

**ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE**

February 7, 2012

3:33 p.m.

MEMBERS PRESENT

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

MEMBERS ABSENT

All members present

OTHER LEGISLATORS PRESENT

Senator Cathy Giessel

COMMITTEE CALENDAR

OVERVIEW: GLEASON DECISION OF 12/30/2011 REGARDING THE ASSESSED VALUATIONS OF THE TRANS ALASKA PIPELINE

- HEARD

PREVIOUS COMMITTEE ACTION

No previous action to record

WITNESS REGISTER

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

POSITION STATEMENT: Testified during the presentation on the Gleason Decision.

CRAIG RICHARDS, Attorney
Walker and LeBreck
Anchorage, Alaska

POSITION STATEMENT: Testified during the presentation on the Gleason Decision.

ACTION NARRATIVE

OVERVIEW: GLEASON DECISION OF 12/30/2011 REGARDING THE ASSESSED VALUATIONS OF THE TRANS ALASKA PIPELINE

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CO-CHAIR JOE PASKVAN called the Senate Resources Standing Committee meeting to order at 3:33 p.m. Present at the call to order were Senators French, Stedman, McGuire, Wielechowski, Co-Chair Paskvan and Co-Chair Wagoner. He noted that Senator Giessel was also present.

CO-CHAIR PASKVAN announced that the committee would continue with the testimony of Mr. Robin Brena and Mr. Craig Richards who will summarize key points regarding market structure on Alaska's North Slope and then present information on the life of the Trans Alaska Pipeline (TAPS), with a focus on the price of ANS crude, reserves, and minimum mechanical throughput.

SENATOR STEVENS joined the committee.

CO-CHAIR PASKVAN noted that Mr. Brena and Mr. Richards would be testifying as Alaska residents, not as paid representatives of clients.

CO-CHAIR PASKVAN shared a memo entitled "Meeting the Governor's Goal of Increasing Oil and Gas Production by 3 Percent a Year", written a decade ago by the director of the Division of Oil and Gas. He referred to the massive volume of information regarding oil and gas production. He recalled the topic of yesterday's presentation - the North Slope's integrated market structure - which magnified the significance of the memo of nearly a decade ago.

CO-CHAIR PASKVAN quoted from the memo:

Mergers and market concentration on the North Slope have created a non-competitive environment in which three majors have a near monopoly that gives them a large competitive advantage in exploration, development, production, and transportation. It is this uneven playing field that has raised the barrier to new entrants from smaller independents to large integrated majors. As long as these majors invested sufficient capital for exploration and development activities, the state accepted the consequence of the

oligopoly. Since the existing majors no longer are willing to invest sufficient resources on exploration or development, the state must look elsewhere. The state must look beyond the existing majors to the new wave of independence and remaining majors. This situation parallels the experience in other oil and gas basins worldwide, several of which have been successful in this transition.

CO-CHAIR PASKVAN opined that it was an important piece of information for the committee to consider in light of yesterday's testimony. He stated that the memo seems to indicate that the testimony from yesterday was supported a decade ago by the director of the Division of Oil and Gas.

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SENATOR WAGONER asked Mr. Brena what would happen to those companies currently exploring on the North Slope if some of their credits were taken away and allotted to new independent explorers as incentives.

ROBIN BRENA, Attorney, Brena, Bell, and Clarkson, P.C., Alaska Counsel for the Fairbanks North Star Borough and lead counsel for the TAPS, inquired if Senator Wagoner was referring to taking credits away from all current producers or just from the independent companies.

SENATOR WAGONER clarified that he meant reallocating some exploration credits that the independent companies currently receive.

MR. BRENA explained that his testimony is directed at establishing tax policy and the first step is to determine what the free market can accomplish. He said until there is a free market operating on the North Slope, it is unknown whether any incentives need to be provided. He reported on active development in the Gulf Coast, in North Dakota, and in the Cook Inlet, without incentives, when free market conditions exist. Another factor is that the price of oil has increased by a factor of five in the last decade.

