

SCR

56

# COMMITTEE REPORT

## SENATE

4/22/77

5/9/77

Date

Mr. President:

The Committee on RESOURCES has had SCR 56  
~~Approving disposal to Alaska Pipeline Co. of royalty gas taken in-kind~~  
under consideration. A majority of the members of the Committee

- recommends it do pass
- recommends it do not pass
- recommends it do pass with attached amendment(s)
- recommends it be replaced with CS for \_\_\_\_\_ and that  
CS for \_\_\_\_\_ do pass
- (and) recommends it be referred to the \_\_\_\_\_  
committee
- reports it back without recommendation
- AND attaches a report of its intent
- (other) \_\_\_\_\_

### MEMBERS SIGNING THE MAJORITY REPORT:

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

### MEMBERS NOT CONCURRING IN THE MAJORITY REPORT:

\_\_\_\_\_ recommends: \_\_\_\_\_  
\_\_\_\_\_ recommends: \_\_\_\_\_  
\_\_\_\_\_ recommends: \_\_\_\_\_

\_\_\_\_\_  
Chairman

MEMORANDUM

April 27, 1977

SUBJECT: Policy Considerations in North Cook Inlet Royalty Gas Sale  
(W.O. #4105, Supplemental)

TO: The Honorable John Rader

FROM: Gregg K. Erickson  
Director of Research

Summary

As you requested, we have provided you, in the form of Ms. Kallab's memorandum of April 26, a review of the history and issues raised by the proposed North Cook Inlet royalty gas sale. After review of Ms. Kallab's findings (in which we concur), we believe that approval of this contract will tend to create far-reaching precedents with respect to the terms and conditions under which the state may make royalty gas available for in-state use, both elsewhere in the Cook Inlet field and in the northern part of the state. In addition, we believe that a brief technical analysis of the charges established by Phillips for transportation of the state's royalty gas is in order.

Precedents That Would Be Established By The Proposed Sale

*As a matter of public policy, there will be no regulatory review of the transportation costs charged against royalty gas.* In general, it makes no economic or technical sense to have a multiplicity of oil or gas pipelines running from point A to point B. Because of the fact that the efficiency of pipeline transportation increases very rapidly as one goes from smaller to larger pipelines, it minimizes the real economic costs of transportation to have a single line of the largest possible diameter. The owner of such a line has a monopoly, but it is a "natural monopoly" in the same sense that an electrical distribution or telephone system is a natural monopoly, i.e., to have more than one system would simply raise costs to the consumer. In the absence of regulatory restraint, however, the natural monopolist will have every incentive to charge "what the market will bear". Ratification of the current proposal may establish an important precedent with respect to the means by which

charges are assessed against gas taken in kind for in-state use elsewhere in Alaska. We may reasonably expect to see many other situations in the future where industrial facilities are served by private carrier lines similar to the Phillips line in Cook Inlet. Use of these lines may be the only reasonable way for the state to bring its royalty gas to local markets. Ratification of the current contract would tend to establish the precedent that the owners of these lines should be permitted to charge for the transportation of the state's royalty gas on the basis of what the market will bear rather than on the basis of the cost to them of providing the transportation service.

*Whenever the state takes its royalty gas (or oil) it will be obligated to bear the cost of increasing production by the amount necessary to maintain the original flow level. In the instant case, these costs are the 10¢ per Mcf which would be charged by Phillips to cover their costs of additional compression facilities.*

*The legislature (and the Alaska Public Utilities Commission) will acquiesce in an arrangement which proposes the construction of a \$4 million gas transmission facility which is, by any standard of technical and economic efficiency, totally unnecessary. Because of the lack of regulatory jurisdiction or the unwillingness of Alaska Pipeline Company (APC) and the Alaska Public Utilities Commission (APUC) to pursue regulatory solutions which may be available under existing law, APC has not been able to negotiate an exchange agreement with Union-Marathon (U-M) which would, as Ms. Kallab's memorandum points out, make the \$4 million "royalty gas line" unnecessary. Although the negotiation of such an agreement would not appear to increase costs to U-M by one iota (they may even reduce them) there are commercial advantages to U-M in refusing to negotiate, since blocking such an agreement limits the alternative supply options of Alaska Pipeline Company and thus enhances the value of U-M's gas reserves in the Kenai field. Of course, Phillips has its own reasons for not wishing to enter into such an agreement; i.e., to retain the royalty gas share.*

*By ratifying this agreement the legislature (and the APUC) encourage the cross subsidization of one group of rate payers by another group. The commission has, as noted in Ms. Kallab's memorandum, stated that the higher costs of royalty gas shall be allocated proportionately among all rate payers served by Alaska Pipeline Company. Until and unless the proposed royalty gas line is built (or an exchange agreement is developed) this will result in those rate payers located in the North Kenai Road Service Area (who consume the relatively high cost gas) being subsidized by the rate payers elsewhere in APC's system. If, as expected, the wellhead price of gas in Cook Inlet rises, it will almost certainly result in the Bernice Lake power plant paying less for its gas than Alaska Pipeline Company is paying for it. Apart from the questions of*

fairness involved, this is certainly an invitation to a rate-payer action in which it would be asserted that the rates charged by APC are noncompensatory and thus not "just and reasonable" as required under existing law.

Technical Considerations With Respect to the Proposed Rates

As Ms. Kallab has pointed out, Phillips has asserted that the 5.5¢/Mcf deduction used in calculating the wellhead value of natural gas for royalty and severance tax purposes is "not appropriate" for the calculation of transportation charges against royalty gas taken in kind. We are not aware of any rationalization of this statement. It seems fairly clear, however, that the difference between this figure and the 20¢/Mcf (escalating at 6%) which they propose to charge is greater than can be justified by any rationale we can conceive. It is possible that neither figure represents a fair and reasonable transportation cost, but it is impossible that both can simultaneously be "fair and reasonable" in the context of the purposes for which they are being used.

