

SENATE FINANCE COMMITTEE
February 16, 2010
1:30 p.m.

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CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at 1:30 p.m.

MEMBERS PRESENT

Senator Lyman Hoffman, Co-Chair
Senator Bert Stedman, Co-Chair
Senator Charlie Huggins, Vice-Chair
Senator Johnny Ellis
Senator Dennis Egan
Senator Donny Olson
Senator Joe Thomas

MEMBERS ABSENT

None

ALSO PRESENT

Jeff Hadland, Economist & Research Program Supervisor, Department of Labor and Workforce Development; Dona Keppers, Audit Master, Tax Division, Department of Revenue; Joyce Lofgren, Petroleum Economist, Department of Revenue

PRESENT VIA TELECONFERENCE

None

SUMMARY

OIL & GAS OVERVIEW

OIL INDUSTRY EMPLOYMENT & RESIDENT HIRE

TAPS HISTORY & TARIFFS

^OIL INDUSTRY EMPLOYMENT & RESIDENT HIRE

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Co-Chair Stedman introduced the topic of oil industry employment and noted that the focus would be on the Arctic oil and gas industry.

JEFF HADLAND, ECONOMIST & RESEARCH PROGRAM SUPERVISOR, DEPARTMENT OF LABOR AND WORKFORCE DEVELOPMENT, went over the data used to develop the numbers on oil and gas employment. He said the primary source of data is from quarterly unemployment insurance contribution reports which contain information on social security numbers, occupation, place of work, and the wages. In addition, there are weekly unemployment insurance records. The data is matched with administrative data files, including the Permanent Fund Dividend file, which is the primary source of information for residency. In addition to the data reported by employers, the department conducts monthly surveys which provide further data.

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Mr. Hadland related that the oil industry had an average annual employment in 2009 that was slightly higher than in 2008; however, the second half of the year showed a slight decline, a trend that is continuing.

Mr. Hadland used a handout entitled, "Alaska Department of Labor and Workforce Development - Oil Industry Employment, Unemployment and Resident Hire" (copy on file). He turned to a graph which depicted employment from 1980 to 2010 - slide 1. Major oil company employment was stable over the year, but oil field and services employment is declining. The projection for 2010 is a slight decline. The forecast is for a .4 percent decline in all jobs statewide and a .3 percent decline in oil industry jobs from 2009 to 2010.

Co-Chair Stedman requested specific information about Point Thomson and general maintenance.

Senator Thomas wanted more information about the dramatic increase in employment from 2005-9.

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Mr. Hadland reported that the data could not be broken down by projects. That would require social security numbers of individual workers on the projects.

Senator Thomas wondered about forecast data from 2003 - 2005 which predicted increases in employment. He inquired if a particular field was a factor. Mr. Hadland shared a number of factors which impact employment forecast projections: revenue estimates, industry sources, and the history of employment.

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Mr. Hadland turned to slide 2, which shows the percent of resident workers in the oil and gas industry from 1988 to 2008. There has been an increase in non-resident workers due to an increased reliance on oil field service company workers.

Co-Chair Stedman returned to slide 1 to point to an increase in employment from 2004 - 2008, but a drop in resident employment during the same period, as shown on slide 2. He requested numbers rather than percentages. Mr. Hadland offered to provide that information.

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Mr. Hadland turned to slide 3 and reported on the total workers working by quarter in the oil industry, from both the oil support and the oil extraction sectors. Oil extraction numbers have remained stable, while oil support numbers have increased until the third quarter of 2009, when there was a decline. Co-Chair Stedman requested information about additional quarters from the beginning of PPT in 2005. Mr. Hadland agreed to provide that information.

Co-Chair Stedman wanted to get a feel for how much is due to employment effort, credits, time, and dollars going into oil extraction, versus oil support.

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Mr. Hadland spoke of monthly oil industry employment from 2005 to 2009 - slide 4. In January of 2005 average monthly employment was slightly over 8,000 workers; currently,

there are about 13,000. In recent months there has been a decline.

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Mr. Hadland described slide 5 which shows the percent of oil industry nonresident workers in Alaska between 1995 and 2008. The information is broken down by oilfield services, oil and gas extraction, and total workers.

Mr. Hadland discussed slide 6 - unemployment insurance (UI) claimants by industry from 2003 to 2009; oil and gas related employment, as well as all industry employment. There was a significant increase of UI claimants in 2009 over 2008 in the oil industry. For all industries, claims increased by about 50 percent.

