

**ALASKA STATE LEGISLATURE  
HOUSE RESOURCES STANDING COMMITTEE**

June 7, 2007

9:08 a.m.

**MEMBERS PRESENT**

Representative Carl Gatto, Co-Chair  
Representative Craig Johnson, Co-Chair  
Representative Vic Kohring  
Representative Bob Roses  
Representative Paul Seaton  
Representative Peggy Wilson (via teleconference)  
Representative David Guttenberg (via teleconference)  
Representative Scott Kawasaki (via teleconference)

**MEMBERS ABSENT**

Representative Bryce Edgmon

**OTHER LEGISLATORS PRESENT**

Representative Nancy Dahlstrom  
Representative Anna Fairclough  
Representative Berta Gardner  
Representative Max Gruenberg  
Representative Kurt Olson

**COMMITTEE CALENDAR**

PRESENTATION - TAPS TARIFF PROCEEDING BEFORE THE FERC; OIL  
PIPELINE INTEGRITY AND CORROSION

-HEARD

**PREVIOUS COMMITTEE ACTION**

No previous action to record

**WITNESS REGISTER**

ROBIN BRENA, Attorney at Law  
Brena, Bell & Clarkson P.C.  
Anchorage, Alaska

PHILIP REEVES, Senior Assistant Attorney General  
Oil, Gas & Mining Section

Civil Division (Juneau)  
Department of Law  
Juneau, Alaska

RICHARD FINEBERG, Investigator  
Research Associates of Ester  
Fairbanks, Alaska

JONATHAN IVERSEN, Director  
Tax Division  
Department of Revenue  
Anchorage, Alaska

TONY BROCK, Technical Director  
BP Alaska  
Anchorage, Alaska

JONNE SLEMONS, Coordinator  
Pipeline Systems Integrity Office (PSIO)  
Division of Oil & Gas  
Department of Natural Resources  
Anchorage, Alaska

#### **ACTION NARRATIVE**

**CO-CHAIR CARL GATTO** called the House Resources Standing Committee meeting to order at [9:08:15 AM](#). Present at the call to order were Representatives Gatto, Kohring, Roses, Guttenberg (via teleconference), Kawasaki (via teleconference), and Johnson. Representatives Wilson (via teleconference) and Seaton arrived as the meeting was in progress. Representatives Gruenberg, Dahlstrom, Fairclough, Olson and Gardner were also in attendance.

Presentation - TAPS tariff proceeding before the FERC; Oil Pipeline Integrity and Corrosion.

[9:08:15 AM](#)

CO-CHAIR GATTO announced that the only order of business would be a presentation on the TAPS tariff proceeding before the Federal Energy Regulatory Commission (FERC) on oil pipeline integrity and corrosion.

[9:09:11 AM](#)

CO-CHAIR GATTO explained to members the committee would review the first red binder this morning and then break for lunch and review the second red binder with the numbered tabs this afternoon. He asked Mr. Brena to testify.

9:11:47 AM

ROBIN BRENA, Attorney at Law, Brena, Bell & Clarkson P.C., first talked about his background. He grew up in Skagway, Alaska. He is an attorney with the Anchorage firm of Brena, Bell and Clarkson. He has an MBA in accounting and finance and a Masters in Law degree in real estate development and finance law. He has been involved in pipeline rate litigation for 20 years and has been involved in 15 to 20 Trans-Alaska Pipeline System (TAPS) cases. Relative to this particular case, he was the lead counsel for Tesoro. He filed a complaint in 1976 to lower the TAPS rates to reasonable levels, resulting in the Regulatory Commission of Alaska (RCA) lowering rates from \$4 to \$2. He has been the lead counsel for Anadarko-Tesoro's effort to lower the federal rates, which has occurred.

MR. BRENA, in response to Co-Chair Gatto, clarified that he represents Anadarko-Tesoro, with regard to the Cook Inlet gas pipeline; Agrium, with regard to Alpine Pipeline Company; and Murphy Oil. In general, he represents independents and value-added manufacturers in Alaska.

9:14:12 AM

MR. BRENA began his overview, which consisted of 17 slides. He told members:

... I wanted to start with just a broad overview and perhaps just stating the obvious, and that is that our oil and gas resources in Alaska have to move through pipelines that don't have competition. They are monopoly-controlled lines. Normal economic forces do not operate with regard to these lines and so regulation is necessary of them.

In looking at what kind of regulation is helpful for these lines, there are just two things that I want to focus your attention on: access and rates. If you come away from this presentation with nothing else, you come away with - get access right, get rates right. If you accomplish those two things in the future, it will maximize the development of the oil

and gas resources in Alaska. It will maximize the state's revenues and it will encourage the development of jobs and value added manufacturing in Alaska. Those are important bi-products of just getting those two issues right.

With regard to oil pipelines, they are common carriers, so access is not a major issue. That's quite different from gas lines in which they are contract carriage lines and access is a major issue. So the rest of my presentation goes to the second element with regard to TAPS, which is rates and explains how the initial decision fits into this. I'm looking at the screen that the people in Juneau must be looking at and I realize it's kind of hard to read that. Let me start out by just saying that much of the history of TAPS is determined off of a settlement that was entered into by the state and the TAPS' carriers in 1985.

9:16:15 AM

The TAPS settlement - there's four aspects of it that I want to be sure that the committee is aware of. First, I want to be sure that you understand what the deal was. You're going to hear a lot of rhetoric from a lot of people that I don't think accurately represents what the deal was. So the deal was, in '85, that they settle all prior rate issues, first of all. All prior rate issues were final. With regard to future rate issues from '85 forward, the deal was that the state would not protest those rates so long as they were at or below a ceiling rate that was established under a methodology set forth in the settlement, which I'll refer to as the [TAPS settlement methodology] TSM method.

Importantly, they asked for the commissioners at FERC and the [Alaska Public Utilities Commission] APUC then, now the RCA, to approve that settlement under a public interest standard and not under the just and reasonable standard. Now that is perhaps the distinction only a lawyer could love but it is an important one for you to understand. When you have a settlement and you ask for it to be approved under the public interest standard, you don't look at whether the rate needs to [indisc.] these criteria under the

just and reasonable standard. They specifically asked both commissions not to take a look at their rates and determine whether or not they were just and reasonable. What they said is, if a financially interested party in the future had a problem with the rates, they could protest them, and if they protested them, then the regulator would set just and reasonable rates. That was the deal.

Now that's important because that's exactly what Tesoro has done to the state rates and that's exactly what Anadarko and Tesoro have done with the federal rates. We have protested those rates as unjust and unreasonable and asked that just and reasonable rates be set.

Please understand that there's nothing in what Tesoro has done at the state level. There's nothing that Anadarko and Tesoro have done at the federal level that resulted in any violation of the state's agreement with the TAPS carriers. They are both continuing to get the benefit of the deal that they struck at the time in '85. From the state's perspective, they are continuing to get rates at or below the levels set forth in their settlement. From the carriers' perspective, the state still isn't protesting those rates as unjust and unreasonable so you'll oftentimes hear that somehow the state is reneging on this deal. It's not reneging on this deal. The deal was the third party shippers in the future could do exactly what we're doing and nothing about it is - it's all consistent with what the terms of the settlement were at the time.

But, that aside, when you try to understand TAPS, the beginning point has to be the TAPS settlement because that's the deal that's determined rates from 1977 to date on the federal side and that's the rate that determines the state's royalty and severance take.

[9:19:38 AM](#)

MR. BRENA continued with his presentation, as follows:

Now, I was asked to go into some detail and I can't do it without talking about it, and just right up front,

some of these different terms that I'm going to be using.

[9:19:48 AM](#)

CO-CHAIR GATTO asked about the standards used to distinguish the terms "public interest" and "just and reasonable."

MR. BRENA replied the difference between the two standards is the difference in the level of review undertaken by regulators during the approval process. When determining a settlement, regulators look at what is in the public interest. If a financially interested party protests a rate, that party has a right to have a just and reasonable rate set. No settlement is involved so the regulators look at what constitutes just and reasonable and, in general, that means a cost-based rate. A cost-based rate was never set in TAPS history until the RCA established one in the state rate at \$1.96 a few years ago. A cost-based rate has never been established at the federal level; this initial decision establishes that cost-based rate. He clarified:

So what we want ... by we I mean anybody that does business in the state or the state - what they have a financial interest in - is rates that are actually based on the cost of providing service and no more. I'll get into more detail in every word I just used in just a minute.

CO-CHAIR GATTO asked if [rates] could change with changes of volume shipped through the pipe.

MR. BRENA said if 2 million barrels are shipped per day and the rate is \$1 and everything else is constant, but then the volume decreases to 1 million barrels per day, the rate doubles to \$2, everything else being equal. Throughput levels have not been disputed in any of these cases. He stated:

We have stipulated to the throughput levels that the carriers used so the throughput is constant. When we talk about the difference between \$2 and \$4 between a just and reasonable rate and the settlement rate, that difference is attributable to excessive returns and not to throughput or operating costs. We'll go through that in great detail in a minute.

[9:22:14 AM](#)

MR. BRENA continued his presentation:

Okay, I've already started using some of the terms and so on page 4 I define them. I'll stay with TSM, because [that's] the method for establishing rates set forth in the TAPS settlement. It's important to understand that that's a settlement method in that everyone that's taken a look at whether that method results in a just and reasonable rate has rejected it. It's been rejected by the RCA. It's been rejected by the Superior Court. It's been rejected in the initial decision by Judge Cintron. The TSM just doesn't result in just and reasonable rates and I'll explain in some detail why. It's fine for a settlement as far as - I mean it met the public policy goals of the state at the time, apparently, but it is not an appropriate methodology to use for actually setting cost based rates. So that's the TSM and that is the method that's been used to establish rates for 30 years on TAPS.

The stand-alone cost method, or the SAC method - I'll talk a little bit about that. The carriers, in defending their TSM rates, have come up with different theories. One theory is the SAC method and basically what that method is it ignores the actual cost of operating TAPS and just builds a hypothetical new line and figures out what the costs would be and then charges that cost. It's a complete exercise in make believe. It's never been used to establish a just and reasonable rate. It's never been used to establish a revenue requirement. It is one of the theories they advanced at the federal site to justify their rates. It does result in rates beginning at \$6.10 and going up to \$28 over the next 15 years. It is one of the active theories of the case that they advanced to justify their rates.

CO-CHAIR GATTO asked Mr. Brena, "Are you saying then that what they would say is hey, if today we had to build the same pipeline, we would have to charge this rate?"

MR. BRENA said that is correct. The rate would be based on the cost of building a hypothetical new line today. It is essentially a replacement cost approach to value without depreciation. He noted as he continues his presentation, the

committee will see that some of the rate theories that have been advanced are so extreme they beg the question of whether they are good faith positions.

MR. BRENA returned to his presentation:

Now where the action is "Original Cost-Based Methods" on the bottom of [page] 4. And there are two and it doesn't really matter what the differences are because they aren't that different but I'll describe them.

A depreciable original cost (DOC) method - and what you do is you just take the amount of investment. It cost us \$1 million to build a pipeline and the pipeline is going to operate for 10 years and we're going to use straight line depreciation. We just get that \$1 million and then we depreciate it over 10 years. Whatever it cost us to build the line we get back in our depreciation allowance. Whatever it cost us to operate the line, we get back in our operating expenses. And then whatever our remaining investment is at the time, we get a reasonable return on it. So in year 5, we have a half million dollars left and let's say we get a 10 percent return so we'll get \$500,000 of return. That is basically how original cost rate making works. It has three basic elements: return of investment, which is [indisc.] allowance, the operating costs and a return on unrecovered investment. Those are the three elements that make up a cost-based rate. It's kind of simple really.

There are two different ways of applying original cost methods. The FERC has adopted one and the RCA has adopted the other. The one the RCA adopted in its Order 151 was the DOC - the depreciable original cost. The difference between the two has to do with the rate profile you're trying to create. If what you're trying to do is flatten out the rates over the life of the facility, then one way you can do that is take a portion of return and push it into the future.

And so what the TOC does, the trended original cost method, is it takes the inflation component of return and just turns it into a deferred return element and recovers it later. And the effect of that is just to flatten out the rate profile a little bit. That's all it is so it just takes - if you have a 12 percent

return and 8 percent of it is real and 4 percent of it is due to inflation, all the TOC will do is take the 4 percent attributable to inflation and recover it in the future.

CO-CHAIR GATTO noted Mr. Brena referred to Order 151 but it has also been referred to as P-97-4-151. He asked if the "P" represents pipeline and "97" represents the year.

[9:27:48 AM](#)

MR. BRENA said that is the RCA docketing convention. "P" stands for pipeline; the docket was opened in 1997 and it was the fourth docket opened that year. That is a seminal order with regard to Alaska's pipelines, particularly TAPS. It establishes the \$1.96 rate. He continued:

And then with regard to the TOC ... I'll refer to the FERC's TOC as the 154 B because that is the order in which FERC adopted the TOC to be applied to oil pipelines. So, I might go back and forth a little bit when I'm talking about FERC between the B and 154 B and the TOC. And I might go back and forth a little bit between Order 151 and the DOC but they're basically, all of them, are more similar than different and how they're the same is that they base the rate on the cost of providing service under an original cost method. I didn't want the differences to be confusing.

[9:29:01 AM](#)

My next two slides kind of summarize the RCA proceedings and where they're at and the FERC proceedings and where they're at. On Slide 5, in the RCA we filed a protest of the 1997 rates. We filed in 1996 saying that the TSM rates, the method and the settlement, wasn't resulting in just and reasonable rates and since we had the right to protest those rates, and that was the deal in the settlement, we did. The TAPS carriers and the State of Alaska defended the TSM rates and asked the RCA to continue to charge them to us. The RCA decision in Order 151 rejected the use of the TSM for setting just and reasonable rates. It said the method set forth in the settlement is not appropriate to use in establishing cost-based rates. And then they set the rate under

traditional cost-based principles and lowered the rate to \$1.96.

To put this into perspective generally, the difference between TSM rates and cost-based rates is the difference of \$2 or \$3 a barrel, depending on the year and the circumstances.

CO-CHAIR GATTO announced a short at-ease to address a technical difficulty.

[9:30:45 AM](#)

MR. BRENA continued:

So, in Order 151, the RCA essentially applied cost-based principles for the first time in the history of TAPS and set an actual cost-based rate. The cost-based rate that they set was about half of what they'd been charging. And to put this in a broader perspective as we go along, when I talk about \$1 a barrel decrease, the state's interest is essentially 25 cents a barrel. So if you talk about \$1 a barrel and you've got 1 million barrels going through the line a day, then you're talking about \$250,000 a day the state has an interest in that outcome.

MR. BRENA continued:

The procedural status of Order 151 is that it was appealed to the Superior Court as an intermediate appellate court and Judge Sedwick affirmed the decision of the RCA in all respects. His decision has been appealed to the Alaska Supreme Court. We've argued that and we're waiting for the Alaska Supreme Court to rule.

With regard to the FERC rate proceedings ...

[9:32:02 AM](#)

CO-CHAIR JOHNSON interrupted to ask if the \$1.96 rate is now a fixed rate where the previous rate was variable.

[9:32:19 AM](#)

MR. BRENA explained that under the tax settlement method that was in effect prior to setting the cost-based rate at \$1.96, the rate varied greatly, from year to year and from carrier to carrier. Their rates were \$3.96 on average but they ranged from \$3.50 to over \$4.00. The TSM resulted in highly variable rates that were about double the rate set by the RCA. He continued with his presentation, as follows:

The FERC rate proceeding - one thing that the RCA's order did is it caused people to take another look at the rate structure on TAPS to figure out what was fair. We had done calculations in the rate proceeding and they suggested that the carriers were earning 100 percent a year on their investment each year for the five years before Tesoro filed its protest - over 100 percent a year return for the remaining investment and so that's one reason we wandered into that.

You might ask what is Tesoro, a relatively small player, doing taking on the combined resources of Exxon and BP and ConocoPhillips when it has a relatively small amount of throughput. But there's a difference. You know, pigs get fat and then hogs get slaughtered and the difference between \$2 and \$4 makes a lot of difference to our clients. If you take \$1 a barrel difference and we ship 25 or 30,000 barrels a day, and you add \$1 a barrel a day, that equals the average of the profitability of the Tesoro refinery during this period when we protested the rates. It has a huge impact on local business so you've got a relatively small player with hardly any throughput, 26, 28,000 barrels a day of the million barrels a day at the time it was going through it and saying this is just way out of line and it making sense financially for that small player to do that even for those small barrels. The state has a huge financial interest in this in relative terms. Its financial interest is 25 percent. It is the big winner or loser in these cases.

On the FERC side, the independents whose - on the North Slope, Anadarko in particular, took a look at the RCA ruling and said it doesn't make a whole lot of sense for the federal rate to be over \$4 and the state rate to be under \$2 so maybe it is time for the federal rate to go down too. And so Anadarko and Tesoro filed in 2005 to lower the federal rate to a

just and reasonable level as well. The rates at the time, and this is putting it in 2006, ranged from \$3.78 to \$4.41 and we stepped forward and asked FERC to lower those rates to \$2.04. The State of Alaska, because it's a signatory to the settlement and I'll discuss the implications of that more later, can't argue that the federal rate or any rate under the TSM is unjust and unreasonable. But they did argue that those rates were discriminatory. And even though they spent the last five or eight years opposing the establishment of a just and reasonable state rate, they said that because the federal rate was higher than the state rate, that it was discriminatory and so the federal rate needed to come down. And so they filed a discrimination action with FERC, asking FERC to lower the federal rate to the state rate level of \$1.96.

The carriers in turn said the state rate was too low and asked the federal government to raise it to the federal rate level. And so those were the three classes of claims that were there: us, the smallest fish in the entire ocean saying let's set just and reasonable rates; the state who can't say that it's an unjust and unreasonable rate - saying it's a discriminatory rate, let's lower it to the state rate; and the carriers who just lost the state case saying that the state rate is wrong and so we're having FERC raise it to the federal level. Those are the three different classes.

CO-CHAIR GATTO asked whether the market value of a barrel of oil affects the rates.

[9:37:26 AM](#)

MR. BRENA said the market value of a barrel of Alaska North Slope (ANS\_ crude oil is determined in the LA Basin, based on competitive market forces - international and alternative crude oils. He did not believe the transportation rate directly impacts the price of ANS but it impacts the profitability of using ANS for a particular refinery.

CO-CHAIR GATTO commented that shipping a \$65 barrel of oil has added expenses, such as running diesels and compressors, paying higher salaries and paying for travel. He said \$1.96 could start to look a little thin and questioned whether a company

might be entitled to an adjustment, depending on the market price of oil.

MR. BRENA said if transportation rates are reduced by \$1, the value of all North Slope oil and gas resources increases by \$1 per barrel in the ground. So the economics of a 100 million barrel field would increase by \$100 million. He said although \$1 per barrel might not make that much of a difference with \$60 per barrel oil, it directly and substantially impacts the likelihood of marginal field development on the North Slope. He explained:

Whenever you can take a buck out of the middle, then you add it somewhere else. It's either upstream or downstream and so that's a buck to somebody's bottom line that's adding value. So that midstream, if it's based on the cost of providing service, is very, very important. It's very, very important to the state because to the degree that as a producer that I can transfer my return from upstream to mid-stream, I get to subtract mid-stream from my royalty and severance taxes. So for every buck I transfer from production to transportation is a quarter I save in taxes. Now that works as long as I'm paying myself the rate and we'll get into the risks of affiliated lines ... but the whole game works as a tax saving mechanism to transfer profitability from upstream to mid-stream and reducing the State of Alaska royalty and severance taxes as long as you're paying the rate to yourself. It doesn't work when you're not paying the rate to yourself.

[9:40:52 AM](#)

MR. BRENA returned to his presentation:

... Okay, so those are the three classes of claims. Tesoro saying the rates are just too darn high. The State can't say that - saying it's discriminatory and so lower the federal rate to the state rate. And the carriers saying the state rate is wrong, let's raise it to the federal rate level.

And let me just comment here. You know, Tesoro is just a small refiner, really. It's grown since this case started so it's a pretty big independent. In relative terms to the people that we're talking to,

it's relatively small. Let me just have you appreciate for a moment what a tremendous effort it takes for a small minnow in the ocean to do something like lower the rates on TAPS. First you have to go litigate between the RCA. Then you've got to litigate before the Superior Court. Then you've got to litigate before the Supreme Court and then you've got to beat off whether or not there's an appeal to the U.S. Supreme Court. Then you've got to go down to Juneau and you've got to defend what you did in Juneau. And then you've got to go back to the RCA because they'll open three or four R dockets and you've got to go through your R dockets. And then, in this case, we had to go back to FERC and defend the rate at FERC because the carriers asked FERC to raise the rate. That's what someone doing business in Alaska has to go through just to get a fair rate off the North Slope.

Please appreciate that and I'll get into the state's legitimate role in being sure that these things are done right in the first place so you don't force your businesses trying to add jobs and value in Alaska ... to do that kind of thing. I can't tell you how much the TAPS carriers - they had to track their expenses in opposing - just trying to set a fair rate on the state side they spent over \$20 million opposed to setting a rate on TAPS. That's how much they spent against our position. And, of course, there's an argument over how much of that we have to pay through our future rates.

