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TAPS SETTLEMENT ANALYSIS MATERIALS

PREPARED BY

THE ATTORNEY GENERAL

FOR

THE GOVERNOR

AND

THE LEGISLATURE

APRIL 12, 1982

MEMORANDUM State of Alaska

TO: The Honorable Jay S. Hammond
Governor
State of Alaska

DATE: April 9, 1982

FILE NO:

TELEPHONE NO:

FROM: Wilson L. Condon
Attorney General

SUBJECT: TAPS Settlement
Analysis Materials
For Distribution To
The Legislature

Attached to this memorandum is a package of materials which I recommend should be made available to the Legislature and its staff or consultants to assist them in their evaluation of the proposed TAPS Settlement with B.P. Pipeline Company. This package includes the following documents:

1. My memorandum to the File dated March 30, 1982, entitled "The Pros and Cons" of Settlement.

2. My Memorandum to the File dated April 9, 1982, summarizing the 10 major features of the Proposed Settlement Agreement between the State and B.P. Pipeline Company.

3. A copy of the April 5, 1982, Draft Settlement Agreement, which is substantially the entire document, subject only to minor technical revisions.

4. My Memorandum to the File dated March 1, 1982, entitled "TAPS STATUS REPORT".

5. Copies of your letters to me dated December 9, 1981, and January 28, 1982, directing my negotiations and memorializing your desire and intent to confer with Legislative leadership before committing to any settlement proposal.

Twenty bound sets of these materials are currently available for distribution as you direct.

As you are aware, there are numerous other documents I have had prepared in connection with our settlement efforts in the TAPS case. These documents, which are privileged attorney-client communication, include supporting material for the conclusions and analysis set forth in the three memoranda to my file itemized above. I recommend that we allow people

who may wish to read any of these documents to do so, subject to the provision that no copies of these documents may be made or publicly distributed until after a complete settlement embracing all eight of the TAPS owner companies is consummated.

It has recently become quite likely that we will be able to achieve such a settlement. B.P. has all but committed to the terms of the settlement agreement, and we believe that they will bring Sohio with them. Our intelligence is that Exxon is 90% likely to join, perceiving that an outcome substantially identical to the settlement will be thrust upon them in any event should they oppose it. We believe that ARCO is at least 80% likely to join if Exxon and Sohio do. Finally the remaining four owners, holding in aggregate less than 10% of the TAPS system, will be hard pressed not to join if the four major owners have.

Nevertheless, there does remain a real possibility of our failing to consummate a complete settlement with all of the TAPS owners. In the absence of an all-embracing settlement, the State's litigation efforts will probably continue. There are passages in some of our background analyses which, if quoted out of context, are susceptible to being mischaracterized as expressions of private disagreement with our publicly advocated litigation position. On the assumption that any document we release without restriction could be used against us in ongoing litigation, I believe that we should maintain strict security over any document that could in any way be twisted to the jeopardy of our litigation posture.

By making these materials available, even for reading, we open the door for their possible use against us. However, I believe it is worth taking this risk to ensure that interested legislators and members of the public can fully review the process by which we have reached our recommendation.

WLC:vrb

MEMORANDUM State of Alaska

CONFIDENTIAL - ADVICE OF COUNSEL

TO: Memo to the File

DATE: April 9, 1982

FILE NO:

TELEPHONE NO:

FROM: Wilson L. Condon
Attorney General

SUBJECT: Outline of Proposed TAPS Settlement Agreement between State of Alaska and BP Pipeline Company

Here, in summary form, is a catalogue of the features contained in the proposed Settlement Agreement with B.P. Pipeline Company:

1. Initial 1982 Tariff: $4.625 per barrel.

2. Reimbursement of State's litigation expenses: B. P. will reimburse the State for its proportional 1/6 share of the $20 million the State has spent on the TAPS litigation from its inception to the effective date of the settlement.

3. Rate Base reduction: in settlement of our Phase II case on construction cost overruns, the rate base will be reduced by $400,000,000. If the other TAPS owner companies do not join in the settlement, B. P. will stipulate to a larger rate base reduction totalling $500,000,000.

4. Inflation escalator: the $4.625/barrel base tariff will escalate annually by 40% of the rate of inflation as determined with reference to the Federal Gross National Product Deflator (the "GNP" index). If inflation exceeds 12% for any annual period, the escalator percentage increases, but only enough so that the discounted average value of the tariff over the settlement period remains constant (stated in 1982 present value dollars).

5. Rate reductions for increased throughput: Rates will be lowered for increases in throughput under the following adjustment formula:

$$\text{New Rate} = \text{existing rate} \times \frac{1.6 \text{ mbd}}{\left[\frac{1}{2} (\text{new throughput less } 1.6 \text{ mbd}) + 1.6 \text{ mbd}\right]}$$

For example, if throughput increases from the current level of 1.6 mbd to 2.0 mbd and the existing rate is $4.625/barrel, the new rate will be $4.111/barrel. If throughput falls off during the life of the settlement, the tariff will increase under this same formula.

6. Adjustment for changes in tax rates: Rates will be increased or decreased to pass along any material increases or decreases in federal or state income tax rates or in ad valorem taxes.

7. Adjustment for expensive disaster: Rates may be increased in the event of disasters costing more than $50,000,000 to repair. The amount required in excess of $50,000,000 will be recovered over 5 years, including a financing cost allowance approximately equal to the prime rate of interest. The companies will absorb the first $50,000,000.

8. Adjustment for pumpability of other crude oil stocks. Rates may be increased or decreased for crude oils other than from the Sadlerochit field to reflect variations in pumpability characteristics.

9. Effective date and duration of settlement arrangement: The settlement arrangement will last for 10 years from the effective date of the FERC's approval of the settlement. At the end of the settlement period we may either extend or renegotiate the settlement or apply to the then appropriate regulatory body for a rate determination.

10. Waiver of claim for refund: In exchange for B.P.'s (and other agreeable pipeline companies') agreeing to these terms and foregoing their claims for higher TAPS tariffs, the State agrees to waive its claims for refunds for past years during which the rates, of course, exceeded the $4.625/barrel settlement figure.

WLC:vrb

MEMORANDUM State of Alaska

CONFIDENTIAL - ADVICE OF COUNSEL

TO: To File

DATE: March 30, 1982

FILE NO:

TELEPHONE NO:

FROM: Wilson L. Condon
Attorney General

SUBJECT: Pros and cons of settlement

This is a revised version of the memorandum originally prepared on March 1, 1982. It incorporates a number of revisions to the computations shown on pages 11, 12 and 15 below. In general, these revisions reflect assumed levels of success from litigation that are higher than the projections that were used in the earlier memorandum. In other words, this memorandum is deliberately calculated to make the settlement proposal look less favorable than it would appear to be from the March 1, 1982 memorandum.

