department of Revenue (DOR) testify today and I have spoken with them. They've run a calculation, and from a professional economist perspective, that is illustrative of what might be the high end of some refunds. But at this point in time, the state's brief isn't asking particular dollar amounts, we're seeking to correct this legal prohibition on unjust discrimination.

1:44:19 PM

CO-CHAIR GATTO asked then if Mr. Reeves is suggesting that were a settlement to be made, the state wouldn't ask for refunds from any past excess charges.

MR. REEVES clarified that the state isn't taking any position that it wouldn't seek its share of refunds. In further response to Co-Chair Gatto, Mr. Reeves explained that under the TAPS settlement agreement the TAPS carriers file new rates annually. Once a rate is filed, it may be protested within 30 days. The state protested the 2005 rates that were filed in 2004 based on the fact that the intrastate rates were $1.96 under the RCA determination and the carriers average charge was approximately $4.00 per barrel. The rates filed for 2006 and 2007 for interstate shipments are higher than 2005 rates. Therefore, the

state has filed protests for the 2006 and 2007 rates as well. He noted that RCA Order 151 determined the just and reasonable level of rates for the intrastate shipments. As Mr. Brose stated earlier, the aforementioned order is subject to legal proceedings and is currently at the Alaska Supreme Court.

1:46:24 PM

SENATOR THERRIAULT posed a situation in which the challenging parties, Anadarko and Tesoro, are successful in obtaining a lower tariff. The aforementioned would work back through the taxation and royalty valuation system and funds would accrue to the state as a result of the success of the challenging parties.

MR. REEVES noted his agreement with Senator Therriault. He highlighted that the state is not a shipper on the pipeline. The tariffs come into play in the calculation of the state's financial interest in the determination of the wellhead value of the oil. He then pointed out that under the state's leases, the state can take the royalty in-value at the wellhead, but that has to be known. Most of the oil is sold on the West Coast, there's a netback calculation that allows deduction of tankerage and tariff cost. Therefore, if the interstate tariff were reduced to the level of the intrastate tariff, then that would relate back to the determination of the wellhead value and the state would receive additional funds.

1:48:03 PM

SENATOR THERRIAULT remarked that the state was only able to claim unjust discrimination because Anadarko and Tesoro went to the RCA requesting a lower intrastate rate. He asked if the aforementioned provided the state the opportunity to make the claim that the formula was being applied improperly because of the disparity between the intrastate and interstate tariffs.

MR. REEVES confirmed that the intrastate rate is widely divergent from the interstate rate, which brings the state into the express provision of the TAPS settlement agreement that denies charging of discriminatory rates.

SENATOR THERRIAULT surmised then that being partners with the companies initially on the settlement methodology bound the state's hands. Even if the state felt that there should be a lower tariff, it wasn't until someone else protected their rights that the state was provided a platform upon which it could build its case.

MR. REEVES said that the state's case is definitely founded in the nondiscrimination provision of the TAPS settlement agreement. Prior to when the RCA reduced the level of the intrastate rates, those rates were calculated under a settlement agreement that's virtually identical to the interstate settlement agreement. Therefore, the rates were nearly always identical and there wasn't discrimination or grounds for a protest such as the state has levied now.

1:49:48 PM

CO-CHAIR GATTO posed a scenario in which the producers were to overwhelming win, and asked whether the RCA would be required to raise the rate up to the level of what the methodology would require from the producers.

MR. REEVES related that the TAPS carriers have argued in response to the state's discrimination claim and Anadarko Tesoro's claim that it's the intrastate rates that are set at an inappropriate level. Section 213(4) of the ICA is cited as giving authority in certain circumstances for the FERC to order an increase in the intrastate rates. However, the burden for that is much greater than the burden to lower the interstate rates under section 2 or 3 of the ICA. Those [sections] require a showing that the intrastate rates don't cover a fair share of their costs, which is a burden the carriers are required to meet in this process in order to prevail. Failure to show the aforementioned results in sections 2 and 3, which merely review whether the difference in rates are outside a zone of reasonableness and only allows for the remedy of lowering the interstate rate.

1:51:11 PM

CO-CHAIR GATTO opined that often in the state it's a situation in which a company has shareholders and the RCA tries to defend the shareholders by ensuring that all of the costs are recovered. He related his understanding that the RCA has already evaluated that the costs are recovered, and therefore have set the rate at $2.00.

MR. REEVES said that these questions are moving into the specific issues of the case, which he said isn't appropriate to enter into conversation about at this point in the litigation.

