

**ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE**

February 6, 2012

3:32 p.m.

MEMBERS PRESENT

Senator Joe Paskvan, Co-Chair
Senator Thomas Wagoner, Co-Chair
Senator Bill Wielechowski, Vice Chair
Senator Bert Stedman
Senator Hollis French
Senator Gary Stevens

MEMBERS ABSENT

Senator Lesil McGuire - excused

OTHER LEGISLATORS PRESENT

Senator Cathy Giessel
Senator Joe Thomas

COMMITTEE CALENDAR

Overview: Gleason Decision of 12/30/2011 by Robin O. Brena

- HEARD

PREVIOUS COMMITTEE ACTION

No previous action to record

WITNESS REGISTER

ROBIN BRENA, Attorney
Brena, Bell and Clarkson, P.C.
Anchorage, AK

POSITION STATEMENT: Presented overview of the Gleason decision.

CRAIG RICHARDS, Attorney
Walker and LeBeck
Anchorage, AK

POSITION STATEMENT: Presented overview of the Gleason decision.

ACTION NARRATIVE

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CO-CHAIR JOE PASKVAN called the Senate Resources Standing Committee meeting to order at 3:32 p.m. Present at the call to order were Senators French, Wielechowski, Stedman, Co-Chair Wagoner and Co-Chair Paskvan.

Overview: Gleason Decision of 12/30/2011

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CO-CHAIR PASKVAN said the committee would take up the only order of business today, a review of the trial de novo of the 2007, 2008 and 2009 assessed valuations of the TransAlaska Pipeline, known as the Gleason decision of 12/30/2011 by Robin Brena, lead counsel for the Municipalities, and Craig Richards, counsel for the City of Valdez.

SENATOR STEDMAN asked what "trial de novo" means.

CO-CHAIR PASKVAN explained that it is a new trial where the court has the ability to accept new facts and render an opinion based on them. He invited Mr. Brena to comment.

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ROBIN BRENA, Attorney, Brena, Bell and Clarkson, P.C., Counsel for the Fairbanks North Star Borough and lead counsel for the municipalities in the 2007-09 assessed valuations case for TAPS, said he had been involved in tax and oil and gas and pipeline work for 30 years. He has been involved in every oil pipeline matter that has gone before the Alaska Supreme Court in that period; he has represented Tesoro when it questioned the basis for the TAPS rates and got them cut in half before the Regulatory Commission of Alaska (RCA), and he represented Anadarko when they went before the Federal Energy Regulatory Commission (FERC) and got the rates cut by half. He was involved in the Cook Inlet pipeline and the Cook Inlet gathering system.

He said he had been involved in complex ad valorem cases and represented every drilling contractor in the State of Alaska as to how drilling rigs should be assessed. He has represented clients with regard to the assessment of tankers and refineries and represented both Fairbanks and Valdez with regard to the proper method for assessing the TAPS.

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SENATOR STEVENS joined the committee.

MR. BRENA clarified that he was not here on behalf of any of his clients, but as a resident of Alaska. He grew up in Skagway and has been an Alaskan his whole life. He has several clients with several different interests, some of which he has mentioned. He was offering his own opinions and not the opinions of his clients.

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CRAIG RICHARDS, Walker and LeBeck, Anchorage, Alaska, said he is a life-long Alaskan and grew up in Fairbanks. He attended universities back East and has practiced law in Anchorage for almost 10 years with Bill Walker. Part of his representation in oil and gas matters, the vast majority of his practice, includes numerous ad valorem disputes including litigating to the U.S. Supreme Court whether or not the oil tankers can be taxed at Valdez and on an ad valorem value of TAPS case since 2004, including with Mr. Brena most of that time. With Mr. Walker he has extensively represented the interests of entities trying to build an LNG pipeline to Valdez. He has been involved in the Point Thomson unit termination case, the proposal to truck LNG to Fairbanks and has regularly acted as the owners' bond counsel for most of the refinancing on TAPS. He and Mr. Walker represented Valdez in front of Judge Gleason for both the 2006 trial de novo that occurred in 2009 and again more recently for the trial de novo for the 2007 and 2009 tax years.

CO-CHAIR PASKVAN asked him what "trial de novo" means in the context of this case.