The motivation for my undertaking this exercise is the reactions of some of the State's TAPS litigation counsel to the probability assumptions set forth in the earlier memorandum. In the past four weeks, it has come to my attention that there are differences of opinion regarding the probabilities of success that the State could expect in the event the litigation should continue. While I stand firmly behind the assumptions spelled out in the March 1 memorandum, I felt it would be a worthwhile exercise to compute the outcome that follows from a set of probabilities that assume greater likelihood of success from litigation.

Qualitatively, these revised calculations and the

modified assumptions upon which they are based do not alter the conclusion of the March 1 memorandum that the proposed settlement of $4.625/40% escalating is superior to the arithmetically-achieved expected value of continuing the litigation. However, the margin of superiority has been reduced from 8 cents per barrel to 4 cents per barrel.

THE PROS AND CONS OF SETTLEMENT

Introduction.

I have reached an understanding with representatives of B.P. Pipeline Company regarding a possible settlement of their part of the TAPS tariff litigation. B.P. has indicated a willingness to stipulate to a 1982 tariff of $4.625 per barrel, 40% of which would escalate with the rate of inflation. The settlement period would last for 10 years. In addition, they would be relieved of refund liability for the years 1978 to the settlement date, during which they have collected $6.35 per barrel. However, they would reimburse the State for $3 million of the $18 million which the State has incurred to date as litigation expenses in the TAPS proceeding. This reimbursement figure is based on B.P.'s approximately one-sixth ownership interest in the TAPS facilities.

I see three inter-related questions to address in assessing whether this proposal is a deal the State should want to take. The first goes to the multiparty procedural setting

of the TAPS case: should we settle with B.P. alone? The second goes to timing: should we settle now or wait? The third goes to the fundamentals of the proposal: is the $4.625/40% escalating proposal a fair deal for the State?

None of these questions is open-and-shut. There are several pros and cons associated with settling in general and this settlement in particular. On balance, I think the pros outweigh the cons. Accordingly, it is my judgment that the State should stipulate with B.P. to this proposal. Here are the considerations as I see them.

1. Should we settle with B.P. alone?

Pluses	Minuses
+ Increased likelihood of total resolution of TAPS litigation.	- Risk of undermining our best possible outcome if total resolution not achieved.
+ At minimum, moderate reduction in scope of litigation.	

At present, the only way to resolve the TAPS litigation by settlement is to start by settling with B.P. separately. None of the other major TAPS owners have made any proposals that would be remotely acceptable to the State. But if B.P. publically accepts a $4.625/40% arrangement the other companies will be hard-pressed to justify 1982 tariffs in the

range of $5.30 (with at least 40% escalators). [1/] Even if a separate settlement with B.P. does not force the other companies into a substantially similar arrangement, it will reduce the number of parties litigating against us and the number of issues to be resolved. This in turn would mean at least modest savings in the cost of continued litigation.

On the minus side, we would risk undermining our best possible outcome if a separate settlement with B.P. does not precipitate an overall resolution. Once we have publicly agreed to a $4.625/40% arrangement with B.P., we will find it hard to justify rates substantially lower. The crux of this consideration is whether the $4.625/40% proposal is a reasonable settlement. For the reasons discussed on pages 6-13 below, I think that it is. Therefore, I think this risk is worth taking.

2. Should we settle now or wait?

Pluses	Minuses
+ Timing propitious for settlement	- FERC decision on Phase I or in Williams Brothers might improve our negotiation position

1/ The weighted average of the settlement proposal advanced in May, 1981, by representatives of ARCO, B.P., Exxon and Sohio, was a 1982 tariff of $5.32 per barrel, 40% of which would escalate with inflation. In late December, 1981, Exxon filed for a rate reduction from their initial rate of $6.27 to a new rate of $5.30. Exxon's action was motivated by the constraining effect of the 1941 antitrust consent decree, which currently acts as a ceiling on oil pipeline rates, but which may soon be dissolved on the motion of the Antitrust Division of the Department of Justice.

The Phase II cost of construction hearings have just begun, and by all expectations will continue for several months in the absence of settlement. Settlement now would have the generally beneficial effect of minimizing legal expenses for all parties. In addition, the cost of construction case is the single largest and most emotionally charged issue in the entire TAPS litigation. Psychological factors favor settling now, before the cost of construction hearings have gotten too heated and the parties have gotten irrevocably committed to their litigation postures.

If we don't settle shortly, the psychological factors will soon turn against settlement for the indeterminate future. Once the parties have become publicly committed to their litigation positions, they are less likely to be favorably disposed to compromise. A lengthy period of emotional run-off will probably be required to get people back to the bargaining table. Countering this consideration, however, are the assurances we have received from B.P.'s representatives that the cost of construction hearings will not polarize their position.

On the minus side, if we settle now we risk losing the potential benefits of a FERC decision either on the appeals from Judge Kane's Phase I decision or in the Williams Brothers case. Williams Brothers is the companion case to TAPS. The FERC's promised rulings on Judge Kane's decision and in Williams Brothers, either of which could establish the definitive

oil pipeline rate-making formula, are both long overdue. The worst case scenario would have us settling with B.P. days before the FERC announces a rate-making precedent which would yield substantially lower rates than we have agreed to.

For several reasons I think this risk is worth taking. First, we have no guarantee that either decision is imminent. Our best intelligence is that the FERC has suspended all consideration of the TAPS Phase I decision pending the outcome of settlement discussions. As for the Williams Brothers case, it has been pending at the FERC, upon remand from the courts, since November, 1978. When the FERC intervened in the court proceedings in the Spring of 1978, its counsel gave oral assurances that the agency would move the case with "dispatch." In any event, the FERC has never shown itself to be capable of swift decision-making on major policy questions.

Second, a major policy pronouncement in Williams Brothers would not necessarily apply to TAPS. Two ratemaking formulas have been advocated on the Williams Brothers record that were not addressed in TAPS. If the FERC were to adopt either, then Phase I of TAPS would have to be reopened before these formulas could be applied in our case.

Third, the Williams Brothers decision could go against us. Four of the five formulas advocated in Williams Brothers are potentially less favorable to us than the formula we advocated in TAPS. Reporting on a most-significant recent

development, a December, 1981 Foster Oil Pipeline Report indicates that John David Hughes, the FERC Commissioner most sympathetic to the State's position, is giving serious consideration to one of these less favorable formulas. This apparent shift in Commissioner Hughes' position significantly alters my estimation of the chances of a FERC precedent going against us. Back in November, 1981, my best judgment was a 50-50 chance of the FERC's adopting either a variation of our advocated formula or a variation of a far less favorable formula. My best judgment now is that the probabilities have tipped to 60-40 against us.

In my judgment, there is not likely to be a better time for settling for the foreseeable future.