Okay, well, I'm back to the FERC rate proceeding - three classes, Judge Cintron agreed with Anadarko-Tesoro's position to the penny, to the penny. It's not very often in complex rate litigation that you get any regulator to agree with any party to the penny. In fact, it's never happened in my career before. That's what just happened at FERC, part of it is because these claims had already been embedded before the RCA and so we were pretty familiar with each other's arguments at this point. But part of it goes to that we put on a fair case in the first place.

The State of Alaska's discrimination claim for dismissed is moot and the reason for that is as soon as they lowered the federal rate down to a cost-based

rate and the federal and state rates were about the same, then there's no reason to worry about discrimination anymore. And similarly, the carriers' efforts at trying to raise the state rate to the federal rate under Section 13-4 of the Interstate Commerce Act, they were rendered moot too because there's no reason to talk about raising the state rate to the federal rate when they're both about the same too.

So, of the three classes of claims, Anadarko-Tesoro's position was adopted to the penny. The state's case was dismissed as moot and the carriers' counterclaims were - under the Interstate Commerce Act - were dismissed as moot.

This is an initial decision by Judge Cintron procedurally where it is. It is a 116 page decision. It's in your binder. It's very well supported as an order, as was the Commission's Order 151. These are massive rate cases that give you some idea of the state rate case is a 65,000 page record. The federal rate case is another 30 or 40,000 plus to 65,000 in the state proceedings so the federal case is an 80 to 100,000 page record. These are massive records and massive cases. ... The judge did a good job and the judge got it right. There's one exception to that we may complain about but, with regard to establishing the transportation rate, the judge got it right.

So, of course it's going to be appealed to the FERC. It's called briefs on exceptions and it's going to go before the FERC. And then, of course, from there it's going to go to the D.C. Circuit and then, of course, from there it will probably go to the [U.S.] Supreme Court, which I don't expect them to hear.

[9:45:38 AM](#)

CO-CHAIR GATTO asked if the [D.C.] Circuit Court will definitely hear the case.

MR. BRENA affirmed it would. He told members the D.C. Circuit Court does a great job in rate cases. That court forced the FERC to do it right in the first place in Farmers Union 2.

CO-CHAIR GATTO asked if the D.C. Circuit is the Ninth Circuit.

MR. BRENA said it is not, and added that FERC sits in the D.C. Circuit's jurisdiction. The pipeline is in the Ninth Circuit so, arguably the case could be heard there, but the D.C. Circuit has a lot of experience reviewing agency decisions and particularly FERC decisions.

CO-CHAIR GATTO asked Mr. Brena if, in his opinion, the D.C. Circuit Court will hear the case.

MR. BRENA said it must because an appeal is a matter of right. The effective life of these cases is about 10 years. He said as soon as the FERC rules, the rates are likely to go down and the money will go where it should be going.

CO-CHAIR GATTO asked if there will be a retroactive payment.

MR. BRENA said yes, to January 1, 2005. He said he will discuss the state's interest and refunds.

[9:47:06 AM](#)

MR. BRENA returned to his presentation:

I thought I'd just summarize the judge's decision on page 7. First, with regard to the TSM, the carriers have never even tried to support the rate elements that are comprised in the TSM and that's what the judge held. She held that they didn't support the TSM so they couldn't very well approve an unsupported method.

One of the major problems with the TSM, and I don't mean for this to be too esoteric, but you remember I said that the three elements of a just and reasonable - one was return on unrecovered investment. The idea is that your return is based on how much money you've got out there. And one of the things the TSM did that was very, very wrong was it divorced the return element from the remaining investment and it permitted an allowance per barrel to be collected. That allowance per barrel last year, taking into consideration the tax impacts as well, is \$1.19 per barrel of additional returns and it has nothing to do with how much investment they still have in the line. Whenever you take return and you link it to throughput

instead of to investment, you're going to get taken to the cleaners and that's what happened.

CO-CHAIR GATTO questioned the origin of the allowance per barrel.

MR. BRENA said it came from fundamentally flawed economic thinking. When the carriers settled in 1985, they did not want to pay retroactive refunds so they tried hard to get to keep the revenues they collected and were successful, for the most part. However, they collected very high rates and lots of revenue, so determining how to back fill that with a cost-based method was problematic. Essentially, they filled the pot by retroactively accelerating their recovery of investment and [dismantlement, removal, and restoration] DR&R to the extent possible. By back-end loading all of this investment, they did not have to pay much in refunds but they did not have much investment left over. In cost-based rate making, your return is based on your remaining investment. He further related:

And I cross-examined the state's economist at the time on this point for a very long time, the better part of half a day, I think. Why did you do that? Then, the allowance per barrel was the crossover point when their remaining investment went down below a certain level that was below what would be an acceptable return. So then they created this allowance per barrel to take the place of return based on investment. And the justification that the economist for the state gave me from the stand when I explored this with him was - is they forewent future profits because they recovered their investment upfront. What I explored with him for a very long time was generally, in business, you want your investment sooner back. The sooner you get it the better it is for you. Why do you give a return because they don't have investment? When they take all their money back don't you think they're earning a return on it somewhere else?

So, if you have this allowance per barrel to give them a return because they got the front end loaded, then the first step is that's economically flawed because it's a benefit to the owner to get his investment back quickly. But if you're saying well what about these profits here? If you give them those profits there, then in effect you've allowed them to double recovered

profit on that same investment. He took it out of the pipeline and invested in over in Turkistan and made a 20 percent return on it over there and now you're giving him 20 percent return here because it's not here. So what sense does that make?

That's the history of it. That's the justification that the state economist gave me on the stand for it. It doesn't make a darn bit of sense to me. It never has. It never will. It's basically flawed economic theory and it goes to - well, that's the history of it.

CO-CHAIR GATTO asked if they have recovered 100 percent of their investment.

MR. BRENA replied, "I have a slide just on the recovery but the scheduled depreciation cost them \$9 billion to build this line, there's about \$600 million of investment remaining based on the method that's been in place for the last three decades."

[9:52:58 AM](#)

MR. BRENA continued his presentation:

I'm back to the summary of initial decision. TSM Opinion 154 B - again that's the federal cost-based approach. She said if we're going to use it, we're going to set cost-based rates and Anadarko-Tesoro got it right.

DR&R - DR&R is a separate entire conversation but let me just say, and I have a slide on it, but she said that it's time to account for the collections of DR&R and your earnings on them and that if you over collected, they should be refunded. There's a lot more to it but that's essentially what she said.

With regard to rates, I mentioned earlier that all the carriers had different rates and they varied year by year and they varied carrier by carrier in any given year. She said we're going to set one rate on the federal side. There's no justification that's been advanced for having these rates bouncing all over the place.

The State of Alaska's discrimination claim for dismissed is moot. The TAPS carrier Section 13-4 claims were dismissed as moot. The remedies for the refunds - she held that it's the increases in rates that are refundable in '05 and '06 with the cost-based rates going forward. So, in effect they raised their rates from \$3 to \$4 in '05 and '06, that's what's subject to refund. It's not subject to refund all the way down to the cost-based rate but going forward we're going to set cost-based rates.

CO-CHAIR GATTO asked if the refund for '05 and '06 has been calculated.

MR. BRENA said the amount depends on how it is calculated.

CO-CHAIR GATTO questioned if it is between \$1.96 or \$2.04 and the charge.

MR. BRENA said the difference is a couple of dollars between the filed and collected rate and the J&R rate. He further said, "But FERC has a policy of only allowing refunds of increases so only allowing refunds down to the last clean rate - that's the way they referred to it. So there's a question about whether those refunds should go all the way down to the \$2.04 level or down to the prior rate filing level for those two years only and I'm sure that's an issue that the state has quite an interest in."

CO-CHAIR GATTO inquired as to the amount in the most recent filing.

MR. BRENA said the rates have increased from \$3.00 to \$5.00 over the last three years. Five years ago the RCA said the rates should be \$2.00.

CO-CHAIR GATTO asked if, "... we can't get below the \$3.00?"

MR. BRENA answered that remains to be seen but the judge's initial decision only went to the last filed rate for those two years. The principle benefit to the state under her ruling is 2007 forward and the potential for DR&R refunds.

[9:56:14 AM](#)

MR. BRENA continued with his presentation:

Slide 8 - I've said this because this is where it actually fits into my presentation. "Just and Reasonable Rates," - what that means is cost of providing service and what that means is if you built the pipeline, you get your operating costs, you get your investment back and you get a reasonable return on your remaining unrecovered investment. That's what just and reasonable rates are usually intended to be. And this is decades and decades of litigation. This has been the result.

9:56:57 AM

I've talked about the next slide, Slide 9. I've talked about the TSM rates are not just and reasonable. They've never been supported. They've never asked for a review. There's never been a review of the rates prior to these cases as to whether or not the TSM produces just and reasonable rates. The owners have never supported their rates, not in a single case. They've never come in and said these rate elements are supported by these costs.

The RCA did a calculation of over collection. If you apply the RCA's approach, if you apply the FERC's approach and you take a look backward to take a look at what the collection should have been, then this is what you end up with. The TSM has resulted in over \$18 billion of over collections. ... The state's interest is 25 percent of that and that would have been from '77 to date and you probably would have earned some money on that difference in the meanwhile.

So - and just to put this in some kind of perspective, it cost them roughly \$10 billion to build the line, \$15 billion to operate it. So all in, they have \$25 billion in this line. They've collected through 2004 \$60 billion ... and all in operating cost investment they got \$25 billion in. I mentioned that the TSM is fatally flawed as a method to set just and reasonable rates. I mentioned the allowance per barrel.

There [are] a few other elements of it that you should be aware of. One is each carrier can make up whatever rate he wants each year. He can project any throughput he wants. He can project any level of cost that he wants and he can get any rate that he wants in

any one year. That's a characteristic of the TSM. Now theoretically, it's supposed to balance out because there's a lagging true-up, where if he's off when the actual costs flow through it kind of balances up. But, in fact, that's just a challenge to change your projections more and more into the future and there is absolutely nothing that says what happens at the end of the life of the settlement when your projections are all out of whack with reality. It's a mess.

The line was depreciated over 2011. This line isn't going to go out of service in 2011. When the TAPS owner put in the right-of-way renewal application, which by law they could only extend for 30 years, they extended it to 2034 and in their application they said the economic life of this line is well beyond 2034. I just got out of an ad valorem hearing before the state assessment review board. I represented the City of Valdez in that case and we were arguing over what the assessed value of TAPS ought to be and the life of the line was a major issue. We put on a case that, based on proven producing reserves alone, in 2050 there will be 136 barrels of oil flowing through TAPS. This line is going to be around a long, long time and all the rate making prior to these cases was based on 2011 - way off. And now the new rates that have been set have been based on the federal rates based on 2034 and in the next rate case, I predict that the rates will be based on 2050, 2060. That will be conservative.

CO-CHAIR GATTO asked if the pipes can survive that long without requiring replacement.

MR. BRENA said reserves must be properly reported to investors, based on SEC definitions. People usually report what they believe is pretty close to the truth to the SEC and the tax authorities. When it comes to calculating rates, people take a more relaxed approach. As an example, BP has told its investors in its fourth quarter 10K report for the BP royalty trust that it intends to continue producing [in] Prudhoe Bay through 2062. He returned to his presentation:

So, anyway, going back to the point - the TSM basis rates on the recovery of investment through 2011, the federal rate is through 2034. Everyone acknowledges

that the life of this line is at least 2034. Realistically, I think it is 2050, 2060, 2070.

One of the things that the TSM does is it says that the way that the mechanism works it establishes a total revenue requirement. We'll say it's \$1,000 and then it uses the plug figure, whatever they collect from the state shippers, let's say it's \$100 is subtracted.

10:02:45 AM

That means they're entitled to collect \$900 from the federal shippers. That's the way the mechanism works. Well, when the state took the \$100 they were collecting from the state shipper and shrunk it down to \$50, then the effect of that was to take the amount that they collected from the federal shippers from \$900 and \$950. So, it doesn't make jurisdictional separations and, in fact, the costs that were specifically disallowed by the RCA as unjust and unreasonable costs then automatically flowed over and reflected from the federal shippers and went to reduce the state's royalty and severance taxes.

In terms of the over-collections to date, not looking forward, just looking back, the TSM has cost the state about \$4.5 billion in royalty and severance taxes plus earnings on that amount from '77 to 2004.

10:03:54 AM

On page 10 is a copy of the rates. This just illustrates the different carrier's rates by the different years - year to year and among the carrier groups. I've already kind of discussed this. ... Page 11 is kind of the heart of the argument over the theory. I want to draw your particular attention to lines 1, 2, 3, 7, 9, 10, 12, 13, 14, and 15.

I want to first point out, on line 1, operating costs. What this is - this is the carriers' theory of how cost-based rates should be established on the federal side based on Opinion 154 B compared with Anadarko-Tesoro's theory. Here they are just lined up side-by-side. Now you can see that the carriers' net result on line 15 is the carriers said that their rate under

cost-based rates should be \$5.53. Anadarko-Tesoro and the judge said it ought to be \$2.04. So the carriers put on a case that said that the TAPS rates, the TSM rates, were too low. Their filed rates were too low by a buck and a half and that's the way that they interpreted Opinion 154 B.

So, if you take a look at operating expenses, you'll see that both of them have identical operating expenses. Everybody agrees to give them every penny that went into operating. If you take a look at throughput on line 13, you'll see that they use the identical level of throughput. So the operating costs and the throughput levels in both of these models [are] identical but the rates are \$3.50 difference. Okay, well that's a lot of gamesmanship to get there when your costs and your throughput are the same.

You see the depreciation expense item? They said that each year they should be entitled to \$335 million and we said \$13 million. They put on a case that said that they want to double recover their investment. That front end loading depreciation that they got paid once, they said that it should have been straight lined and they should be paid that investment back a second time. That was the essence of their federal case. They said we should get our investment back twice. We disagreed and the judge disagreed.

Deferred earnings: \$224 million versus \$7 million. They actually got deferred earnings in the TSM all the way back to '77. They said they should be able to go calculate it and get a second helping of deferred earnings and so they tried to double recover the inflation component.

If you take a look at the return allowance, the return on equity, their return on equity was almost \$300 million. Ours was 30. It's because of the difference in the calculation of investment. If your investment is a lot higher, you get a lot more return. Also their return calculation was high. The total return allowance, you can see - well the total revenue requirement - line 12, they said \$1,750,000,000 a year. We said \$647,000,000.

Take a look at the tax allowance on line 9 - \$300 million versus \$40 million. When you get a tax allowance equal - you know, you get to gross up for taxes and so if your return is higher, this is a matter of calculation, your tax allowance is a lot higher. So when you pump up your investment, you pump up your return and you pump up your tax allowance. That's hundreds of millions of dollars at each step. So [those are] the differences between our cases before the FERC. The Anadarko-Tesoro case is the one that the judge thought was most reasonable and specifically made a point of saying you don't get to double recover your investment. You just don't get to do that in rate making. You only get it back once.

[10:07:54 AM](#)

MR. BRENA continued:

Slide 12 shows the build-up from their rate to our rate and where the money is and what the differences are. Please don't be confused by the revised rate being \$1.98 because that's the \$2.04 cent rate just stated on a composite basis. That is the \$2.04 rate. The \$2.04 rate is the Valdez rate. The \$1.98 is a composite rate. It's the same effective thing.

And you can see that them wanting to get their deferred earnings twice, the shippers, the ratepayers pay them their deferred earnings once and they wanted it a second time. That was \$1.78 of the difference. You can see that they had a starting rate base adjustment that was 29 cents in the difference. And you see them wanting to recover their investment twice, a portion of their investment twice, particularly pretend that they had gotten straight lined for the last 30 years when they had actually gotten accelerated, that's \$1.31 a barrel. And those are the major differences in the theory and the rates.

[10:09:05 AM](#)

CO-CHAIR GATTO questioned whether the accounting procedure rules are so flexible that these monstrous adjustments can be made, i.e. declaring deferred earnings twice. He asked if anyone could make such a statement without a red face.

MR. BRENA said they have made that statement for over a decade at multiple proceedings and forums.

CO-CHAIR GATTO asked if the state could do that with its own investments and tell the IRS it wants accelerated depreciation but in five years change its mind and take the straight line depreciation.

MR. BRENA said it could not. He asserted their theories strain credibility in his and others' minds.

[10:10:53 AM](#)

MR. BRENA continued:

DR&R is a separate conversation but I just want to bring it to your attention because there is a huge amount of potential money at stake for the state and so I just want you to have some idea of the magnitude of the issue.

As I mentioned earlier, this is just the cost of taking a pipeline out of service at the end of its economic life. The basic concept is that whatever it costs you to take it out of service, of course you can't collect it from your rate payers because you don't have rate payers when you've taken it out of service. Even if you did have rate payers, the last person on the line shouldn't pay all that cost. It ought to be paid by everybody because that's a cost that everybody should spread over the entire life of the line.

The carriers have collected \$1.5 billion from 1977 to date for DR&R. A huge issue in the federal case and will remain for some time is how do you determine what their earnings have been on those collections because those are shipper funds. We put on a case that the judge disagreed with but we showed what they have actually earned. We went back and calculated their unrestricted return on equity for the companies that were distributed the funds. So this is how much they made actually. They made \$15.7 billion so, in total, they have collected and earned \$17.2 billion.

Now their need - and this is all in same term dollars, their need is \$2.6 billion. They said they need \$2.6

billion. They have actually collected \$1.5 billion. They have actually earned \$15.7 billion on the \$1.5 billion that they've collected. So they're \$17.2 billion richer for a \$2.6 billion cost.

Now one of the basic principles of cost-based rate making is you don't get a profit on your cost, you just get your costs back. You get a profit on your investment. You don't get a profit on your costs. Whatever it costs to operate, you get that back.

[10:12:40 AM](#)

CO-CHAIR JOHNSON asked why the judge disagreed with the \$15.7 billion if Anadarko-Tesoro laid out a case that definitely said that is what they made and what the difference would be.

MR. BRENA replied the difference is substantial. He explained the judge said, for rate making purposes, there was no authority to look through the regulated entity to what their parent companies actually made on distributed funds and attribute that back to the ratepayer or the regulated entity. She did not want to trace them all the way to their actual integrated use. The judge did hold the companies collected and earned \$2.9 billion to date and their need is \$2.6 billion. She based that on "Moody's AA Actual." He pointed out those funds were not actually invested in Moody's AA Actual and if one looks at the regulated entity, their allowed returns were massive and were higher than the parent companies' 15.2 percent actual use. That is and will continue to be an issue to the proceeding.

[10:14:03 AM](#)

CO-CHAIR JOHNSON inquired whether [a copy of] the judges ruling of \$2.9 billion is included [in the documentation provided].

MR. BRENA said it is not; that amount is actually a calculation.

CO-CHAIR JOHNSON asked Mr. Brena if that is his calculation versus the judge's calculation.

MR. BRENA clarified the judge did not do a calculation. She determined how a calculation would be done. If one does that calculation, the amount is \$2.9 billion. He asserted this is the area in the case where he doesn't agree with the judge.

CO-CHAIR JOHNSON asked if that is the only area where Mr. Brena disagrees with the judge. He suggested 15.7 is a huge number and he wants to deal with information that a judge has found to be credible, which the \$2.9 billion obviously is. He asked Mr. Brena to point out his discrepancies with the judge's opinion.

MR. BRENA said that is the only issue where he disagreed with the judge. He remarked the judge didn't say that earning lacked credibility. She used it in her reasoning to reject a risk-free rate calculation. She did not disagree with the earnings amount of \$17.2 billion; she said as a regulator she could not trace the funds through to their actual use. He stated the companies actually collected and earned a total of \$17.2 billion, the sum of \$15.7 billion and \$1.5 billion. He didn't want to give members the impression that the judge disagreed with his calculation. She did not. She actually used it to reject one of their positions. The problem was she could not trace the funds. All of those funds were distributed to the parent companies and use for unrestricted equity. She pointed out that FERC looks to the regulated entity, not to what the parent companies made with the distributed funds.

CO-CHAIR GATTO asked if Mr. Brena calculated the \$15.7 billion by looking at the annual rate of return and determining, "this money earned the same annual rate of return as the company in general and therefore this money, even though it's mixed in the overall money that the company has, this specific money, if it earned only its percentage of all the money, would have earned \$15.7 billion. Is that how you arrived at that number?"

MR. BRENA replied, "Exactly."

[10:17:34 AM](#)

REPRESENTATIVE GARDNER inquired whether the judge said she lacked jurisdiction to use that calculation.

MR. BRENA said she did not use that term. She said no FERC authority allowed it to use the parent companies' returns to determine the earnings on the DR&R fund. Given that she rejected the parent companies' use of capital structure, she looked at Moody's AA actual.

[10:18:20 AM](#)

REPRESENTATIVE GRUENBERG asked what kind of authority the judge indicated she would need to use the parent companies' earnings.