MR. BRENA replied that he had been involved in this case for several years. Judge Gleason issued an order concerning the 2006 tax year last year; this year the most recent decision concerned the 2007 and 2009 tax years. The 2006 trial was five weeks long and the other one was nine weeks. Trial de novo means that it is heard anew; over 700 motions were made and included defining everything. Trial de novo can mean anything from what the Superior Court is going to completely disregard, hearing the matter anew based on its own evidentiary record all the way to deference to administrative proceedings that allow limited evidence on limited topics. Judge Gleason's findings with regard to trial de novo were kind of between the two extremes. She gave deference to the State Assessment Review Board with regard to the assessing authorities as the courts are prone to do and plugged facts into the methods that were applied.

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He said this has been intense and contentious litigation and had over a half million pages of discovery. Their presentation will be in the context of tax policy.

CO-CHAIR PASKVAN stated that all of the documents before them today and the exhibits themselves will be posted on BASIS. Mr. Richards said they would provide additional documents on request.

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MR. RICHARDS said their source materials are intended to illustrate Judge Gleason's decision and the types of information behind it. She agreed with the municipalities' positions with regard to the market structure and the integrated nature of the operations on the Alaska North Slope combining upstream (production) and midstream (transportation) assets. She largely agreed with their perspective on the reserves and the production profiles associated with them as well as their perspective with regard to what the minimum capacity of TAPS is to operate. She essentially adopted their positions on those key elements that are matters of concern to legislators.

He said she also shared many of their concerns with trying to get reliable information to make good decisions and he fought very hard to make some of that information public so it could be shared with Alaskans.

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In the 2006 case, the state had assessed TAPS at \$4.2 billion and Judge Gleason ultimately assessed it at about \$10 billion. The 2007, 2008 and 2009 assessments were \$4.5 billion, \$6.1 billion and \$9 billion, and as a result of her decisions those assessments went from \$8.9 billion to \$9.6 billion depending on the year.

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SENATOR FRENCH said he didn't recall what the tax consequences of the Judge's decision were and asked how much more the pipeline owners would have to pay.

MR. RICHARDS replied the state levies a statewide oil and gas tax of 20 mils or 2 percent of the assessed value. About half of that goes to the state and the other half is split up between the municipalities involved in the case. It amounts to roughly \$180 million.

SENATOR FRENCH recalled that industry came in with an opening valuation for TAPS of \$1 billion in what he calls the "Gleason 2" decision.

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MR. BRENA replied their position was that the value of the pipeline was \$850 million in 2006 with slight variations for 2007 through 2009 slightly at around \$1.2 billion. Their case advanced about a quarter of the state's assessment and about a tenth of what Judge Gleason found.

SENATOR FRENCH said it's funny that the state would be so far off from the Judge's valuation and odd that the state wouldn't have a better idea of what the pipeline was worth. Typically, the assessors go as high as they can, the taxpayers go as low, and then you pick some number in the middle; but here you have the taxpayer low, the assessor medium and the final decision is above that. It would be like if his house is worth \$300,000 and him having the nerve to look the mayor of Anchorage in the face and saying its worth only \$30,000.

MR. RICHARDS responded that from the mid-1980s to 2005 the value of TAPS wasn't set through a rigorous assessment process, but more by negotiation between the oil companies and the state. It wasn't really until the municipalities injected themselves into the process, because their tax bases were going down, that this rigorous process of valuing the asset became an issue. It just took a couple of years to work out how to go from the old methodology to a more standard methodology for these sorts of long-lived special purpose properties.

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SENATOR FRENCH asked what has prevented this issue from being sort of an annual dispute.

MR. RICHARDS replied that was before his time, but his impression is that the state treated it as a negotiation. Once you accepted the TAPS Settlement Method (TSM) (with accelerated depreciation built in) or an income methodology as the basis of valuation and other features that were going to result in that value going down, the state was just in the process of negotiating with the North Slope producers every year how much it should go down. Very little intellectual inquiry went into whether or not TSM really reflected a meaningful way to value this asset. The first real appeal in the 2005 case forced intellectual rigor to be applied to that issue.

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MR. BRENA said these matters can be litigated intensively and puts millions of dollars in tax revenue at risk. For example, a proper cost study to determine what beginning points should be used in applying the cost approach to value costs millions of dollars for facilities like this. This type of litigation is not undertaken lightly, but when the value gets so far off, people get involved. The state got half of the increase and the municipalities got the other half. It wasn't just limited to those municipalities; Anchorage, for example, received increased tax revenues as a result of this litigation even though it did not participate.