3. Is $4.625/40% a fair deal for the State?

Pluses	Minuses
Financial Considerations	
+ Seal off exposure to worse outcomes	- Loss of opportunity for better outcomes
+ Lower than can be justified under technical analysis	
+ Immediate increase in State revenues	- No refunds
+ Save projected litigation expenses	
Policy Considerations	
+ Certainty of tariffs for 10 years	- Increased risk of TAPS being deregulated
+ Eliminate potential adverse impact on ANGTS	- Loss of rate-making precedent

Financial Considerations

The chief reason for settling any dispute is to buy certainty. The advantage of settlement is that it seals off exposure to any worse result. The corresponding disadvantage is that it costs the opportunity for any better result. After extensive fact-gathering and detailed technical analysis, I have concluded that the $4.625/40% escalating proposal is significantly better than the net present value of the sum of our most likely best and worst case probabilities, even after allowing for the possibility of the State's ultimately winning refunds plus interest.

The concept of net present value is simple enough. The value of a set of choices is merely the sum of the products of the various pay-offs multiplied by their respective probabilities. Take, for a simple example, a two-choice lottery in which there is a 60% chance of winning $4.00 and a 40% chance of losing $5.00. The value of this set of choices is $.40, computed as follows: [.60 x $4] + [.40 x-$5] = $2.40 - $2.00 = $.40. This method of analysis is helpful in assessing the $4.625/40% escalating TAPS tariff proposal.

In my view, these are the relevant possibilities and probabilities which cover the 10 year settlement period: I judge there to be a 25% probability that the FERC will simply avoid making any decision on the TAPS tariffs. (For my reasoning, see the discussion in the TAPS Briefing Paper at pages

67-69 and pages 74-75). Within this range, I have been advised by our special counsel handling the consent decree proceeding that there is a 50% probability that the consent decree will have been vacated. In this case, B.P. can be expected to leave its rate at its current tariff level of $6.35/barrel -- increasing it periodically to keep it at this level in constant dollars. Correspondingly, I believe there is a 50% probability that the consent decree ceiling will be left in place pending a FERC decision on proper oil pipeline rate making methodology. In that case, B.P. would likely follow the other TAPS owners and lower its 1982 rate to the consent decree area of $5.43/40% escalating (which is equal to $4.47 stated in constant 1982 dollars).

As for the remaining 75% probabilities, Commissioner Hughes' recent pronouncements (see p. 7) have caused me to reassess the likelihood of the FERC's staying with the utility-formula advocated by the State and adopted by Judge Kane in his Phase I decision. Although I now believe that the odds are 40% for the utility formula and 60% that the Commission will adopt some variation of the trended original cost formula, to downplay the settlement proposal I have based my computations on a 50% probability for the utility formula. As calculated by our technical consultants, the utility-formula variation I think most likely is equal to $3.07 in constant dollars over the settlement period, but this figure does not allow for the possi-

bility of our reducing rates in the Phase II cost of construction and cost of service cases. Accordingly, I have further lowered this outcome to a 10 year tariff of $2.79 in constant dollars. (This assumes a success level of approximately 40% in Phase II. 2/) As for the TOC variations, I have considered the possibilities of the FERC's choosing a low, a medium, and a medium-high real rate of return coupled with a major rate-base reduction, to allow for a reasonable level of success in the cost of construction case. All of these possibilities and probabilities reduce to the following matrix:

1. FERC AVOIDS DECISION = 25% overall probability	Net present value
A. Tariff stays at $6.35 (constant dollars) x 12.5% =	$0.7938
B. Tariff goes to $4.47 (constant dollars) x 12.5% =	0.5588

2/ If we were 100% successful in both our Phase I cost of construction and cost of service cases, the effect would be to reduce the tariffs by $.97 per barrel. Discounting this figure at an 8% assumed rate of inflation over 10 years yields a present value equivalent of $.708 per barrel reduction per year in constant (1982) dollars. A 40% success level would thus mean a net reduction of $.283 cents per barrel. In other words, I have assumed a 40% probability of our being completely successful in all of our Phase II litigation, which is arithmetically the equivalent of a 100% probability of our achieving 40% of our maximum potential rate reduction. In my judgment, this is a reasonable, but quite optimistic, probability of success in light of what we know about the sympathies and leanings of the current panel of FERC commissioners.

2. FERC DECIDES TARIFFS AND METHODOLOGY = 75% overall probability

A. Modified Kane methodology + 40% success in Phase II:

Tariff goes to $2.79 (constant dollars) x 37.5% = 1.0425

B. TOC with 5% real rate of return:

Tariff goes to $3.64 (constant dollars) x 3.75% = 0.1365

C. TOC with 6.5% real rate of return

Tariff goes to $4.40 (constant dollars) x 22.5% = 0.9900

D. TOC with 7.0% real rate of return

Tariff goes to $4.56 (constant dollars) x 11.25% = .5130

TOTAL = Net Expected Value of tariff (in present value dollars) over settlement period = $4.0346

Since the $4.625/40% proposal is the equivalent of only $3.802 in present value dollars, it is clearly lower than the net expected value tariff of $4.0346.

However, the settlement proposal requires the State to forego the possibility of refunds, so some allowance must be made for that. Once again, the net present value analysis enables us to compute the expected value of the refund. In the 25% probability that the FERC ducks a decision on TAPS, there would be no refund possibility at all. As for the remaining 75%, for the reasons discussed on pages 61 and 67 of the TAPS Briefing Paper, I think it is rather unlikely that the FERC

will require refunds, whatever methodology it might choose. My judgment sets the odds of refund -- should the FERC decide methodology -- at only 40%. 3/ Nevertheless, to be conservative and to downplay the proposed settlement, I have estimated the gross probability of refund at 50% for purposes of the following computations. The net probability of refund, then, is 50% of 75%, which equals 37.5%.

Within this 37.5% probability, the refunds could be very large or rather small, depending upon the methodology adopted. (Parenthetically, it should be remembered that the State's interest is only about 24% of each dollar of any owner company's refund exposure. Since the State's interest is a constant per cent, however, no special computations need to

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3/ This is a very difficult judgment call because the choice of either the utility formula or the trended original cost formula would logically seem to require the FERC to address and decide the question of refunds. Especially under the time path of the TOC approach, where rates are lowest in the early years and highest in the later, the companies' refund exposure would be enormous.

There are, to my mind however, several ways for the FERC to side-step the consequences of "methodological purity." Since both the utility and the TOC formulas are untried methodologies as far as oil pipeline rates are concerned (and TOC has never been used to set rates of any kind), it seems highly likely that the FERC would adopt some sort of transition arrangement to ease the shift from the ICC valuation approach to any other ratemaking methodology. I would expect the present body of FERC commissioners to seize upon this device of "the transition" as the means of vastly ameliorating the companies' refund exposure which would otherwise be an apparent requirement of deciding the case.

made in computing the net present value of any owner company's refund exposure.)

The key variable is the time path associated with each methodology. Under the TOC methodology, tariffs are lowest in the early years and highest in the later years. By contrast, under the utility-methodology, rates are highest in the early years and lowest in the later years. B.P.'s refund exposure turns on the difference between $6.35, the rate it is currently charging, and the rate determined for the years up to 1982. Accordingly, its refund exposure is greatest under the TOC scenarios.