MR. BRENA stated that the first step is to establish a baseline that does not substitute for a free market system from which to form tax policy. He said he has not done an analysis of incentives; however, he believed the key is to find the right companies to incentivize and reward the behavior being sought.

Next, would be to target incentives that will optimize the development of the North Slope.

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CO-CHAIR PASKVAN thanked the presenters for their participation and left it to them as to how to proceed with their testimony.

MR. BRENA related that he has a high opinion of the author of the memo, Mark Myer, and said he agrees with the memo. He commented on the barriers to new entrants, as referred to in the memo, and concurred with the suggestions made. He noted that he has worked for twenty years on achieving opportunities for independent producers.

MR. BRENA summarized yesterday's presentation. The production and transportation of Alaska's North Slope does not operate under a free and open market system of economics. It is a market place dominated by the "big three" oil companies. After 35 years of operation, there is one independent shipper on TAPS and most of the independent producers are selling their oil upstream so they don't have to deal with the barriers associated with transporting their own oil. He opined that the nature of those barriers are due to permitting culture, access to field facilities, and cost of transportation by pipeline and by tanker. He suggested that the state should do everything possible to reduce those three barriers.

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MR. BRENA said he also believes that, when establishing tax policy, there is a natural evolution in an oil basin. In the initial phase, the major producers build a major infrastructure that opens up the region in order to develop the major fields. After that, the independents come in and develop mid-sized and smaller fields. He maintained that an efficient tax policy should recognize the existing market structure and the state of development in the North Slope. It should not attempt to substitute tax incentives for objectives that a free market system is capable of achieving. Open access lower transportation rates will optimize development on the North Slope, especially in light of current and projected oil prices.

MR. BRENA stated that tax policies should not attempt to provide tax incentives to least willing and least efficient producers for that stage of development of the basin. He pointed out that of the big three, ConocoPhillips indicated some willingness to do some exploration and development, particularly in the area of heavy oil. He opined that it was important to develop heavy oil.

He reported that British Petroleum (BP) closed down their exploration activity in the early 2000's and indicated it needed a billion barrel field in order to justify its tax structure. BP left exploration in Alaska for other parts of the world. He said he shared a similar view of Exxon as a company that was not willing to explore in Alaska.

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MR. BRENA referenced page 13 of a memo from BP.

CO-CHAIR PASKVAN noted that all documents will be posted on BASIS and are accessible at the meeting so that the public can have access to them.

MR. BRENA related that he was lead counsel for the municipalities on the ad valorem case with regard to the Gleason Decision, as well as representing Anadarko and Tesoro in the Federal Energy Regulatory Commission (FERC) matter regarding the inclusion or exclusion of funds spent for strategic reconfiguration of whether they should be "float through" in rates. The BP memo was a public document from the latter case.

MR. BRENA read from the BP memo:

As described in the Pump Station Electrification Appraise FM of March 2003, Alaska's role in BP's portfolio is to provide a stable production base and cash flow to fuel growth elsewhere in the business while improving margins and returns.

MR. BRENA termed BP's view of their Alaskan operations as a "cash cow" to fund other exploration in other parts of the world. He maintained that BP has been upfront with this information. He reiterated his suggestions about how to deal with tax incentives.

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CO-CHAIR PASKVAN pointed out that the quote is found on page 13, Section 2.1, of the document.

MR. BRENA added more information about litigating large cases in Alaska. He said there are three ways to approach an issue, litigation, negotiation, and legislation. Sometimes legislation attempts to change the outcome of litigation. He referred to comments on page 15 - RCA Issues. "We've considered the risks that the Regulatory Commission of Alaska (RCA) will exert approval authority over the proposed facility changes." He

stated that the RCA has specific statutory authority over the abandonment of all facilities. The issue was decided and RCA approved strategic reconfiguration based on certain representations by the owner companies. He added that BP prepared a legislative solution in case the RCA seeks to intervene.