CO-CHAIR WAGONER wondered how relevant this discussion was and said he thought they were going to have a presentation so the Alaskan people understood that the pipeline wasn't in any real dire threat of shutting down any time soon. He asked if the decision would be appealed to the Supreme Court.

MR. BRENA replied probably.

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The overview consisted of the following parts:

Market structure

- integrated operations with concentrated market power
- stages of developing the resource
- barriers to competitive entry

The Life of TAPS

- Price of ANS crude oil
- reserves and throughput
- minimum mechanical throughput

Access to information

Conclusion

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MR. BRENA said the production of Alaska North Slope oil is a very integrated operation by three major companies and it is important to understand the stages of development for the Alaska North Slope and where in the evolutionary process the resource is, because at different stages there are different market players and participants with different incentives. In terms of applying tax policy he said it is important to understand what stage you are at. He would talk about the TAPS rates and how they are barriers to competitive entry. He said he would talk about that within the context of other major oil basins like North Dakota and the Gulf that both have hundreds of shippers, secondary marketers and independents in full play developing

those fields. Hundreds of holes are being drilled and compared to here where after 35 years of operation on TAPS there is one independent shipper and a few independent producers, only one of which isn't associated with one of the major three and only one of which ships down TAPS and takes their oil directly to the market. The purpose is to inquire whether or not the marketplace has been allowed to work on the North Slope, because "you don't want to be in the position of incenting people through tax policy to do what the market could otherwise do."

MR. BRENA said market structure, the stage of development and the barriers to entry that exist for independents are preventing the market from working as fully in Alaska as it does in other locations and could be addressed by tax policy.

The key things that determine TAPS' life are the production profile and the ability of the pipeline to continue to operate; those economics are ultimately what determines its life. For instance, for every \$10 increase in the price of oil the life of the Prudhoe Bay field decreases by 5.5 years. The life of the Prudhoe Bay field, and perhaps Kuparuk (development of its heavy oil), will determine the life of TAPS. The other satellite fields will come on and go off before getting to its end. He would talk about the price of ANS crude oil and its projections, the reserves and throughput, and Judge Gleason's decision as well as the minimum mechanical throughput in terms of what the physical capacities of the pipeline are.

SENATOR FRENCH asked what allowance should be made for the possible introduction of OCS oil into the pipeline. The state doesn't get any tax revenue from it, but it does extend the life of the line.

MR. BRENA replied that he hoped the state could negotiate some way to realize some of those revenues off the OCS. But, certainly, he said additional throughput from any field extends the life of this facility. And as the life is extended more development opportunities surface.

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He said he would talk about what they don't know, too, because Judge Gleason's decision was based on things they do know such as proven reserves, existing technology and what can legally be deliverable today. An example of what they don't know is that that while 9.6 billion barrels of proved reserves is what justified the construction of TAPS and 16 billion barrels of oil has been produced through 2009, the proved reserves are still

between 7 billion and 8 billion. The proved reserve estimates have gone down only by 2 billion barrels; this is because of field growth, additional sources, additional technology (directional drilling) and different opportunities.

MR. BRENA said when Judge Gleason looked at the proven reserves she assumed that no others would come on line and no technology would be developed. In many ways, it is the floor; and if anyone were betting money, they wouldn't bet that the world would remain stagnant for the next 40 years when they have seen what has happened in the last 30.

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MR. BRENA said the last major area he would chat about is access to reliable information and said, "I cannot tell you how incredibly difficult it is to get reliable information in order to litigate these cases, and that is with the full power of the court, with taking depositions, with doing everything that we can do...with regard to the reserves, with regard to the capacities of these facilities."

He said he is in different cases where the life of TAPS is at stake. The life of TAPS is important in setting the transportation rate for TAPS, because it is used to determine the depreciation allowance that goes into each year's rates. On July 10, he started a hearing before the FERC (concurrently with the RCA) with regard to what the life of TAPS is for the purpose of setting just and reasonable rates. Another whole cycle of discovery will become available in the summer because of it. He said, "I can't imagine a more intensively litigated issue in Alaska in the last five years than the one we're sitting here to discuss today. Just about every expert that has an opinion has testified or been crossed. And if somehow they've missed it, then we're going to take another run at it this July."