It is my best judgment that under the revised Kane methodology, the resultant rates for 1978 and 1979 would be at least as high as B.P.'s current rate of $6.35. Consequently, there would be no refund exposure for these years. As a best estimate for B.P.'s refund exposure for the years 1980 and 1981, I have taken Judge Kane's unmodified 1978 and 1979 rates for B.P. and applied them against B.P.'s throughput for 1980 and 1981. For the TOC scenarios, our consultants have computed the rates from 1978 forward, so the determination of B.P.'s refund exposure is much easier. For all scenarios, I have also allowed for interest compounding at 6.25% per year up to 1982. This is the current legal rate of interest on rate refunds awarded by the FERC.

Once again, I have assessed the probability of the

FERC's using the modified Kane methodology at 50% and the probability of the FERC's using a TOC methodology at an aggregate of 50%. I have also allowed for the possibility of a low, medium, and medium-high real rate of return with the TOC methodology. The computations are available on separate work papers. Here is the resultant matrix:

Net Probability of refund = 37.5%

A.	B.P.'s exposure under modified Kane (utility-type approach) $237,576,000 x 50% =	$118,788,000
B.	B.P.'s exposure under TOC, 5% Real ROR $1,194,983,000 x 5% =	59,749,000
C.	B.P.'s exposure under TOC, 6.5% Real ROR $736,489,000 x 30% =	220,947,000
D.	B.P.'s exposure under TOC, 7% real ROR $660,108,000 x 15% =	$99,016,000
TOTAL =	gross present value of B.P.'s refund exposure, assuming there are refunds. =	$498,500,000
	x 37.5% net probability of refunds	x .375
	Net present value of B.P.'s refund exposure =	$186,938,000

The bottom-line of these calculations is that B.P. faces a likely refund exposure of $186,938,000 if we reject the settlement. At its effective rate of 24%, the State's refund interest has an expected value of $44,865,000

On the other hand, since the constant dollar net

present value tariff is larger than the constant dollar value of the settlement, B.P. will have likely foregone future revenues if we accept the settlement. The magnitude of this revenue loss is the difference between the constant dollar values of the NEV tariff and the settlement tariff, multiplied by the throughput over the 10 year settlement period.

Assuming an annual throughput of 1.6 million barrels per day for TAPS as a whole and a one-sixth share for B.P., B.P.'s 10-year throughput equals 973,330,000 barrels. Multiplied by the 23.26 cent difference between the NEV tariff and the settlement figure yields a 10-year revenue loss of $226,397,000 in constant 1982 dollars. Since this figure is $39,459,000 larger than B.P.'s net present value refund exposure, the conclusion which follows from this analysis is that the settlement clearly favors the State, even after allowance is made for the possibility of our receiving refunds plus interest if we choose to reject this settlement.

In fact, when the $39,459,000 NEV revenue shortfall is divided by the 10-year projected throughput of 973,330,000 barrels, the result is a constant dollar value margin of 4 cents per barrel by which the settlement favors the State. Translated back into a 1982 tariff escalating at 40%, this means a settlement figure as high as $4.675/40% would appear to equalize the value of B.P.'s present refund exposure and future revenue loss.

It should also be noted that no allowance has been made for the non-quantifiable benefits associated with settlement.

Aside from B.P., I am not aware of anyone who has analyzed the case as thoroughly or as carefully as we have. I am aware of other opinions to the effect that a mid-way split between our best and worst case probabilities would be much lower than $4.625/40%. I believe that these opinions may be sincerely held, but I do not share them.

The remaining financial considerations focus on the revenue impact of settlement on the State. On the plus side, settling with B.P. at $4.625/40% will mean an immediate annual increase in State royalty and severance tax income of approximately $35 million. In addition, the State would also receive an immediate one-time payment of $3 million, representing B.P.'s reimbursement of its proportional share of the State's TAPS litigation expenditures.

If settlement with B.P. should precipitate settling with the remaining TAPS owners on substantially similar terms, the annual increase in State royalty and severance tax revenues would grow to approximately $200 million and the State would recover the balance of the $18 million it has spent on TAPS to date. As an additional plus, if settlement with B.P. precipitates a general settlement, the State would thereby save another $15.6 million, which represents the projected cost of liti-

gating the case to a conclusion.

On the minus side, settlement means foregoing any refunds. I do not regard this as a great sacrifice for several reasons. First, as pointed out in the technical analysis above, I think there is a low overall probability of the FERC's ordering refunds under any circumstances. Second, even if FERC should order refunds, the likelihood is that such an order would be stayed pending appeal. The current interest rate on FERC refunds is 6.25%, so the State would be losing considerable time-value on whatever refunds it might ultimately receive. At best, the receipt of refunds is a very speculative contingency which will not be realized, if ever, until some time in the indeterminate future. Finally, as the technical analysis has shown, the settlement is better for the State than the net present value tariff even after allowing for the possibility of the State's receiving a refund plus interest.

One concluding comment is in order as regards the foregone possibilities of refunds and/or lower tariffs. At stake here is the public's money. The crucial issue is to define the extent to which better results should be sought at the risk of realizing substantially worse outcomes. In my judgment, a more conservative philosophy is required when handling the public's money than when an individual is handling his own. I believe that the responsible course is first to minimize the down-side risks to the fullest practicable extent and only then

to endeavor to maximize speculative gains on the up-side. In my opinion, the $4.625/40% settlement is fully consistent with this philosophy and still achieves a better result than can be justified on purely probabilistic analysis.

Policy Considerations.

As a policy matter, settlement carries the twin advantages of bringing certainty to TAPS tariffs for at least the 10-year settlement period and reducing uncertainties in several related areas. As long as the TAPS litigation continues, uncertainties will be prolonged in the areas of royalty revenue projections, severance tax revenue projections and state income tax projections. This in turn causes difficulties in fiscal and permanent fund planning.

Those who pay or collect these taxes and prepare or audit the returns face additional uncertainties associated with computation and reporting. Under the new apportionment formulas that have just gone into effect on January 1, 1982, it will be impossible to make final State income tax computations until TAPS tariffs are finally established. Amended returns will have to be filed (and audited) for all of the years during which TAPS tariffs will have been litigated.

Another policy advantage to settlement is the elimination of potentially adverse impacts on the financing and construction of the Alaska Natural Gas Transmission System

(ANGTS). The very strength of our cost of construction case could convince potential investors that the risks of constructing the ANGTS are far greater than presently perceived. Similarly, the strength of our cost of service case could convince investors that the ANGTS is potentially far less profitable than presently perceived.

On the minus side, a settlement of any kind could increase the likelihood of TAPS' being deregulated by Congressional action, and could kill any incentive the FERC has to devise a satisfactory oil pipeline rate-making formula. In other words, while settlement would increase certainty for the next 10 years, it could mean greater uncertainty as to what will happen to TAPS tariffs at the conclusion of the settlement period.