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SENATOR FRENCH commented on the aggressiveness of the strategy. He summarized BP's document to say that if the RCA moves to assert authority over facility changes, BP will try to change the law to prevent that. He asked if Mr. Brena agreed.

MR. BRENA agreed and noted the strategy was consistent with when he acted on Tesoro's behalf through the RCA to reduce the rates from over \$4 to \$1.96, and changed their return from over 100 percent on unrecovered capital down to a 12 percent return, which led to BP's involvement with HB 277 in 2005. HB 277 provided that the state would agree to a settlement that is deemed a just and reasonable rate and interveners and independents don't have the right to contest it. It took away an independent shipper's right to even be heard by the regulator.

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MR. BRENA stressed that these were not theoretical issues, but real issues. He referred to the non-development of Milne Point by ConocoPhillips because of excessive transportation costs. He quoted from page 29 of the Cicchetti Report. Commenting on trading Milne Point to BP, Conoco President and Chief Executive Archie Dunham said, "We traded in all our Milne Point properties in Alaska to BP. It broke my heart to trade Milne Point, but we had to do it. All the value of that property was taken away from us in the pipeline tariffs."

MR. BRENA noted that the price of oil was less at that time and the transportation rate was more, but emphasized that these are real issues. He stated that this was Conoco acting before they were integrated in Alaska; they had to leave a field behind.

CO-CHAIR PASKVAN requested a discussion on the Trans-Alaska Pipeline System (TAPS).

MR. BRENA related that he would discuss three areas in the life of TAPS. The first area is the price of ANS crude oil. Every ten dollar increase in the price of oil adds 5.5 more years to TAPS. He maintained that "a rising tide raises all ships." The second

area is reserves and thru-put profiles, and the third area is minimum throughput.

He noted that in the Judge Gleason Order, the municipalities' estimates of reserves were adopted, as well as the ANS price projections for crude oil, and the minimum throughput analysis advanced by the municipalities.

He explained that the analysis worked by taking the reserves to create a throughput profile and when that number hits 100,000 barrels per day, that is what is deemed to be the life of TAPS in Judge Gleason's analysis.

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MR. BRENA turned to the first area in the life of TAPS, the price of ANS oil. He noted that there has been a lot of focus on throughput declines, rather than price increases. Currently, there is greater value going through TAPS than ever before. He figured 2.1 million barrels, times \$10 a barrel, does not compare to 600,000 barrels at \$100 a barrel. The value of the reserves today is greater than it ever has been: \$700 billion worth of proven reserves on the North Slope, a huge economic driver. He emphasized that the oil would find its way to market, despite what some would say.

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CO-CHAIR PASKVAN asked for clarification of the term "proven reserves." He wondered if it was North Slope conventional oil.

MR. BRENA replied that he is using the definition that Judge Gleason used, which says that the reserves have to be based on known technology, be economically feasible, and be legally deliverable into TAPS. Judge Gleason did not include most of Point Thomson in the definition. Mr. Brena concluded that it is a very narrow definition of proven reserves, which is important because it's conventional oil; there are no probable or speculative reserves included, as well as nothing from the Outer Continental Shelf. Also not included is 95 percent of heavy oil or any shale oil.

CRAIG RICHARDS, Attorney, Walker and LeBreck, added that Judge Gleason looked favorably on the categories that the Department of Revenue uses in terms of oil that is under production, under development, and under evaluation - oil from development projects that might not be sanctioned or funded yet.

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MR. BRENA continued to discuss the topic of throughput decline. He related that in the last five years, the value of throughput has increased, has economic leverage and is growing. He said it was important to keep that in mind. He stated that when he questioned experts to see if any pipeline in the world had ever "shut in" economic production, he found that the answer was "no." He reminded the committee that Alaska has \$700 billion in proven reserves and there are engineering solutions for every potential problem.