Notwithstanding that, he said there is a great deal of information that Judge Gleason relied on that is not public and that he couldn't share with them. And the FERC and the RCA would rely on information that they cannot share either. It goes specifically to producer reserve information and production profiles, the kinds of things that are tightly held by the industry.

MR. BRENA said he would talk about access to information because that is the bedrock for sound public policy. In forming tax policy that is going to impact Alaska's future for generations to come they should "have absolutely reliable information,

particularly when the tax policy is to benefit the people that are known to have the information.

SENATOR STEVENS remarked that it is difficult to make honest decisions when you don't have all the information and asked if keeping information is unusual in this industry and if other states have access to this information.

MR. BRENA replied that everybody likes "to keep the keys to the realm closely held" and he didn't blame anyone for doing that. Within the context of litigation he signed confidentiality certificates, but his perspective is should the information be shared with policy makers who have literally billions of dollars of tax policy questions to resolve before them. In his case, less money was at stake, but a mechanism is available to get that information so that the record and the decisions that are made are not inconsistent. In this case, you have public information that is highly unreliable, private information that is used by industry for its decision making (which is probably most reliable because it's the way they run their businesses) and information that is shared with investors that is based on very strict parameters. This committee would making more important decisions than the Judge did with less information and if he were on it, he would very much want direct access to the reliable information and have it reviewed by who can distill it down so that legitimate policy questions can be asked and answered.

SENATOR STEVENS stated that it's hard to make good decisions about Alaskans "without knowing who is telling you the truth."

MR. BRENA said the FERC and the RCA will be making decisions about what parts of the information they are going to use on life of line issues that will be public and non-public. If the committee feels it should be shared, they should express that and it would be supportive of his considerable efforts to make this information public.

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MR. RICHARDS said the Department of Revenue has access to some information and doesn't have access to other information. Some of the information it has access to it doesn't share with this body or the public at large, but at the end of the day, the legislature is the policy maker that justifies the reduction in taxes. So, it seems incumbent that those that have the information that seek reductions in taxes to bring it forward to justify why it's appropriate to do so.

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MR. BRENA said as a practical matter, if the people with the information don't advance it, the way the courts deal with that under the Civil rules and legal precedent is it permits a "negative inference" to be made. If you have information that would support your case or that is relevant to it that you don't advance, then the assumption is that you're not advancing it because it doesn't support your position. If you have an information void and who you're litigating with has access to the information and they are not advancing it, the court takes that into consideration and if he were a policy maker he would certainly take that into consideration.

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MR. BRENA said he had Mr. Eyre, an expert in unitary appraisal, identify an integrated economic unit and explained that sometimes that unit involves more than just what is being assessed and the parts can't easily be separated. So, one way to approach valuation using an income approach is to look at the income for the whole unit and then try to assign the value that is created to its parts; one way to do that can be done by investment. That is not an approach that Judge Gleason adopted, but she said it was helpful in her case. The beginning point for such a unitary analysis had remarkable consistency between the owners' position and the municipality position. Mr. Eyre did a cash flow and net present value analysis of ANS oil based on that so he could determine what the value of the Alaska North Slope was. He determined that the value of that income stream on an integrated basis, taking into consideration the upstream production as well as TAPS (the mid-stream transportation corridor), was between \$40 billion and \$50 billion.

The owners advanced a gentleman named Dr. Smith who criticized Mr. Eyre and said it should be 10 percent lower. But for the purposes of this conversation it doesn't really matter whether of TAPS is \$35 to \$45 billion or whether it's \$40 to \$50 billion, because they trying to frame whether it's "kind of reasonable." Dr. Smith thought the entire Alaska North Slope was worth \$36.4 billion in 2007 and \$46 billion in 2009 (these values heavily shift based on the price of crude oil and production). Mr. Eyre's valuation went from \$40 to \$50 billion and Dr. Smith's went from \$36 to \$46 billion. The way they allocated that system value to TAPS was quite different, but the way they determined the entire integrated value was quite similar.