These risks are significant, but I think they are worth taking. In this inflationary period in which we live, everyone's time-horizons have shortened considerably. Few people are willing to commit themselves to any major financial arrangement for more than 10 years. TAPS might be deregulated even if we do not settle. The owner companies are fighting hard for deregulation right now. If we do not settle and TAPS is deregulated, we lose all of the benefits of settlement. Meanwhile, a lot can happen in 10 years. Even if today's Congress were to agree to deregulate TAPS at the end of the settlement period, changed circumstances might persuade a 1990's

Congress to reinstitute regulatory controls.

As for the precedent value of TAPS, I share the opinion that the case has grown beyond the ability of the FERC to manage or decide. A precedent-setting decision, if it comes at all, is as likely to come from Congress as from the FERC. Even if FERC should issue a landmark ruling, I anticipate years of appellate litigation challenging it. And when the appellate process has run its course, changed circumstances in the 1990's could conceivably undermine the applicability of whatever precedent remains.

Conclusion

There is a significant likelihood that TAPS will not be resolved by litigation. At best litigation will be costly and enormously protracted. Settlement is the best way to revolve the issue of TAPS tariffs. Settlement minimizes to the fullest practicable extent the significant possibilities of the State's realizing a far worse outcome if the litigation process continues. Settlement with B.P. is the only apparent device for bringing about a general settlement.

Now is the most favorable time for settling that we are likely to see for the foreseeable future. A tariff of $4.625 per barrel, commencing in 1982, 40% of which would escalate with inflation, is a very fair settlement for the State. It is 4 cents per barrel better than the result that can be

justified under purely technical analysis, even allowing for the possibility of refund plus interest. It is my professional judgment that it should be accepted.

WLC:pjg:RS

SETTLEMENT AGREEMENT

A. Introduction and Summary

Construction of the Trans-Alaska Pipeline System ("TAPS" or the "System") was completed during 1977, and during that year petroleum began to flow from Prudhoe Bay through the System to Valdez, where it was (and is) loaded onto tankers for transport to its destination. Since the first TAPS tariffs were filed in May and June of 1977, the companies that own the System have been defending their tariff rates in administrative litigation (now denominated FERC Docket No. OR78-1 and identified herein as the "TAPS rate case") brought by the State of Alaska, the United States Department of Justice, the Arctic Slope Regional Corporation, the staff of the Alaska Public Utilities Commission ("APUC"), and the staff of the Interstate Commerce Commission (prior to October 1, 1977) and the Federal Energy Regulatory Commission (after October 1, 1977) (the "Protestants").

An initial decision in Phase I of the litigation was rendered by an Administrative Law Judge on February 1, 1980, and argued before the Federal Energy Regulatory Commission ("FERC" or the "Commission") on July 1, 1980, but the Commission has yet to issue its decision in Phase I of the case. Evidentiary hearings in Phase II of the litigation began in

February of 1982 and will consume many months. Given the likelihood of appeal, it seems fair to say that absent a settlement no end to the TAPS rate case is yet in sight.

After considering the history and prospects of the litigation, and the uncertainty it has created for the eight pipeline companies that own TAPS (the "TAPS owners" or "owners") and the State of Alaska (the "State"), the owners and the State began some months ago to explore ways of settling the litigation. Following lengthy negotiations, the State and one of the owners -- BP Pipelines Inc. ("BP") -- have agreed to settle all of the issues in Docket No. OR78-1 on the terms set forth below. BP and the State have determined that the benefits that each will derive from this Settlement -- both pecuniary and non-pecuniary -- are such that it is superior to continued litigation and that each will receive adequate consideration for its agreement to enter into the Settlement.

The State and BP do not seek to impose this Settlement upon the other TAPS owners and, with one exception, the Settlement's terms do not depend upon its acceptance by TAPS owners other than BP. The State is prepared to settle with each TAPS owner on equivalent terms, however, and both the State and BP hope that all of the TAPS owners, as well as the Department of Justice, the Arctic Slope Regional Corporation, the APUC staff, and the FERC staff, will join in the Settlement.

The terms and conditions of the Settlement are, briefly, as follows:*/

(1) Concurrent with the filing of the Settlement with the FERC, those settling owners whose tariffs exceed $5.50 per barrel will reduce their tariffs to $5.50 per barrel. Shortly after FERC approves the Settlement, the settling owners will file new tariffs not to exceed $4.625 per barrel for shipments of Sadlerochit petroleum from Pump Station 1 of TAPS to Valdez.

(2) The Settlement Agreement shall remain in effect for ten years from its effective date, subject to annual adjustments for inflation, throughput variations, extraordinary events, and tax changes. There are no provisions for modification, extension, or renewal of the Agreement at the end of that period, and it is the intention of the parties that the Agreement shall have no precedential value.

(3) The settling owners will not refund any portion of the tariffs collected prior to the effective date of the Settlement. They will, however, reimburse the State for their proportional share of all costs (including legal fees) that the State incurred to prosecute the TAPS rate case.

(4) The settling owners will reduce their carrier property accounts by their proportional share of $400 million (if all TAPS owners join in the Settlement) or $500 million (if all TAPS owners do not join in the Settlement).

(5) The State will dismiss all of its claims against the settling owners in Phase II of the TAPS rate case with prejudice. The settling parties will also dismiss all of their claims in Phase I of the TAPS rate case, but without prejudice to their rights to reassert those claims at the termination of the Settlement for the period following said termination.

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*/ The actual terms and conditions of settlement are set forth in Parts B, C and D of this Agreement. In the event of any disagreement between this Part and Parts B, C & D, Parts B, C & D control.

(6) If all of the Protestants are not bound by this Settlement Agreement, or if the FERC fails to give it timely approval, the Agreement shall be void and of no further force and effect.

B. Definitions

Effective Date - The first day of the month following the month in which the Commission approves the Agreement.

Extraordinary Event - Act of God, act of war, storm, flood, glacial surge, civil disorder, seismic event or other similar catastrophe. Corrosion, subsidence, or a collapse, fire, explosion, accident or similar event shall also be deemed an Extraordinary Event if the TAPS owners can demonstrate that the event could not have been prevented by their exercise of reasonable prudence.

Index - The most recent published estimate of the Implicit Price Deflator for Gross National Product, as published by the Bureau of Economic Analysis of the United States Department of Commerce, or any successor thereto, in the "Survey of Current Business."

Measurement of Time - Year O is the one year period immediately preceding the Effective Date. Year 1 is the year commencing on the Effective Date. The year designated as year "n" is a year following year 1 which commences on the "n-1" anniversary of the Effective Date.

Net Barrels - Barrels of 42 U.S. standard gallons at $60^{o}F$ net of basic sediment and water as recorded on the loading ticket at Valdez.

Proportional Share - All figures in this Agreement are expressed on a System-wide basis. Whenever a cost, expense, adjustment, payment or benefit is to be apportioned among the TAPS owners, each owner's portion of the total -- its "proportional share" -- shall be equal to its composite percentage ownership share of TAPS on the Effective Date.

Settling Owner - Any TAPS owner who has executed this Agreement and agreed to be bound by its terms.