He questioned whether any authority exists that prohibited her from taking action.

MR. BRENA answered the judge said no precedent existed; she did not say that she lacked authority.

REPRESENTATIVE GRUENBERG asked if that is the point of appeal.

MR. BRENA said the briefs have not been filed yet.

REPRESENTATIVE GRUENBERG asked Mr. Brena if he plans to include that point in the brief.

MR. BRENA said he is considering it. He then continued his presentation:

Let me point out too, that we had put on an alternative case. The \$2.04 was what we put on as our primary case and what we asked her to accept. With regard to the DR&R, the FERC deals with it conceptually two ways. They kind of create a fund or they kind of allow a rate-based credit. We did ask for them as an alternative to apply a rate-based credit and she didn't like that idea much either.

But let me point out that everything that we're talking about goes to transportation rates and then DR&R is not a current transportation rate because she didn't allow the collection of any DR&R in the \$2.04 rate. The DR&R goes, what do you do because you've collected \$1.5 billion over - since 1977 forward and you haven't accounted for it and you haven't said what you've earned on it and nobody knows how big the pot is. You guys say you need \$2.6 billion but we don't know how much you have. So what do you do about it?

What we said is regulator regulate. This needs regulatory oversight. They need to provide an accounting. We need to set an earnings rate. We need to figure out how we're going to figure this out. You can't wait for 30 more years and then just litigate it, so that's our basic position. So I want to be sure, too, how the DR&R fits into the case that we prevailed in the position that there should be no further DR&R collections in the \$2.04 rate because they haven't demonstrated that they needed the DR&R.

[10:20:47 AM](#)

CO-CHAIR GATTO referenced a document before committee members named "United States of America 119 FERC 63,000-007." He asked members to turn to page 74, "Issue 3F," and said it is pertinent to the current discussion. He read from page 74, "What is the appropriate rate of investment?" and said that is followed by a description of how the companies determine that. He read:

The carriers claim that the cost of capital should be based on the capital structure of the carriers' parent companies, the parent companies' cost of debt and a cost of equity established using the TCF methodology with oil pipeline proxy companies or using a risk premium methodology if appropriate .... Additionally, the carriers argued that they should get a two percentage point equity rate and premium.

MR. BRENA said the consistency of rejecting the companies' capital structure to determine return by tracing through the DR&R funds was important to the judge and is one reason she did not trace the funds. Regarding what Co-Chair Gatto just read, he explained the parent companies' capital structure for major oil is heavily weighted towards equity. They requested the highest, most heavily weighted equity structures that FERC has ever considered and they lost. The equity decreased from 90 percent to 45 percent.

[10:23:53 AM](#)

MR. BRENA continued his presentation:

I wanted to comment on the State of Alaska's positions because this committee has an oversight function and the state's stake and the lessons for the gas line, my last slide. Let me say in the history of the State of Alaska's position, or Slide 14 - let me start out by saying none of the points I'm about to make are comments on the Palin Administration or the current attorneys involved in these cases. I know that Phil Reeves was available to answer questions to this committee today or he was going to be. I think very highly of Phil Reeves and he's one of the best that they've had on these kinds of issues for some time. And the Palin Administration, I believe, is headed in the proper direction in terms of trying to rein in the abuses in pipeline transportation. So these are

comments on the prior history generally because - and I go into history because if you don't figure it out, it's hard to correct it and so I just want to tell you my opinions for the value that they contribute and we'll kind of go from there.

The state has consistently been out-resourced in pipeline matters - consistently. They've been out-litigated. They've been out-negotiated. They've been out-staffed just across the board. So, anything that you guys can do to get the state the resources they need to do these jobs right is what they need to do. They compete with the best and the brightest in the world. People that go around and do this, you know, this is all they do. They know their stuff well. I've been litigating against these guys for a couple of decades. They are good. They are very, very good and that needs to be recognized.

The state has had very limited success with regard to the oil pipeline. The state has never established a just and reasonable rate in Alaska's history - not one, not one ever. That's too bad because if you establish just and reasonable rates, you establish principles that apply to pipelines but then you go back to if what you're always doing is negotiating, and never - it's just common sense. If you're going to negotiate with me and you know that if our negotiations break down, I'm going to take you to court and beat you, then you negotiate differently with me and I do beat you. You negotiate differently with me than if we're negotiating and I never end up taking you to court all the way through and forcing the hard decisions on the system. So you've got to win some cases to get good deals from major oil. If you don't, you're not going to get them - period.

The results have been bad settlements and one of the things about the settlements that strikes me in particular is that there's no way to be sure that the deals stay fair for the parties. You know, like the TSM deal. They took the state out of the game - a major financial player. They took the state out of the game and then they linked return to throughput that they know a whole lot more about than you guys ever will. And then, when the throughput was a whole lot higher than what everyone thought it would be,

then they were making a 50 to 100 percent return a year on the line while the state sat helplessly by as a signatory to the settlement and couldn't do anything about it.

Well, if you do a deal, you don't base it on information that you don't have control of and you do it in a way so that if it goes out of sync with reality, you can bring it back. You don't just enter long term 20 or 30 year deals without those basic principles. Nobody does it in business and stays in business and it's what the state does, consistently.

[10:27:52 AM](#)

CO-CHAIR GATTO asked, "So making 50 to 100 percent on the line because the line was entirely within the state, then FERC had no influence?"

MR. BRENA said for regulation to work, someone has to ask it to work. The state is the obvious player to do that because it has the greatest financial stake in the outcome. However, the state agreed to sit on the sidelines. He pointed out that 30,000 of 800,000 barrels of oil moving through TAPS daily are owned by independents. The rest of the oil is moving through affiliates so the BP shipper is not going to file a protest against BP pipeline and the producer is saving 25 cents of every dollar from the state royalty and severance taxes. They analyze this on an integrated economics basis. When you have affiliated shippers on an affiliated line and not many independents, and the state is on the sidelines, there is no one to ask FERC to do its job. No one has, which is why FERC has never established a just and reasonable rate on an Alaskan line until its initial decision.

MR. BRENA continued his presentation:

Okay, some of the settlements that the state has entered into, like the feeder lines going into TAPS, they're agreements on rates. It's not clear what the depreciation is that's in that rate. It's not clear what the DR&R is in those rates. Given the fact that they go back and restate that - I mean I'm in a case where they've said that the depreciation that they collected under a settlement shouldn't be counted against future rates and therefore we should be able to collect it again from future rate payers. Well you

ought to be pretty clear about, in your settlements, about what elements of that settlement that affect future rates - about what you're collecting in that rate. I mean if, for example, you don't know what the depreciation is, then when that settlement ends, what you have is a mess because you don't know how much investment is left in there. You don't know how much DR&R has been collected. You don't know what the earnings rate is in the DR&R. Every one of the state settlements is like that.

10:30:21 AM

The Murkowski gas line agreement - the only worse deal I've ever seen in the past was that one and I won't go into that anymore.

The state has put itself on the sideline in these old deals but they are also restrictively interpreting the terms of those to keep themselves on the sideline longer than they need to be.

The duty to defend the TAPS settlement, for example, I made a major point of saying that third parties had the right, under the settlement, to go ask for a just and reasonable rate and that's what we've done. The carriers have advanced arguments and said that under the TAPS settlement agreement we don't have that right. The state has sat silently by while the carriers have misinterpreted the settlements that they've entered into with the regulators.

So I think that they're - and the state actively litigated against in-state shippers for a decade trying to force down our throat TSM rates, which were far higher for - after, you know, please share with me just for a minute - I was at the hearing where the RCA or the APUC at the time approved the settlement. I was there for Tesoro and I said that the APUC should approve the settlement. The reason that I said that is because prior rates were settled and future rates, if we disagreed with them we could protest them and get what was fair. So we agreed with it because that was the deal.

When we finally went around to file and to argue that the future rate was unjust and unreasonable, the

carriers started arguing we didn't have the right to do that. That was a part of the deal. It's always been part of the deal and so they went back and said well, Robin, you supported the settlement. Yes, I did, but the settlement said we had the right to protest future rates and now you're telling me the settlement says we don't have the right to protest future rates. That wasn't the settlement that I supported.

[10:32:30 AM](#)

CO-CHAIR GATTO asked if the settlement was in writing.

MR. BRENA said it is in writing and was stated in testimony and they haven't been able to persuade anyone of their positions.

REPRESENTATIVE GRUENBERG asked Mr. Brena to describe the deal he thought was made.

MR. BRENA said it was described in sworn testimony. The representations and presentations to FERC and the RCA made clear that future rates were not settled. They filed a 50-page explanatory statement of their settlement in detail and brought in their experts. The carriers' argument metamorphosed from saying the original deal was something different to the fact that FERC somehow approved it over the passage of time.

CO-CHAIR GATTO said he is amazed there is no document that says the parties agree to specific stipulations rather than simply saying something was on the record so cannot be disputed.

MR. BRENA clarified the settlement does not settle future rates. He continued his presentation:

The no clear consistent policy or client - I started the presentation by saying you need to get two things right. You need to get access right and you need to get rates right. If you don't do those two, then you haven't got it done. One problem - there's no clear policy concerning access and, obviously, to the degree that Alaska has to rely on independents and is trying to open up competition on the Slope and maximize its resources, obviously to the degree that it can open up the Slope to other players is better for the state. So the state should have a clear and consistent policy for open access to fuel facilities, to pipeline

facilities, to the whole system necessary to develop the resource.

[10:34:56 AM](#)

REPRESENTATIVE WILSON recalled that when this issue was debated during the regular session, the producers were opposed to the state having access.

MR. BRENA said he did not hear all of the producers' arguments so he could not respond. He added that with an affiliated controlled gas line, there is tremendous financial incentive to not open access to that line to a competitor.

REPRESENTATIVE WILSON believed the majority of the producers argued against access but some did want it.

MR. BRENA agreed that trying to get open access from a controlled facility would be very difficult.

[10:36:27 AM](#)

MR. BRENA continued with his presentation:

So no clear or consistent policy or client - you know, there needs to be a clear policy towards open access. There needs to be a clear policy on cost-based rates. People that build infrastructure should be able to get their investment back. They should be able to make a reasonable return. They should be able to recover their operating costs. But they shouldn't be able to game it into a tax savings mechanism against the state by having such exorbitant returns that, in effect, they are transferring profitability from production to transportation and impacting the ability of independents to explore on the Slope, impacting the state's royalty and severance taxes, and impacting the value of those resources to value added manufacturing in Alaska.

The no clear client comment - the attorney general has interpreted a statute to mean that the attorney general is both the attorney and the client on oil pipeline matters. That's never made any sense to me. I think they are reading the statute wrong and what you have is, over the years you've had an attorney general without a client. I've often tried to say

okay, well who is your client, who do I sit down and talk with? Issues with regard to natural resources, it seems, should be left to the Department of Natural Resources and that should be the client that the attorney general represents. But they've interpreted that statute to mean the attorney general is the client and the attorney general is the attorney. It's a misreading of the statute in my judgment. It's something the legislature ought to clarify - who the client is to the degree it's being interpreted and applied that way.

Trying to get accountability for these pipeline calls - whose making these decisions? I've tried to trace them through and good luck. There is a shape shifting body of people that are involved in decision making that go - some are in DOR, some are in DNR, some are in the Governor's Office, some are in the Attorney General's Office. There isn't one consistent line of responsibility. So it ought to be policy driven, it ought to be policy driven by the department as it is in every other area that is responsible for the development of our resources, which to me is DNR.

CO-CHAIR GATTO asked if Mr. Brena is saying the DNR commissioner should be the lead player while the attorney general would assist the commissioner with contract making.

MR. BRENA emphasized in every other area of law, attorneys have clients, but not themselves. In gas and oil pipeline policy matters, the attorney is the policy maker because of how they have interpreted the statute. The result has been a blurred and shifting authority within the state as to how the policies are to be made and implemented.

REPRESENTATIVE DAHLSTROM asked who "they" are in regard to interpreting the statute.

MR. BRENA clarified he was referring to the attorney general's interpretation of AS 42.06.140 (a)(10).

REPRESENTATIVE DAHLSTROM asked if Mr. Brena was referring to the current attorney general.

MR. BRENA said he was referring to former attorneys general. He added they do things with a certain amount of bureaucratic momentum. This is an unusual area that needs to be straightened

out. He finds it amazing that the attorney general, who is the acting attorney for resource development agencies, has interpreted the statute to mean the attorney general is the client and attorney. It makes no sense.

REPRESENTATIVE GRUENBERG said the members of the House State Affairs Committee have pursued other areas where the attorney general's role is questionable but he was not aware of a problem in this area. He then read AS 42.06.140 (a) (10):

The commission ... [referring to the RCA] shall provide all reasonable assistance to the Department of Law in intervening in, offering evidence in, and participating in proceedings involving a pipeline carrier or affiliated interest and affecting ... the interests of the state, before an officer, department, board, commission, or court of another state or the United States.

He said he reads that as only authorizing the commission to assist the attorney general in its representative capacity, such as an investigator or police officer would assist the district attorney.

MR. BRENA agreed with Representative Gruenberg's interpretation.

REPRESENTATIVE GRUENBERG asked Mr. Brena if he has any written documentation to show the Department of Law has interpreted the statute as he described.

MR. BRENA said he would check to see whether he has any written information to substantiate his assertions. He has asked the attorney general's office who its client was. In P97-4 when the state was opposed to lowering the rates to just and reasonable levels, he raised that issue in the hearing room for the record. He offered to follow up and get that information to the committee.

[10:42:56 AM](#)

REPRESENTATIVE DAHLSTROM asked the co-chairs to request clarification from the current attorney general.

REPRESENTATIVE GRUENBERG believed the House State Affairs Committee members are interested in dealing with the question of whether the attorney general represents the state or the governor.

MR. BRENA asserted resource development is within the purview of the Department of Natural Resources (DNR) so this is one arrow DNR should have in its quiver. He then continued his presentation:

Slide 15 - thank you for your patience. The State of Alaska financial stake and I use this as a rule of thumb, the 25 percent, that's historically correct. The new tax regime had made that calculation more complicated and ... so I'm just using that as a rule of thumb. But of refunds and interest for 2005 and 2006, and the judge's ruling did say that it's just an increase in rates for these years subject to refund and I suspect that that will be something that people are considering, whether to take a brief on exceptions for. The state has a huge financial interest in that issue. My client does not - clients.

Then 25 percent of lower refunds or interests - 2007 going forward - I think we're going to be able to get the \$2.04 rate. Anything above that - I mean once you get that in place then the benefit starts flowing. I think we're going to be able to get there by the end of the year. I hope we can. The DOR's calculations that you've seen in the paper and that have been reported to this committee I think understate the benefit to the state and what they assume in their calculation is that the benefit ends at the end of 2008 because that's the termination of the TSM.

So they assume that ... beginning in January 1, 2009 that cost-based rates are just magically in effect on TAPS. Well, I showed you their case that said that a \$5.63 rate was the way they calculated Opinion 154 B so they put on two cases. They put on two alternative cases: the SAC that said that the rate ought to be \$6.00 and the Low Cost Method. And their 154 B calculation said it would be \$5.63. They put on a 5 and a half buck case and a 6 buck case to justify a \$4 rate.

Now if you think that in January 1, 2009 without these decisions all of a sudden Anadarko-Tesoro's or the state's interpretation of 154 B is going to be automatically put in effect, then go ask Alice because that's just not going to happen. So, the deal where

our calculations of benefit from just [indisc.], are going to carry forward.

[10:46:34 AM](#)

Now there would be a counter-argument that would suggest that at the end of the line is agreement among the parties with regard to depreciation balances and property balances and those kinds of things. That's not persuasive to me. So, the real benefit of this to the state is on a going forward basis but at long last cost-based rates are being set on TAPS and that means that the tax avoidance game is ended. That's the real benefit here.

CO-CHAIR JOHNSON asked whether the state can sue to recover that money even though the state defended the producers in the case and has [offered] a settlement agreement.

MR. BRENA responded, "You get your money despite yourself."

CO-CHAIR JOHNSON asked whether the state will have to take the case to court.

MR. BRENA replied:

Anadarko and Tesoro, or their representatives in the back room, ought to get a Christmas card from the state. ... I'm hopeful that the state will be able to walk through the front door and say if the FERC does establish a J&R rate, a just and reasonable rate, that refunds ought to be available. Please understand that it's Anadarko-Tesoro's theories that are making the state money. Anadarko-Tesoro doesn't have a dog in this fight. In fact, we lose a little bit of money if the state makes money in these historic years.

CO-CHAIR JOHNSON asked if the state is precluded from taking legal action because of its previous agreement.

MR. BRENA said the assistant attorney general is reviewing that right now. He does not believe a lawsuit will have to be filed. The mechanism for refunds is to ask for clarification, and when FERC orders refunds, they are paid. If FERC establishes a rate and orders refunds, they are paid, so no independent legal action should be necessary. He said the amount of the refund for 2005 and 2006 is in question because the basis on which it

will be calculated is unknown at this time. That is not a refund issue; it is just a question about the amount.

MR. BRENA continued his presentation:

And then, of course, unless the state has given it away through the royalty settlements, there is also an opportunity for 25 percent of the DR&R refunds. To take it back to the theories that we advanced, you know the \$17.2 billion versus the \$2.9 billion, it doesn't matter what number you use. If you use the \$2.9 billion, you take the life of this line out 40 years and you use the judge's decision, then earnings are going to accumulate on the weighted cost of capital, say at 8 percent. So your earnings are going to go up for the next 30 years at 8 percent. Your costs of DR&R are going to go up by 2 or 3 percent so you are already over-collected. Thirty years from now you are going to be massively over-collected. It doesn't matter what calculation you use. There [are] massive over-collections and refunds.

[10:50:22 AM](#)

If you use how much they actually made on it, then there are 2 or 3 billion at stake now. If you use the judge's calculation of prior earnings, then there's a hundred million at stake now and refunds, and there will be 2 or 3 or 4 or 5 billion at the end of the life of the line. Either way, please pay attention to it. It's a whole bunch of money and it makes a difference.

[10:50:55 AM](#)

REPRESENTATIVE GUTTENBERG asked Mr. Brena to address his opinion of how the attorney general's office defines its duty to defend.

MR. BRENA said eight years ago he wrote an assistant attorney general a 23 page memorandum on the duty to defend. He explained the history of the agreement and his exact position. He agrees and disagrees with parts of the state's position. He agreed that the state cannot sign a deal that says it will not protest a rate as unjust and unreasonable as long as it is operating under the TSM because it cannot sign a deal and then violate it. He agrees the state cannot say it's unjust and

unreasonable. He believes locking into a deal like that disallows any opportunity to assure the deal stays fair.

MR. BRENA then said the state does not have a duty to defend something that is not being attacked. Part of the deal was that any third party shipper could get a just and reasonable rate on these lines. The attorney general stepped up at the time and said the state might not even be involved in those proceedings. His concern is that since the state did step up, it first read the duty to defend to mean it had to oppose Anadarko-Tesoro. He further said:

Well you don't have to oppose somebody. We were getting what they said the deal was. So I think that they misread their duty to defend in opposing establishing just and reasonable rates before the RCA and I think - and at this point they changed their position on most but not all of that. And I think that they are unduly restrictive in their interpretation of it on the federal side. On the federal side, for example, like - we're talking about refund issues. Let me give some examples. I hope that the state will step forward, even though it says that it can't say that a J&R rate should be established because it agreed to live with the TSM rates. But the question is if the FERC establishes our J&R rate, then what are ... the legal consequences of that? I don't think there's anything restricting the state from saying that.

So I think the state should speak and hasn't spoken to say what the deal really was and what it wasn't. I think the state should speak and hasn't spoken with regard to what the deal is silent on. DR&R is a perfect example. The settlement agreement says DR&R will be collected. It doesn't say whether it's refundable. It doesn't say how it will be accounted for. It doesn't say what the earnings rate will be. The settlement that the state entered into is silent on all those massively critical terms. So why should the state under the duty to defend sit silently by and not speak on those issues? I think that they should. So I think that they misread the duty to defend and, by the way, even when we get our rate, our \$2.04 rate or our \$1.96 FERC rate, nothing changes the deal that the state is in. So if nobody is attacking it, there's nothing to defend.

So, in summary, I think the state misinterpreted and misapplied the duty to defend in opposing the in-state refiners trying to get a fair rate on the state side and I think that their interpretation to date on the federal side has been more restrictive than the contract calls for. I think the state is staying on the sidelines when it ought to get in the fight, particularly when the carriers are misrepresenting what the original deal was or adding terms to it that weren't settled. Does that respond to your question?

[10:55:55 AM](#)

REPRESENTATIVE GUTTENBERG said it did.

MR. BRENA offered to provide a copy of his 23-page memorandum on the duty to defend.

[10:56:23 AM](#)

REPRESENTATIVE GUTTENBERG noted that under the judge's ruling, the difference between the intrastate and interstate rates is about \$2.00. He asked Mr. Brena to address how the carriers justified applying that cost.