One way to frame this is to say in 2009 Dr. Smith estimated the total value of the assets to be \$46 billion and Mr. Eyre estimated \$50 billion, a \$4 billion difference. TAPS is assessed at about \$10 billion and the entire upstream assets are assessed between \$9 and \$10 billion. So, the entire tax scheme is capturing only half, about \$20 billion, when both experts agree that the integrated operations are worth between \$46 and \$50 billion. That's taking \$20 billion off the table. You could say that the taxpayers are underpaying their taxes by half even today with the increased valuation of TAPS.

SENATOR FRENCH asked if these values represent the value of the crude oil flowing through the pipeline.

MR. BRENA answered yes.

MR. RICHARDS added without taking gas into account, and after taking out royalty and all state and federal taxes. It's effectively the discounted cash flow value to the working interest owner after taxes are paid.

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MR. BRENA said this number represents taking multiple billion dollars a year in free cash flow, assuming you get it every year into the future, in this case 2060; so it's a discounted cash flow value. It's the value of the annuity.

SENATOR FRENCH said it's not just one year's production; it's all of the future years of production brought back to this year.

MR. BRENA said this is the value based on what is known of the income stream over time discounted back or what is known as the income approach.

SENATOR STEDMAN clarified that the Revenue Source Book doesn't go into the net cash flow to the industry; it's just cash expectations of income for the state both restricted and unrestricted. The point that is being made is that this value is extremely sensitive to changes in the state's tax structure.

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SENATOR WIELECHOWSKI said this is essentially the companies' profit at a net present value and asked if PPT (put in place in January 1, 2007) and ACES (put in place in January 1, 2008/09) was factored in somewhere.

MR. RICHARDS replied yes.

SENATOR WIELECHOWSKI asked if it is based on economically recoverable oil.

MR. RICHARDS replied they are based on the proven reserves as defined by the court, which is not too far off from how the SEC might use that phrase in the internal company reserves report.

MR. BRENA remarked it is a very narrow definition.

SENATOR WIELECHOWSKI asked if it is safe to assume that as the price of oil fluctuates the projections for decades fluctuate.

MR. BRENA replied yes.

SENATOR WIELECHOWSKI asked if he knew the price of oil they were predicting when they did these numbers.

MR. RICHARDS replied this is the EIA's price forecast that is adopted for each year; it is a variable but escalating for each of those years and assumes a 1 percent real growth in oil price after the end of its 20-year forecast.

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MR. BRENA said when they get into the life of TAPS and the price of ANS crude portion they will have each of the EIA forecasts in charts and source materials on all of the projections including the one that came out last week.

He said the take-away point from this is the question of whether a \$10 billion value is reasonable for TAPS given that it is an essential part of an integrated operation that is producing a \$40 to \$50 billion value and given that all the upstream assets are assessed by the state in the \$9 to \$10 billion range.

MR. RICHARDS said that part of the explanation of that shortfall is that in the 1970s the state had a minerals reserves tax that was deleted in the 1980s. So, unlike in Anchorage where a person pays tax on the value of the improvements on his land, on the North Slope they don't pay a tax on the value of the mineral estate. So, the value of the leases isn't captured in the ad valorem setting. That is one of the reasons put forward for this big gap between the values of what is being taxed and the total value of the unit.

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MR. BRENA said he shared that analysis in order to, at a very broad level, say that a \$10 billion value seems to be a more rational value than a \$1 billion value. Another way he tends to think about it is that the court accepted a very detailed cost estimate of \$20 billion to replace the functionality of TAPS today. The question is would it be replaced if it just disappeared today with 7 to 8 billion barrels of proven reserves? Times that number by \$100 bbl and there are \$700 billion of proven reserves on the Alaska North Slope and he didn't think that would be stranded "over a \$20 billion check." He said solutions for low flow issues have to be considered within the context of the value of the oil behind the pipe and that: "There is \$700 billion of proven reserves sitting in the North Slope. Is it going to find a market? Yes. Is it going to be stopped from finding a market over a \$20 billion cost? No. And it's not economically rational to say otherwise."

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Another way to frame the value is that owners say it would cost \$20 billion to replace the pipeline, but would they replace something that is only worth \$1 billion? He thought they would spend \$100 billion. In another context, owners changed out 16 miles of transit lines (from 16 inches to 28 inches) as a result of corrosion problems at a cost of greater than \$600 million (with infrastructure and camps in place) with no tariff. TAPS, by comparison, with its 800 miles of 48 inch pipe is worth way more than \$1 billion. He said it's pretty clear that Judge Gleason's decision is conservative with regard to value and that the TAPS owners have been underpaying their taxes for decades.