Settling Party - Any party to the TAPS rate case who has executed this agreement and agreed to be bound by its terms.

Throughput - $[V_n]$ - The volume of petroleum, measured in millions of net barrels (rounded to the nearest tenth of a million), loaded onto vessels at the System terminal at Valdez during the twelve months commencing on the n-1 anniversary of the Effective Date.

C. Terms and Conditions

C.1 Tariff Equation

The maximum allowable tariff per barrel for shipments of Sadlerochit petroleum from Pump Station 1 to Valdez terminal in year 1 shall be $4.625. In year n the maximum allowable tariff $[T_n]$ shall be computed as follows and rounded to the nearest one tenth of one cent:

$$T_n = \$4.625[A_n][B_n] + [C_n] + [D_n] \quad \text{(Equation C.1)}$$

In Equation C.1:

$4.625 = the Base Tariff

A = the Inflation Adjustment, as defined in paragraph C.2, infra.

B = the Throughput Adjustment, as defined in paragraph C.3, infra.

C = the Tax Adjustment, as defined in paragraph C.4, infra.

D = the Extraordinary Event Adjustment, as defined in paragraph C.5, infra.

C.2 Inflation Adjustment

The Inflation Adjustment [A_n] in year n shall be computed as follows:

$$A_n = 1 + [(I_{n-1} - I_o)/(I_o)][H] \qquad \text{(Equation C.2)}$$

In Equation C.2:

I_{n-1} = the Index for the quarter prior to the quarter in which year n began.

I_o = the Index for the quarter prior to the quarter that included the Effective Date.

H = the Adjustment Factor, determined as follows:

$(I_{n-1}-I_{n-2})/(I_{n-2})$	H
.12 or less	.4
More than .12 to .16	.6
More than .16 to .20	.67
More than .20	.75

where

I_{n-2} = the Index for the quarter prior to the quarter in which year n-1 began.

C.3 Throughput Adjustment

The Throughput Adjustment [B_n] in year n shall be computed as follows:

$B_n = (584)/(292 + .5V_{n-1})$ (Equation C.3)

In Equation C.3:

V_{n-1} = Throughput in year n-1.

Provided that $B_n = 1$ unless V_{n-1} is greater than 596 (million barrels) or less than 572 (million barrels).

C.4 Tax Adjustment

The Tax Adjustment $[C_n]$ for year n shall be computed as follows:

$C_n = [E_n] + [F_n] + [G_n]$ (Equation C.4)

In Equation C.4:

$$E_n = [1 - TR_{n-1}][(AVT_{n-1} - 162)/(V_{n-1})]$$

$$F_n = .03T_{n-1}[1 - TR_{n-1}]\{[(SR_{n-1})/(.094)] - 1\}$$

$$G_n = .21T_{n-1}\{[(TR_{n-1})/(.46)] - 1\}$$

where

TR_{n-1} = the maximum Federal tax rate on taxable corporate income as provided in section 11(b) of the Internal Revenue Code of 1954 and/or any successor thereto.

AVT_{n-1} = The combined ad valorem taxes paid by all TAPS owners in year n-1, in millions of dollars.

SR_{n-1} = the maximum State tax rate on the taxable corporate income of pipeline companies, as provided in AS 43.20.011(e) and/or any successor thereto.

Provided that $E_n = 0$ unless AVT_{n-1} is greater than \$174 million or less than \$150 million; $F_n = 0$ unless SR_{n-1} is greater than .099 or less than .089; and $G_n = 0$ unless TR_{n-1} is greater than .48 or less than .44.

And provided further that if at any time during the term of this Agreement the State fundamentally alters the basis or methodology used to compute the income tax liability of the settling owners (e.g. from the unitary method to individual accounting), or levies a new tax on the settling owners of a kind or type that is not in effect on the date this Agreement is filed with the FERC (e.g. a gross receipts tax), and if the net effect of the alteration and/or the new tax is an increase of more than $12 million in the combined annual tax liability to the State of all TAPS owners, then [F] in succeeding years shall be computed as follows:

$$F_r = [1 - TR_{r-1}] [(ST_{r-1} - ST_o)/(V_{r-1})]$$

where

r = 0 (zero) for calendar year 1982 and increases by 1 on January 1 of each succeeding calendar year.

ST_{r-1} = the total annual non-ad valorem tax liability of the TAPS owners to the State in year r-1

ST_o = the total annual non-ad valorem tax liability of the TAPS owners to the State in calendar year 1982, as determined under the law in effect on the date this Agreement is filed with the FERC.

C.5 Extraordinary Events Adjustment - If the occurrence of an Extraordinary Event in year n mandates expenditures in excess of the sum of the Extraordinary Event Deductible (J_n) and any amounts reasonably recoverable from insurers or

third parties, such excess expenditures may be recovered over the five years following the year during which repair, replacement or reconstruction of the damage or loss occasioned by the Extraordinary Event is completed, by the addition of an Extraordinary Event Adjustment [D_n] to the tariff in each such year, computed as follows:

$$D_n = \left(\frac{K}{Vn\text{-}1 \times 10^6}\right)\left(1 - \frac{I_q}{\frac{1}{(1+Iq)^5}}\right) \quad \text{(Equation C.5)}$$

where

$$J_n = \left(1 + [(I_{n-1} - I_o)/(I_o)]\right) \left(\$50,000,000\right)$$

I_q = the difference between the Index for the quarter in which the Extraordinary Event occurred and 95% of the Index for the same quarter of the preceding year, divided by the Index for the same quarter of the preceding year.

K = Expenditures necessitated by an Extraordinary Event that exceed the sum of J_n and any amounts reasonably recoverable from insurers or third parties, plus imputed interest on advances of repair, replacement or reconstruction funds made after expenditure of, and in excess of, the sum of J_n and said reasonably recoverable amounts at a rate per annum equal to I_q from the date of each such advance until the anniversary of the Effective Date following completion of repairs, replacement or reconstruction.

Provided that no settling owner shall be eligible for an Extraordinary Event Adjustment unless it maintains, in full force and effect, property and casualty insurance on its interest in TAPS that is neither narrower in scope of coverage nor smaller in amount (adjusted for inflation) than that in effect for such owner on January 1, 1982.

C.6 Pumpability Adjustment - Filed tariffs for petroleums from formations other than the Sadlerochit formation may differ from the tariff [T_n] computed pursuant to paragraph C.1 of this Agreement, but any such difference shall be reasonable, non-discriminatory, and computed solely to reflect differences in pumpability.

D. Additional Provisions

D.1 Termination - This Agreement shall terminate on the tenth anniversary of the Effective Date (the "termination date"). It is the intention of the settling parties that this Agreement have no precedential value or effect.