1:51:56 PM

SENATOR THERRIAULT highlighted from the staff report that there are many statements that the companies didn't provide adequate data or any data at all regarding whether the costs are just and reasonable. Under the companies' claim that the RCA rates should be raised, he asked if the companies will have to provide actual cost data showing that the rate should be raised in order to be just and reasonable.

MR. REEVES said that he suspects that the attorney for Anadarko Tesoro may be willing to speak more about this claim. He noted that the just and reasonable claim is an Anadarko Tesoro claim versus the State of Alaska's nondiscrimination claim. He, again, related his hesitation in getting into more detail about the case.

1:53:08 PM

MARK HANLEY, Public Affairs Manager, Anadarko Petroleum Corporation, began by noting that he had provided the committee with a copy of the press release dated November 27, 2002, from the RCA regarding its decision. The aforementioned opened Anadarko's eyes as to the rates in the state when the RCA claimed that there were $10 billion in excess collections in rates that were 57 percent too high. Therefore, Anadarko looked into the issue. Mr. Hanley informed the committee that Anadarko is a 22 percent owner at Alpine, which amounts to about 8 million barrels a year of production. When the intrastate rate is at $1.96 and the interstate rates for 2007 are over $5.00 a barrel, that amounts to about $3.00 a barrel. The aforementioned amounts to a fairly significant amount of money on Anadarko's 8 million barrels a year. He mentioned that the state's value would be much higher than that of Anadarko's. He then related that in November 2004 Anadarko filed a case on the interstate rate. He reiterated that it's a significant dollar amount to Anadarko, and added that it does impact expiration economics. Mr. Hanley commented that Anadarko is happy to have FERC staff support its position.

1:55:55 PM

KIP KNUDSON, External Affairs Manager, Tesoro Alaska Pipeline Company, related the following testimony:

> Tesoro Alaska is a value-added success story in our state. For 38 years, we've been manufacturing fuels for Alaskans with Alaska's resources. In fact, in

1977 Tesoro had the honor of being the first Alaska refinery to purchase crude shipped on TAPS. Today, we purchase roughly 30,000 barrels out of the North Slope. We buy every drop that's produced in Cook Inlet, roughly 17,000 [barrels]. And we're in the odd position of being an Alaskan refinery in this huge resource-rich state having to import oil to fill our refinery with crude. So, one of the reasons that we're in the case is we think that the economics need to be improved so that we can have an opportunity to buy more crude off the North Slope.

There are a couple of points that I'll just mention that are in the brief that are important to Tesoro. First, that the methodology agreed to by the TAPS owners, this is the TSM [TAPS settlement methodology] in no way precludes a party that was not signatory to that settlement in seeking a just and reasonable rate through the regulatory process. The second point, and it was also recognized in the brief, is that the TSM methodology ... does not tease out this just and reasonable rate. Tesoro's objective is simple, just and reasonable rates should be in effect for TAPS using the standard and accepted principles of ratemaking well known at both the federal and state regulatory levels. We believe that just and reasonable rates will have a significant benefit to the state, to the treasury, and have the added benefit of increasing exploration and development of marginal fields on the Slope.

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CO-CHAIR GATTO suggested that if the producer owns the pipeline, then the amount of the tariff almost doesn't matter because they are paying themselves. He asked if the state becomes a loser as the tariff increases when the producers are simply paying themselves.

MR. KNUDSON explained that the higher the costs associated with producing and shipping the oil, the lower the netback value at the wellhead. The state's taxation policy is based on the wellhead value.

SENATOR THERRIAULT added that the higher the transportation costs, the larger the fields have to be in order for to someone to put them into production and ship [the oil]. For the smaller

players that are not owners of the pipeline, the shipping cost is lost to another entity, the pipeline company. Therefore, there is the potential chilling effect on some exploration and development activities. Senator Therriault disclosed that he owns $5,000 in Tesoro stocks.