MR. BRENA stated that he didn't come here to argue about the value of TAPS, but he wanted to give them some idea of his frame of reference. Finding no questions he went into the market structure overview.

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Market Structure Overview

- Integrated operations with market power
- stages of development
- barriers to competitive entry

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MR. BRENA stated understanding that the North Slope is an integrated operation and what that means in terms of the economics is important in determining its value. The Big Three own 95 percent of TAPS and 96 percent of all production on the North Slope and will continue so into the foreseeable future.

What that market power actually means is as important as the stages of development and barriers to competitive entry are.

He said the questions is why TAPS has been in operation for over 35 years and independent production from the North Slope is less than 30,000 barrels a day and why independent production from this particular basin is virtually non-existent when it's what is driving the Gulf of Mexico and North Dakota. TAPS has one independent shipper; all the other shippers ship on their affiliated producers. So, BP, the producer, transfers its oil to BP, the shipper, who ships its oil on BP, the pipeline company, that goes to Valdez and puts its oil on BP, the tanker, that then is delivered to the market and the refinery that uses that oil. That is as integrated an operation as you can get and each of the Big Three has that same structure. Judge Gleason recognized that dominance.

MR. BRENA noted two reports by Dr. Ciccetti and Mr. Sullivan, a retired FERC litigator who is now a private consultant, on the dominance of Alaska's three major companies and how the North Slope has had very little independent activity after 35 years of operation.

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SENATOR WIELECHOWSKI asked if he could identify impediments to independent oil companies coming into the Alaska market.

MR. BRENA replied to some degree yes and to some degree no. If an independent decided to bid on a lease and drill a hole on the North Slope they would need access to field facilities and there have been situations where independents have had to build pipelines right next to a pipeline that is operating at half capacity or less. That is a barrier to entry. He likened it to the telecom solution that required dominant market participants to share facilities. This was also partially addressed in the ARCO merger when certain companies had an obligation to make field facilities available under reasonably economic terms and conditions.

He said that potential pinch points to drilling are access to field facilities and common carrier transportation. Some specific terms and conditions in the conditions of TAPS work to the disadvantage of independents. For example, it has storage penalty provisions. If a small company takes its oil down to Valdez it takes a while to build up a tanker-full, and yet penalties are imposed depending on the utilization of the Valdez Marine Terminal if the oil stays there too long. Well, if you're

shipping 1,000 barrels a day because you're just coming on line and a tanker is 400,000 barrels, it will take a few days to build up enough oil to bring in a tanker. In order to do that, you have to pay storage penalties if the facility utilization is above a certain point.

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Another example can be found in the "new shipper provision" in Unocal's tariff where an independent is limited to 10 percent if the system is maxed out to capacity. Even then the owner company could nominate 5 percent. So, it would take 10 years of nominations to be in the same position as the person who controls the tariff and controls the pipeline.

MR. BRENA said another huge barrier to entry is excessive profits on transportation. For every dollar added to the tariff a dollar per barrel is subtracted from the profitability of your field. If a group is trying to drill a 100-million barrel field, \$1 of additional tariff reduces the economics of that field by \$100 million. As examples he recalled when the price of oil was a little lower and the TAPS tariff was a little higher that Milne Point was given up and the long history of excessive charges in terms of transportation corridors and access to facilities. In the recent RCA case, Tesoro cut the rates in half lowering the profitability on TAPS by \$2 barrel, which in turn increased the value of every barrel of oil on the North Slope by \$2 barrel. That had a huge impact in terms of barrier to entry.

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He said Judge Gleason noted the RCA held that in 1997 dollars that TAPS had overcharged cost based rates by \$13.3 billion and surmised if the transportation costs off the North Slope had been \$13.3 billion less, would there have been more activity on the Alaska North Slope? Of course, there would have been a huge impact. Mr. Brena said after spending 30 years litigating transportation rates and tariff provisions he had a lot of examples. Further he stated:

The market dominance that happens by three companies isn't happening by accident; it's happening by design; it's the best way for them to optimize their shareholder value. I don't fault them for doing it, but it's not the best for the development of the resource and it's not the best for independent participation and an open and competitive market place in the Alaska North Slope.