D.2 Litigation Expenses - Within 30 days of submission of the Settlement Agreement to FERC the State shall submit to the settling owners a complete accounting, with such support as may be reasonably required to verify amounts expended, of the costs it has incurred in prosecuting and settling the TAPS rate case since June of 1976, including fees and costs actually paid to attorneys and consultants, and costs incurred for communications, travel, transcripts, duplicating, postage, storage, and delivery (collectively "TAPS litigation expenses"). Within 90 days of the Effective Date, the State shall submit to the settling owners a complete accounting, with such support as may be reasonably required to verify amounts expended, of the State's TAPS litigation expenses through the Effective date and for two months thereafter. Provided,

that the State's average daily TAPS litigation expenses for the period between the last day included in the first accounting and the end of the second month following the Effective Date shall not exceed the State's average daily TAPS litigation expenses for year 0.

Within 30 days of FERC's approval of the Settlement or 30 days of the State's second submission hereunder, whichever occurs later, each settling TAPS owner shall remit to the State its proportional share of the State's total TAPS litigation expenses, as submitted. If the FERC order approving this Agreement is appealed, and as a consequence of such appeal is reversed or vacated (in whole or in substantial part) by a court of competent jurisdiction, then the State shall refund any amounts it has received pursuant to this paragraph within 60 days of the issuance of the court's mandate.

D.3 Refunds - In consideration for the payment of litigation expenses described in paragraph D.1 and the other terms and conditions of this Agreement, the State agrees to withdraw, with prejudice, its claim for a partial refund of the tariffs collected by the settling TAPS owners for shipments prior to the Effective Date. The settling parties agree that neither the State nor any other person shall be required, by virtue of this paragraph, to return any refunds previously paid by any TAPS owner to the State or any other person. It is a

condition of this Agreement that the FERC order approving the Settlement provide that the settling owners shall not be required to refund any portion of the tariffs collected for shipments prior to the Effective Date. Provided, that this paragraph shall not extend to any refund that may become due by virtue of an election of a settling owner under paragraph 3 of the Stipulation and Agreement entered into by the parties to the TAPS rate case on February 11, 1982, ("Exhibit A" hereto). And provided further that this paragraph shall not extend to the rights and responsibilities of the settling parties under the Final Judgment entered in United States v. Atlantic Refining Co., et al., Civil Action No. 14060 (D.D.C. December 23, 1941).

D.4 Phase I Settlement - Each settling party agrees to dismiss its claims in Phase I of the TAPS rate case, without prejudice to its rights to reassert those claims at the termination of the Settlement for the period following said termination.

D.5 Phase II Settlement - The State agrees to withdraw, with prejudice, its cost of construction claims in Phase II of the TAPS rate case. The State further agrees to dismiss its other claims in Phase II of the TAPS rate case, but without prejudice to its rights to reassert those other claims at the termination of the Settlement for the period following said termination. Each settling TAPS owner agrees

to write down, on December 31, 1984, the amount recorded for pipe line construction costs in carrier property accounts 030, 155 of the Uniform Systems of Accounts Prescribed for Oil Pipeline Companies Subject to the Provisions of the Interstate Commerce Act, 18 CFR Part 352, or its successor, by its proportional share of $500 million, and to reflect that writedown in the first Annual Report, Federal Energy Regulatory Commission, Form P it files with the FERC, and equivalent form it files with the APUC, after December 31, 1984, by writing down, by its proportional share of $500 million, the amount recorded in account 030, 155 on Form P Carrier Property Schedule 230 and Form P Depreciable Carrier Property Schedule 231. If this Settlement Agreement is joined by all TAPS owners within 90 days of the Effective Date, each TAPS owner's obligation under this paragraph shall be deemed satisfied if it writes down carrier property accounts 030, 155 by its proportional share of $400 million on December 31, 1984, and reflects this writedown in filings with the FERC and APUC as described above.

D.6 Dismantling, Removal, and Restoration - In accounting for the obligation imposed on it by Stipulation 1.10 Completion of Use in the Agreement and Grant of Right-of-Way for Trans-Alaska Pipeline (January 23, 1974), each settling owner shall, on the termination date of this Agreement, have accrued no less than 1/365th of the amount provided in Schedule A, line 9 of

the TAPS Initial Decision (February 1, 1980) for each day from the date each settling owner commenced accruing removal and restoration charges through the day prior to the termination date.

D.7 Depreciation - In accounting for depreciation during the term of this Agreement, the settling owners agree that they shall abide by the terms, conditions and schedules of the Stipulation and Agreement entered into by the parties to the TAPS rate case on February 11, 1982, ("Exhibit A" hereto).

D.8 Implementation

No later than the next business day following the day that this Agreement is filed with the FERC, each settling owner shall have filed, and used its best efforts to put into immediate effect, a tariff of not more than $5.50 per barrel or its present tariff rate, whichever is less, for shipments of Sadlerochit petroleum through TAPS. Each settling owner shall utilize its best efforts to assure that it puts into effect a tariff that complies with paragraph C.1 of this Agreement for petroleum shipped through TAPS at the earliest possible date, and in no event later than 5 business days, after the Effective Date. Subsequent adjustments shall be made once each year, and shall go into effect for petroleum shipped through TAPS within 60 days of the anniversary of the Effective Date.

If no protests are filed to the Settlement Agreement, this Agreement shall be null and void and of no further force and effect unless the Commission approves the Agreement in an order acceptable to all of the settling parties within 60 days of the date on which the Agreement is filed with the FERC. If any protests are filed to the Agreement, the Agreement shall be null and void and of no further force and effect unless the Commission approves the Agreement in an order acceptable to all of the settling parties within 90 days after the Settlement is filed with the Commission, or on or before January 1, 1983, whichever first occurs. The settling parties agree that an order will not be deemed acceptable unless it dismisses each settling owner from Phases I and II of the TAPS rate case. If an FERC order approving this Agreement is appealed, and as a consequence of such appeal is reversed or vacated (in whole or in substantial part) by a court of competent jurisdiction, then upon issuance of the court's mandate this Agreement shall become null and void and of no further force and effect.

D.9 Index Substitution - In the event that the Bureau of Economic Analysis of the United States Department of Commerce, or any successor thereto, ceases to publish the Index or substantially changes the publication frequency, composition or construction of the Index, the settling parties shall promptly agree upon a substitute index for use in the implementation of this Agreement.

D.10 Enforceability - The settling parties agree that if, at any time during the term of this Agreement, TAPS tariffs are no longer subject to Federal or state regulation, this Agreement shall be deemed a binding contract among them. It shall in that event be governed by and construed in accordance with the law of the State of Alaska, and shall be enforceable in an action for specific performance brought in Alaska Superior Court (or any successor thereto) in Anchorage, Alaska. The settling parties hereby consent to the jurisdiction of said court.

D.11 Extraordinary Changes in Throughput - This Agreement shall become null and void and of no further force and effect if annual throughput falls below 219 million barrels during any twelve month period for any reason other than the occurrence of an Extraordinary Event, or exceeds 730 million barrels during any twelve month period because of additions of pipe or pumping equipment to the System beyond that contemplated by the original TAPS design, i.e. one 48 inch pipeline and 12 pump stations with 3 pumps operating at each station.