MR. BRENA asked for clarification of the question but first explained when the state said the federal rate was too high under the discrimination theory and asked the FERC to lower the federal rate to the state rate, the carriers argued that assuming FERC has that authority, Section 13.4 of the Interstate Commerce Act (Interstate Commerce Act) says the federal government can set aside and establish a state rate if the state rate is noncompensatory and a burden to interstate commerce. He asked Representative Guttenberg if his question was in regard to the carriers' claims under Section 13.4 of the ICA.

REPRESENTATIVE GUTTENBERG said the carriers are adding the difference onto their interstate rate so he is trying to determine how the carriers would justify that to interstate oil.

MR. BRENA said one mechanism of the TSM establishes total revenue requirement regardless of jurisdiction. He continued:

Say that's \$1,000 and then whatever the state rate pays, whatever the state shippers pay, say \$100, they pay and then the rest they get from the federal

shippers and so the rest in that case would be \$900. When the RCA lowered the federal rate by half, it took the \$100 and turned it into \$50, which means, because of the way the TSM works, they are allowed to collect \$950 because either way they are still entitled to continue to collect \$1,000, and it's just a matter of whom from. When the state shrunk the rate, then they shrunk the state contribution, then they grew the federal contribution, which cost the state royalty and severance taxes, which is another flaw in the settlement.

But, how did the - I'm understanding your question to say how could they justify asking federal shippers to pay for portions of rates that have been specifically held by the state to be unjust and unreasonable.

REPRESENTATIVE GUTTENBERG said that is correct.

MR. BRENA replied:

I don't think that they could do it without the - I mean how do you say that excessive return on the state side that was disallowed by the state commission automatically has to be paid by federal shippers? That's not fair and that's not fair at all. And they weren't successful in that and that is one of the many reasons why the TSM jurisdictional allocations are misallocations. That's one of the many reasons why the TSM can't work to set just and reasonable rates because it disregards jurisdictional integrity.

[11:00:23 AM](#)

REPRESENTATIVE SEATON asked Mr. Brena to elaborate on his statement about giving away the 25 percent DR&R refund through royalty settlement agreements.

MR. BRENA told members the state has comprehensive royalty settlement agreements with all of the major producers. He does not believe those agreements contemplate DR&R at all but he believes [the carriers] would argue that any refunds associated with DR&R should go to the affiliate shippers. In that case, BP pipeline would pay BP shippers a huge refund. That only affects the state because the wellhead value of Prudhoe would increase retroactively. He advised it is necessary to think through whether that issue was settled under the comprehensive royalty

settlements that the state has entered into and whether funds are available now, which would impact the funds for royalty calculations for those periods or for the current period.

REPRESENTATIVE SEATON questioned whether that is a state issue and not something Mr. Brena is concerned with. He clarified he is trying to figure out who needs to analyze that.

MR. BRENA believed the assistant attorney general should be asked whether the state has a financial interest in DR&R refunds if they are ordered. Those issues are being decided by the FERC. The judge suggested putting it off until the end of the life of the line but he disagrees. However, regardless of when it is addressed, the question is whether it is refundable and where the economic benefit flows. He pointed out his clients have an interest in the state rates for DR&R. The RCA put off the DR&R until the end of the life of the line and closed the rates down without forcing them to justify the collection of the rates for prior periods. He agrees with the RCA's actions in P 97-4 but not in P 86-2.

REPRESENTATIVE SEATON asked Co-Chair Gatto to have the committee follow-up on that issue.

[11:03:46 AM](#)

CO-CHAIR GATTO suggested having a separate fund for DR&R collections.

MR. BRENA said that is an interesting concept. Given the state is comprised of 50 percent state-owned land and the primary DR&R obligation is contained in the right-of-way agreements, he believes the state should strengthen its leases and right-of-way agreements to ensure its financial stakes are protected.

[11:05:26 AM](#)

CO-CHAIR GATTO asked Mr. Reeves to give his presentation after Mr. Brena was finished and the committee takes a short break.

[11:06:20 AM](#)

MR. BRENA continued with his presentation:

Having been in the trenches for a couple of decades, I've learned some basic lessons. And so I want to share those with you guys. You can ignore them or

listen to them. It's clearly your choice but I want to be sure you hear it. The first thing is don't leave anything to FERC.

[11:06:53 AM](#)

CO-CHAIR GATTO interrupted to note that Alaska Gasline Inducement Act (AGIA) has rolled-in rates with a 15 percent top, yet shippers are allowed to protest the rolled-in rates. FERC is involved in the protest with the words "rebuttable presumption." He asked Mr. Brena to explain the connections between peaks and rebuttable presumptions and what the objections to rolled-in rates could be.

[11:07:49 AM](#)

MR. BRENA said he was not prepared to comment directly on the terms of AGIA but he would comment on some of the underlying concepts. He explained:

The first, if a shipper wants to protest a rate, there's nothing that's a deal between the state and whoever the pipeline owner is that keeps that person from being able to go to FERC and say the rate is too high. ... So when I say don't leave anything to FERC, I don't mean foreclose a shipper's rights to take an issue to FERC. What I mean by don't leave anything to FERC is that one major thing that the Murkowski gas contract did was leave a lot to FERC. All the details I'm sitting here talking about weren't addressed and that's where the money is. So, it's too important to leave the issues - let me back up one more step.

You need to understand FERC isn't known as a real active regulator and FERC's regulatory policies have evolved within the context of Lower 48 pipelines that it regulates, which largely have competitive alternatives. So if you develop a policy, you know, down south, if I've got some gas in the line and you want to charge too much to put it through your pipeline, I'll go put it in your pipeline or her pipeline or I'll build my own. Those aren't options up here. So at the core, FERC is not, as a matter of its regulatory structure and mission and the way it's defined its policies with regard to pipeline regulation, is not well suited to the circumstances of Alaska.

Secondly, pipeline regulation is the poor step-child at FERC. They don't like it. They don't like to have to do it. They view it as disputes between large financially interested parties that have minimal impact on customers and they want to be done with it as quick as they can. So when you take all those that we have policies based on an entirely different set of circumstances that exist in Alaska, and the regulatory hesitance to get involved in these massive cases between well-financed parties, then FERC is not a very good arbitrator or protector of the state's financial interest.

So, my suggestion is that the state takes care of its own financial interests by contract. These are your resources. You have several opportunities to take care of and maximize the value of your resources and not leave it to the whim of a regulator in D.C.... The way the leases are written and what the terms are - very important powers. You have the right-of-way agreements. You have whatever kind of deal gets struck under whatever legislation. It should define the way that FERC will regulate because whatever you guys agree to, FERC will go along with. But if you don't agree, and if it's silent, then the carriers are going to be in a favorable forum to increase the profitability of these lines to levels and ways that foreclose independence from exploring on the Slope, getting access to this line and paying fair rates. And that's not in your interest. It's not in your tax interest. It's not in any of our interests that that happen.

So don't - don't leave important issues for the FERC to decide because the devil is in the details. Strike deals where you agree on what you're going to present to FERC because whatever you present to FERC is what FERC will go along with. If the state and the carriers agree, whoever the carriers are, if the state and the carriers agree on cost-based rates, open access, rolled in rates, FERC is going to go along with that. If you guys don't address it, then you'll have a huge amount of unnecessary litigation that will probably result in compromises to the state's financial interest. So - and I've learned long, long ago, don't try to solve a local problem in D.C. So

don't leave major, major issues. Access, and this goes - the second thing, resource the effort. Get the best and the brightest. Perform your oversight function. Be sure it's being done. Have it be an open process; resource the effort properly.

[11:12:46 AM](#)

REPRESENTATIVE ROSES asked if Mr. Brena means by "resource the effort" that the state gets out-litigated, out-negotiated and out-staffed so it needs to hire somebody to do it. He noted Mr. Brena said don't leave anything to FERC but he also said the state is not in the best position to negotiate so the state is caught between a rock and a hard place.

MR. BRENA said he means it should be a priority from top to bottom; he believes it is in this Administration. By "resource the effort" he means hire the best and the brightest because the opponents will be the best and brightest at every level. He pointed out the expectation has been that people who play infrastructure games make 50 to 100 percent return and cost the state 25 cents on every dollar for that access. They control the North Slope's development through control of the infrastructure and shift profitability away from the development of the resources both upstream and downstream. The state needs clear policies on open access and cost-based rates. Those two things will end the games that have cost the state billions of dollars.

[11:15:05 AM](#)

CO-CHAIR GATTO said the public demands that legislators take action so legislators tend to rush. It takes a certain amount of courage to say we're just not ready. He said it is difficult for politicians to do both jobs - the economics and politics. He said he favors an economic focus because the state does not want a bad deal. He wants one that will benefit future generations.

[11:16:35 AM](#)

MR. BRENA said the legislature has a constitutional mandate to maximize Alaska's resources.

CO-CHAIR GATTO indicated that Mr. Brena's arguments bolster the legislature's argument that it is not ready. Everyone is working together, but it still may take time.

MR. BRENA said he favors development of the resource and building a gas line or multiple gas lines and nothing he is saying should be interpreted any other way. He is saying those things need to occur but should be subject to contracts that make sense for Alaska and the independent explorers and independent refiners.

CO-CHAIR GATTO said legislators know that 35 TCF is not enough. If additional exploration does not occur, the state will not have enough resource and will run out before the gas line is paid for.

[11:18:45 AM](#)

MR. BRENA continued with his presentation:

I think I clarified what I meant by resource the effort. "Get Gas for Alaskans." You know, in third world countries, they extract the resource and ship it to somewhere else to add value. That's what happens in third world countries all over the world. If it's possible to add value to that resource before it's shipped, and we're seeing, for example, Saudi Arabia moving in the direction of rather than just extracting and exporting its crude oil, of building refineries so that it can export products, anything that we can do to get gas to value-added manufacturing in Alaska would have a huge, huge impact. I was sitting around talking with somebody yesterday and I said what would happen if they put in the leases that 30 percent of the gas and oil had to be processed in Alaska - value added. What would that do to the economy of Alaska - that one simple lease term sentence? Who knows? And I'm not suggesting that. I'm just saying think about it and find ways. We've got Agrium running at less than half capacity for gas. We've got Tesoro constrained on gas. The value-added manufacturing in this state adds tremendously to the economy of this state.

Figure out ways that we can maximize the value of the resource in Alaska before it's exported. Why can't we do better than a third world country that simply exports its gas and crude oil? Why can't we do what we need to do to add value to that resource to the degree it's possible to get it done? So we need ... a

fundamental shift in thinking. We've got gas prices going through the roof for 60 percent of Alaskans because of these increases in these contracts linked to Henry Hub. I was involved in those cases - getting the most recent contract rejected by the RCA because they're just getting ridiculous.

So we've got \$7 gas, we've got industry shutting down. We got Tesoro constrained at its refinery because of its gas constraint. We've got crude oil drawing up to our own in-value manufacturers in Alaska. Those guys add a lot of jobs, high paying jobs, to the state. The future of this state depends on your ability to shape public policy so that independents can get access to the Slope and develop those marginal fields and so the value-added manufacturing has a way to realize the benefit from those resources.

So please get some gas for Alaskans. Get access right. There's no - if people can't get in the line, they won't invest in drilling the holes. And get the rates right. I've talked about those issues, rates a lot more than access, but those are things you've got to get right. You've got to get gas for Alaskans. You've got to get access right. You've got to get rates right. The policies that you develop have to do those three things. If they do those three things, then a whole lot of good things are going to happen. If they don't, a whole lot of good things aren't going to happen. So when I view, based on my experience, what I'd suggest, that's the heart of it.

The last one I changed - I said have a very good reason. I changed "damn" to "very good reason" but if you give control of this gas line to a few major producers, be sure you know what you're doing and you have real good reasons for doing it. And I say that because just on a fundamental economic level, you need to understand the way the game works. Okay. If Representative Seaton owns the line, he is the producer and it's his line, and I want to ship gas in it, it has to go to the market that he is serving. He has no incentive at all to let me into that line. And so, he's going to nominate 100 percent of capacity to the contract carriage provisions to his own arm. He is going to service Chicago or whatever markets the pipeline goes through.

Now I come in and I want to service those same markets but to do that, I need his cooperation. Think about that. I need his cooperation to compete with him. Now first, there is no capacity in the line because he has nominated 100 percent of it. It doesn't cost him anything to nominate 100 percent of it because he pays it to himself. So the whole concept of some sort of demand charge - he's paying it to himself - so what if he pays demand charges to himself. He has to carry the cost of the line. He's happy to do that to keep me out of his markets.

Okay, so how do I get in? Okay I can't get in. I asked him to release part of his capacity. He has no obligation to do that. I've got to go litigate it in FERC for five years in order to get it. That works on my economics? I'm trying to develop a field here. I'm trying to bring something on line. In order to do it, I either need him to bless it, which means I've got to give away a huge amount of the profitability of the field, or I have to go litigate at FERC for 5 or 10 years before I can even start my first [indisc.] Not a very good position to put me in.

Then the expansion - okay, well why don't you, since you have it all nominated because you predict you're going to need it all Representative Seaton, why don't you double the capacity of it or add 25 percent of it. Okay. Are his engineers going to hop right on that job? Okay. Are those costs going to be penciled out exactly? No wonder why he doesn't want rolled-in rates because rolled-in rates mean that he'll have to share the cost. Well he designed this line so it's even expandable. If he has choices, okay, he's going to build the line so it covers his capacity. He can build that line with the initial design so that it builds it to that capacity. He can make incremental expansion cheap or expensive. What's he going to do?

Well, I'm not impugning bad motives to anybody but I am saying follow the economics because he has an obligation to his shareholders to maximize the value of their resource. Is he maximizing that resource by agreeing to expansion, letting me compete in his markets, bring excess gas into those markets - depress

the retail price of the gas in those markets, cut down his transportation rates? Of course not.

So think about the impact just on access if he is both the producer and the pipeline owner. FERC never deals with these issues because those third party lines ... in the Lower 48 aren't owned by the producers. They are owned by independents so none of the FERC policies are going to save us. Think about the impact on rates. He's got this thing going on where he pays himself the highest rate possible because every dollar he overcharges himself, he saves himself a quarter in state royalty and severance taxes. Now I want to come in. He's squeezing the economics of my field. He's squeezing it because I can't get in. He's squeezing it because it's not cheaply expandable. He's squeezing it because it's going to take years of litigation to do that. Now he has a rate. Now I've got to go into a rate case? So think about the perfect example of the impact on rates from affiliated ownership in TAPS. No matter who calculates it, there's been billions of dollars of over-collections and that's come right out of whoever wants to develop the resource. They can't develop that resource. It's a hurdle.

And then finally, think about the impacts on the State of Alaska's power to manage and tax its own resources. When you link the producer and the pipeline owner, you see the negotiations are over producer profitability. We're talking about a highway here. We're talking about a pipeline. We're talking about transportation. We're talking about midstream. If he is both of those, then he's going to negotiate for a better deal as producer and so you're going to be talking about tax systems. You're going to be talking about arbitration in Seattle rather than in the state courts. You're going to be talking about all of these things where you're going to be asked to give away the state's rights to manage its own resources.

Now let me switch that. Let's say he's the producer but you're the pipeline owner and I'm the state.

[11:27:53 AM](#)

Well then if you can't get in, you're going to litigate for me. If the rate is too high, you're going to litigate for me. There is a natural balance when it's a third party shipper and when the producer is a third party shipper and the pipeline is owned, then there's a natural incentive for regulation to work. I'd just ask you to think through the way that the game actually works in terms of the fundamental economics for how pipelines work because the fundamental economics for pipelines say affiliated-owned lines have restricted access and high rates and nonaffiliated-owned lines have open access and lower rates.

My last slide is some jump sites to some of the orders and stuff that I thought might be helpful background. If you choose to, you can go to them and take a look at it.

[11:28:46 AM](#)

CO-CHAIR GATTO thanked Mr. Brena for his presentation and asked Mr. Dietrick if he was prepared to talk to the committee after its lunch break.

[11:29:34 AM](#)

LARRY DIETRICK, Director, Division of Oil Spill Prevention and Response, Alaska Department of Environmental Conservation (ADEC) said he did not have much to add on the pipeline tariff issues but would be available whenever the committee reconvened.

[11:29:54 AM](#)

CO-CHAIR GATTO asked Mr. Reeves to address the committee.

[11:30:22 AM](#)

PHILIP REEVES, Senior Assistant Attorney General, Oil, Gas & Mining Section, Civil Division (Juneau), Department of Law (DOL), told members the following:

... I'm the assistant attorney general charged with managing the current TAPS litigation at the FERC. I'd like to start out with a quick review of the state's protest position in the current TAPS-FERC litigation

then review the judge's decision on the discrimination claim and explain where we're looking to go from here.

Just real briefly on the duty to defend question - the state is party to a settlement agreement with the TAPS carriers that was executed by the parties and approved by the FERC in 1985. I'll refer to that as the TSA.

The TSA is a legally binding contract between the parties and its term runs at least through the end of 2008. It provides a formula and criteria under which the carriers annually calculate and file new TAPS rates. It expressly requires the parties to defend against any litigation that affects the validity and enforceability of the agreement or any provision thereof. This duty to defend is a contractual duty and, in essence, requires the state to support and defend TAPS rates that are filed in conformance with the TSA. If the state were to protest TSA conforming TAPS rates at FERC, the TAPS carriers would surely petition the FERC to dismiss the state protest as they have repeatedly done in the current FERC litigation and, in our judgment, the FERC would likely dismiss the state in order to keep it from breaching its FERC-proofed contract.

After the current protest in December of 2004, the TAPS carriers filed 2005 interstate rates for TAPS' shipments from Pump Station 1 to Valdez that were a volume rated average of \$3.71 a barrel. The RCA regulated intrastate rates for shipments from Pump Station 1 to Valdez have remained at \$1.96 a barrel since the RCA's decision on Tesoro's protests in Dockets P 97-4 and P 03-4. Thus, the 2005 TAPS rates for identical shipping services varied by \$1.75 a barrel depending on whether the shipments were in interstate or intrastate commerce.

The final paragraph of the TSA rate methodology, Section 211 (e), provides that notwithstanding any other provision of the TSA, rates charged for TAPS services are subject to legal prohibitions on unjust discrimination and undue preference. In other words, rates that are unjustly discriminatory or unduly preferential are not TSA conforming rates. The TSA duty to defend applies only to TSA conforming rates and thus the state was able to protest the TAPS 2005

interstate rates on the grounds of unjust discrimination.

The legal prohibitions on unjust discrimination and undue preference are set out in Sections 2 and 3 of the Interstate Commerce Act. I'll refer to that as the ICA just for shorthand. The ICA was enacted in 1885 and so there's a long history of rate discrimination case law to rely on when applying its terms. The basic premise of the ICA discrimination case law is that rates charged for substantially identical services must be substantially identical. Thus the state's protest cites to the nearly double rates charged for interstate versus intrastate services on TAPS as proof of unjust discrimination. The remedy for unjust discrimination under ICA Section 2 is to reduce the higher rate to a level comparable to the lower rate. The state is therefore seeking to have the interstate TAPS rate reduced to approximately the level of the \$1.96 intrastate rate.

Now the state initiated the current litigation at the FERC by filing its discrimination protest to the 2005 TAPS rates. A day after the state filed its protest, Anadarko and Tesoro jointly filed a protest to the 2005 TAPS rates on separate grounds. The FERC consolidated the protests for a hearing.

[11:34:48 AM](#)

MR. REEVES continued:

The parties have since continued their protests on the TAPS 2006 and 2007 rates on the same grounds. Anadarko and Tesoro are not parties to the TSA and they are not subject to the duty to defend and have taken no position in this litigation on whether the '05, '06, and '07 TAPS rates are calculated and filed in conformance with the TSA.

Mr. Brena has explained again today, obviously well explained, Anadarko and Tesoro's challenges in this case but I would say that a focus of the case was on the fact that Anadarko claimed the FERC rates are not in conformance with the FERC non-settlement rate methodology, which is known as the Opinion 154 B

methodology. That's the just and reasonable rate methodology that the FERC utilizes.

In response to the Anadarko and Tesoro evidence regarding its TAPS 154 B calculation, the TAPS carriers filed their own much higher 154 B calculation. In response to the state's discrimination protest, the carriers then claimed that their 154 B calculation shows that the intrastate rate is too low and the discrimination should be alleviated by increasing the intrastate rate. The state therefore responded by presenting its own 154 B reference rate calculation to establish that the intrastate rate did cover its fair share of costs of operation of TAPS. The state's 154 B evidence presents rates and rate components very similar and close to those presented by the Anadarko-Tesoro evidence.

The focus of the litigation thus became an argument over the proper calculation of the non-settlement 154 B rates for TAPS. Judge Cintron's decision, following a lengthy review of the filed testimony and arguments from all of the parties regarding the appropriate calculation of TAPS rates under 154 B methodology, Judge Cintron ruled in favor of Anadarko-Tesoro's protest and found that the carriers should be required to file new rates going forward after 2006 at approximately \$2.00 per barrel. She then moved on to address the state's discrimination claim and in paragraph 263 of pages 112 to 113, she ruled:

This decision contemplates new rates that will be substantially less than the carriers' 2005 and 2006 original filings. Anadarko-Tesoro's Opinion 154 B interstate rate calculation is \$2.04 for 2005 and \$1.83 for 2006. The state's Opinion 154 B reference rate for interstate rates is \$1.96 and \$2.05 for 2005 and 2006 respectively. The intrastate rate set by the RCA is \$1.96. The difference between these rates and the RCA established rate are minimal. Accordingly, the discrimination has been alleviated and the state's discrimination claims are rendered moot.