We do not assert that we can establish or even estimate what would be a "fair and reasonable" charge for transporting the royalty gas ashore, but we do concur with the sentiments expressed by Dr. Dave Knudson, petroleum economist with the Department of Revenue, who (writing as a private citizen) states that he can find "no justification that a pipeline costing \$10 to \$12 million perhaps nine years ago (which is most probably highly depreciated) should have a cost of service of 10¢ per Mcf". Mr. Knudson's letter, dated April 6, 1977, is a part of the royalty board's official file on this matter, and a copy of it is attached for your convenience. Although we believe fair and reasonable charges in this instance can only be determined by an appropriate regulatory proceeding, we do categorically assert that the calculations contained in "Table I" do not conform to any of the possible rate-making methodologies that are used by regulatory commissions in the United States.

GKE:jm  
Attachment

Received  
File Ak Pipe  
?

Mr. Donald Wold, Executive Director  
Oil and Gas Royalty Advisory Board  
Department of Natural Resources  
State of Alaska  
Juneau, AK 99801

April 6, 1977

subject: the proposed contract between State of Alaska and Phillips  
Petroleum Company for North Cook Inlet royalty gas

Dear Don:

After reading the draft contract attached to this letter, I am required to inform you that I believe this contract to be severely prejudicial to the natural gas consumers served by Alaskan Pipeline Company.

Specifically, I am troubled by Article 9.1, Article 9.2, and Article 11.1. These articles establish a basic cost of service, an escalation factor to be applied to this basic cost of service, a provision for higher costs of service due to compressor costs, and an exemption of this natural gas transmission system from Alaska Public Service Commission control.

I have seen no justification that a pipeline costing 10 to 12 million dollars perhaps 9 years ago (which is most probably highly depreciated) should have a cost of service of 10¢ per Mcf. Regarding the rate of escalation to be applied to the basic rate (i.e., 6 per cent per annum), I would like to point out that in all cost of service projections which I have made show declining transportation charges through time even given a general inflation rate of 6 per cent. I am unaware that future compression costs for State of Alaska royalty gas separate from net working interest gas will require payment on the basis of 10¢ per Mcf and inflated each year thereafter at 6 per cent. In short, the underlying economics of the above mentioned contract should be worked out prior to signing the contract. This is especially so given the fact that contract Article 11.1 frees Phillips from Alaska Public Service Commission supervision.

The delay required by this staff work should not be lengthy.

RECEIVED  
APR 07 1977

ALASKA ROYALTY  
OIL & GAS BOARD

Sincerely,  
David L.T. Knudson

David L.T. Knudson  
7510 Chad  
Anchorage, AK 99502

AGO 785692

# STATE OF ALASKA THE LEGISLATURE

POUCH Y - STATE CAPITOL  
JUNEAU, ALASKA 99811  
907-465-3800

## LEGISLATIVE AFFAIRS AGENCY

### MEMORANDUM

April 26, 1977

SUBJECT: North Cook Inlet Royalty Gas Sale (W.O. 4105)

TO: The Honorable John Rader

FROM: Elke Kallab *Ek*  
Research Analyst

This is in response to your request to look into matters relating to the proposed sale of state royalty gas from the North Cook Inlet gas field to Alaska Pipeline Company. You were particularly concerned with the gathering and compression charges Phillips Petroleum Company, the operator of the North Cook Inlet gas field, is planning to assess Alaska Pipeline Company for producing and transporting the royalty gas to Alaska Pipeline Company, and the question of whether Phillips Petroleum Company would come under the jurisdiction of the Alaska Public Utilities Commission or the Alaska Pipeline Commission as a result of transporting gas for Alaska Pipeline Company.

#### Summary

It would appear from the available records and all the information we have obtained that the added gathering and compression charges, negotiated between Phillips Petroleum Company and Alaska Pipeline Company will be allowed to be flowed through by virtue of Order No. 3, Docket U-75-68 issued by the Alaska Public Utilities Commission December 17, 1975, unless the APUC can be convinced to reopen the case in order to determine if the added charges are "reasonable and just". Furthermore, the Attorney General's office has issued legal opinions which exempt Phillips Petroleum Company from Alaska Public Utilities Commission or Alaska Pipeline Commission jurisdiction, since contracts, which have been submitted to the Legislature for approval, propose that Phillips Petroleum Company transport the royalty gas from the platform to a delivery point onshore for the State with Alaska Pipeline Company taking delivery onshore from the State and reimbursing the State for any costs incurred.

However, we believe sufficient grounds exist to question some of the propositions or assumptions which have been put forward to advance the argument that the royalty gas sale as presently proposed is in the best interests of the State and the public.

AGO 7856 93

April 26, 1977

We submit the following information to provide you with an abbreviated history of what has transpired to date regarding the sale of royalty gas from the North Cook Inlet gas field to Alaska Pipeline Company, as well as to discuss in some detail the various issues which are involved in this matter.

After you have had an opportunity to read this memorandum, we would appreciate receiving your comments and instructions as to how you wish us to proceed. We would be happy to expand on any point or matter, or answer any questions you may have.