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As another example of barriers to entry, he said if independents are going to ship 1 percent on TAPS, they have to "line fill." This means they are obliged to fill their 1 percent as a shipper. TAPS, a 48 inch pipeline that is 800 miles long, holds 90 million barrels of oil or so. The line fill obligation requires maintaining working capital equal to their percentage of shipment in TAPS. Tesoro Refinery, as an example, has 500,000 barrels of line fill at \$100 a barrel. That's \$50 million of working capital tied up just for the privilege of transporting oil through TAPS.

These are realistic barriers to entry, Mr. Brena said, and obviously faster permitting and those kinds of things also have an effect, but the real things that move the economic barometer are what he is trying to focus on. As a practical matter what an independent producers does is just sell it to one of the Big Three for a price that reflects the discount associated with that market dominance. All of which are significant barriers to entry.

CO-CHAIR WAGONER said he didn't see charging for warehousing oil as a negative and asked how that differs from a wheat farmer who doesn't belong to the local grain growers, but rents space from one to store his wheat until he sells it. It's a charge that the companies take into account as part of their business plan prior to going into the development of oil resources on the North Slope.

MR. BRENA said that is a fair comment, but it's also a system for a company that is big enough to never incur that penalty, but if you're small enough so the oil needs to be accumulated in order to get a tanker-full, it is a charge they will be exposed to. So, if you're looking at barriers to entry for small companies that is a penalty that a major oil company does not have because their volume is such that they don't have to store it in order to get access to the market. In a grain situation, it can be sold whenever and in whatever size truck or rail car is available. If the wheat farmer had to rent an entire train, then TAPS would be more comparable to a grain situation.

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SENATOR STEVENS asked what "pinch point" means.

MR. BRENA replied that he is using the term casually and not technically. He means what the challenges are if people in this room want to produce Alaska North Slope crude oil - in what

arenas and what types. You have to analyze permitting, timing and access to field facilities, whether those facilities are open or closed to your use and under what terms and conditions they are and whether you have to duplicate facilities that are underutilized in order to get into the market.

The next area of analysis he talked about were the midstream assets, the transportation and common carrier pipeline, to get the oil from the North Slope to the market. The analysis has three major focuses: tankers, common carrier pipelines and field facilities. He calls those pinch points because he believes that market dominance shows up as a competitive advantage in each of those arenas and therefore, they need to be discussed and thought about separately.

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MR. RICHARDS said another example of where state tax policy creates a barrier to entry is that severance taxes allow a deduction based on the cost of transportation, and since TAPS was built this deduction has created a governmental incentive to get the tariff as high as possible. If you're paying the tariff to your affiliated shipper, you don't really care what the tariff is because it goes out of one pocket and into another. So, the integrated shippers' incentive is to get the tariff as high as possible, which has a negative side effect of hurting a third-party guy, because they will have to pay that when the cost of transportation might be significantly lower.

MR. BRENA expanded that an integrated owner wants a high tariff strategy, because it optimizes tax deductions from the state. He said a 1977 BP Tariff Memo in the Source Materials has a frank internal discussion explaining that they want the highest tariff rate possible, not because it has anything to do with operating the pipeline, but because it is integrated economics. An independent is paying that high tariff not from his left pocket to his right pocket, but to another company as a real cost creating a significant competitive advantage for the owner that has production and transportation alignment. So, if there is an extra dollar of profit, it costs the independent a dollar more to get their oil to market than it costs the integrated producer.

Depreciation also advantages the owners, because when someone builds a pipeline it's a sunk cost; it's money that has already been spent and it's just a matter of whether they get to deduct it or not. For the independent it's not a sunk cost; they have to share in the cost of actually building the facility as it

goes along. Then there are the operating costs. One would think nobody would go out and spend a dollar, but if they spend a dollar and it increases their operating costs, 25 percent of which are subsidized by the state in ACES, there would be less resistance to the idea.

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MR. BRENA said [BP] recently spent \$700 million for the purpose of strategic reconfiguration of TAPS and they are trying to include that amount in their rates; they're self-nominating and that gets included in their rates they will be able to deduct it for a total of \$1 to 1.2 billion in deductions. The state is aggressively opposing them, but the fact is that the integrated players aren't very efficient when it comes to building pipelines and when it comes to major reconfiguration it's just as bad. Building TAPS was originally estimated to cost \$800 million and the final cost was \$8 billion; strategic configuration was originally estimated to cost \$224 million and is now running over \$700 million and it's not done yet.