So, in summary, Judge Cintron found that by equalizing the TAPS interstate and intrastate rates going forward, her ruling for Anadarko-Tesoro alleviated the

discrimination that the state had protested. Now that sounds reasonable as far as it goes, however the state's discrimination protest does not seek relief, only from discrimination and rates charged after 2006. We also seek to cure the discrimination rates already charged in 2005 and 2006. And in ordering refunds for 2005 and 2006, Judge Cintron ignores our discrimination protest, which she found to be moot, and relies on a legal precedent that has applied only in a select few just and reasonable rate cases - that is in non-discrimination cases. The precedent she relies on limits refunds to the difference between the rates actually charged and the last permanent unprotested rate that was in effect prior to the filing of the current protested rate. In this case she ruled that the 2004 TAPS rate was the last legal rate for calculation of refunds.

So based on that narrow precedent, Judge Cintron has limited the refunds for 2005 and 2006 to the difference between the TAPS rates charged and the 2004 TAPS rate, which averaged about \$3.05 a barrel. Her decision to limit the refunds is subject to a legal challenge even when applied in the context of a J&R rate protest and the FERC staff presented that challenge in their reply brief earlier in this proceeding. The state has an alternative and perhaps stronger argument to raise the refund limitation ruling through its discrimination protest.

[11:39:23 AM](#)

That's because under Interstate Commerce [Act] Sections 2 and 3, rates that are unjustly discriminatory or unduly prejudicial are illegal and the remedies for such illegal rates is to remove virtually all of the discrimination by resetting the interstate rates at a level comparable to the lower interest rate charged for comparable services.

Judge Cintron acknowledged this requirement for equivalents in interstate and intrastate rates when she determined, as I quoted earlier, that by setting interstate rates that are minimally different from the intrastate rates, she had alleviated the rate discrimination protest by the state. However, the effect of her proposed refund decision is to allow the

carriers to retain tariff payments at a \$3.05 rate for 2005 and 2006. This is still one dollar more than the \$1.96 intrastate rate or than the 154 B rate that she established as appropriate for 2005 forward. Her refund decision does not create the minimal differences between interstate and intrastate rates that she relied upon to support her findings that the state's discrimination claim is moot.

So, where are we going to go from here?

[11:40:31 AM](#)

MR. REEVES continued:

The state is considering filing exceptions to Judge Cintron's decision on refunds on a couple of points.

First, we feel that the state's discrimination claim is likely not moot since the judge's refund decision shows that substantially different rules will apply in calculation of refunds in a J&R rate litigation as opposed to discrimination litigation.

Second, we think that allowing the carriers to retain a \$3.05 per barrel rate in calculation of refunds for 2005 and 2006 does not appropriately remedy the discrimination and rates for those years. In accordance with a ruling on the discrimination claim, the refunds must result in no more than minimal differences between the TAPS interstate and intrastate rates for 2005 and 2006, as well as going forward.

So that pretty much concludes my remarks. I understand that there are some people from the Department of Revenue who will be testifying regarding the numbers involved in the different refund scenarios. It's my understanding the state has a couple hundred million dollars at stake, including interest. That concludes my testimony. I would be happy to attempt to answer questions.

[11:41:47 AM](#)

CO-CHAIR GATTO requested that Mr. Reeves to submit his testimony in writing to be included in the record.

11:42:20 AM

REPRESENTATIVE SEATON asked if anything in the royalty settlement agreements would limit the state's ability to recover 25 percent of the DR&R refunds.

MR. REEVES said he recently discussed that issue with Anthony Scott at DNR. They realize the need to go back through the royalty settlement agreements through any tax settlements to determine exactly what limitations exist and what actions the state can take once the FERC issues an enforceable refund order. He noted 25 percent is an "off the cuff number." Half of that would be from royalties and half would be from production taxes so both of those agreement areas will have to be reviewed. Because the state is not an actual shipper on TAPS, it will not receive refunds directly. The refunds will primarily be determined by recalculating the wellhead value of the oil and of taxes owed. He noted the state has many different royalty agreements on different fields. Those agreements may have limitations but that has not been the focus up to this point in time. However, he is working with DNR's Division of Oil and Gas on that.

11:45:09 AM

MR. REEVES asked to address questions regarding the Department of Law's position asked during Mr. Brena's presentation.

CO-CHAIR GATTO asked Mr. Feinberg if he wished to testify at this time.

11:45:35 AM

RICHARD FINEBERG, Investigator, Research Associates of Ester, said at this point he would much rather listen to the differences between Mr. Reeves' and Mr. Brena's comments. He thanked the committee for its efforts and strongly encouraged the committee to obtain the written materials Mr. Reeves reviewed because of confusion on some of the points he made. He said, as a member of the public, it is unfortunate as a matter of public policy that Mr. Brena had to carry this function when he has a dog in the fight. He commended Mr. Brena for his clear and powerful testimony.

MR. FINEBERG said the testimony presented to the committee has been so excellent, he sees no need to repeat what has already been presented. He encouraged committee members to request

written responses from the Department of Law to ensure they get clear answers on key points. He asserted his questions and Mr. Brena's testimony are very consistent.

CO-CHAIR GATTO noted that Mr. Reeves has agreed to provide the committee with his written testimony.

[11:48:32 AM](#)

MR. FINEBERG then asked if this hearing will be transcribed into a written format. He feels it is important for committee members to know exactly what they heard today compared to what they see in writing.

[11:49:13 AM](#)

CO-CHAIR GATTO said notes will be available from House Records without an official tape. He then asked Mr. Fineberg if he agrees with Mr. Brena's disapproval of a Department of Law attorney acting as both attorney and client.

[11:52:24 AM](#)

MR. FINEBERG said he believes very strongly that a line agency should be making tariff policy. He expressed concern that he did not fully understand Mr. Reeves' testimony about the discrimination charge. He understood one argument but not another. He felt the public policy needs to be very clear and he believes the history of the TAPS settlement clearly states that policy should drive tariff management issues and should be made by a line agency.

MR. FINEBERG told members he worked at the Office of Management and Budget in the 1980s and has studied and watched government for 35 years and spent 10 years in Juneau. He stated:

I cannot think of any other place where the Department of Law is its own client. It serves as the executor for client agencies and, I believe, that's where many of our problems stem from. That is not all of them and that is why I think we should submit, in writing, but I strongly believe that policy for tariff management should be vested in a line agency with close interagency cooperation. Then we turn the Department of Law loose and let them run and get the job done for us.

MR. FINEBERG clarified that he is the principal investigator in his own firm. He is an independent economic and environmental analyst. He is a consultant largely to non-profit and government agencies on North Slope and TAPS issues.

CO-CHAIR GATTO asked if he is testifying for a paid client.

MR. FINEBERG said his testimony and work on petroleum production profits tax (PPT) last year and all of the work he has done this year have been done on his own initiative and at his own expense. He was a state bureaucrat and is delighted to do some public service, so he is not representing any client.

CO-CHAIR GATTO expressed appreciation for Mr. Fineberg's work.

MR. FINEBERG told the committee, for the record, many of the projects he works on are funded by the environmental community.

[11:55:12 AM](#)

REPRESENTATIVE SEATON asked if Mr. Reeves had any comments to make.

[11:55:47 AM](#)

MR. REEVES said he would like to address the question of what state agencies are involved in tariff practices. He said he doesn't have any policy view or make policy on the interrelationship between the various agencies. However, it has been suggested that statutorily, DNR should be the line agency. He has no problem with that and is working closely with DNR. However, he pointed out that 50% of the state's financial take comes from property taxes, which is in the purview of the Department of Revenue. This issue is overseen by a committee made up of members from the Department of Law, Department of Revenue, and the Department of Natural Resources. He asked members to remember that the Department of Revenue does have a stake in these decisions.

[11:57:08 AM](#)

REPRESENTATIVE SEATON asked Mr. Reeves about items not covered under the duty to defend the TAPS settlement agreement, such as DR&R and what would be done with those funds. He asked if the Department of Law assumes if something is not specified in the agreement, it is still required to defend that, rather than proceed forward with further clarification of those items.

MR. REEVES said the language in the duty to defend applies to any litigation that affects the validity or enforceability of the agreement. In this case, the state's protest on discrimination grounds was very legitimate. The state is concerned that it not be dismissed from the case, particularly since Anadarko-Tesoro is capable of defending itself.

11:58:56 AM

REPRESENTATIVE SEATON said he would like to see some of the issues brought up in testimony in writing and to know whether the current Administration's position is to defend items that are not specified in the TAPS settlement agreement or whether its role is to clarify those items.

12:00:07 PM

REPRESENTATIVE GRUENBERG referred to AS 42.06.140(a)(10), and asked Mr. Reeves to comment on the Department of Law's construction of that statute.

MR. REEVES replied that he tried to respond to that issue when he pointed out that both the Departments of Revenue and Natural Resources are line agencies that have roughly equal financial interests in royalties and taxes. The Department of Law's practical policy is to work with both departments in all matters involving TAPS at the moment. He said he has not participated in, nor is aware of, any formal interpretive review of that statute.

12:01:39 PM

REPRESENTATIVE GRUENBERG asked Mr. Reeves, "Do you believe that the Department of Law is its own client?"

MR. REEVES replied:

The only way I can answer that is the attorney general, by that statute ... is charged with certain duties. I certainly agree, and our practice is, that the Department of Natural Resources and the Department of Revenue both have statutory duties that relate to this and therefore we work cooperatively on it. So who is the client? Is it the Department of Natural Resources? Is it the Department of Revenue? Is it the Department of Law? I don't really have an answer

to that. I think it's kind of a - you know, it's not the typical attorney/client situation that you have in private practice so I'm not sure that I can answer that. And, to the extent that it requires a policy decision, I'm not authorized to really take that on here.

REPRESENTATIVE GRUENBERG asked Mr. Reeves if he sees any conflicts between the three departments and how he would handle them if he did.

MR. REEVES answered conflicts occurred when the Department of Law was defending the TAPS settlement before the RCA based on its duty to defend. He was not involved in the case at the time and does not know the level of the conflicts. As a practical matter now, department representatives have substantial discussions on TAPS issues and work to reach a consensus.

[12:04:07 PM](#)

REPRESENTATIVE DAHLSTROM reminded members that the co-chairs have agreed to ask the current attorney general to address Representative Gruenberg's questions.

[12:04:51 PM](#)

MR. FINEBERG offered an historical perspective. He said in 1990, the Commissioner of Revenue, the late Hugh Malone, recommended that DNR be the lead agency. He informed members that a complicated and detailed historical record on this issue is available and he hoped the committee would get as much information in writing as it can.

[12:06:39 PM](#)

JONATHAN IVERSEN, Director, Tax Division, Department of Revenue, told members he has updated some numbers that he previously presented to the committee based on revised numbers from the administrative law judge's decision. He ran numbers out to 2008 because, at that time, the state has the option to renegotiate. He said no one disputes the tremendous benefit the future tariff reductions will bring to the state. He explained:

With that assumption, if we also make the assumption that a final refund would be coming based on this decision after it works its way through the court system in 2010, we're looking at an amount of roughly

\$500 million. If you add, then, at 10 percent interest, it's adding about \$100 million in interest at that point. So that would be about \$600 million.

If we took our previous numbers, which are all based at the \$2 rate, instead of at the '04 rate that the judge imputed for '05 and '06, then that number, including interest, at '10 goes up to around \$800 million. So those are some speculative numbers and I just want to clarify that those are speculative but that's what we've run so far based on the new numbers.

CO-CHAIR GATTO said that members are interested in the amount as they need to be aware of future sources of revenue to run the state in the future.

[12:08:55 PM](#)

CO-CHAIR GATTO recessed the meeting to 1:30 p.m.

[1:44:50 PM](#)

CO-CHAIR GATTO reconvened the meeting and introduced Mr. Brock and asked him to begin his presentation.

[1:45:00 PM](#)

TONI BROCK, Technical Director, BP Alaska, explained his position is a new one with three primary duties. One of his roles is to provide petro-technical shared resources to all of BP's North Slope operations. He also defines BP's tactical and strategic plans for operations management systems and processes. His third role is to independently verify that BP's operations adhere to BP's standard code and policy. He gave the following testimony:

I'd like to start off - I'd like to introduce myself and my organization and then, Mr. Chairman, take this forward through the events since August of last year with a view to sharing with you the areas that BP has been in action, and share with you our process for assuring integrity over the pipeline systems that we have on the North Slope since the incidents of 2006. And then I shall take you through a lot more detailed presentation on the OTL - oil transit line -system with the present program that we've been managing this winter. And then finally I will take you through BP

Alaska - our forward plan, actually, just addressing what have we learned through 2006 and what are the issues that we're addressing as an organization, not least in integrity management but as an organization moving forward.

Again, my name is Toni Brock. I've got 21 years with BP Exploration and I've worked in operations around the globe during that period of time. I've worked the North Sea, Southeast Asia, West Africa, the Gulf of Mexico. My last job was as an operations manager for one of our fields in the North Sea before coming to Anchorage to set up the new position of the Technical Directorate in Anchorage, Alaska. I moved here with my family, my wife and two sons, in August 2006. I moved from Aberdeen, Scotland.

My primary role when I moved over here was actually to start to set up this new technical directorate organization, as I said. The role was seen as a new role. It was seen to add independent oversight to how we run our operations. It was set up to look beyond the day-to-day operations but to be more strategic on how are we actually going to set up reliable, safe operations and manage them for the future looking at BP's future of 30 years, 50 years future in Alaska. That was the primary role to do that.

Over the course of the last eight months, I actually set up that organization. The organization has in the order of 150 people. Of those 150 people, 60 of them are new positions to BP Alaska. Those positions are primarily focused at technical authorities and engineering capability within the organization in Alaska.

Since the end of 2006, we've been heavily engaged with the other operating entities in Alaska, such as the ACT business units, such as Northstar, Endicott, and Badami and also Milne Point and greater Prudhoe Bay, defining accountabilities and roles within our BPX organization to insure we have consistency in approach and a clear line of accountabilities for managing our day-to-day operations and insuring integrity in our facilities.

In the course of this I'd like to actually refer to the presentation that I've given out and what I'd like

to do is just go through the slide packet. There are a considerable number of slides. What I'd like to do is go through them and in the course of the presentation I'm very happy to take any questions that you may have and at the end again I will take any questions you may have.

So my primary focus is actually just to give you a brief update of how we resumed business and restarted production in greater Prudhoe Bay, then move to operations and integrity assurance and pipeline renewal and the forward plan.

[1:49:42 PM](#)

REPRESENTATIVE GRUENBERG asked if the committee is going to review activities back to the 1990s to look at how the corrosion was allowed to occur or if the committee would only be looking at the recent past.

CO-CHAIR GATTO said the legislature is trying to determine whether to retroactively disallow the pipeline repair costs as a credit against revenue.

[1:51:25 PM](#)

MR. BROCK said he is not a tax expert so his presentation is focused on the future. His role is to ensure that BP has learned from the past so that this type of incident does not occur again. He said hundreds of thousands of emails have been sent over the last seven years related to different discussions and decisions associated with budgets and activities. Getting the right balance between the targets set and actual expenditures is an ongoing part of any business to ensure that it is safe and viable. He said he has not reviewed all of the documents nor does he have the insight to be able to answer questions about them. He can only assure the committee BP is looking to ensure safe operations in the future.

CO-CHAIR GATTO said the legislature would expect no less and appreciates his testimony.

[1:52:21 PM](#)

MR. BROCK continued his presentation:

First of all I just wanted to ... orientate the committee members to greater Prudhoe Bay itself and this slide actually shows you the extent of the OTL systems ... as they relate to the gathering centers and flow stations, just to keep everybody up to speed. On the left hand side of the slide, we refer to GCs ... which are gathering centers, these are processing plants. Their primary purpose is to separate oil, water, and solids from the oil that is produced from our wells before actually putting them into the transit line system, which you'll see there is red on the diagram.

The references on the right-hand side of the slide to FS2, FS1, FS3 - these are flow stations. These have exactly the same purpose as gathering centers. This is just a naming [indisc.] that comes from the different heritages of the field when it was ARCO and BP operated. But, for the purposes of this, I just want to draw a reference to the GC1; GC2 to FS2 is our primary oil transit line for greater Prudhoe Bay. Over the course of 2006, we had two leaks on that transit line system. One was actually one mile downstream from GC2, between the section of line between GC2 and GC1. The other was actually very close to the facility at FS2. You can see there's a line from east to west that's approximately 16 miles.

What I want to do now, I'd like to take you through some of the business resumption program that BP put in place within 100 days of the incident. Over the course of that time, to reestablish production at the facility, and you'll remember we shut down production at the eastern side of the field after the leak because we wanted to provide greater assurance that we understood the integrity of that line before starting up production. In the course of that we actually removed installations and inspected and reinsulated over eight miles of the transit line system. The section that was inspected was actually the section that is in service today. The section in the west where we had a leak between GC2 and GC1, and the section from FS1 to FS2, those sections were actually put out of service and they're not in service today.

In the course of that time, we actually installed five new bypasses. The issue for us there was that at the

time we didn't know whether we'd be able to reestablish integrity within the systems that were currently in place so we actually moved to put five bypasses in place to ensure that we could get secure enough supply in the event that we couldn't prove integrity of the existing systems.

Also in the course of this we actually put 34 hot taps in place in the western area of the field to drain off oil from the line that actually had corroded through and was leaking. And the idea was to de-oil that line and give us satisfaction that that line was actually safe and there was no other threat to the environment. In addition to that, with the isolation of that section at GC2, we no longer had the ability to pig that section from west so we actually installed a temporary pig launcher in the western side to allow us to pig that line with the smart and maintenance pigs.

By the end of the year, we'd actually run six cleaning and one gauge pig and two smart pigs through the eastern side of the field and similarly for the western side of the field to verify the integrity of that system. The results from those smart pigs verify that the sections that we had in service were actually fit for service. On that basis, we actually started up at FS2 and our oil collect unit, through the Endicott bypass system.

We actually, at that period, got a lot of cooperation and support from the regulatory committees and agencies to get our permits and commercial agreements in place and we appreciate what we got from the state on that. In the course of our inspection, we've actually removed two 40 foot sections from the line to allow us to conduct an in-depth investigation into the mechanistic cause of the corrosion itself. Actually in the course of the 100 days we actually increased our North Slope count population by 700 personnel. Today, we're actually running at peak personnel numbers in excess of 2,000 people that our count set at the North Slope. That's a 44 percent increase over normal numbers.

Over the course of that period and through the winter we actually went through seven major production start-ups, which was a particular task in the course of the

winter. Actually, in January of 2007, we actually reestablished production rates at a number prior to the leak, so 430,000 barrels a day.

This diagram that I've showed illustrates the transit lines and the simple [indisc.] format. It shows you the positioning of the bypasses in relation to the OTLs. What I'd like to refer to there is the red sections are sections that we have out of service. The section on the left between GC2 and GC1 actually has been decommissioned and it has been deconstructed through the course of this winter and is no longer in place. The section between FS1 and FS2 is going to be decommissioned and deconstructed through the course of December-January this year and early '08.

This just gives you a sense of where we are with regards to the bypass status and we do have a bypass in place at flow station 2 but at flow station 1 we actually have a bypass that's been built but it's not in service. It's not in service because to put it in service, we'd interrupt production and we don't see an integrity reason for us actually to put that line in service right now. In the event of an issue, it will take us two days of shutdown to actually put that line in service and commission it. Similarly for flow station 3, we reckon the line is in place and the final time will take us seven days if need be.

For the western area, we have a fully operational bypass in GHX, GC1, and that is installed and it's going to be in service until we get the replacement line in. Similarly for GC1 and GC3, we have bypasses in place and constructed and we estimate it would take five days for us to actually commission those systems if need be.

That was really just a very quick overview of what we did to respond to the initial spill, to reestablish integrity in the line, and also to provide efficient redundancy so that we could reestablish reliable oil flow through Prudhoe Bay. The next series of photographs are really an illustration.

[1:59:16 PM](#)

REPRESENTATIVE FAIRCLOUGH asked for the definition of "OTL."

MR. BROCK replied oil transit line.

REPRESENTATIVE FAIRCLOUGH asked if the deconstruction costs are being charged against incremental removal and restoration on the pipeline.

MR. BROCK said he would have to refer that question to BP's commercial team. He offered to get an answer to the committee.

CO-CHAIR GATTO asked Representative Fairclough if she used the word "deconstruction."