SENATOR MCGUIRE said she understood Mr. Brena's argument that the value of oil is higher because it is trading at a higher price, but she maintained that the market can change. She asked what would happen if ANS prices drop back to \$30 or less. She pointed out that the volatility goes both ways. She also asked Mr. Brena for his theory was on why the "Big Three" oil companies were coming to the state for a reduction in high taxes which they maintain are detrimental to investment.

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MR. BRENA addressed volatility in price. Judge Gleason used the U.S. Energy Information Administration (EIA) prices. At some point policy decisions have to be made based on the best information at hand, which is that there is going to be real growth in the price of oil over the next decade. He discussed the disparity between ASN and WTI crude oil, which he said was predominantly because WTI has stranded oil in Oklahoma that can't make it to the refineries on the Gulf Coast. He called it a temporary condition due to imbalance in the market and should not drive a tax policy in Alaska.

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MR. BRENA emphasized that whatever tax policy Alaska adopts should not be based on the prediction that the pipeline will shut down tomorrow. He said he does not believe that any discussion of a tax policy should be made under an artificially created concept of crisis, such as TAPS shutting in \$700 billion worth of oil.

MR. BRENA discounted the idea that the oil companies were playing games. Instead, he suggested they were attempting to gain profits and expand their margins in Alaska. He suggested that before the state takes any action, it should find out what the oil companies' current development plans are, what their projections are, in the form of specific documents. He cautioned not to give \$2 billion to the oil companies to go "do what they were going to do, anyway."

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SENATOR MCGUIRE addressed the challenge of obtaining those documents from the oil companies. She stressed that there was no "meeting behind closed doors." She pointed out that she referenced the price discrepancy between WTI and ASN because it demonstrates precisely what can happen in a political decision.

MR. RICHARDS opined that the focus should be getting the oil companies to invest in existing fields. A lot of the discussion is based around progressivity, which misses the mark regarding the concerns the oil companies have raised. He said oil companies are concerned about capital investment decisions meeting positive net present value requirements. He suggested the focus should be on ACES, not driving investment dollars away by making otherwise positive projects negative cash flow at different oil prices based on the tax structure. He encouraged a tax structure that would give the oil companies positive project investment incentives across the whole range of oil prices.

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MR. BRENA said that he did not mean to imply that oil company positions were not public. He noted he would address the proprietary nature of oil company information in tomorrow's hearing. He recommended seeing oil company information in order to make policies, and if it was not forthcoming, it would be "very persuasive."

MR. BRENA turned to the EIA price forecast charts.

CO-CHAIR PASKVAN clarified that EIA is the U.S. Energy Information Administration.

MR. BRENA addressed price forecasting as the best indicator in "The Life of TAPS". He referred to a chart by Dr. Cicchetti which shows the price impact of three political events for the past three decades. He showed a graph of the average annual world oil prices in three cases from 1980 to 2035. Based on the best information of today, the price of oil in 2035 would be \$130 to \$140 per barrel.

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He discussed another graph based on EIA forecasts and noted that the most likely forecast recently went up. He said that all oil price projections have real growth.

MR. BRENA reiterated a previous statement that an increase of \$10 per barrel equals 5.5 years for TAPS. He related that when

Judge Gleason decided that the life of TAPS would end between 2065 and 2068, the decision was based on a very restrictive view of what proven reserves would be produced and did not include Point Thomson. When any price of oil projected today is factored in, it is not possible to find an economic limit with regard to production. Judge Gleason "cut it off at 100,000 barrels, even though 100,000 barrels continue to be economic to produce." The life of TAPS was not cut off because the economics changed, but because the minimum mechanical capacity of TAPS was deemed by Judge Gleason to be 100,000 barrels.

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MR. BRENA turned to the topic of unproven reserves, which were not included in Judge Gleason's decision. He listed ANWR, the Chukchi Sea, the Beaufort Sea, and NPRA as found in a chart produced by the National Energy Technology Laboratory (NETL). He stated that these reserves were economically recoverable and were likely to be produced.

CO-CHAIR PASKVAN asked if those reserves were in addition to the proven reserves.