EK:mo  
Enclosures

ATTACHMENT TO MEMORANDUM OF APRIL 26, 1977  
CONCERNING NORTH COOK INLET ROYALTY GAS SALE

Background

In August of 1975 Alaska Pipeline Company (APC) first approached the State to purchase the State's royalty gas from the North Cook Inlet gas field. APC needs additional supplies of gas to assure continued service for its North Kenai Road customers, which includes the Bernice Lake power plant as the main customer, and some 285 other small customers. These customers are presently being supplied by gas APC has contracted for with Union-Marathon (U-M) from the Kenai gas field.\* The original contract was for ten years, expiring April 30, 1977, for a total of 10 Bcf of gas. Due to unexpected heavy usage, APC used up its committed supply in August 1976. The contract has been extended by U-M using "Anchorage" reserves from a second contract APC has with Union-Marathon for gas from the Kenai field.

In addition to the immediate need to replace the exhausted gas supply on the North Kenai Road, APC also needs to build up its diminishing dedicated gas reserves, particularly in the Anchorage area. (The need for added dedicated reserves was apparently the major consideration for allowing flow through of higher priced royalty gas in APUC's Order No. 3, according to former Commissioner Richard D. Edwards, who heard the case.)

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\* A map showing location of the gas fields, pipelines and other pertinent information relating to this memorandum is enclosed for ready reference.

The North Cook Inlet royalty gas for which APC made an offer is now being used by Phillips Petroleum Company, the producer/operator of the North Cook Inlet gas field, to meet 70 percent of its contractual requirements with Tokyo Gas and Tokyo Electric.

APC offered to pay the State the same price as the State is receiving from Phillips for royalty gas taken in value by the State from the North Cook Inlet field. At the time APC assumed this price to be 45¢/Mcf at the wellhead and 5.55¢/Mcf for transportation from the platform to Phillips' Kenai LNG plant. However, as discussions continued, it became quite clear that Phillips did not accept the 5.55¢/Mcf figure as an appropriate transportation cost. They indicated that the 5.55¢/Mcf charge was ". . . worked out and used as a deduction for computing wellhead value of the gas for purposes of paying royalty and taxes . . ." and that it was not the appropriate price differential for the kind of arrangement APC was contemplating.<sup>1</sup> As a result APC and Phillips entered into negotiations to arrive at a mutually agreeable charge for gathering and added compression costs. By negotiation the charges were agreed to be 10¢/Mcf for dehydration and delivery of the royalty gas to shore, and a 10¢/Mcf charge for added compression facilities required to deliver the State's royalty gas in-kind, to be increased by mutual agreement as further compression facilities were needed to maintain production. Table I and II, enclosed, were supplied by Phillips Petroleum Company at the request of the Alaska Royalty Oil and Gas

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<sup>1</sup> Letter from Phillips Petroleum Company to Alaska Gas and Service Company, dated January 9, 1976.

Development Advisory Board to "justify" the added gathering and compression charges.

The royalty gas which APC hopes to buy from the State is more expensive than gas APC receives and has under contract from other sources. APC expected that the Alaska Public Utilities Commission (APUC) would allow them to flow through the added costs entailed in purchasing the royalty gas, which then were thought to be 50.45¢/Mcf at the Kenai LNG plant gate, and also that the APUC would allow APC to "commingle" the higher priced royalty gas with lower priced gas APC purchases from other suppliers. (Apparently "commingling" is used by the parties involved to mean what is usually referred to as "rolled in" or average cost pricing).

The APUC did in fact permit the commingling of the higher priced royalty gas with lower priced gas available to APC in their Order No. 3, Docket U-75-68 issued December 17, 1975. The order provides that the differing costs would be averaged on a monthly basis to insure a "proper" price to consumers, since the North Cook Inlet royalty gas is available only as produced by Phillips in meeting their own needs, and thus a predictable and fixed daily volume cannot be assured. The APUC estimated that the commingling of royalty gas with lower priced gas would increase the costs to customers between 2¢-5¢/Mcf per month.

In addition, the APUC allowed APC to flow through the costs of royalty gas purchases from the North Cook Inlet gas field. In doing so they did

not mention any cost figures on which the flow through provision was allowed.

(The royalty clause in the commission's December 1975 order states that it was imperative for APC to build up its reserves. However, it also provided that if the royalty clause was not used to reflect an average cost of gas on or before August 1, 1976, the APUC would commence an investigation to determine the reasons for the non-use and to determine whether the royalty clause should be deleted from APC's tariff. APC did provide the APUC with information why they could not take delivery of the North Cook Inlet royalty gas. There is no indication that the APUC took any action as a result of this.)<sup>2</sup>

APC also proposed to build a "royalty" pipeline from the onshore delivery point to its Anchorage line, a distance of approximately 30 miles and at a cost of approximately \$4,000,000, to absorb the excess gas over and above that required to meet the North Kenai Road demands, thereby hoping to reduce the rate at which the reserves dedicated to Anchorage in the Kenai field would decline. However, APC stressed that an "exchange" of gas using Union-Marathon's transmission line from the Kenai gas field to the North Kenai Road would be preferable to a literal transfer of excess North Cook Inlet royalty gas since such an "exchange" would reduce the need to construct the "royalty" line. Such an "exchange" agreement has not been worked out between the parties which would be affected.

<sup>2</sup>

*Letter from Alaska Gas and Service Company to Alaska Public Utilities Commission, dated September 29, 1976.*

Around December of 1975, Homer Electric Association (HEA) too made application for the North Cook Inlet royalty gas to provide electricity on the Kenai Peninsula. Much of the available royalty gas from the North Cook Inlet gas field would be used to supply the Bernice Lake power plant on the North Kenai Road, which HEA hopes to acquire from Chugach Electric Association, and which is now being supplied by APC with gas from the Kenai gas field. Additional generating facilities HEA is planning to construct would use up the remaining available royalty gas from the North Cook Inlet gas field. On March 30, 1976 HEA withdrew its application for the North Cook Inlet royalty gas since it had found another reliable supply source for its new generating facilities, and APC had assured HEA that they would supply the Bernice Lake power plant with gas.