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ROBIN BRENA, Attorney at Law, Brena, Bell & Clarkson, P.C., informed the committee that he is the attorney who represented Tesoro in the proceeding before the RCA that lowered the state rate from $4 to $2. He also informed the committee that he is also the attorney representing Tesoro and Anadarko in the case requesting that FERC establish just and reasonable rates and lower the rates from $5 to $2. Mr. Brena explained that just and reasonable rates means that a carrier has an opportunity to recover its cost of operating a pipeline, the original investment, and a reasonable return on the investment that it hasn't yet recovered. The basic premise of just and reasonable rates or cost-based rates is that what someone is charged is based on the cost of providing service to them. Mr. Brena highlighted that the $1.96 rate the RCA established on TAPS was the first just and reasonable rate on TAPS in its 30 years of operation, which essentially cut the rate in half. He reminded the committee that the TAPS rates have gone from an average of $3 in 2004 to $5 on average in 2007 while the state rate has been $1.96, $2, which is the right rate. The amount the TAPS [carriers] are collecting over the $2 rate is excess return and essentially results in the TAPS carriers making a 100 percent return on their equity for each year they operate TAPS. Mr. Brena said that after going through the state and federal proceedings, every objective third party has said the right rate on TAPS is about $2. Those third parties include the RCA, the Alaska Superior Court, and the RCA staff. Mr. Brena mentioned that staff to Co-Chair Gatto was sent copies of the briefs of all parties.

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MR. BRENA, referring to slide 3 of the PowerPoint titled "Overview of TAPS Litigation to Establish Just and Reasonable Rates", highlighted that the 1985 settlement didn't establish just and reasonable rates and didn't purport to do so. Therefore, the TSM doesn't work to set cost-based rates. He pointed out that the TAPS carriers have an allowance per barrel for throughput that's $1.19, which has nothing to do with the costs. Furthermore, under the TSM [the TAPS carriers] are

allowed to make up whatever rate desired based on their subjective projections of cost and throughput. In fact, the rates among the [TAPS carriers] vary, although their costs are the same. Mr. Brena opined that the depreciation of TAPS under the TSM is erroneously based on an economic life of 2011 while it's commonly accepted that it's well beyond 2034. "So, the TSM doesn't work, never worked, was a bad deal for the state, and resulted in rates that are twice what they ought to be," he stressed. Mr. Brena then directed attention to page 4 of his presentation, which relates that through 2004 the TAPS carriers have collected $60 billion, invested $10 billion, and spent $15 billion operating the line. Therefore, the TAPS carriers have spent $25 billion to build and operate TAPS and have received a return of $60 billion. From any business standard, that's excessive. When one compares the $35 billion in return and taxes the TAPS carriers received compared to traditional ratemaking cost-based just and reasonable rates, the TAPS carriers over collected by $14-$18 billion depending upon the approach. The overcollection by the TAPS carriers was held by the RCA and observed by FERC staff and the Alaska Superior Court. Translating that overcollection into impact on the state was made more complicated by the petroleum production profits tax (PPT). Prior to the PPT, for every $1 the TAPS rate is too high, the state loses $.25 in royalty and severance taxes. Therefore, for a million barrels a day with a TAPS rate that's $1 too high, it amounts to $250,000 per day that it costs the state. Currently, the TAPS rates are between $2-$3 too high, which is a substantial amount of money in additional royalty and severance tax if FERC establishes just and reasonable cost-based rates by applying the traditional methodologies that the RCA did.

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MR. BRENA directed the committee's attention to slide 5, which compares TSM with two other methods. The comparison relates the excessive returns of the TAPS carriers. Mr. Brena reiterated that the proper rate is about $2, although under the TSM it's $4 and has increased to $5. In order to justify the rates before FERC, the TAPS owners did not elect to defend the rate elements in the TSM but rather presented a proxy case that they said represented cost-base ratemaking. He said that in order to get the rate close to what the TSM was, the TAPS carriers had to go back historically and put the already collected deferred earnings and accelerated depreciation in the rate base and request a return in taxes and request to collect it twice. The aforementioned is the basic flaw of the proxy case as it would

permit double recovery of the actual investment in TAPS by the TAPS owners.

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MR. BRENA identified dismantlement, removal, and restoration (DR&R) as another major issue, which is explored on page 10. From 1977 to date, the TAPS carriers have collected $1.5 billion in DR&R, which has largely been front-end loaded. The collections and earnings for the TAPS carriers amount to $17.2 billion in 2005 dollars. The TAPS carriers estimate that they only need $2.6 billion in 2005 dollars, which means that the TAPS carriers over collected by $14.6 billion to perform DR&R. Mr. Brena highlighted that one of the fundamental principles of ratemaking is that when one precollects a cost item from ratepayers, the entity isn't entitled to a return on the collection of operating costs. In this situation the TAPS carriers, with the ratepayers' money, have made over $15 billion in excess returns and refuse to acknowledge that it's refundable.