MR. BRENA said yes. He referred to a chart that showed that the value of remaining crude for the next 25 years will exceed the current cumulative value of oil shipped in real and nominal terms.

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MR. BRENA discussed the impact of oil production in the Outer Continental Shelf (OCS). In the late 2020's and 2030's the upward capacity of TAPS will be challenged again based on Shell's projections.

SENATOR WIELECHOWSKI noted that the chart was from Shell's presentation.

MR. BRENA pointed out that Shell has \$4 billion invested and the resources consist of drilled holes and productive wells. He said the longer production is delayed, the longer the life of TAPS will be.

MR. BRENA turned to a chart that showed ANS historical and forecast oil production from producing fields, known undeveloped fields, and undiscovered fields. He commented that the discussion about tax policy focuses on what happens right after a rapid decline and when throughput is expected to stabilize. He pointed out that at that point of slope development, there is

less investment associated with production and more associated with maintenance, as seen in recent years.

He noted that some of the decline is as a result of breakdowns of field facilities, such as in Prudhoe Bay due to corrosion. He concluded that the more the decline, as a result of delays in projects or field facility problems, the longer the life of TAPS will be. He encouraged the committee to believe that TAPS will be around for a long time and there is plenty of time to evaluate it. He said that this is a perfect time to make tax policy decisions because oil production is stabilizing and then will increase.

SENATOR PASKVAN asked if that table included any potential shale.

MR. BRENA said that it does not include any shale; it is conventional oil only. Nor does it include 95 percent of heavy oil, of which there are 20 billion barrels. He recalled that there were 9.6 billion barrels of proven reserves when TAPS began; today there are between 7 and 8 billion barrels. He emphasized that fields grow and technology changes, which will also be true in the future.

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SENATOR WIELECHOWSKI inquired who developed the forecast.

MR. RICHARDS replied that it was Dr. Hite.

MR. BRENA added that Dr. Hite developed the forecast for the Department of Energy, not for litigation purposes.

MR. BRENA related that the reserve estimate and production forecast that Judge Gleason adopted was developed by Dudley Platt. Judge Gleason was taxed with the job of trying to determine which of the experts was correct, so she looked at proprietary internal documents of the major oil producers. She maintained that Mr. Platt's predictions were consistent with those internal documents. He called that a "reality check."

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MR. BRENA explained the second criterion used by Judge Gleason was financial reporting to the U.S. Securities and Exchange Commission (SEC). He explained BP's Prudhoe Bay Royalty Trust and auditing procedure by Miller and Lents, Ltd.

CO-CHAIR PASKVAN referenced slide 51 as the source of that information.

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MR. BRENA referred to BP Royalty Trust documents and gave an example of a report to SEC, which used only proven reserves and the price of oil on December 31 of the prior year. Today, the average of 12 months is used instead. The document stated that based on \$96 oil, BP expected continued economic production at a declining rate through 2075.

MR. BRENA concluded that Judge Gleason had access to inside information that was shared with the investment community and shown to potential buyers. Those sources of information were consistent with Dudley Platt's forecasts.

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MR. RICHARDS added that Judge Gleason also found that DOR's current forecasting methodology did not reflect internal oil company numbers. He noted that slide 46 lists her concerns with DOR's new forecast approach, which changed from a pool analysis to a well-by-well forecast methodology. Judge Gleason was concerned that DOR did not have enough information on individual wells and their interaction with other wells.

He turned to slide 47, an example of a well profile DOR used to project production which was complex and difficult to use. Judge Gleason found that DOR had to make projections on new wells without having adequate data. Those are a couple of examples of why Judge Gleason found that DOR was underestimating the amount of total production that would probably occur on the North Slope.

SENATOR STEDMAN stated that he had just received the current SEC 10K filings, or annual report, from December 31, 2010. He said he did not see any reference to Miller and Lentz or regarding TAPS lasting until 2075.