Contract 76-1, selling the State's royalty gas from the North Cook Inlet gas field to APC, was executed June 4, 1976 and approved by the Legislature May 20, 1976. The records show that the House passed SCR 106 on voice vote, and the resolution passed the Senate 17-2. The major provisions of this contract were--

Quantity:	All royalty gas available from the North Cook Inlet, gas field.
Delivery Point:	The wellhead. Phillips' platform.
Price:	55.5¢/Mcf to July 1, 1977 with subsequent annual price escalations based on the highest of three pricing alternatives.
Expiration Date:	July 1, 1984, the same time Phillips' contract with Tokyo Gas and Tokyo Electric expires.

Appendix "A", enclosed, sets out the key provisions of this contract together with those currently before the Legislature.

APC discovered that they could not take delivery of the gas under Contract 76-1 for a number of reasons, the most significant of which was that APC would have to take delivery of the gas at the platform, which would subject Phillips to regulatory jurisdiction of the APUC or Alaska Pipeline Commission as a utility. Phillips refuses to be subject to any regulatory jurisdiction. Their refusal to be regulated dates back to the very beginning of the negotiations when the State was first approached by APC to take its royalty gas in-kind rather than value, and has always presented a potential risk to the successful completion of negotiations. An attempt to exempt Phillips from regulatory jurisdiction by the APUC or Alaska Pipeline Commission by way of a waiver proved impossible since to do so Phillips would have had first to submit to the jurisdiction of the APUC or the Alaska Pipeline Commission to be granted the waiver, a condition unacceptable to Phillips.

Another difficulty arose as the result of APC not being able to take all of the royalty gas available as provided for in Contract 76-1. The average daily royalty gas production from the North Cook Inlet field amounts to between 15-17 MMcf based on previous years' production. APC's estimated average daily needs to service their North Kenai Road customers is approximately 8 MMcf. Since APC has not constructed a

"royalty" pipeline from the delivery point on the North Kenai Road to their "Anchorage" line, and since they have not been able to work out an "exchange" agreement with Union-Marathon, APC is unable to utilize the excess amount of gas. The contract does not allow APC to resell the excess royalty gas to Phillips (although Phillips was agreeable to such an arrangement) since this would violate the contract provision which required that all of the royalty gas sold to APC be used within the State. Since Phillips exports its gas to Japan, selling any excess royalty gas back to Phillips would be in violation of Contract 76-1.

In conjunction with the excess volume which would have been used if a "royalty" pipeline had been in existence, APC told the APUC in September of 1976 that the short life of the contract (July 1, 1984) was one of the reasons for them not constructing a connecting line. Such a line would have allowed for APC to slow the decline of reserves dedicated to Anchorage, the main reason the APUC allowed the flow through tariff for royalty gas. In addition, such a line would also assure a stand-by gas supply for North Kenai Road customers in case production or supply from the North Cook Inlet field were to be interrupted for any reason.

By the end of January, 1977 APC petitioned the State to "re-draft" Contract 76-1 in order to make the contract operational.

To accomplish this it was suggested that the State have the royalty gas transported to shore thus avoiding APUC jurisdiction over Phillips' pipeline, since the State is not a utility. APC would take delivery at

or near the Kenai LNG plant and reimburse the State for any costs incurred. A legal opinion from the Attorney General's office was secured, at the insistence of Phillips, which holds that Phillips is not a utility subject to APUC jurisdiction. Another legal opinion was issued exempting Phillips' pipeline from Alaska Pipeline Commission jurisdiction on the basis that the pipeline is not used as a common carrier by Phillips, and that it is not subject to the common carrier provision of the current law, since the pipeline was constructed prior to the enactment of that law. (Exemption of Phillips' pipeline from APUC jurisdiction had been supported by the Alaska Royalty Oil and Gas Development Advisory Board as early as December 1975 to facilitate the sale of royalty gas to APC.)

It was further suggested that APC would be required to take only such amounts of royalty gas as they had need for. Any gas APC was unable to take delivery of as it became available was to be sold to Phillips as if the State had continued to take its royalty gas in value.

These changes and other provisions were incorporated into agreements between Phillips and the State, and APC and the State. The contract between APC and the State is now awaiting legislative approval, with the agreement between Phillips and the State having been submitted to the Legislature as an exhibit to the APC contract. The key provisions of the two agreements are listed in Appendix "A", which is enclosed.

## Issues

### Gathering, Compression and other Charges or Costs

The amount charged APC by Phillips for dehydration and transportation is 10¢/Mcf. The amount charged APC by Phillips to add a compression unit to maintain capacity in the gathering system is set at 10¢/Mcf. (The agreement between Phillips and the State, and the contract between APC and the State provide that APC will make all payments for the State's account directly to Phillips.) Both of these charges increase at a compounded rate of 6 percent per year. As further compression facilities are installed in the future, additional charges are to be mutually agreed upon by the parties involved. In addition, APC must pay Phillips in proportion to its deliveries for any new or increased taxes and charges which are levied against Phillips with respect to the gathering of royalty gas.

Phillips has supplied data on the gathering and compression charges negotiated between themselves and APC for delivering the State's royalty gas. (See Table I and Table II enclosed.) These figures have not been scrutinized as to whether they are just and reasonable by the Alaska Royalty Oil and Gas Development Advisory Board or the APUC. However, it has been suggested that they are on the high side.