REPRESENTATIVE FAIRCLOUGH said yes, that was the word Mr. Brock used. She explained:

That's why I was wondering ... earlier this morning we had a conversation about those costs being fixed and sort of in an account or what Tran Alaska Pipeline ownership ... as the oil team takes those dollars, we're looking at, I believe, \$1.5 billion as proposed to be collected. And I'm wondering if they are going to charge that cost of dismantlement, removal and restoration, which would decrease that fund and goes along with what Max was saying. We're trying to determine what charges the corporations are going to come back and charge against the line and I want to know if we're deconstructing a portion of the pipeline now, whether we'll have incremental hits to the DR&R and how that will affect the FERC and the rate calculations going into the future.

CO-CHAIR GATTO asked if DR&R funds are reserved for use when oil no longer flows or whether it is accessible before that time.

MR. BROCK said he is not familiar with the requirements of that act.

CO-CHAIR GATTO thought DR&R applies to decommissioning the pipeline so he would not expect that fund to be tapped for anything prior to that.

REPRESENTATIVE FAIRCLOUGH said BP has removed a part of the pipeline and put in a new line, which would be part of the cost of TAPS as a whole. She said deconstructing part of the line could open up a way to use that fund.

2:02:02 PM

REPRESENTATIVE SEATON asked that the committee get an answer on whether the DR&R fund can be used for TAPS and the flow lines. He thought the flow lines are not included because TAPS begins at Pump Station 1.

CO-CHAIR GATTO noted if the DR&R fund was used to pay part of the costs, it couldn't be declared as an expense against the revenues.

2:02:57 PM

REPRESENTATIVE FAIRCLOUGH thought Co-Chair Johnson's analysis is correct, that being that Mr. Brock is speaking about a BP-owned line, not TAPS.

MR. BROCK told members this line at Prudhoe Bay is owned by the working interest owners: BP, ConocoPhillips, Exxon and Chevron.

REPRESENTATIVE FAIRCLOUGH said under that scenario, if the owners deconstruct a portion, they could hit DR&R for a portion of those funds because that is the purpose of those funds. However, they could also consider the costs as an expense because they are creating a new line.

2:03:50 PM

MR. BROCK continued his presentation:

As I said, these photographs are really - I'm not going to go through them in detail, but they just reference the scope of the work that was undertaken to put the bypasses in place. We've had some inquiries in the past to the extent of these lines. These are relatively short, small bore diameter pipelines that give us the extra redundancy to bypass the existing oil transit lines if need be and I'll quickly move through these.

What I did want to refer to actually is - so in BP's response to the leaks in 2006, our primary concern was to reestablish the integrity of the lines and then reestablish production and I talked to that. In addition to that actually, there [are] broader implications of how we operate in Alaska. One is that we want to actually ensure that we had a good

understanding of the corrosion mechanism at hand and, as such, we've done a number of things to do that. In the course of our investigation, we've determined that there are three factors that contributed to the microbial-induced corrosion that we now feel was the causal factor of these leaks. That is actually in the build-up of or combination of sediments, water, and low-flow velocities within the oil transit lines themselves.

We also actually started to start a part of the Department of Transportation correct batching order to carry regular maintenance pigging on all of our oil transit lines and also run intelligent pigs to verify the integrity of those systems. And we've also improved the safety standards that we work to and integrity standards that we work to as we've got all of our oil transit lines on to the Department of Transportation's pipeline integrity management program. Prior to this, the oil transit lines in greater Prudhoe Bay weren't covered by this standard and we volunteered to bring that line into that standard now and, in effect, we're in compliance now with that standard.

[2:05:45 PM](#)

REPRESENTATIVE GRUENBERG noted that Mr. Brock said BP was just recently made aware of the cause of the corrosion, however according to some [of BP's] e-mails, BP was aware that corrosion was likely if steps to prevent it were not taken. He asked Mr. Brock if he was aware of those e-mails.

MR. BROCK replied he has seen numerous e-mails from different staff that made different assertions regarding corrosion and inspection regimes within the field. He added the oil transit lines were low-risk lines with regard to corrosion. BP removes the gases, liquids and solids from the lines at the processing facilities prior to entering the oil transit lines. The oil transit lines only carry sales-quality crude. Those lines have been inspected on a regular basis over the past 30 years. Those inspections, up until the second half of 2005, showed insignificant or negligible corrosion within the lines. After that BP did see an increase in the corrosion rates so it increased the frequency of its inspections and scheduled smart pig runs. Unfortunately, the leak occurred in March, prior to the scheduled smart pig run.

2:07:35 PM

REPRESENTATIVE SEATON referred to a memorandum he sent to BP after BP staff testified on Aug 18, 2006 before the House Resources Standing Committee. During that testimony, a BP staff member stated what Mr. Brock just said: that BP didn't anticipate corrosion because the water is removed from market-ready crude before it enters the line. The committee's information was that the TAPS operators knew the pipeline would be subject to corrosion if it wasn't pigged regularly and BP agreed to use cleaning pigs every two weeks, as well as to regularly use smart pigs. BP says it has the same oil in its gathering lines but didn't pig those lines for years. BP would be responsible for the cost of pigging the gathering lines and couldn't charge those costs off to the tariff, as it could with TAPS. He questioned why Alyeska anticipated the problem on TAPS but BP did not on its gathering lines. He noted BP has not responded to his memorandum.

MR. BROCK said BP runs maintenance pigs every other day at its BP greater North Slope facilities. With regard to its pigging philosophy for its transit lines versus Alyeska's operations, pig runs are determined by a number of factors, primarily through operational requirements or corrosion management. Smart pigs provide information on the line's integrity and identify corrosion spots. The maintenance pigs used at Alyeska ensure that lines are clean and are run for operational reasons. Prudhoe Bay crude is relatively sweet with little wax. Other North Slope fields feed into Pump Station 1 that have wax in them. That travels down TAPS and comes out of the line itself. His understanding is that one reason Alyeska pigs so frequently is to remove the wax build up because it affects the hydraulics. In the greater Prudhoe Bay's short pipeline system, wax does not build up; it is run at higher temperatures. However, that phenomenon occurs in TAPS' 800 mile pipeline.

REPRESENTATIVE SEATON asked Mr. Brock if Alyeska's maintenance pigging is done to test for corrosion as well.

MR. BROCK opined that corrosion could be part of it. He said he is not familiar with how Alyeska deals with its corrosion systems but believes many factors are considered when looking at a maintenance pigging operation.

REPRESENTATIVE SEATON requested a written response from BP to his memorandum dated September 7.

MR. BROCK apologized for the lack of formal response and ensured one would be forthcoming.

[2:12:35 PM](#)

REPRESENTATIVE OLSON pointed out the transit lines have not been pigged since 1998. Legislators have been told that one reason they have not been pigged is because the build up of wax prevented BP from getting a pig into the pipeline, which contradicts what Mr. Brock stated. To ignore that problem for eight years is, in his mind, criminally negligent.

CO-CHAIR GATTO agreed it is confusing to hear that the shorter lines have no wax but that they couldn't be pigged because of too much wax. He repeated the need for a consistent written statement from BP management.

[2:14:52 PM](#)

REPRESENTATIVE DAHLSTROM asked Representative Seaton who the memorandum was addressed to.

REPRESENTATIVE SEATON replied it was addressed to the chairs of the House and Senate Resources Committees, the Administration and to BP. He noted Steve Marshall of BP made the statement to the House Resources Standing Committee that lead to the memorandum.

REPRESENTATIVE DAHLSTROM noted that Mr. Brock was not responsible for the response but asked him for a date when the committee could expect to hear from BP.

MR. BROCK said he would have a response to the committee by the end of the month.

[2:16:19 PM](#)

CO-CHAIR JOHNSON expressed appreciation for Mr. Brock's work to correct the problems but said the committee anticipated finding out the cause of and how the leak occurred. He expressed concern that the committee's questions are not being addressed to the appropriate person. He asked that the committee get testimony from the appropriate person in the near future to get those questions answered. He suggested directing questions to Mr. Brock about what has been done to remedy the problem.

CO-CHAIR GATTO said the committee has access to BP management through Mr. Brock. He is sure Mr. Brock can convey the committee's concerns.

2:18:41 PM

REPRESENTATIVE GRUENBERG agreed with Co-Chair Gatto and said the committee's questions have nothing to do with Mr. Brock personally. Members just want answers to their questions. He stated his questions relate to a series of emails to and from BP staff that appear to use a form of company shorthand. He asked Mr. Brock to provide committee members with a key to what was discussed; particularly in emails dated June 4, 1999 that refer to a PW inhibitor and EC 1081A injected at stations GC2 and GC3.

CO-CHAIR GATTO asked what document Representative Gruenberg was referencing.

REPRESENTATIVE GRUENBERG clarified he was looking at two e-mails on the bottom of page 2 in Exhibit 4.

MR. BROCK explained that a PW inhibitor is an inhibitor added to produced water (PW) systems. When oil is produced, water and gas are produced with it. As the water and gas are separated out to the export line, the produced water is reinjected to maintain reservoir pressure. That term refers to a produced water line for transportation of the produced water back for reinjection. He explained the water is entrapped in the oil when it is initially produced.

REPRESENTATIVE GRUENBERG asked if a produced water inhibitor is a type of chemical.

MR. BROCK said it is.

REPRESENTATIVE GRUENBERG asked that chemical would have helped to prevent corrosion.

MR. BROCK said the word "inhibitor" is used in a broad sense in this case. He explained:

My understanding is that the chemicals used have got two purposes. One is actually to aid inhibition in the line but the system itself is inhibited from the wellhead. As we produce oil, we inject inhibitor directly at the wellhead and other parts of the processing plant. Actually, produced water is

inhibited as it goes into the produced water system from inhibition injected earlier on in the process. What we're experimenting with here was actually enhanced inhibition but also produced water has some entrained oil in it and actually what we were noticing was a build up historically of solids within that line, kind of a film within the line but it does effect the efficiency of the system and actually the inhibitor here had a surfactant quality. It is what helped break up that lining in the pipeline itself - a bit like a washing detergent. Through the course of our operations in Prudhoe Bay, we continuously look for different types of inhibitors for our produced water system to just aid the efficiency of that system. Over the course of the years we have numerous trials ongoing to find inhibition.

REPRESENTATIVE GRUENBERG asked, "When you talk about inhibiting this sort of thing, would it have inhibited and potentially prevented the type of corrosion that did occur?"

MR. BROCK answered it would not have in this case. The produced water system is independent of the oil transit line system where the leak occurred.

REPRESENTATIVE GRUENBERG asked if, in Mr. Brock's opinion, the failure to put the inhibitor into the system would not have any effect on preventing the corrosion.

MR. BROCK replied:

In this particular case, the inhibitor referred to - as I read through the series of e-mails as I understand it in the document - was part of a trial. We have ongoing trials in this area and that let's us know it had no effect on the corrosion and the leak on the oil transit line system.

[2:24:08 PM](#)

CO-CHAIR JOHNSON asked where the August leak occurred.

MR. BROCK said that leak was a few hundred yards down the line from FS 2 to FS 1.

CO-CHAIR JOHNSON noted the e-mail references GS 2, GS 1, and GS 3, so surmised that the inhibitor was not removed from the pipe that leaked.

MR. BROCK affirmed that is correct and clarified that BP has numerous pipeline systems in the field: gas lines; seawater lines; gathering lines for gas, water, and liquid; the oil transit lines; and produced water lines. Those systems are independent of each other. That e-mail refers to a produced water line, which is independent of the oil transit system.

REPRESENTATIVE GATTO stated:

I was shaking my head because it said being injected at G2 and G3. It would have been in the section at G2 but it was a different line that they're referencing here, a line different from the line that did, in fact, corrode.

MR. BROCK said that is correct.

REPRESENTATIVE GRUENBERG said he needed to clarify that the inhibitor was not put into the line that leaked; it was removed from another line.

CO-CHAIR GATTO asked if the inhibitor was in the line that leaked.

An unidentified speaker said it was not.

REPRESENTATIVE DAHLSTROM asked if the inhibitor mentioned is the standard chemical mixture used so that members could assume that was in the line that leaked.

MR. BROCK replied:

What I can say is the inhibitor that we referred to in this e-mail was specific to a produced water system so it wasn't in the oil transit line system. The oil transit line system was inhibited with a different inhibitor.

REPRESENTATIVE DAHLSTROM asked Mr. Brock how many types of inhibitors are used.

[2:26:40 PM](#)

MR. BROCK said BP has inhibition programs for all of its lines. He furthered:

What we'll have is we'll have inhibition programs for all of our lines so we have the lines that come from the wells are inhibited so as we get production out of the wellhead, we inject inhibitor at that part of the system. That inhibitor is dosed to allow - to keep retained a percentage of inhibitors to right the system even as it goes through into the TAPS - Trans Alaska Pipeline system itself and that's our primary inhibition system and that's the inhibition system that inhibits the oil transit lines. The produced water system has an additional inhibition in that line itself. And the role of that was twofold. One was to act as kind of a cleaning agent. Secondly was to see if we could improve inhibition in that line itself. One of the challenges we have with this type of trial is that the rates of corrosion that we have take years and years to manifest themselves so short time trials take time to monitor and it takes us time to evaluate them so it's quite common we'll have corrosion coupons in the line that we'll put in. We'll do inhibitor trials for awhile with new coupons and then we'll retract the coupons and do assessments on them to determine if the inhibitor was effective or not. That's quite a long, drawn out process.

[2:28:19 PM](#)

CO-CHAIR GATTO pointed out chemical corrosion is caused by water on metal but biological corrosion also occurs. He asked if both types are treated with a different substance or whether BP uses biocides and rust prevention agents.

MR. BROCK said BP's system uses an inhibitor and biocides combined.

CO-CHAIR GATTO asked which is more severe.

MR. BROCK replied the two have different purposes. The biocides kill the bacteria while the inhibitor coats the pipe to protect it.

CO-CHAIR GATTO asked if water corrosion of the pipe is more severe than biological corrosion.

MR. BROCK said that depends upon the operating environment and other contributing factors, such as temperature pressure. All of those issues need to be addressed in BP's corrosion program.

CO-CHAIR GATTO said he was curious to know whether answers exist at this time because he is often asked about how the corrosion happened by the public. He asked where the bugs come from.

MR. BROCK said the bugs are in the matter that formed the oil.

CO-CHAIR GATTO asked if they live in the seams and come up with the oil.

[2:30:14 PM](#)

MR. BROCK said they do. He added BP evaluates the corrosion mechanisms and threats within given systems because each type of environment in which the corrosion manifests itself is unique to a certain set of circumstances. BP evaluates the correct inhibition for a given circumstance and a given system.

[2:30:38 PM](#)

REPRESENTATIVE FAIRCLOUGH asked what the capacity volume is on the lines BP is running.

MR. BROCK said the oil transit lines are currently running at approximately one-quarter of their peak throughput rate with a current volume of about 350,000 to 400,000 barrels per day.

REPRESENTATIVE FAIRCLOUGH, for the record, stated:

Some of the validity of using inhibitors versus pigging or other things that actually physically touch the system on the interior of the line makes a big difference on capacity volume and flow through and so I would expect, from what I know about the inhibitors and the cleaning of the line, that if the line is not running full we're going to have more corrosion because the inhibitors aren't hitting where they are supposed to hit anymore.

CO-CHAIR GATTO asked if the replacement line has a smaller diameter so it would fill more quickly.

MR. BROCK said reduced volume impacts the velocity. BP reviewed the existing system to determine repair options. Its primary concern is that Prudhoe Bay is a declining field yet it has a long life ahead of it. BP wanted to design a system that would be useable for the next 50 years and a system optimal for the types of production rates and fluids it would carry. BP felt the current system design of pigging, chemical inhibition, metering and leak detection needed to be replaced. As such, it chose to replace the existing system rather than repair it.

CO-CHAIR GATTO asked if BP has used plastic pipe.

MR. BROCK said it has not used plastic pipe at Prudhoe Bay but it has commissioned an entire overhaul of its corrosion management strategy of its North Slope operations. BP has the final draft report for approval and that strategy suggests considering life-of-field material selection. As BP looks for renewal and to building new facilities to deal with the transition from viscous oil to gas, it is looking at stainless [steel] materials and plastic for future operations and refurbishment

CO-CHAIR GATTO said he recognizes plastic could fracture at minus 80 degrees.

MR. BROCK acknowledged the basic premise is that plastic pipe has good corrosion resistance but relating that to valves and safety and pressure systems presents a challenge.

CO-CHAIR GATTO said he was curious because a new hospital installed an all plastic sewer line.

[2:34:24 PM](#)

REPRESENTATIVE GRUENBERG referred to an e-mail on the top of page 4 in Exhibit 4 from Dominic Paisley (ph) to PBU, etc. He noted Mr. Brock said these e-mails referred to a different pipeline. He asked if the statements in that e-mail are equally applicable to the pipeline in question.

MR. BROCK said he was not in a position to review all the technical aspects referred to in the email to determine whether they refer to a likely corrosion assessment. He is not aware of what assumptions were used regarding the life of the pipeline and what inhibition systems were in place at that time.

REPRESENTATIVE GRUENBERG asked Mr. Brock if he knows what caused the corrosion in the pipeline in question.

MR. BROCK replied:

In the oil transit lines, we feel it was a combination of water, sediment build up and low velocity in the lines. The low velocity in the lines allow solids to fall out and water to fall out and they create an environment that prevented inhibition from working effectively.

REPRESENTATIVE GRUENBERG asked, "Well, if it was potentially water, wouldn't the same kinds of statements that are made here possibly be applicable there as well?"

MR. BROCK responded, "The case for the oil transit lines is the combination of the factors."

CO-CHAIR GATTO commented:

I'm guessing the critters need water to survive and when you get water trapped and the critters are living in the water, you've got it all precipitated out and it's being covered with solids, that's a great environment. You get to hide underneath in the low spot of the line and then as the biocides come through they kind of float over the top and do not necessarily penetrate the solids and you have a wonderful set up for eating away in a very localized area ... ultimately causing failure. Is that how it works?

MR. BROCK said he believes that is how it works. His primary goal is to understand the causal factors so that the operating environment within the pipeline systems can be changed to ensure the bugs are killed and cannot breed in that environment. So far, BP has enhanced the ability to inject corrosion inhibitor directly into the OTL systems. BP does regular maintenance pigging right now to remove any water from the system. Maintenance pigs are used on the oil transit lines on a weekly basis. He noted, as a result, the lines have no solid build up and no bacteria build up.

[2:39:05 PM](#)

CO-CHAIR GATTO asked what BP would do if it discovered the problem was due in large part to low velocity. He questioned

whether the velocity could be increased by alternating the use of Line A and Line B.

MR. BROCK said BP is looking at two areas; the new system design has addressed that. The smaller diameter pipe will increase the velocity to three feet per second. The pump out at the flow stations could be increased but that is constrained by the export pumps at the facility at this time. Those are major pieces of equipment so the facility would have to be shut down to replace or upgrade those pumps.

[2:40:09 PM](#)

MR. BROCK continued his presentation:

... We're probably going to cover some of the material that we've already covered in terms of the causal effects and, as I said, we actually tried to - we referenced a combination of water sediment bacteria that led to this particular circumstance occurring and we are doing a detailed analysis of that so it comes out again in another slide.

What we looked at in our corrosion mitigation strategy, we looked at a number of different contributing factors. We looked at carbon dioxide build up in lines, which is corrosive. We looked at continuous inhibition against that. We looked at stagnant water or sediment in lines and we used maintenance pigs to extract that. And like I said before, in the course of a year, we will run hundreds of maintenance pigs across a multitude of our lines. We've got full-time teams working entirely on that. That's their full job at the greater Prudhoe Bay.

And in terms of bacteria ... we'll scrape the side walls to remove any bacteria build up with the pigs and use biocides in there. There are chlorides within the biocides to kill the bugs.

CO-CHAIR GATTO said when carbon dioxide is added to water, carbolic acid is created, which eats away metal.

MR. BROCK continued:

Where we're at right now - the status - is the lines were cleaned extensively before the ILIs were run and

we run weekly and monthly cleaning pigs, depending on which system we're talking to. We put supplemental corrosion inhibitor into the OTLs and we analyze our returns for bacteria build up and a repeat of the circumstances we had before. Since August we've actually carried out over nearly 24,000 ultrasonic inspections. We do repeat inspections over areas we know we've got known corrosion. The idea there is that we're able to monitor the rate growth of any corrosion. We will actually repeat smart runs this summer and through the third quarter of this year. That is to further verify that we're in control of any further corrosion within the system.

This slide is really just to illustrate some of the techniques that we use to do that ultrasonic inspection. We do deep ultrasonic inspection a foot at a time. It's a very detailed inspection over this period and it gives us a representative example of the condition of the line itself.

One of the things that is notable is that unlike other pipeline systems in the Lower 48, our lines are above ground and we have access to them. As such, we actually conduct a lot of external UT inspections. That's one of the reasons why we talked to - why we were comfortable that we didn't run more smart pigs. Well, we actually compliment the smart pig runs with extensive UT inspections. That's not something that other systems have got the luxury to do. To do that you do need to remove the insulation from the system to get access to the wall of the pipe itself.