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MR. BRENA said that Senator Stedman was correct that in 2010 and 2011 the data was withheld as a result of the data appearing in litigation. Contained in the 10K report is data from years 2006 - 2009 and a chart that shows the correlation of each of those data points - slide 56. He pointed out that there is tremendous consistency between the data points. He said, "As the price of oil goes up, the life of Prudhoe goes out." He noted that

further sources of information would be forthcoming that would contrast public information on the life of TAPS.

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MR. BRENA addressed minimal mechanical throughput as shown on slide 59. He stated that there is no hydraulic limit on TAPS; however, there is a mechanical limit, which is less than 50,000 barrels per day (BPD). He said this information comes from the "the owner's expert witness." He related that there are operational constraints on the continuing operation of TAPS; however, the problems have been solvable when there is economic oil to produce.

SENATOR WIELECHOWSKI requested clarification of the decision Judge Gleason made and the people and information she relied on to make her decision.

MR. BRENA explained that there was a nine week trial and involved a most thorough discussion of TAPS. He said Judge Gleason had been involved in previous trials similar in nature. He spoke highly of Judge Gleason's credentials.

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MR. BRENA returned to operational concerns and reported that former Alyeska Chief Operating Officer, Dan Hisey, concurred that there is no hydraulic or mechanical minimum throughput limit on TAPS. Alyeska will continue to find ways to move the oil. He stressed the importance of keeping in mind the tremendous value of the oil, which is a huge economic incentive to keeping the line going.

MR. BRENA related that one of the solutions to keeping the oil moving is to add heat. He referred to slide 79, prepared by Mr. Hisey, which shows mitigation measures available to keep the oil moving. He said that assuming continued decline, which he said he does not believe will happen, the state is at a stabilized level of throughput that will begin to increase. When Shell comes online, it will go up substantially. He predicted that production may reach the point where it will push the limits of TAPS again.

He referred to a flow study done by BP that showed that TAPS could operate down to 135,000 barrels a day. Once a certain low point is reached it is possible to add heat and recirculate the oil.

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MR. BRENA pointed out that adding heat would cost approximately \$1 billion to \$2 billion over the period of decline. There is heat currently being added to heavy California oil.

MR. RICHARDS pointed out key studies included in members' packets. In the JTG study, on page 11, there are five scenarios regarding operating TAPS at ultra-low flows. The Carpenter study, on page 8, shows a determination made that TAPS can be operated with heat down to very low flow. Below 50,000 to 70,000 barrels a day would require solutions other than heating.

SENATOR STEDMAN asked why BP would spend the effort or money on developing the analysis to run the pipeline at 100,000 barrels a day, if they never thought they'd be at that point.

MR. RICHARDS explained that the purpose of the study was simply to book their proven reserves. The SEC requires certain assumptions to be made to book reserves, such as economic testing.

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MR. BRENA added that Alyeska did a low flow study with a range from 300,000 barrels per day to 1.14 million barrels per day. He emphasized that it is not a question of whether or not they will get the low flow, but when. The other two studies, JTD and Carpenter, were for BP and assessed how low TAPS could go because they wanted to book additional reserves and add to the value of their company for financial reporting purposes. They determined TAPS could go down to 135,000 barrels per day without recirculation. Their experts testified TAPS could go down to 50,000 barrels per day with recirculation. That allowed BP to book 63 million additional barrels and to increase the value of their company by 63 million, times the price of crude oil.

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MR. RICHARDS brought the committee's attention to the Larkspur Study where BP lays out where the heaters need to be located along TAPS in order to get down to 100,000 barrels per day and the cost of doing so.

MR. BRENA noted that Alyeska studies issues for years. One way to know when "they are serious" about implementing a solution is when they spend money. They have yet to study the issue of low flow pigging or to buy heaters. He mentioned the Flint Hills heat recovery system. He concluded that knowing a company's process provides information as to how impending an issue is.

CO-CHAIR PASKVAN said he looked forward to the conclusion of the presentation at tomorrow's meeting.

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CO-CHAIR PASKVAN adjourned the Senate Resources Standing Committee meeting at 5:00 p.m.