Perhaps one way to get a better handle on these charges would be to request the APUC to review the royalty gas clause of its December 1975 order as it applies to allowing flow through charges. At the time the

flow through provision was granted the transportation cost figures were thought to be considerably less than those proposed now. It is questionable whether the APUC would have allowed the currently proposed flow through charges, considering their comment in the order that the flow through provisions proposed by Alaska Gas and Service Company (AGAS), the distribution affiliate of APC, were ". . . so broad that nearly all increases in any . . . cost of purchased gas could be flowed through."<sup>3</sup> This tends to raise some doubts concerning APC's assertion that the APUC had intended to allow any and all flow through costs. The APUC order also states that the cost of royalty gas will be "somewhat higher" than the price of gas from other gas supplies now committed to APC. Other supplies are priced at 41.5¢/Mcf for gas from the Kenai gas field, compared to 84.65¢/Mcf for royalty gas from the North Cook Inlet field, i.e., 104% higher.

It is of particular interest to note that one of the reasons the APUC allowed the added costs was to provide APC with the opportunity to obtain additional gas to supplement their dwindling reserves, particularly in the Anchorage area. Since the "royalty" line to move North Cook Inlet gas to Anchorage has not been built, and APC is not required under the contract to deliver gas to Anchorage, the question arises as to whether the added flow through charges should be allowed by the APUC. It is difficult to ascertain from the written material we have reviewed how hard APC negotiated with Phillips for less than the agreed to

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<sup>3</sup> *Alaska Public Utilities Commission Docket U-75-68, Order No. 3, dated December 17, 1975, page 7.*

charges of 10¢/Mcf for transportation and 10¢/Mcf for compression. Records show that APC discouraged the APUC from developing " . . . 'a complete record' of the negotiations (between APC and Phillips) for the Commission's files . . ." <sup>4</sup>. The question arises as to what incentives, if any, existed for APC to negotiate for lower charges if APC assumes that any added costs can be passed on automatically to the consumer under U-75-68(3)?

The argument that the royalty gas from the North Cook Inlet gas field is cheaper, even with the added 20¢/Mcf cost for transportation and compression charged by Phillips, than any "new" gas available to APC in the Cook Inlet is debatable. APC cites a \$1.45 price for similar gas in Cook Inlet being offered by Pacific Alaska LNG to support its contention. (We understand the above to be a "spot sale".) However, since the contract with APC provides that the State will receive the highest of three pricing options on the annual anniversary of the contract, one of which is the highest price paid within a 100 km radius from the Phillips platform, and since we have been advised that the gas for which Pacific Alaska LNG is making an offer is within the 100 km radius, it is unlikely that APC can escape paying the \$1.45 (or even a higher) price within the next year. Therefore, the assertion that regardless of the added transportation and compression costs the royalty gas is still a bargain is not quite accurate, and APC is not entirely candid when using this argument to attempt to convince the Alaska Oil and Gas Development

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<sup>4</sup> Letter from Alaska Gas and Service Company to Alaska Public Utilities Commission, dated September 29, 1976.

Advisory Board, the APUC or the Legislature " . . . that it appears royalty gas will always be available . . . at less cost than any other likely 'new' gas."<sup>5</sup>

At the same time APC told us that the above situation could not happen since no comparable sale to that provided for in the current contract would occur, and they, therefore, would never be subject to the pricing provision which calls for the highest price to be paid

". . . by any purchaser in the upper Cook Inlet area for gas of similar conditions of delivery; with due regard to appropriate factors including, but not limited to, differences of BTU content, delivery pressure, terms of the contract and connection charges." (Current Gas Purchase Contract, page 10, lines 3-8)

#### Royalty Line

One of the reasons APC cannot make Contract 76-1 of last year operational is that the contract provides that APC take all of the royalty gas available from the North Cook Inlet gas field. To have use for all royalty gas APC needs to ship approximately 50 percent to its Anchorage consumers, since only approximately 8 MMcf/day can be utilized on the North Kenai Road.

APC has been "flirting" with the idea of building a connecting "royalty" line from the North Kenai Road area to its "Anchorage" line, which delivers gas to Anchorage from the Kenai gas field from the beginning of the negotiations. However, they also have indicated that they would

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<sup>5</sup> Letter from Alaska Pipeline Company to Alaska Oil and Gas Development Advisory Board, dated April 15, 1977.

prefer to enter into an "exchange" agreement with U-M and Phillips to exchange royalty gas from North Cook Inlet with U-M gas from the Kenai gas field. This would be technically feasible, and cost far less than the proposed royalty line, since U-M runs a transmission line from the Kenai gas field to the North Kenai Road area, with APC running a line from the Kenai gas field to Anchorage. An exchange agreement would thus avoid a literal transfer of gas and eliminating construction of a "royalty" line. (See enclosed map.)

When APC found it impossible to work out an "exchange", they decided to build their own line to connect with the Anchorage line. However, this decision brought with it the request for all of the State's royalty gas from the North Cook Inlet field for the life of production rather than for a limited term through June of 1984. This request was not accepted by the State and Contract 76-1 provides for a termination date of July 1, 1984.

The question as to whether APC would build a royalty line continued and as late as February 2, 1977 APC informed the Alaska Oil and Gas Development Advisory Board that they would take such quantities of royalty gas as they could readily resell to their North Kenai Road customers, and not be committed to installing a pipeline connecting to their existing pipeline to Anchorage, although they could do so at their option.<sup>6</sup> The

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<sup>6</sup> Letter from Alaska Pipeline Company to Alaska Oil and Gas Development Advisory Board, dated February 2, 1977.

most recent indications are that APC is inclined to build the connecting line upon approval of the contract by the Legislature, since " . . . it appears that there is sufficient benefit from the royalty line to justify the investment by APC."<sup>7</sup>

The physical absence of the royalty line not only prevents APC from providing Anchorage with much needed dedicated reserves, which was the APUC's reason for the royalty clause which allowed flow through of costs and commingling of lower priced Kenai field gas with North Cook Inlet royalty gas, but it also prevents APC from providing North Kenai Road customers with stand-by gas should the royalty gas ever be insufficient to meet demand.