This is an illustration of a smart pig. This to itself is one of the tools that we used on the OTL systems. The brushes you see on the right hand side are actually giant magnets. They create a magnetic flux and that allows us to [see] deviations within that flux and read out - give us an insight to any wall thickness and any deviations within the pipeline itself.

As I said, we've carried out extensive analyses to determine the mechanism associated with these failures. On the western operating area of the field, GC2 to GC1, we've had a consultant, Dr. David Dukette, carry out a complete and thorough investigation and he

has confirmed that it is microbiological induced corrosion - is, in effect, the mechanism at hand here.

In the eastern operating area, we are actually carrying out a similar review right now and we hope to have that report back by the end of the second quarter of this year. In both cases we took out 40 foot sections associated with the leaks so that we could do a detailed analysis of the actual leak itself. These diagrams just illustrate the process for removing the pipe and give you an example of the pitting. Mr. Chairman, you just referred to this type of very localized pitting that we feel is the leak path.

[2:44:33 PM](#)

REPRESENTATIVE GRUENBERG asked if the photograph on the left shows a segment of the pipe being removed.

MR. BROCK said that is correct.

REPRESENTATIVE GRUENBERG asked for a description of the photograph in the middle.

MR. BROCK said the pipe was actually cut into sections to analyze samples. The middle photograph shows sections from the pipe sample that were removed being cut. The last photograph is an example of pit and corrosion.

REPRESENTATIVE GRUENBERG asked about the size of the pit.

MR. BROCK estimated the pit to be 1/4 inch.

REPRESENTATIVE GRUENBERG asked if it goes through the pipe.

MR. BROCK said that particular pit did not.

CO-CHAIR GATTO asked if the photograph was on the inside or outside of the pipe.

MR. BROCK clarified it is on the inside of the pipe.

CO-CHAIR GATTO noted a lot of gauging around the pit and asked if that is additional corrosion or was caused by the pig.

MR. BROCK said he is trying to determine whether that is residual water from washing the sample. He was not sure.

MR. BROCK continued his presentation:

One of the areas I wanted to show is - in carrying out our investigations, we've actually determined that we'd look at a broader, holistic corrosion control strategy for all of our facilities on the North Slope. We've called in an external team of BP experts and industry experts to do that. We've also brought in our working interest owners - ConocoPhillips and ExxonMobil. We've actually been through and developed a new strategy for our operations in the North Slope that's at the final stage of sign off.

In addition, we're actually increasing our Corrosion Inspection and Chemicals team. That's what the CIC stands for. We've increased by 60 percent and we will increase that team by 100 percent. Here in Anchorage they will have over 30 permanent BP staff members working on that team. Their primary role is actually to take the strategy and develop specific plans for each of our facilities with regard to the systems and processes that they manage. This system will cover all of our operations from drilling to oil production to water handling.

In addition to that, we're going to put additional positions on the North Slope. These additional positions will be lead corrosion positions and their job will be to coordinate our inspections and our corrosion monitoring at our North Slope facilities. This is a new position to enhance our understanding at the facility level.

In addition now we're also working on a new smart pigging philosophy. We have a new strategy that's being delivered. This year we'll be running approximately 18 smart pigs and we just ran the first of those additional smart pigs this week.

In addition to that, we're committed to improving overall awareness of corrosion in the North Slope environment and, as such, BP had actually sponsored a program through NACE to develop a new week long class, which our personnel will go through and it will be open to all of the members of the industry to actually raise awareness with regard to corrosion beyond the

preliminary understanding. BP is funding 100 percent of that.

2:48:39 PM

REPRESENTATIVE SEATON asked if 18 smart pig runs will occur in 2007.

MR. BROCK said 18 individual smart pig runs are programmed to be run in the overall pipeline system. That will cover gathering lines, the OTLs, and the produced water systems.

REPRESENTATIVE SEATON asked if 18 smart pigs will be used continuously in the field.

MR. BROCK said a number of pigs could be run on different lines multiple times. They will be different sizes and run through different systems.

REPRESENTATIVE SEATON inquired whether BP's entire system will be covered in one year.

MR. BROCK said it will not. It will cover the area BP believes needs to have smart pigs. That is determined by the program schedule or from review information from the leak.

REPRESENTATIVE SEATON asked what percentage of BP's lines in the Prudhoe Bay unit will be covered.

MR. BROCK said he could not answer that question at this time but would provide the information at a later date.

CO-CHAIR GATTO asked how Mr. Brock would respond.

MR. BROCK said he would send a letter to Co-Chair Gatto for distribution to committee members.

2:50:55 PM

REPRESENTATIVE GRUENBERG referred to an e-mail at Tab 3 dated July 27, 1997 and asked if the e-mail related to the line in the first diagram under discussion.

MR. BROCK said the e-mail contains no reference to a specific system but he does not believe it is referring to TAPS.

REPRESENTATIVE GRUENBERG said it looks like BP came up with a long-term smart pigging contract 10 years ago. He asked Mr. Brock if, prior to 2006, BP had a smart pig contract in the section of the line under discussion.

MR. BROCK did not know.

[2:52:52 PM](#)

REPRESENTATIVE SEATON said, regarding his September memorandum, workers at Alyeska said they were extremely concerned for several years that BP had no way to handle an anticipated large amount of sediment that could not be handled by Pump Station 1 filters. He said the e-mail refers to Pump Number 1 so it appears that is the line under discussion. He asked Mr. Brock to incorporate that item into his response. He stated:

This is what is very much of concern, as Representative Olsen had said earlier and we had information from other sources at Alyeska that the concern was that BP couldn't run a smart pig because they couldn't handle all of the sediment that was going to come out of that line. It seems like this e-mail here, and this is way back from '97, is indicating that this has been a problem that had been anticipated from the Prudhoe Bay unit for a long time. So if you would find out exactly which lines these are talking about, and if this anticipated the identical problem of not being able to run those pigs because there was no contingency for handling the solids other than slugging Pump Station Number 1 and shutting it down.

MR. BROCK agreed to do so.

[2:54:57 PM](#)

CO-CHAIR GATTO referred to the first page of Exhibit 23, which was a 2005 e-mail from Kip Sprague. He read:

Bitch, bitch, bitch. I will try to wrestle down some middle ground between the reality of the situation and some feel good place holders just to get people off of your back. However, I will not run or sacrifice an inspection strategy and program with limited resources based on the conveyance of maintenance and our operational impact.

CO-CHAIR GATTO said that is negligence in his opinion and expressed concern that a better response was not provided. He asked what a BP administrator would do with such a statement.

MR. BROCK stated it is disappointing to hear an employee so frustrated by the process. BP needs to create an environment in which employees can voice their concerns and issues so they don't get to that stage of frustration.

CO-CHAIR GATTO said the e-mails capture his attention because they show BP's record rather than glossy photographs that show what BP is doing now to correct problems. He asked Mr. Brock to express his concern that BP hears complaints and then produces beautiful brochures to respond to them.

MR. BROCK said he would do that. He told members:

I mean words are words, presentations are presentations and they actually don't mean anything unless you take action. What I'd like to tell you is that there are a number of things that we've taken real clear action on. One is we set up the technical directorate as such it's an independent body. So these types of inquiries and queries actually have got a functional oversight rather than being buried in the line organization. So we have that independence when it comes to issues of safety or the integrity of our facilities. We have an independent body now that has oversight on the decision making process. That's first and foremost.

Two, this body that Kip Sprague worked for, CIC, [is] embedded in the greater Prudhoe Bay organization. That organization reports directly to me. Bill Hedges, who is the CIC manager, reports to me and Kip reports to Bill Hedges. I report directly to Doug Suttles. So we have greater transparency to the organization so that these issues aren't left buried in the organization itself.

Finally, I think one of the issues for us is ... our full understanding of risk. When we look back at the analysis from Bruce Allen into the concerns we had and how these leaks occurred, their reference was that this wasn't actually about cost cutting or such. Their evidence pointed to our overall awareness of risk

within the system itself. And on that, in effect, what we've actually done is we've actually put in place a rigorous risk register, risk review process. That process is being embedded at the field level. It's been embedded at the technician level, the operator level and, as such, is managed up through the field line to the senior members of the management team in BP Alaska. That system will be there. We review it on a regular basis. It's my role to present that. Doug Suttles is President of BP Alaska and I'm to ensure that we take proper action on these types of issues so they get resolved and overall we're focused on reducing risk within our field.

These are the things that we've done as part of our overall package to actually address the learning of the past.

[3:01:39 PM](#)

REPRESENTATIVE SEATON referred to Tab 18, page 2, regarding the analysis of risk from Richard Rollun (ph) to CIC and others. He read:

John and Rick,

Please see below a request from Roger. As with previous years, our variable costs are in basically two areas: inspection scope - reduce scope and increase risks, inhibition levels - reduce inhibition levels and increase risk. And then when outlining risks it would be important to make sure that we note all the potential risks and not just the increased corrosion and leak risks, including commitments to ADEC, reputation issues, workforce perception if reducing inspections, inhibition levels and regulatory requirements - any risks there.

REPRESENTATIVE SEATON then said it sounds like BP had fully analyzed the impact of the budget cutting risks. The next part of the e-mail read:

I want to see what it will take in terms of actions and risk mitigations to those risks to reduce your LE by \$1 million by Wednesday morning .... We are in the process of shutting down major repair work to contribute \$2 to \$4 million.

REPRESENTATIVE SEATON noted that e-mail was sent in 2003. He said that correspondence discusses a comprehensive look at risk; not just inspections, inhibitions, and leaks. The author was also concerned about reputation and workforce perception. He questioned how the new analysis differs from that one and the differences in treatment.

[3:04:17 PM](#)

MR. BROCK repeated it is disappointing to see the frustration in the workforce. The workforce was trying to find the balance between the right amount of expenditure to ensure the system is safe and viable. The concern is that workers felt frustrated that they were compromising choices. He pointed out:

Looking forward - and there's a multitude. You have a document here that references numerous e-mails and, as I've said, there's probably hundreds of thousands of documents where if we take at any given point there's a reference to some cost cutting and people's concerns and opinions relating to that. We can go back in these in depth, but actually I think what we need to do is actually look forward to see what have we heard. There's a leadership team in BP Alaska and we've been listening really hard, not just to the concerns of our employees here, and we have taken these on board, but also to the findings of Bruce Allen, which we commissioned to actually get to the root cause of leaks here in Alaska to move beyond the mechanistic causes to go on to the systemic issues and the organizational issues within BP Alaska.

As such, we've listened to them. We've looked at the recommendations and we're taking action with those recommendations. From my perspective, I'm actually proof. I'm the technical director. I have, at this moment in time, over 150 technical experts reporting in to me. That is different. The Corrosion Management Team reports in to me. If they have concerns about compromise of their program, then I will address them and I'll address them independently of the line, whether it relates to production or to cause. My primary concern is the integrity and safety of our operations. That's a demonstration of what's changed.

In addition to that, our leadership team is committed to changing some of the processes that we use to manage and make decisions. Risk is actually much more transparent in our business from the line up. It's captured in a systematic way and it's reviewed on a regular period. We look for resolutions of issues. We look to engage the corporation's open communications. If our employees have concerns, we want them to be able to communicate them to senior leadership without fear or concern as it relates to them. We actually want to encourage people to raise these issues so they can be addressed.

So what I'd say is we're in the early stages. I can show you presentations but really we have to go beyond words. I feel that we're now starting to get into action. We've reorganized ourselves. We've put a new leadership team in place. We're starting to address the issues of the systemic culture and what it needs to be to be a leading operator in Alaska for the next 30 years.

In the course of the presentation I'd like to get to the last slide where I can talk to you more specifically about some of the - where we're in action and what actions we're looking to do.

[3:07:12 PM](#)

CO-CHAIR GATTO referred to Section 26, mid-page and read:

I just have a couple of concerns, the biggest thing that we haven't pigged our sales transit line in over 15 years and I really don't know what to expect.

CO-CHAIR GATTO said that is a frightening statement. He continued reading, as follows:

Ignition of the launcher, the launcher door seal, O-ring, the sump pump and all of the associated piping are unknown. We can functionally check the drain sump system but it would probably be prudent to have all the associated lines inspected prior to returning the system to service as they are at a low point and have been stagnant for years. I need to spec out and order some replacement O-rings for the launcher doors.

CO-CHAIR GATTO pointed out the e-mail also reveals the launcher doors hadn't been opened for 15 years.

[3:08:14 PM](#)

REPRESENTATIVE GRUENBERG asked if BP is faced with the choice of doing preventative maintenance or setting aside clean up funds for use in the case of a spill, whether a tax structure that allows BP to deduct preventative maintenance costs but not clean up costs due to negligence would encourage BP to take preventative steps.

MR. BROCK said BP's primary focus is on safe operations. If it needed to invest in preventative maintenance to ensure the line is safe and integral, that is the action it would take.

REPRESENTATIVE GRUENBERG referred to an e-mail at the bottom of Tab 5, which talks about 10 percent across-the-board cuts and says, "...which we are most confident would allow significant measurable corrosion damage to occur." He said that illustrates to him that safety was not BP's priority; its policy was driven by the bottom line.

MR. BROCK said that e-mail was sent in 1999; his statement referred to BP's priorities today. He repeated BP's first priority is the safety of its employees, the integrity of its plants and the impact its operations have on the environment. BP will take whatever actions are necessary to ensure it operates to that standard.

[3:11:43 PM](#)

REPRESENTATIVE DAHLSTROM reiterated her concern that Mr. Brock is not the appropriate person to ask certain questions of because he is being asked to make policy statements for the company. She stated the need to hear from higher level management.

[3:12:36 PM](#)

REPRESENTATIVE SEATON reminded the committee that these e-mails were sent when ELF was in place. Under the PPT, any spill related costs are non-deductible while preventative maintenance costs are deductible.

[3:13:26 PM](#)

REPRESENTATIVE ROSES felt it is important to discuss the e-mails. He continued:

... First of all, if we address these and we know that we have an issue over whether we have negligence or not and we get back to dealing with the bills that are out there to determine whether or not there's going to be the allowance of the deduction over those costs to replace the pipe, which is part of what this conversation is about, I think the next question that we would be asking them is okay, we've identified the problem in the past. Now what are you going to do to prevent it from happening in the future? And I think that's what he's here to tell us but we keep continuing to go back to trying to hammer away on what caused the problem rather than answering the question of what are we going to do to prevent it in the future. So, I would hope that we could at least finish this presentation before we keep going back to this part.

[3:14:32 PM](#)

MR. BROCK continued his presentation:

...This was just a reference to the pipeline surveillance that we have right now that gives us a higher level of assurance that the system is integral but I'll move quickly on to the current OTL construction and then talk a little bit about the oil transit line system itself and the replacement of that transit line system. I'll try and capture the main points. There [are] a lot of slides here and I'm very happy to take any questions but first and foremost if I could just dwell on this particular slide and spend a little bit of time on it.

We've looked at the operation of this line. We've looked at the state of this line through extensive UT inspection and from smart pig inspections. Actually, we've determined, looking at the longer life of field, the next 50 years that now is an optimum moment, given the condition of the line. It's been in operation for 30 years in one of the harshest operating conditions in the world. It's operated well for those 30 years up until 2006.

This system though, is a big system. It was made for four times the capacity that it had previously. Looking at the lessons we have learned, and we need to actually redesign this system so that it actually provides the right level of operability, the right level of management and maintenance that we feel is now necessary to take us through for the next 50 years.

And, as such, we're building a new system. We're not repairing the existing system. And we're building a new system because one, we want to size it right so we get the right materials and we get the right velocities in that line to mitigate against an occurrence similar to the leaks we had in '06. In addition, we want to put in permanent pig launching and receiving at facilities that they would turn to the doors and the catchers that you referred to in one of the previous e-mails. [These are] permanent pig launching and receiving facilities, facilities that can be accessed and used year-round, not just in areas when the weather is conducive to operations.

We want to put in place a new leak detection system. We have an existing leak detection system that meets our requirements right now but want to put in place a new leak detection system that is more robust and want to actually trial some new leak detection technologies to see if we can improve what we already have.

In addition to that, it will take the building of, not only an addition to put the pipeline but we're looking to building 20 modules on skids that will provide the facilities that we talked about above. And ... I think our lines right now are 34 inches nominally across the field, with the exception with FS 1, which is 30 inches. These lines are going to be sized for the full life of field, which will be 20 inches, 28, 15 and 12, respectively for it to cross the west to the eastern side of the field.

As I said, we talked to the new system as we're going to put it, so we talked to the pig launchers and receivers for all sections. We've talked about dedicated automated chemical injection in these lines and we talked to a more sensitive, repeatable, turbine full meter systems and a software package that is

consistent with other software systems that we use in the Lower 48 and in the trial of the LEOS sensitive early detection system. All of the new pipelines [being put] in place will be in compliance with DOT 195. They will be carbon steel but they will be fusion epoxy resin coated for external coating.

Installation of these will be in higher ... vertical support members (VSMs) to facilitate wildlife access around the pipelines themselves so that we've elevated the systems where possible to avoid any clash with the wildlife and create a better environment for that - and also raising them higher to get away from snow drifts or ponds associated with the lines themselves. In addition, that will give us better access to our corrosion coupon systems and maintenance.

[3:18:26 PM](#)

CO-CHAIR JOHNSON asked if Mr. Brock is classifying the rebuild as maintenance or reconstruction.

MR. BROCK said he would classify it as reconstruction of a new system with a gross cost of approximately \$250 million.

CO-CHAIR JOHNSON asked if the new system would fall under the replacement category under PPT and whether a tax deduction could be claimed in the future under PPT. He questioned whether this system is necessary and whether BP is building a Cadillac when something less expensive would suffice.

MR. BROCK said he will refer those questions to BP's tax experts. He said BP does need a new system for continued operations at Prudhoe Bay for the next 30 years. The pipeline systems need to be modified to handle more viscous fluids and heavy oil on the western side of the field. He noted DOT and ADEC have established new standards that require modifications.

[3:21:11 PM](#)

REPRESENTATIVE DAHLSTROM likened the project to residential reconstruction in which various types of funding are sought depending on the project and tax benefits. She said the state may have to provide more exact definitions of such projects so that the state and companies are using the correct terminology.

[3:22:23 PM](#)

MR. BROCK continued his presentation:

This is just an insight into one of the new pig launchers that we've put in place. Some of the facilities that we have right now are temperate and adverse weather conditions are difficult for the operators to safely operate. Our proposal is that we will actually put - these new facilities will be permanent, will give us year-round access and we're using the operating groups and the operating teams to actually help us design these so that these are actually easier to operate and maintain and give them year-round access to the facility.

I guess the comment here is we've had extensive requirements from local, state and federal agencies to allow us to have permits to go ahead and start the construction of the new system. As such, we've had great cooperation from the agencies as such and I just wanted to recognize that as seeing it firsthand.

[3:23:15 PM](#)

CO-CHAIR GATTO referred to page 31, and said two points are worth noting. At the top, it says, "Prior to the arrival of Tony Brock and the creation of the Technical Directorate, there was no formal process for assessing risk." Further down the page, it reads, "Risk register is developed under Technical Director Tony Brock." He pointed out Mr. Brock is on the "good page."

[3:24:01 PM](#)

MR. BROCK continued with his presentation:

...This is really an overview of the leak detection system and we're putting in new hardware, new reliable systems. We're putting in a new software package. These are, what we believe, are the best available technologies within the industry. The industry has moved on quite a bit. These are systems that will be in place and reliable for 30, 40 years. The lower reference is actually to a pretty unique technology. It's a LEOS system. It's a system that is sensitive to very small leaks. I don't know if you can recall back to the eastern operating area, but we actually

had pinhole leaks of drops of oil that were coming through and, as such, the leak detection system - it went below the radar of that type of system. So we're actually trialing this new technology to determine if this more sensitive technology is applicable. It is the first time that it's been deployed in an Arctic environment in this circumstance. We have a similar system in our Northstar transit line but that's buried in the seabed. This is exposed to a much harsher climate and greater swings in temperature. This is an interesting trial for us. It will take us a couple of years to prove it through winter and summer operations but I think it's a unique system and I look forward to seeing what the findings are on that.

On the transit line system itself, we had an extensive construction season through January and April. We've constructed two sections of the pipe. It has not been put in service yet. It needs modules to be constructed to allow us to do that. The overall replacement of the 16-mile sections will be completed and we hope to commission those in the fourth quarter of 2008.

This is really just some of the major project accomplishments and this, to date, took considerable effort by BP and it was driven, in part, by the fact that - one is the existing system is we are carrying out extensive tests and inspections at the moment to ensure integrity of that system. We do believe that it is an old system and we do want to put a new system in place. We put a lot of engineering effort into designing a new system and starting the construction and the project, so we made great progress on that but, as I said, the 20-inch and 18-inch sections are installed and I'll reference those and then - a follow up slide.

The next series of photographs are really - I'm not going to go into detail, they really give you an idea of the scope. This is really just an example of just a piece of insulated pipe at the gathering center 2-1. These are the VSMS I spoke to. I'm really just going to move through these unless someone has a specific question but it's just an illustration.