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Co-Chair Hoffman asked if the rise shown in slide 6 is due to hiring more out-of-state workers. Mr. Hadland related that the increase in UI claims can be caused by many different factors. Co-Chair Hoffman said it looks as though it is caused by more non-resident workers. Since 2002, the number of non-resident oil industry workers has increased. Mr. Hadland reported that the UI claims are from all workers. There is not a disproportionate share of non-resident workers who are receiving UI benefits. Co-Chair Hoffman maintained that in-state claimants doubled. Mr. Hadland explained that the inter-state claims are not necessarily from out-of-state residents.

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Senator Ellis referred to slide 5 and asked if the percentages shown are average numbers of nonresident oilfield services workers per year. He wondered if some companies have a much higher number. Mr. Hadland agreed that the rate varies between employers. He noted that resident hire rates are published annually and that information is available.

Senator Ellis said he had heard that the nonresident workforce at one company was between 50 and 55 percent. He opined that there were a number of companies with higher than 32 percent non-resident workers.

Co-Chair Stedman asked for additional information about individual company employment percentages. Mr. Hadland said he could provide that information. Senator Ellis voiced appreciation. He suggested the information may create pressure to hire in-state workers.

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Mr. Hadland turned to the subject of Alaska unemployment insurance weeks paid by month - slide 7. He reported an increase in the number of "weeks paid" the last several months.

Mr. Hadland provided a copy of the most recent press release from the Department of Labor and Workforce Development - slide 8. It provides an overview of unemployment in Alaska and the U.S. on a monthly basis.

Mr. Hadland turned to a graph which shows the monthly oil industry employment for the U.S. Co-Chair Stedman wondered if that same information was available for Alaska. Mr. Hedland referred to slide 4, but noted there was a slight difference.

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Co-Chair Stedman suggested it would be helpful for the committee to see the national and state charts match up. Mr. Hadland agreed to provide that information.

Senator Thomas turned back to slide 1, Alaska Oil and Gas Employment 1980-2010. He pointed out that employment was up from 2003 to 2009 and then flattened out. Slide 2 shows a downtrend in resident workers. Slide 6 shows an increase in UI claimants. He concluded that if the employment is up, but the UI claims are also up, then the people being employed are not Alaskan residents.

Mr. Hadland said that the employment decline occurred in the last half of 2009 and that resulted in the spike in UI claims. Although the average for the year is trending up, employment is going down. He speculated that other factors could cause UI claims to increase. The largest numbers of UI claims are from electricians, plumbers, and pipefitters. The data is not necessarily in conflict.

Co-Chair Stedman review requests for further information on regression similarities between the national oil industry and Alaska's oil industry.

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^TAPS HISTORY & TARIFFS

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DONA KEPPERS, AUDIT MASTER, TAX DIVISION, DEPARTMENT OF REVENUE, listed her credentials and introduced Ms. Lofgren. She outlined her presentation as covering netback calculations, tariff history, and going forward.

Co-Chair Stedman asked for a definition of a netback.

JOYCE LOFGREN, PETROLEUM ECONOMIST, DEPARTMENT OF REVENUE, referred to a handout entitled, "TAPS Tariff History & Going Forward" (copy on file). She shared information on slide 3. She said that in Alaska, state oil and gas leases and production tax statutes calculate royalty and tax based on wellhead value. Oil is primarily sold at West Coast refineries. Wellhead value is calculated through a netback process that allows for deduction of transportation costs to point of sale.

Ms. Lofgren turned to slide 4 to describe two primary transportation cost components, pipeline tariffs and marine (tanker) costs. Pipeline tariffs are set by state and federal regulators. Intrastate rates are set by the Regulatory Commission of Alaska (RCA). Interstate rates are set by the Federal Energy Regulatory Commission (FERC).

Ms. Lofgren showed a simple calculation of the netback process - slide 5. It was estimated with February 2010 data. She listed deductions taken to arrive at the ANS wellhead price. Co-Chair Stedman defined ANS as Alaska North Slope.

Ms. Lofgren showed slide 6, a graph that depicts the TAPS tariff relative to the price of crude oil. She stressed that this relationship was extremely significant to the Department of Revenue because of the millions of dollars affected. There were times when the TAPS tariff was half of what the price of crude was.

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Ms. Lofgren spoke of the initial TAPS tariff - slide 7. She related that TAPS began shipping oil in 1977. The initial tariffs filed by TAPS carriers charged over \$6 per barrel. The filed rates go into effect subject to refund until litigation is completed.