APC has indicated that a royalty line would not be feasible if the present contract were not approved this year, because the contract only extends to June 1, 1984. We do not find this argument very persuasive. APC fully expects to get the royalty gas from the North Cook Inlet gas field for the life of production once the contract has been signed. Furthermore, it should be noted that the new contract provides that the contract can be extended prior to its termination, a provision absent from Contract 76-1.

The Legislature may wish to consider extracting a firm commitment from APC that they will build a royalty line immediately, making it a con-

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<sup>7</sup> *Letter from Alaska Pipeline Company to Alaska Oil and Gas Development Advisory Board, dated April 15, 1977.*

dition of contract approval. If this can be accomplished, then APC should be required to take all of the royalty gas which becomes available after completion of the line, and the 3 Bcf "best reasonable effort" provision should be deleted from and/or revised in the APC contract as well as the agreement between the State and Phillips to avoid delays in deliveries once the line is operational.

### Jurisdiction

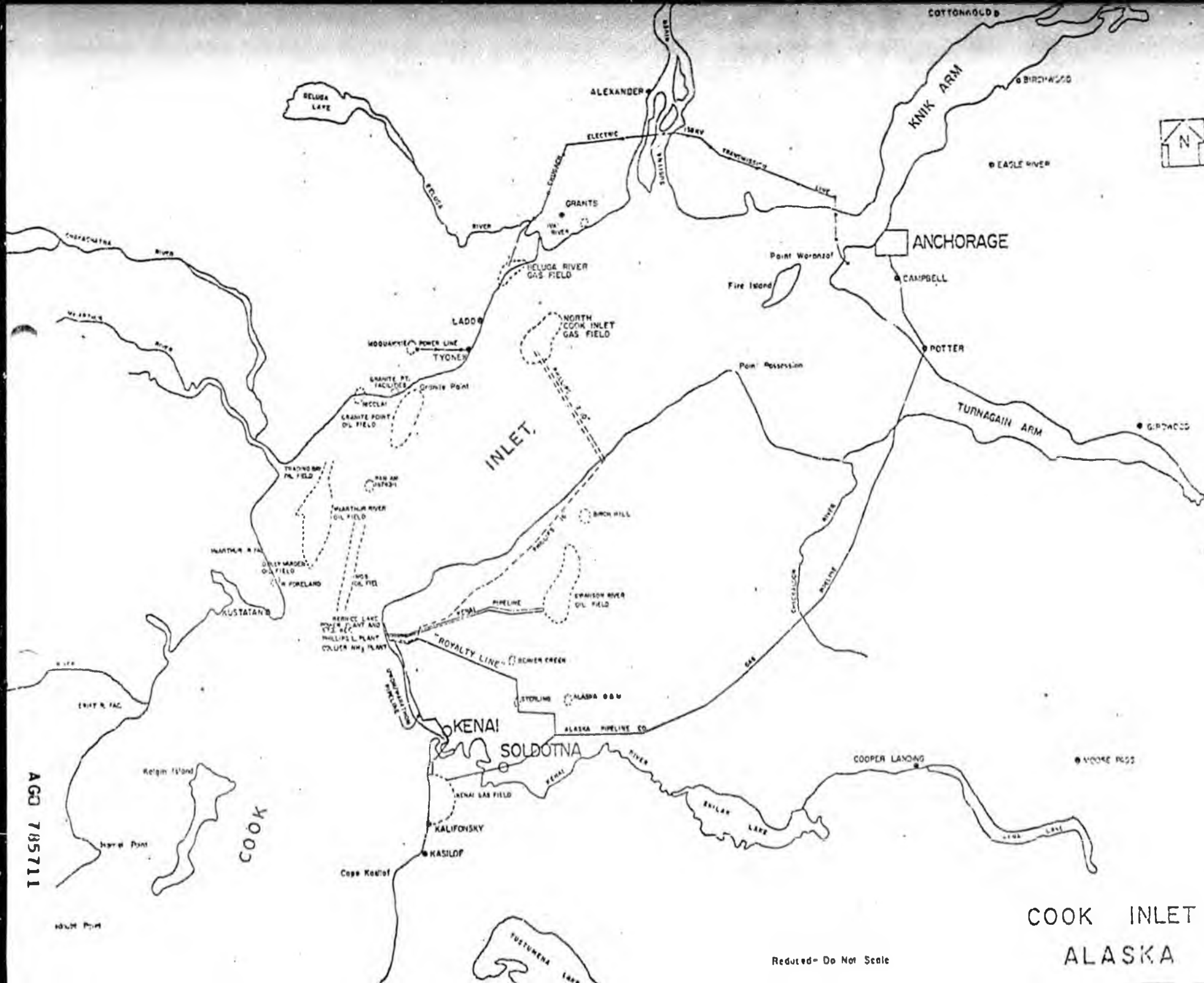
Present indications are that there is no possibility for APUC or APC jurisdiction over Phillips' pipeline, in as much as Phillips operates and maintains the line for its own purposes. Phillips has not violated any laws, and both agreements provide that should Phillips come under either FPC, APUC or Alaska Pipeline Commission jurisdiction, the agreements terminate. Short of revoking their right-of-way permit and substituting a right-of-way lease, which may be possible but almost certainly would entail litigation, there appears to be no way to make them submit to regulatory jurisdiction.