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MR. BRENA opined that it's important to note that in regard to just and reasonable rate matters, the FERC staff requested that the judge adopt the positions of Anadarko and Tesoro. He then directed attention to slide 11, titled "Indicators of a Bad Pipeline Deal". The indicators of a bad pipeline deal are as follows: the process was not transparent and competitive; rates are not based on the costs of providing service; access to existing and expansion capacity is limited; major rate and access issues are not resolved; the State of Alaska's inherent powers are restricted; no protections against self-dealing, affiliated transactions; linkage to nontransportation matters; economic assumptions are unknowable without reopeners; unnecessarily complex; and certainty is confused with predictability. Mr. Brena informed the committee that there was a meeting of all the independents regarding whether to negotiate a TSM 2 after the expiration of the existing TAPS methodology. Without exception, the independents who gathered said they could and would rather work with a predictable just and reasonable standard than an artificial rate based on certainty that may be too high for shippers and too low for the carriers.

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MR. BRENA then addressed the "bits and pieces and fair deal." He said:

> Nobody is saying you take part of a settlement and apply it going forward. What we're saying is that whatever the investment of the recovery profile was in the past, you recognize it in future rates because the ratepayers actually paid that amount. So, how do you transition from a settlement methodology to a just and reasonable methodology. We think you have to recognize the investment that you've already recovered once and you don't get a chance to recover it twice.

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CO-CHAIR GATTO asked if the Internal Revenue Service (IRS) has ever intervened such that it reviewed the books [of the TAPS carriers] and declared that the amount of tax paid from the filers was incorrect.

MR. BRENA responded that he isn't aware of any rate matter in which the IRS has ever intervened. With regard to DR&R, the collections of DR&R were assumed by the parties not to be deductible until the time of use, which means that deductions for the removal of line wouldn't be received until it was actually removed. After the deal was struck with the assumption of the need to collect a tax allowance, the carriers obtained a private letter ruling that allowed them to deduct $800 million. One of the problems with the DR&R estimates was that it was based on the assumption of a federal tax rate of 43, but it shifted to 36 and although it was assumed not to be deductible, that was changed.

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CO-CHAIR GATTO inquired as to the significance of allocating an allowance per barrel. He asked if it's traceable to a cost or something that requires it be there.

MR. BRENA reminded the committee that the allowance per barrel started at $.35 in 1981 dollars and was inflation adjusted until it went into effect in 1991. The allowance per barrel for 2006, the allowance plus the tax allowance, is $1.19 per barrel. In the case, it's uncontested that the allowance per barrel is a noncost element and isn't directly related to the cost of providing service. Generally, when a return on a pipeline is determined, the investment is reviewed. This is an allowance

per barrel that has nothing to do with the remaining investment. Essentially what has happened with TAPS is that the carriers were allowed to charge rates upfront that included a rapid accelerated depreciation. Therefore, the carriers received their investment upfront. As soon as the TAPS carriers recovered most of their investment, the allowance per barrel began and provided them a return element that's unlinked to the remaining investment, which was too low. Mr. Brena said that a key determinant of whether a rate is cost-based is whether the return element is linked to remaining investment or not. The allowance per barrel isn't linked to the return element and it's the primary way that the carriers are overcollecting a just and reasonable rate today.

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CO-CHAIR GATTO posed a scenario in which a person were to do accelerated cost recovery and recovered 95 percent of the cost and then switch to straight line. He asked if the switch is to only recover the remaining 5 percent or does the straight line go back as if it was there in the beginning.

MR. BRENA explained that the very concept of depreciation is that one is allowed to depreciate the actual cost, which was approximately $10 billion. Through 2006 the TAPS carriers collected $9.5 billion of the $10 billion invested, and therefore they only had $500 million left. The aforementioned is the basis on which the return is determined since the return is on the remaining investment. The carriers have put forth a case that has taken their actual investment level from $500 million to $2.5 billion and have sought to recover their investment twice. With regard to Co-Chair Gatto's proposed scenario, Mr. Brena said that the 5 percent remaining should be the basis for the future rates. The aforementioned is the case under Anadarko's and Tesoro's theory of the case, but not under the TAPS carriers' theory of the carrier. Mr. Brena explained:

> Under the carriers' theory of the case, they went back and took a half a billion dollars and they went back and sought to say that instead of the accelerated depreciation that they said that they were going to recover and that they did include in their filings and that they did charge their ratepayers. In over 100 filings, they went to go back and to restate those balances where the supporting schedule showed accelerated depreciation and that supported the rate. And they went back and tried to restate all those to

straight line. That's not the way cost-based rates are set.