Ms. Lofgren reported that the TAPS tariff has been controversial since the beginning. She discussed the initial TAPS tariff litigation which began in 1977 - slide 8. The state protested the initial tariffs at the FERC and the APUC (RCA predecessor). In 1985, with no end in sight to the litigation, the state and the TAPS carriers negotiated a settlement.

Co-Chair Stedman asked, for the benefit of those listening, who owns the tariff when it gets paid to TAPS. Ms. Lofgren explained that TAPS has five owners: Conoco, ExxonMobil, BP, Unical, and Koch. There are two tariffs, intrastate and interstate. Co-Chair Stedman commented that the owners of TAPS are the same participants as in Prudhoe Bay and Kuparuk. Ms. Lofgren said that was correct.

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Ms. Lofgren turned to slide 9 - TAPS Settlement Agreement (TSA). She explained the TSM methodology. A formulaic method to calculate annual rates was created. It involved five tariffs due to the joint ownership arrangement. The agreement also provided for an annual true-up based on actual costs. The settlement formula set a ceiling on the filings. It was agreed that the state would not protest the charged rate unless it was higher than those derived from the TSM methodology, there were imprudent costs, or it was inconsistent with the law.

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Ms. Lofgren explained slide 10 - other TSA provisions. The agreement binds only the state and TAPS carriers. It left open that third party shippers are free to challenge settlement rates any time. The state could audit annual filings. The agreement could be terminated by any of the parties by January 1, 2009; otherwise it was set to expire at the end of 2011.

Ms. Lofgren shared information on slide 11 - TAPS intrastate rate protest. In December 1996 Tesoro Alaska filed a protest of the 1997 TAPS intrastate rates. In 2002, RCA issued Order 151 which stipulated that the rates charged during 1997 to 2000 were not just and reasonable. A lower intrastate rate was established and refunds were ordered.

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Ms. Lofgren discussed interstate rate protests - slide 12. In 2005, the state protested carriers' interstate rates for unlawful discrimination. The state argued that the difference between the interstate and intrastate rates violated TSA and Interstate Commerce Act prohibitions. Anadarko then protested 2005 rates as not being just and reasonable. The state and Anadarko protested 2006, 2007, and 2008 TSA-based annual rates.

Ms. Lofgren reported on the FERC Decision and Opinion 502 - slide 13. In May 2007 the FERC Administrative Law Judge (ALJ) Cintron issued an initial decision finding the TAPS 2005 and 2006 interstate rates not just and reasonable. In June 2008 FERC issued Opinion 502 affirming the ALJ on all issues. They ordered carriers to file new 2005 and 2006 rates based on current FERC regulatory formula (154-B methodology). They also ordered refunds based on re-filed rates. The refunds for 2005-2006 resulted in an additional \$600 million to the state for adjusted production tax and royalty liabilities.

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Ms. Lofgren discussed 2007-2008 TAPS rate protests - slide 14. The result was that FERC ordered TAPS carriers to recalculate and re-file 2007 and 2008 annual rates based on Opinion 502 methodology. The refunds for 2007-2008 resulted in an additional \$200 million to the state for adjusted production tax and royalty liabilities.

Co-Chair Stedman asked for the total TAPS tariffs per year for marine transportation. Ms. Lofgren did not have those numbers, but offered to provide them. Co-Chair Stedman said there was about \$1 billion total in shipping TAPS tariffs. Ms. Lofgren gave an example: 250 million barrels at ten cents equals \$25 million a year.

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Ms. Lofgren shared information about the TAPS settlement, which terminated effective January 1, 2009 - slide 15. The state terminated the settlement. She discussed the post-settlement rate protests - slide 16. The TAPS carriers filed new intrastate rates at the end of 2008 - early 2009, and the new interstate rates in the second half of 2009. The state and Anadarko protested those rate filings and a new rate hearing is set at the FERC for October 2010.

Ms. Lofgren showed a graph which depicts the components of the TAPS Tariff over time - slide 17. It is not to be confused with total operating expenses; it is dollars per barrel. The components have changed over time. It depicts the effect of the settlement agreement.

Co-Chair Stedman asked what year the change from the settlement agreement took place. Ms. Lofgren said the drop happened in 2005. Co-Chair Stedman noted it was a substantial change. Ms. Lofgren agreed. The major component of the TAPS tariff is now operating expense. Early on, the major component was depreciation. After-tax margin is no longer a part of the rate calculation.

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Ms. Lofgren turned to slide 18 - cost of service components. She listed the components added to operating expenses: return of rate base, return on rate base, allowance for funds used during construction (AFUDC), and income tax allowance. Co-Chair Stedman asked if AFUDC included all capital expenditures. Ms. Lofgren explained that it takes a period of time before AFUDC are inserted into the carrier's property in service. Cost of service or total revenue requirement is the sum of the components.