To avoid future problems, the Legislature may provide that

1. All pipelines not currently covered by our common carrier statute agree to common carrier status retroactively to retain their pipeline right-of-way permits (Right-of-Way Leasing Act-38.35.120).

2. Sec. 43.06.630(9) of the Alaska Pipeline Commission Act be amended so that gas processing plants are covered in the definition of what constitutes a pipeline or pipeline facility, and deleting the reference to transportation as a common carrier.
  
3. The possibility should be explored if producers/operators of oil and gas fields located in remote or inaccessible locations, such as a platform, should be required to enter into mandatory exchange agreements with more favorably located fields or transmission lines, which are regulated by the APUC, to avoid jurisdiction, while at the same time protecting the public interest.

These suggestions have not been thoroughly investigated nor checked with the Division of Legal Services, but are offered as a beginning to remedy the current jurisdictional problems with which the State is faced as it affects Phillips' pipeline.



AGO 785711

COOK INLET  
ALASKA

Reduced - Do Not Scale

TABLE I

PIPELINE

Estimated Present-Day Replacement Cost .....	at least	\$25,000,000
Estimated Present-Day Replacement Cost Depreciated to 1977 .....		17,300,000

ESTIMATED COSTS

	<u>\$/Year</u>
Depreciation (20 Years) .....	\$1,100,000
Rate of Return 15% on Depreciated Investment .....	1,520,000
Income Tax @ 52.5% (State & Federal) .....	1,700,000
Operating Expense .....	2,750,000
	<hr/>
TOTAL .....	<u>\$7,070,000</u>

Cost/Mcf @ 43 Bcf/Year = 16.4¢

Cost/Mcf @ 55 Bcf/Year = 12.9¢

T A B L E I I

COMPRESSORS  
(FIRST UNIT)

To maintain capacity in the gathering system and compressors to handle the full 12.5% royalty gas volume, it will be necessary to install compressors at an earlier date. Also, it is estimated that to maintain this capacity it will be necessary to install an additional compressor unit over and above that required for maintaining deliveries without the State taking its royalty gas in kind. Estimated differential in compressor investment is \$5,000,000.

Cost of Compression

	<u>\$/Year</u>
Depreciation (10 Years) .....	\$ 500,000
Rate of Return 15% on Average Investment .....	375,000
Income Taxes @ 52.9% (State & Federal) .....	420,000
Operating Expense .....	715,000
	-----
TOTAL .....	\$2,010,000

Minimum Annual Payment	= \$2,010,000
Royalty Gas Volume @ 4.3 Bcf/Year	= 5.4 Bcf
Royalty Gas Volume @ 5.5 Bcf/Year	= 6.9 Bcf
Cost/Mcf @ 5.4 Bcf	= 37.2¢
Cost/Mcf @ 6.9 Bcf	= 29.1¢

Phillips agreed with Alaska Pipeline Company's request to a compressor charge of 10¢/Mcf on a space-available basis and no minimum annual charge.

APPENDIX "A"

KEY PROVISIONS

PROPOSED REVISED CONTRACT

CONTRACT 76-1

CONTRACT BETWEEN STATE AND PHILLIPS  
(with APC being a signatory)

CONTRACT BETWEEN STATE AND APC

Quantity:

ARTICLE II  
All royalty gas available, when and as available.

ARTICLE IV

1. Phillips shall use its "best reasonable efforts" to deliver not less than 3 Bcf of royalty gas annually (without requiring installation or operation of added pipeline and compression facilities), and subject to
  - a. availability of capacity in Phillips' facilities to handle volumes in excess of Phillips' own requirements;
  - b. availability of royalty gas at the platform;
  - c. APC's requirements; and
  - d. APC's ability to take the requirements.
2. Over or under deliveries of royalty gas shall be carried in an over and short account. In the event the takes by the State (APC) shall ever be 60 MMcf less than the amount of royalty gas available, Phillips shall purchase the excess undelivered quantities of royalty gas over 60 MMcf from the State, and pay the State a price equal to that amount which Phillips would have otherwise paid the State had the State taken its royalty gas in value.

ARTICLE III

1. Up to all royalty gas available, subject to
  - a. APC's ability to take the entire amount of royalty gas available on any given day;
  - b. APC's need and available delivery facilities.
 APC shall use its "best reasonable efforts" to take not less than 3 Bcf of royalty gas annually.
2. Over or under deliveries of royalty gas shall be carried in an over and short account. In the event the takes by APC shall ever be 60 MMcf less than the amount of royalty gas available APC is not permitted to make up for any such underdelivery and the State may sell the undelivered quantity of royalty gas to Phillips.

Delivery Point:

ARTICLE III  
Delivery point shall be the same for APC as it has been for State, which is Phillips' platform.

ARTICLE III & V

Delivery point shall be at or near the existing pipeline tap being presently used to deliver gas from Phillips' pipeline to the Tesoro refinery, which is located in the general vicinity of Phillips' Kenai LNG plant on the North Kenai Road.

ARTICLE V

APC's connection into Phillips' pipeline system at or near Phillips' pipeline tap serving the Tesoro refinery. It shall be the same delivery point as that of the State and Phillips.