2:22:58 PM

SENATOR THERRIAULT, referencing slide 11, directed the committee's attention to the bullet point regarding access to existing and expansion capacity is limited. He asked if Mr. Brena means that with a tariff that's too high, the bar is set too high in regard to economic access.

MR. BRENA responded that the aforementioned is intended to be a broader question than just TAPS. He pointed out that TAPS is a common carrier line, and therefore theoretically anyone can nominate into it. However, there are provisions in the tariff that restrict an individual's ability to shift from carrier to carrier. There are restrictions in total capacity by contract such that all the carriers and the state have agreed to the capacity limits. The aforementioned effectively reduces the possibility of competition among the carriers. Mr. Brena noted that TAPS includes restrictions on the tariffs on TAPS restricting how long crude oil may be stored at Valdez so that small producers have to pay large storage fees in order to accumulate sufficient crude oil for transportation out of the state. Setting aside TAPS, this point was focused more at the gas line, which would be a contract carriage line rather than a common carriage line. He opined that it's a bad deal when the first entity gets to tie up the entire line and control the market it's serving through the control of the infrastructure on the line.

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CO-CHAIR GATTO asked if it's typical for producers to own pipelines.

MR. BRENA said that producers own pipelines that are necessary to get the oil and gas resources they're developing to the market place. In the Lower 48 there are a lot of alternative lines. Generally, the lines associated with production are relatively short lines until they reach the pipeline infrastructure that is subject to regulation and thus that pipeline is subject to competitive forces due to the multiple selections of the pipeline grid of the Lower 48. However, in Alaska there is one pipeline from these fields and there will always be one pipeline whether it's the gas line or TAPS. Therefore, the terms for use of that pipeline need to be fair

for the producer and its affiliates as well as to subsequent independents [working] on marginal fields.

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REPRESENTATIVE SEATON recalled Mr. Brena's earlier comment regarding small carriers having to pay high storage fees in Valdez in order to accumulate enough product to transport. The aforementioned is an impediment to small explorers. He asked if that storage is part of the TAPS agreement or is it a separate charge through the Port of Valdez.

MR. BRENA said that it's a term and condition of each of the carriers' individual tariffs and isn't addressed by the 1985 TAPS settlement. Mr. Brena clarified that he didn't mean that the high storage costs is the only restriction. When reviewing an independent producer's ability to do business in Alaska, one must review whether there is open access to existing facilities within the leases and fields or whether the independent producers are forced to build duplicative facilities. Mr. Brena said that it's difficult for an independent producer, particularly for a marginal field, to bring it on line if field facilities aren't open. It's also difficult if the regulated facilities and transportation rates are too high because for every $1 the TAPS rate is too high, it's a $1 less per barrel of the value in the ground of the field. Therefore, a 300 million barrel crude oil field on the North Slope is worth $300 million less to that producer if the TAPS rate is a $1 too high. In this case, the rates are $2-$3 too high, which amounts to $1 billion dollars in net impact to the economics of an independent producer of a 300 million barrel field. Mr. Brena then pointed out that there are a series of barriers associated with tankage because there are only a few people who provide transportation service by tanker. All of the aforementioned are barriers to independent producers and illustrate that a system is in place that works for integrated major oil rather than for independents.

2:29:24 PM

JONATHAN IVERSEN, Director, Anchorage Office, Tax Division, Department of Revenue, said that he was asked to put together a scenario regarding the effects on state revenue due to possible FERC rates. At this point, it's quite speculative and would only be for illustrative purposes, he clarified. Mr. Iversen said that through 2008 there isn't any change in state revenue impacts. He said that in his scenario, the possible FERC rate

of $2 from 2005-2008 was used. The year 2008 was chosen because it's likely that the 2009 rates won't be filed under the TSA because the state has noticed renegotiation of the TSA and can terminate the agreement as of January 1, 2009, if a new settlement isn't agreed upon. He related that DOR's scenario uses $2 rates through 2008, assumes a refund year of 2010, and a state share of 25 percent. He noted that the refund amount calculated would include interest. The calculation utilizes DOR forecasted barrels. The DOR calculation arrives at a state share of $818 million as a refund amount. Mr. Iversen noted that the aforementioned isn't in writing and the assumptions can be tailored to anything the legislature would like.

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REPRESENTATIVE WILSON inquired as to how much DOR predicted the production would drop.