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SENATOR STEDMAN asked how long the 1977 memo has been in the public realm.

MR. BRENA replied that he put it in docket number P97.4 established in 1997 and it has been in the public realm since the early 2000s.

SENATOR STEDMAN recalled how the legislative members had talked loosely about the impacts of tariff many times and this is the first time he has seen it.

MR. RICHARDS remarked that the preamble to the TAPS Settlement Agreement (TSA) says the same thing.

MR. BRENA stated that he worked an awful long time to get cost based regulation in Alaska, which is what the statutes provided should be the case from the beginning. It took tens of millions of dollars of resources.

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SENATOR FRENCH said the 1977 memo is shocking - as bald a statement as you can possibly get to game the tariff system to take advantage of the State of Alaska. He commended him for his work.

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MR. BRENA responded that he doesn't blame any company for optimizing its shareholder value. If he were running a business and had an opportunity to obtain market dominance and obtain advantages over a competitor through integrated operations, he would do that. However, the legislature has its role, which is for the public good and the regulator has its role. Recognizing this is important for everybody and it should balance out. In the case of TAPS it didn't for 30 years.

CO-CHAIR PASKVAN asked him to reflect on comparing Alaska's market structure to North Dakota's.

MR. BRENA responded that Mr. Sullivan's testimony (slide 21) talks about 180 shippers in the Enbridge system and marketers that buy and sell at different points from the fields. He compares that with Alaska that has one independent shipper, no resellers and no marketers at all - and Alaska has been around longer. After 35 years of operation you would expect a more open and competitive marketplace on the Alaska North Slope than what is there. The other basins have opened up faster and a lot more thoroughly.

Were he a policy maker he would want to know what needs to be done to attract independents to the North Slope. One of the dilemmas is they are being asked to pass specific tax policy in a closed market. "You sure don't want to be giving away Alaskan tax dollars in order to solve a problem that an open market place could solve." He said it doesn't make a whole lot of sense to try to talk someone into doing something that he doesn't want to do it.

He didn't think they needed to go as far as the Gulf of Mexico and North Dakota but just look at Cook Inlet. It was essentially closed for a lot of years by a few major producers of gas.

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MR. BRENA said he represented Agrium in trying to keep the plant open. The first thing he did was open up the infrastructure. The SIGS system was private, so any independent on the other side of the Inlet that had gas, Agrium couldn't buy it because they had no way to get it to market. They had to sell it to one of the people that had control of the pipelines coming across the Inlet, in this case it was SIGS. They got SIGS subject to regulation by the RCA so that Agrium could make deals with the independents. The next step was Enstar, but it had gone into some long-term contracts. So, they sold gas to the export market through the LNG facility.

Today the pipelines are open so independents can make it to the market and Enstar, after years of urging, is now having competitive bids for excess amounts (spot market). So if someone found some gas, there is a place to put it. With a combination of those things and a more aggressive tax policy to encourage development, Cook Inlet is having tremendous independent activity. The majors are not the leaders. It has to do with what stage the basin is in of its development. The major fields are done; so they have to get control of the infrastructure in a way that makes it accessible to the independents that come in as the next wave of potential producers that are interested in the incentive and have a different cost structure - and want to develop the resource. He said that BP announced years ago that it was not doing any more exploration in Alaska and it closed down its exploration office; it's now using its interest in the Alaskan fields to fund exploration and developments in other parts of the world.

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MR. BRENA said Cook Inlet is a good example of where majors aren't interested. Large predators need large prey. Their cost structure demands that they go after billion-barrel fields wherever they are in the world. That is their role in the marketplace. Now in Prudhoe with regard to oil and Cook Inlet with regard to gas it's the independents' turn at bat. All they need to do is have an open market situation so they can get access to field facilities and reasonable transportation rates. That would go a long way to opening up the Alaska North Slope Basin in the same way the Cook Inlet has been opened up and is now effectively working.

MR. RICHARDS added that Exxon hasn't drilled a well in Alaska except Pt. Thomson, which the state made them drill, since the early 1980s and asked if any amount of tax policy going to make Exxon decide to explore up here.

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CO-CHAIR PASKVAN said that was an interesting point; he thanked them for their presentation and adjourned the meeting at 5:10 p.m.