Price:

- ARTICLE V
1. To July 1, 1977 55.5¢/Mcf
  2. July 1, 1977-July 1, 1978 the higher of
    - a. 60.36¢/Mcf or
    - b. price State would have received had it continued to take its royalty gas in value or
    - c. the highest price paid by any purchaser in the Upper Cook Inlet area (within a 100 km radius of Phillips' platform) for similar quality gas and similar conditions of delivery.
  3. July 1, 1978 and each succeeding 12 month period the higher of
    - a. the previous year's price plus 2¢/Mcf or
    - b. price State would have received had it continued to take its royalty gas in value or
    - c. the highest price paid by any purchaser in the Upper Cook Inlet area (within a 100 km radius of Phillips' platform) for similar quality gas and similar conditions of delivery.

ARTICLE VI

1. To July 1, 1978 64.65¢/Mcf
2. July 1, 1978-July 1, 1979 the higher of
  - a. 66.65¢/Mcf or
  - b. price State would have received had it continued to take its royalty gas in value or
  - c. the highest price paid by any purchaser in the Upper Cook Inlet area (within a 100 km radius of Phillips' platform) for similar quality gas and similar conditions of delivery.
3. July 1, 1979 and each succeeding 12 month period the higher of
  - a. the previous year's price plus 2¢/Mcf or
  - b. price State would have received had it continued to take its royalty gas in value or
  - c. the highest price paid by any purchaser in the Upper Cook Inlet area (within a 100 km radius of Phillips' platform) for similar quality gas and similar conditions of delivery.

CONTRACT 76-1

Gathering and  
Compression  
Charges and  
Taxes; Other  
Charges

CONTRACT BETWEEN STATE AND PHILLIPS

ARTICLE IX

1. 10¢/Mcf for gathering costs to delivery point to increase 6 percent per year compounded annually on the anniversary date of the contract.
2. 10¢/Mcf for added compression costs to delivery point to increase 6 percent per year compounded annually on the anniversary date when the facilities were first used.
3. Additional compression charges to be mutually agreed upon between the parties, which includes APC since they are signatories of this contract (see also 12.3). If no agreement is reached within 90 days after Phillips serves notice about such added costs, then this contract is terminated.
4. Additionally, the State must pay Phillips any new or increased fee, imposts, duty, charge, excise or tax in proportion to the amount of royalty gas delivered to the State as it relates to gathering and compression.

ARTICLE XIV

Effective: Upon approval by the Legislature of the contract between the State and APC.  
Expiration: June 1, 1984 unless terminated or extended prior to that date.

ARTICLE IX, XI & XIV

1. Will be terminated immediately if deliveries to State (APC) have not commenced by June 30, 1978.
2. If subjected to regulation as a utility (11.2).
3. If added compression cost cannot be agreed upon within 90 days (9.3).
4. If contract between State and APC is terminated.
5. If terminated the State's election to receive its royalty gas in-kind is revoked, and royalty gas available shall be sold to Phillips in value.
- 6.

CONTRACT BETWEEN STATE AND APC

ARTICLE VI & VII

1. 10¢/Mcf for gathering costs to delivery point to increase 6 percent per year compounded annually on the anniversary date of the contract.
2. 10¢/Mcf for added compression costs to delivery point to increase 6 percent per year compounded annually on the anniversary date when such compression facilities are ready for use. (This is different from State/Phillips agreement.)  
This does not obligate Phillips to install any compression facilities or to operate any compression facilities already installed.
3. Additional compression charges to be mutually agreed upon between the State and APC. If no agreement is reached within 90 days after the State serves notice about such added costs, then this contract is terminated (7.5).
4. APC must pay the State any amount for which the State is obligated to reimburse Phillips for a proportion of new or increased fees, imposts, duties, charges or taxes. (This leaves out excise.) (The language is somewhat different from State/Phillips contract, but the effect would seem to be the same.)
5. APC must pay the State any additional costs not covered in the contract and incurred by State in transporting the gas to shore.

ARTICLE VII

Effective: Upon approval by the Legislature.  
Expiration: June 1, 1984 unless terminated or extended prior to that date.

ARTICLE VII

1. Contract shall terminate immediately if deliveries to APC have not commenced by June 30, 1978.
2. Either State or APC may terminate this contract by giving 30 days notice to the other if Phillips comes under regulation as a utility.
3. Contract may be terminated if added compression cost cannot be agreed upon within 90 days.
4. Contract may be terminated if contract between State and Phillips is terminated.
- 5.
6. State may terminate upon 30 days notice to APC if the State cannot arrange for satisfactory transportation of royalty gas to shore.

Term: ARTICLE VI  
Effective: Upon approval by the  
Legislature 5/20/76  
Expiration: July 1, 1984

Termination  
Clause: ARTICLE VII  
Allows APC to terminate the contract  
within 30 days of written notice to  
State if APC is unable to make satis-  
factory arrangements to take delivery  
of the royalty gas. APC may not ex-  
ercise this right after January 31,  
1978.

CONTRACT 76-1

Representation  
and Condition  
Precedent:

Payments:

Miscellaneous

CONTRACT BETWEEN STATE AND PHILLIPS

ARTICLE XI

Phillips, by entering into this contract, shall not be subject to regulation by the FPC, APUC or APC.

Should they become subject to regulation as a utility this contract may be terminated by either party upon 30 days' notice.

ARTICLE XII

APC to make all payments for State's account directly to Phillips.

CONTRACT BETWEEN STATE AND APC

ARTICLE VIII

Neither this contract nor APC's use or disposition of the royalty gas will subject Phillips to FPC, APUC or APC regulation.

ARTICLE IX

1. Assignments of interest by APC may be made "...to conform with...(APC's) various financing documents or as may be desirable to...(APC) as to...(APC's) commonly owned affiliate or subsidiary."
2. If APC does not receive or purchase all royalty gas available, then State can dispose of that portion not taken, provided no gathering and compression charges are incurred by APC as a result.

Legislative Affairs Agency  
Research Division  
April - 1977