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Ms. Lofgren explained slide 19 - TAPS throughput and tariff. The left side shows millions of barrels per year (production) and the right side shows dollars per barrel. She stressed the significant impact production has when calculating a tariff. She emphasized how important the throughput or deliveries are.

Co-Chair Stedman returned to slide 18 to ask for more information on the TAPS settlement methodology, opinion 502, and the "shift down". He asked if the state was currently operating under 502. Ms. Lofgren said that was correct. She reviewed the components of the tariff again - slide 17. She discussed an after-tax margin that was part of the total revenue requirement. It started out at 35 cents per barrel back when the settlement agreement was entered into. It was to increase at the rate of inflation. It also had to be figured into the income tax allowance. The after-tax margin and the income tax allowance disappear after the settlement agreement and the change to Opinion 501, which is strictly a cost-based tariff.

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Co-Chair Stedman referred to slide 19 and asked if the spread between Opinion 502 and the TSA was around \$650 million on 240 million barrels a year. Ms. Lofgren agreed. Co-Chair Stedman asked if it adds value to the wellhead and increases the state's share. Ms. Lofgren said that was correct under 502, as opposed to being at the higher tariff resulting in a lower wellhead. If the tariff is lowered, there will be a higher wellhead. Co-Chair Stedman emphasized the "magnitude of the dollars we're working in". Ms. Lofgren agreed it made a huge impact.

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Ms. Keppers discussed the importance of the other essential component piece for calculating the tariff, the throughput - slide 20. She pointed out that the tariff increases if the costs increase, the throughput declines, or a combination of both.

Ms. Keppers described the throughput required to maintain the 2010 tariff level - slide 21. She spoke of methods to address the throughput issue. For example, Alyeska Pipeline has been undergoing low flow studies to understand the impacts of reduced throughput. They believe that TAPS will continue to operate in a safe and efficient manner for the plan period with additional investment. They also believe the physical life of TAPS will last as long as the integrity of the pipeline and facilities are maintained adequately to allow continued safe and environmentally sound transport of crude.

Ms. Lofgren discussed another way Alyeska is working on throughput issues - working on strategic reconfiguration of new pumps.

Co-Chair Stedman requested information about slide 21. Ms. Lofgren explained how calculations were done to determine the throughput level needed to maintain the 2010 tariff level. The point of the table is to show that "you don't necessarily have to have increased tariffs just because the cost of service is going up".

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Co-Chair Stedman referred to a statute change that allowed the state to put forth a "fair and reasonable tariff". Ms. Lofgren said there is a regulation that addresses the reasonableness test of cost of transportation. Regulations will be calculated using a cost-based methodology and implemented by the Department of Revenue. Co-Chair Stedman asked when those regulations would be in place. Ms. Lofgren reported that the regulations were out for comment now. Co-Chair Stedman stated that regulations' impact on the tariff will have to be addressed.

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Ms. Lofgren pointed out that regulations would not affect the tariff so much as determine what the Department of Revenue would allow for taxes.

Ms. Lofgren spoke of the tariff going forward - slide 22. She said there would be a uniform rate on TAPS, a filed rate of \$4.10. There is currently no settlement agreement between the TAPS carriers and the state. There will be no access to data other than FERC filings and protests. There are stacked rate filings and protests. There is a FERC hearing scheduled for October 2010.

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Senator Egan asked how often operating expenses are audited. Ms. Lofgren said that it has been some time since TAPS has been audited. Senator Egan referred to a previous slide regarding the FERC ruling. Ms. Lofgren explained that the tariff is not audited.

Ms. Lofgren talked about the complications of having stacked rate filings and protests. She reported that there is a FERC hearing on October 2010 to discuss unresolved issues. She noted that FERC does audit the TAPS tariff, even if the state does not.

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Senator Thomas noted that the second greatest component of the TAPS tariff, about 12 percent, is "other". He requested a definition of "other". Ms. Lofgren explained that it was the rate of return, which entails the return on equity on the rate base and the deferred return. Co-Chair Stedman asked for figures on the rate of return. Ms. Lofgren thought it was about 12 to 14 percent. She reported that in 2008 or early 2009 the FERC put out a policy which now allows a proxy group to determine the rate of return. The rate of return on the rate base was significantly higher than in previous years.

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ADJOURNMENT

The meeting was adjourned at 2:30 PM.