This is the welding of the pipe itself and these welds, when we put them in place, actually the procedure and the welding itself is checked thoroughly not only by BP experts but by Houston construction experts and Department of Transportation experts. This is just, again, sandblasting to allow us to coat the weld after the weld's been completed. This is an example of the techniques we use for weld inspection. This is the follow up insulation and covering of these welds. I'm really trying to demonstrate here that we're extremely thorough in the construction and the quality assurance process associated with these pipelines.

This is just an illustration of the pipe being lifted into position. We really had phenomenal performance from the team working on this. The majority of the staff came out of the Fairbanks union holds. A lot of the extra workers came up from Anchorage and Fairbanks to help us in this construction operation. This is just an illustration of the line to Flow Station 1. This is ... an illustration. The yellow sections show you the sections of pipeline that we have currently constructed and are in place.

This is one of the final slides to give you an overview of the contracting parties that have come into play here. The highlighted ones are actually Alaskan businesses that have supported this operation. You can see an extensive number of people in that and the companies in that. And we had, working on the pipeline itself, something in the order of 300 to 350 at peak working specifically on this pipeline installation and that will carry through and some appeared as we start to look at construction of pods and modules.

This is the final slide, ... we're actually just really starting to address some of the queries that the committee had. These series of leaks actually have - were a surprise to us. We pride ourselves in being a lead operator in Alaska and we have a huge role to play. We've had a huge role to play in the last 30 years and we want to be here for the next 50 years and be seen by the state as a respected and trusted operator. We want to be a lead operator in Alaska. That's our goal and it's a priority of the

leadership team that's in place and (indisc.) here today. Events of 2006 show that we've got some things to learn and we need to change how we operate and we're committed to doing that. In the process of reacting to these spills, we've done a lot of listening, a lot of learning. We know that there are corrosion gaps that we need to address and we know we need to improve our risk management. If you look at our overall infrastructure and ensure integrity of that entire system and we have the balance right with cost management. We invest on our facilities and get the balance right between safety integrity and the business. We need to get our organization right so that the organization functions and the issues that are raised are addressed in a timely manner. We need to pay attention to communication of culture. We've got a series of documents here that relate to the frustration of our employees. That's not acceptable. We need to create the right culture and environment where people can openly address their issues and voice their concerns and they need to be addressed in a timely manner.

So what we're focused on right now is we've talked about organizational changes. We've got the technical director but also in the greater Prudhoe Bay organization we've added a number of positions to give us greater supervisory control and a better span of control. We've put area managers in place to address some of the issues about a scale as complex and as big as greater Prudhoe Bay.

We've got an extensive program for workforce renewal. [We recruited] 50 technicians last year and we're bringing in another 40 this year and we'll look beyond that to ensure that we have the right workforce in place going forward.

We're expanding our communications to encourage broader open communications within our working environment. And [indisc.] the place of addressing the cultural issues that prevailed to ensure that we have one BP that's trusted and respected to deliver safe, reliable operations.

In the plant we're taking immediate actions to manage our oil transit lines. We've modified our operating

practices. We've modified some of our maintenance practices. We have this greater control and assurance. We're carrying out comprehensive inspections. In that we've actually commissioned a new corrosion management strategy and in that strategy we're looking at short term needs to address any specific risks that are out there in our facilities.

We're replacing our oil transit line systems in greater Prudhoe Bay and we've actually brought a team in under Gary Bugel (ph), to set up a renewal projects team and that team will be dedicated to looking at the longer term renewal requirements of the greater Prudhoe Bay facilities and the North Slope in its entirety.

We're introducing new standard technical practices that are BP practices in the technical directive to ensure that these standards are enforced. We've got a process. We're looking to comply with new regulations with the Department of Transportation but also the local ADEC offices and also the regulatory office Process Safety and Integrity Management. As we talked to, we've got a new, improved risk management process. We've got a new corrosion management strategy. We're looking at putting in place rigorous performance measures so that we can actually monitor integrity management across our facilities, not only in integrity management but also in corrosion so that I get to see, on a regular basis, are we conducting the inspections we said we were going to conduct. Are we acting on the result of those inspections where they raised concerns?

So our overall goals are to establish trust from the public, be an industry leader in Alaska, transform our culture to one that's going to prevail for 50 years, and provide sustainable performance through a new operations management system.

[3:33:33 PM](#)

CO-CHAIR GATTO thanked Mr. Brock.

[3:33:48 PM](#)

REPRESENTATIVE SEATON requested a written response from BP regarding whether BP has billed the other Prudhoe Bay partners for the repair and maintenance work required by the shut-down. He commented that one of the criteria under the PPT is that if the partners decline to pay for certain items, those items would not be eligible for a state [deduction]. It was his understanding, as of a month ago, that no billing had been sent to the other partners. He pointed out the legislature needs to know whether it needs to create another way to address the system, possibly by improper maintenance criteria, or whether that is covered under existing law. He then asked whether BP employees have received any communications telling them not to put their concerns in e-mail messages.

MR. BROCK replied none whatsoever and, in fact, employees have been encouraged to voice their concerns and pursue them until resolved.

[3:37:24 PM](#)

CO-CHAIR GATTO clarified Representative Seaton questioned whether employee concerns are in writing.

MR. BROCK said he was clarifying that BP employees have not been told to not put their concerns in writing.

[3:37:44 PM](#)

CO-CHAIR GATTO said the legislature is working with the federal government to obtain as much information as possible. He asked Ms. Slemons of the PSIO to give her presentation.

[3:38:14 PM](#)

REPRESENTATIVE GRUENBERG said it is his understanding that various state officials gave BP the "okay" to not perform maintenance and inspections. He asked Mr. Brock if he could comment on how that affected the company.

MR. BROCK said he can't comment on that specific example but said BP is committed to working with state regulators, particularly with the new PSIO office to ensure that appropriate standards are in place and that BP adheres to those standards.

REPRESENTATIVE GRUENBERG asked if, in the future, BP knows an action should be taken but a state official says that action is unnecessary, BP should be let off of the hook.

MR. BROCK thought BP would operate to the higher standard.

REPRESENTATIVE GRUENBERG asked if that is a new policy.

MR. BROCK said that has always been BP's policy.

[3:40:22 PM](#)

The committee took an at-ease from 3:41 p.m. to 3:48 p.m.

[3:48:16 PM](#)

CO-CHAIR GATTO called the meeting back to order and asked Ms. Slemmons to brief the committee.

[3:48:23 PM](#)

JONNE SLEMONS, Coordinator, Petroleum Systems Integrity Office (PSIO), Division of Oil & Gas, Department of Natural Resources, told members she was not expecting to testify today. She offered to answer questions or address a particular topic if requested.

[3:48:50 PM](#)

CO-CHAIR GATTO referred to a letter and read:

Questions:

What did BP tell the Alaska Department of Environmental Conservation in order to justify its request that ADEC waive the pigging requirement in the May 29, '02 compliance order by consent?

[3:49:31 PM](#)

MS. SLEMONS told members on May 16, 2007 the Congressional Committee on Energy and Commerce and Subcommittee on Oversight Investigations requested that the State of Alaska respond at a follow up hearing to an initial hearing held immediately after the partial shutdown of the Prudhoe Bay Unit. She thought the initial hearing was held on May 15, 2006, and that the commissioner of ADEC testified at that hearing. She testified at the May 16, 2007, hearing along with a representative of the Pipeline and Hazardous Materials Safety Administration from the U.S. Department of Transportation, a representative from the Chemical Safety Board, and a representative from the

Occupational Safety and Health Administration. The committees were reviewing the Texas City refinery explosion and whether any similarities to the Prudhoe Bay spill existed. The two questions in the letter Co-Chair Gatto referenced were asked of her at the hearing. She answered them to a degree so the committee requested more detailed information. She noted that letter was sent to the congressional committee members with a list of enclosures over one page long; House Resources Standing Committee members do not have those enclosures.

REPRESENTATIVE GRUENBERG interrupted and inquired as to what letter Co-Chair Gatto was referring.

[3:52:35 PM](#)

MS. SLEMONS noted that she provided Co-Chair Gatto with her copy of the letter [to congressional committee members]. She then told members, regarding the first question about what BP told ADEC about the pigging requirement, she does not work for ADEC and that Mr. Dietrick may have more information to offer. She continued:

In our letter, which was, of course, coordinated with the Department of Environmental Conservation [DEC] and others in the state, we referenced various documentation that outlined a sequence of communications from BP that began several years earlier, or at least one year earlier with their indicating that there was significant sediment in the lines, to the point that the testing of the leak detection system, which DEC was requesting - requiring, would be compromised. Let's remember too that DEC's focus was on insulation and proper operation of a leak detection system. Their primary focus at that time was not sediment or pigging or anything of the sort. So the pigging requirement was included in their consent order as a prerequisite to ensuring that the leak detection system could be properly tested and operate properly.

So, BP had told them that there was so much sediment in the line that they did not feel that the lead detection system could be properly tested and operated. So DEC included the pigging requirement in the consent order to solve that problem. After the consent order was issued, BP came back to DEC and said in fact, we were mistaken, there's not nearly as much

sediment in those lines as we thought originally and there's probably a half inch of e-mail documentation that captures the internal discussions within BP on that issue. So they told DEC that the sediment wasn't nearly the problem that they originally thought that it was. In addition, they told DEC that they had installed pig launching and receiving facilities, adequate to allow pigging at any time in the future. This was important information for DEC to know because it could have eliminated in their minds any concern that they might have had remaining about what low sediment levels they believed were still in those lines.

CO-CHAIR GATTO asked whether DEC requested the data to back up BP's statements about the sediment levels.

MS. SLEMONS said she was not sure what back up information was provided to DEC. She offered to look into that. She then continued her response, as follows:

So, that's what BP told DEC and that was - they then followed that up with a request - a written request, that the pigging requirement be waived and DEC agreed that that was appropriate and waived the pigging requirement in the consent order.

CO-CHAIR GATTO remarked that BP told DEC it overestimated the problem so wanted to be excused from the requirement and DEC agreed.

MS. SLEMONS said that is correct but, regarding BP's overestimation of the problem, BP also said it had installed the pig launchers and receivers, which would allow them to pig at any time and would address the remaining sediment levels. With that information, DEC agreed.

[3:56:37 PM](#)

REPRESENTATIVE SEATON asked if the pigging requirement was put in place for testing and leak detection purposes. Initially, DEC was told there was too much sediment to pig, but was later told the sediment level would not make the leak detection system inoperable so, because DEC's focus was the leak detection system, it waived the pigging requirement.

[3:57:27 PM](#)

MS. SLEMONS said that is correct but again added that DEC was also told pigging facilities were now available and pigging could occur any time in the future and took that into account.

[3:57:49 PM](#)

REPRESENTATIVE GRUENBERG asked Ms. Slemons to describe the initial requirement.

[3:58:12 PM](#)

MS. SLEMONS noted a copy of the consent order was in members' packets and that it contains several requirements for certain actions by certain dates.

REPRESENTATIVE GRUENBERG asked if it required that a certain amount of pigging be done.

MS. SLEMONS said it did.

[3:58:29 PM](#)

REPRESENTATIVE GRUENBERG asked if DEC was told the pigging could not be done because of too much sediment.

MS. SLEMONS said DEC was originally told that there was a great deal of sediment in the line, which is why DEC required the pigging.

REPRESENTATIVE GRUENBERG said DEC decided the pigging was unnecessary when the amount of sediment was found to be lower than estimated.

MS. SLEMONS replied, "In conjunction with the information that pigging launchers and receivers had been installed, that pigging could be conducted at any time in the future, DEC agreed that it was not necessary for purposes of testing the leak detection system."

REPRESENTATIVE GRUENBERG surmised that BP never followed through with the pigging.

MS. SLEMONS said that appears to be the case.

REPRESENTATIVE GRUENBERG asked why DEC did not take the additional step of ensuring that at least a minimal level of pigging was done.

MS. SLEMONS reminded members that prior to 2006, people were ignorant of the regulatory gap on the North Slope on the OTL lines [and], in fact, were jurisdictional for the Office of Pipeline Safety and the U.S. Department of Transportation. She continued:

DEC's authorities would extend to those lines only for purposes of environmental protection of air quality and land and so forth and so they did not have a requirement to ensure system integrity of the lines in their ordinary course of business. U.S. DOT would have had that authority. Now the gap arises in that there were some exemptions within the federal regulations that allowed those lines to fall through a gap - create the gap, if you will, in that lines that were in remote areas of very low populations were allowed to be exempted, as were - there were a couple of exemptions as I understand it and another one was that - let' see, the population and the remoteness were the two that these lines were ...

[4:00:59 PM](#)

REPRESENTATIVE GRUENBERG asked if BP was aware of the gap in regulatory authority at the time DEC waived the pigging requirement. He stated, "Because it would seem to me if they were involved in regulating this, then they must have thought they had required - they had the authority."

[4:01:16 PM](#)

MS. SLEMONS said it is her understanding that DEC believed that U.S. DOT had and was exercising regulatory jurisdiction and that both parties were unaware that the regulation was not be properly exercised.

REPRESENTATIVE GRUENBERG asked if DEC was de facto regulating up to that point.

MS. SLEMONS replied DEC was regulating pipelines from its perspective as an environmental safety agency, to her understanding. DEC was implementing its mission via oversight of the leak detection systems. Therefore, the consent order by

decree focused on that system. The DEC was not so much interested in overall operation and regulation; it was interested in ensuring that any breach of integrity was immediately identified and remedied.

REPRESENTATIVE GRUENBERG asked if the legal gap has been remedied.

MS. SLEMONS answered that it has, to her understanding. Congress passed the Pipes Act in late 2006, which expands the Office of Pipeline Safety's authority and puts the lines in question within the jurisdiction of the Pipeline and Hazardous Materials Safety Administration and that agency is actively pursuing regulatory authority over those lines now. When the first bill was enacted in 2006, DEC was in the process of promulgating regulations to bring flow lines under its authority. She believes all regulatory gaps have been addressed, however one of the primary tasks identified in Administrative Order 234, which established the Petroleum Systems and Integrity Office, requires that PSIO do a statutory and regulatory gap analysis to ensure that any remaining gaps on state lands regarding oil and gas are addressed. PSIO is currently doing a gap analysis.

REPRESENTATIVE GRUENBERG asked if a copy of that analysis will be presented to the legislature.

MS. SLEMONS said she would be happy to provide the legislature with a copy and that she has committed to make annual reports to the legislature on the PSIO's activities and findings.

CO-CHAIR GATTO asked whether DEC and the PSIO believe the one percent threshold is adequate. He said the spill was detected by a workman who smelled oil and the amount discovered on the ground was the equivalent of six or seven days of leaking. He noted a significant amount of oil leaked before it was detected.

MS. SLEMONS deferred that question to Mr. Dietrick of DEC. She said DEC has been looking at its requirements for the detection systems and the best available technology.

REPRESENTATIVE GRUENBERG asked if federal law preempts state law or whether they have concurrent jurisdiction.

MS. SLEMONS said she was uncertain but believed federal law preempts. She drew members' attention to the fact that the Pipeline and Hazardous Material Safety Administration and DNR

have signed a letter of intent to cooperate in sharing information and findings to prevent miscommunication.

REPRESENTATIVE GRUENBERG asked that Co-Chair Gatto request a written response to that question.

REPRESENTATIVE ROSES asked whether BP ever actually made a determination that the amount of sediment was lower than expected. He asked:

Wasn't it BP stating that they had an excessive amount and then therefore, it was stated that a pig needed to be used to clean it up so that the system could be tested properly and then they later on came back and said oh no, there wasn't as much as we said there was. So, the only really determination we have is their first statement and their second statement and no proof of anything in between.

MS. SLEMONS pointed out that BP reported to DEC through the annually required charter agreement report that routine maintenance pigging was part of BP's program for its OTL lines. Without jurisdictional authority, DEC would have assumed that regular maintenance pigging was being done.

REPRESENTATIVE ROSES asked if that kind of a discrepancy occurs in the future, something will be done to verify the correct statement.

MS. SLEMONS said it will; the agencies are trying to learn from mistakes.

CO-CHAIR GATTO asked if a camera travels through the pipeline to measure sediment levels.

MS. SLEMONS said the smart pigs collect and communicate data. When a smart pig emerges from the pipe, the amount of information it provides about the condition of the pipe is very detailed.

CO-CHAIR GATTO asked, "I imagine they have arms on springs and if they don't quite reach the end of the pipe, now they're on a bunch of rocks that get all measured - not measured - recorded so that at the end of the pipe you'll say at Section 142D we certainly seem to have an inch and a half of sediment?"

MS. SLEMONS said it is her understanding that a smart pig can report a location and other information about obstacles or obstructions.

REPRESENTATIVE GRUENBERG asked if BP made any factually incorrect statements in the key correspondence about pigging.

MS. SLEMONS said it is difficult to know exactly what information was available to the people making the statements. However, the correspondence does seem to imply that the pigging activity was either planned and never carried out or misrepresented. She said it is impossible to say whether purposeful misstatements were made from the documentation she has seen.

REPRESENTATIVE GRUENBERG pointed out the statutes prohibit false statements. He questioned whether those statutes adequately cover this type of correspondence and whether the departments' procedures follow the statutes. He wants assurance that the factual information provided in future correspondence can be relied upon and, if not, legal consequences will ensue. He asked Co-Chair Gatto to request an answer to that question from the PSIO.

CO-CHAIR GATTO asked if Representative Gruenberg is asking whether the penalty should be a felony.

REPRESENTATIVE GRUENBERG said the consequence could be a felony or a misdemeanor. Under statute, false swearing is a misdemeanor. He noted his questions are whether a situation like this is covered by statute and whether the departments' procedures follow the statutory requirement so that if factual information is not provided, the Department of Law can take action. Then, the legislature could determine whether the penalties are adequate.

CO-CHAIR GATTO remarked, "And I could see the problem as a lot, there's less, and neither term is quantifiable if, indeed, those were the terms that were sent as part of the correspondence that was involved in canceling the operations."

REPRESENTATIVE GRUENBERG said in matters of this type, it may be a matter of crafting the statutes with mens rea, so that criminal intent is not required; reckless behavior could be penalized. He said his concern is whether the legislature needs to take a look at whether the statutes are properly crafted.

MS. SLEMONS related that DOL is looking closely at the 2006 events on the Prudhoe Bay unit. She felt comfortable that DOL's findings will provide a detailed answer to Representative Gruenberg's question.

REPRESENTATIVE SEATON asked Ms. Slemmons if she is comfortable with the sufficiency of the changes proposed by BP.

MS. SLEMONS noted that BP is implementing far reaching organizational changes, largely in response to requirements placed on it by the Office of Pipeline Safety. She believes BP is sincere. She noted her personal concern is that "a ship the size of BP doesn't turn on a dime." It is difficult to change an organization's culture. She said BP has been responsive to the different agencies; she is hopeful BP is successful.

REPRESENTATIVE SEATON asked if the Office of Pipeline Safety oversees the modules and all other infrastructure on the Slope. He said he is concerned because the fire prevention and control offices have lost people with knowledge of very intricate systems.

[4:18:54 PM](#)

MS. SLEMONS told members:

... The Office of Pipeline Safety, as per its name, looks at pipelines and their jurisdiction do still have some limits. The letter of intent benefits not only the petroleum systems integrity office at DNR by being able to look at the federal information that they have, it also benefits them at being able to look at what we gather and find in the upstream for [indisc.] fields. In fact, facilities themselves, such as production centers, modules, gas processing facilities and those kinds of things, are one of those things that have escaped regulatory oversight, I believe, for quite some time other than elements like labor, [Occupational Safety and Health Administration] OSHA, fire protection, that kind of thing. It is one of the missions of the PSIO to fill those gaps and we will be looking at facilities, not just pipelines, in the system integrity plans that we will be requiring from the unit [indisc.]. We'll be assessing the technical sufficiency of those plans and then we will be performing on-site assessments to ensure that operators are complying with the system integrity

plans that are established. So, in short, to answer your question, yes, we intend to look at facilities as well as pipelines.

REPRESENTATIVE SEATON expressed concern about the staff cuts in the upgraded systems because, to his understanding, proper training to operate those systems has not occurred.

[4:20:50 PM](#)

MR. FINEBERG commended Co-Chair Gatto for the committee's efforts.

[4:21:29 PM](#)

MS. SLEMONS told members it is her hope that the Petroleum Systems Integrity Office will be reporting its findings to the legislature routinely. She appreciates the committee's interest in its work.

[4:22:02 PM](#)

CO-CHAIR GATTO asked how the PSIO came about.

MS. SLEMONS replied:

Mr. Chairman, it's had two life times already in its short history. It was originally formed under the Murkowski Administration under a different name. You may remember it as the Lease Monitoring, Engineering and Integrity Coordinator's Office - LMEICO. That concept, while the goal and the mission remain the same, the administrative structure and so forth have been changed pretty significantly. Under Governor Palin, it is the Petroleum Systems Integrity Office and that's where we're going forward with it.

[4:22:48 PM](#)

#### **ADJOURNMENT**

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 4:22 p.m.