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JOYCE LOFGREN, Economist, Tax Division, Department of Revenue, said that the department uses the production forecast that will be issued in the Spring 2007 Resources Book. The production forecast is about 10 percent lower in volume than what it was in the fall. In response to Co-Chair Gatto, Ms. Lofgren said that although the volumes have decreased, the most recent forecast of oil prices are somewhat higher than they were in the fall.

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SENATOR THERRIAULT related his understanding that the model presented by DOR covers 2005 through 2008.

MS. LOFGREN clarified that through 2007 is history. She explained that it's the Horst (ph) historical TSM model that is provided to the state and the state has developed a model that attaches to that and forecasts out for the long-term forecast.

SENATOR THERRIAULT surmised then that since the numbers are historic, the department does know what the throughput, the price, and the tariff charged was. With that knowledge, he surmised, that the department performed calculations with different throughput, price, or tariff in order to determine the impact to the value flowing to the treasury in different scenarios.

MS. LOFGREN said that is correct.

SENATOR THERRIAULT said, "It's not calculating or counting on any kind of penalty or anything like that because the state hasn't asked for any, it would just be the result of Anadarko and Tesoro being successful in their challenge and the tariff being set using the methodology that they suggest."

MS. LOFGREN said that's not exactly the case. She explained that in the case the department has run, the tariff is about $2 "but that is by a little bit - the unwinding of the TSM model and we're using our forecasting based on that type of methodology rate base."

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SENATOR THERRIAULT inquired as to the total.

MR. IVERSEN answered that it's $818,132,589, which assumes a state share of 25 percent in the 2010, with interest.

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CO-CHAIR GATTO asked if the department has run comparisons of the PPT versus the old method.

MS. LOFGREN related that the department worked through several iterations last week and is currently in the throws of analyzing it now.

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REPRESENTATIVE GUTTENBERG, referring to page 24, bullet 6, of the FERC staff briefing, highlighted the following "the TSM uses a cost allocation rate design mechanism that allows cost properly allocated to interstate rates but disallowed by the RCA to be reallocated to interstate rates." He asked if the department agrees with the aforementioned and inquired as to what impact that has on state revenues. He also asked if FERC has the authority to do the aforementioned.

MR. IVERSEN said he didn't know the answer and recommended posing those questions to Mr. Reeves.

2:38:09 PM

CO-CHAIR GATTO asked if the $818 million includes any DR&R funds

MR. IVERSEN specified that the calculation doesn't include any DR&R.

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CO-CHAIR GATTO asked if the department could identify the DR&R proceeds collected and the current value.

MS. LOFGREN pointed out that in the original settlement agreement the DR&R was "a particular amount, dollar value collected year". She offered to obtain the exhibit specifying the aforementioned.

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JOHN RUSH, Oil & Gas Revenue Auditor, Tax Division, Department of Revenue, related that the TSM allowed for about $1.5 billion over the life of the agreement to be collected for DR&R. A certain amount each year was collected. As mentioned earlier, it was front-end loaded. The DR&R was collected in the rates charged. Depending on the interest rate, "that could go anywhere from $4-$6 to maybe $9 billion ... on what you've earned on that money." He recalled that Mr. Brena spoke about a tax deduction on the aforementioned. Mr. Rush opined that there are significant interest and tax effects along with the $1.5 billion that has been collected thus far.

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SENATOR THERRIAULT surmised then that the calculation resulting in the $818 million didn't anticipate the possibility that FERC may determine DR&R was overcollected and an adjustment in the rates as a result. Senator Therriault characterized that as very speculative.

MR. IVERSON said that both points are correct.

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REPRESENTATIVE SEATON requested that DOR provide an outline of the run that it's making on the tariff and the differential in order to review the terms.

MR. IVERSEN said that the department can provide that.

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SENATOR THERRIAULT asked if the House Resources Standing Committee would continue to monitor this as different milestones are reached because there are significant potential impacts to the treasury and the next transportation system for resources.

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CO-CHAIR GATTO echoed his comment from an earlier press conference that the most important thing for the gas line is the tariff. If the state doesn't have control over the tariff, he expressed concern with the result of getting independent explorers to seek additional gas that's necessary to make the gas line an economic reality.

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REPRESENTATIVE SEATON highlighted, with regard to small carriers and high storage fees, that entities will need people to come forward and bring those issues to the legislature. The legislature, he opined, needs to know publicly about other significant blockages.

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**ADJOURNMENT**

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 2:47 p.m.