D.12 Entire Agreement - This Agreement embodies the entire agreement and understanding between the settling parties and supersedes all prior agreements and understandings relating to the subject matter hereof not specifically referred to herein.

D.13 No Waiver - No failure to exercise, and no delay in exercising any right, power or remedy hereunder or under any document delivered pursuant hereto shall impair any right, power or remedy which a settling party may have, nor shall any such delay be construed to be a waiver of any of such rights, powers or remedies, or an acquiescence in any breach or default under this Agreement of any document delivered pursuant hereto, nor shall any waiver of any breach or default of a settling party hereunder be deemed a waiver of any default or breach subsequently occurring. The rights and remedies herein specified are cumulative and not exclusive of any rights or remedies which a settling party would otherwise have.

D.14 Notices. All notices, requests, consents and demands hereunder shall be effective when duly deposited in the mails, certified mail, return receipt requested, or transmitted by telex, addressed to the respective party at the address set forth below.

State of Alaska: Attorney General
State of Alaska
Department of Law
Pouch K, State Capitol
Juneau, Alaska 99811

BP Pipelines Inc.: President
BP Pipelines Inc.
620 Fifth Avenue
New York, NY 10020

Any of the above may change such address by notice in writing given to the other parties to this Agreement.

D.15 Successors and Assigns - This Agreement shall be binding upon and inure to the benefit of the settling parties and their respective successors and assigns.

D.16 Counterparts - This Agreement may be executed in any number of counterparts, all of which taken together shall constitute one agreement, and any settling party may execute this Agreement by signing any such counterpart.

D.17 Amendment and Waiver - Neither this Agreement nor any provisions hereof may be changed, waived, discharged or terminated orally, but only by an instrument in writing signed by the party against whom enforcement of the change, waiver, discharge or termination is sought.

MEMORANDUM State of Alaska

CONFIDENTIAL - ADVICE OF COUNSEL

TO: To The File

DATE: March 1, 1982

FILE NO:

TELEPHONE NO:

FROM: Wilson L. Condon
Attorney General

SUBJECT: Status Report

TAPS STATUS REPORT

1. Breakdown of Expenditures.

The TAPS litigation has been staggered into 2 phases by the Federal Energy Regulatory Commission (FERC). Phase I addressed the general methodology question: What formula should be used to set tariff rates for oil pipelines in general and for TAPS in particular. Phase II will address the specific questions of what actual dollar amounts should be plugged into the formula developed in Phase I.

The biggest single issue in Phase II focuses on the level of wasteful or imprudent expenditures Alyeska ran up in the construction of TAPS. This has become known as the "cost of construction" case. The remaining issues in Phase II have been clustered together and have become known as the "cost of service" case.

The following table breaks down the actual and projected expenditures associated with each Phase of the case.

TAPS Expenditures -- Historical and Projected
(Rounded to nearest thousand)
(000 omitted)

	Phase I (including settlement efforts and APC appeal)	Phase II		Department of Law Administrative
		Cost of Construction	Cost of Service	
Actual Expenditures to date (FY 77 - to mid FY 82)	3,916	12,175	1,275	300
Projected Expenditures for balance of litigation effort (mid-FY 82 to end of FY 87)	460	11,920	3,070	675
Totals	4,376	24,095	4,345	975

Overall grand total of actual plus projected expenditures = $33,791,000.

2. What remains to be done.

Phase I. The administrative record is complete. The Administrative Law Judge adopted almost all of the position advocated by the State. This decision now must be defended in appeal proceedings first before the FERC and then before the courts.

Phase II.

Cost of Construction. All pre-trial work has been substantially completed. Cross-examination of witnesses commenced on 2-24-82. When cross-examination of our witnesses is completed, we will have to cross-examine the owner companies' witnesses and present our rebuttal case. Next, briefs will have to be submitted to the FERC. Lastly, appellate work will probably be required, either to defend our victories or to reverse any unfavorable decision.

Cross-examination, at least of our witnesses, is expected to take an enormous amount of time. The owner companies have notified us that they expect to cross-examine our first witness alone for at least 8 weeks. We have a total of 30 witnesses. In recognition of the time and expense of the cross-examination hearings, the Phase II budgets reflect nearly as much money to complete the cost of construction and cost of service cases as was required to do all of the case preparation.

Cost of Service. Pre-trial work is nearly complete. Final drafts of written direct testimonies and related exhibits are in production and will be filed on 3-12-82. What will then remain is cross-examination of our witnesses and their witnesses, presentation of our rebuttal case, briefing, and whatever appellate work may be required.

3. Options in lieu of full-scale litigation with outside counsel.

As alternatives to continued full-scale litigation with outside counsel, the Department has considered:

(1) Settlement;

(2) Reduction in scope of case; and

(3) Increased involvement of Attorney General's office.

Settlement. General settlement discussions between the State and representatives of the four major TAPS owners have been going on for nearly a year. At this point settlement appears more likely than ever before, but still less than a 50% probability. Within the past month, ARCO, Exxon and Sohio rejected the State's most recent settlement proposal. To date they have not made any counter-offers of their own. House Counsel for B.P. has indicated his willingness to recommend to his management settling at a 1982 tariff of $4.625, 40% of which would escalate at the rate of inflation for the next 10 years. It is presently unclear whether such a proposal would be acceptable to the Legislature, assuming it might be acceptable to the Governor. It is also unclear what effect a separate settlement with B.P. would have on continued litigation with the others.

Reduction In Scope of Case. The State would not benefit enough to justify abandoning either or both Phase II cases. On the plus side, the State could save a projected $12 million by abandoning the cost of construction case and/or a projected $3 million by abandoning the cost of service case. On the minus side, this would mean throwing away $12.2 million that has been spent to prepare the cost of construction case and/or $1.3 million that has been spent to prepare the cost of service case.

The State would also lose the rate-reducing value of either or both cases. The cost of construction case has 4 times the dollars-and-cents potential of the cost of service case, but the cost of service case raises more traditional issues that have a greater likelihood of being fully successful. Consequently the return on each dollar of litigation investment is about the same for each case.

It may be possible to negotiate a partial settlement on some or all of the issues raised in the cost of construction and cost of service cases. However, voluntarily scaling down now would seriously impair the State's negotiating position in any such settlement discussions.

If the legislature is unwilling to fund full-scale efforts for fiscal 1983, a more cost-effective alternative to terminating either Phase II case would be to fund full-scale efforts for the first three quarters of the fiscal year. Funding for the last quarter could then be reserved pending an examination of progress achieved in settlement negotiations and/or the hearings through 3-31-83.

Increased Involvement of Attorney General's Office. The State would probably not save enough to justify increasing the involvement of the AGO. The logical areas for the AGO to assume responsibility are briefing and appellate work. Allowing for the huge size of the administrative record, the Department of Law would need to be increased by 3 to 5 attorneys plus related secretarial, clerical and administrative personnel. Since most if not all of the appellate work requires a Washington, D.C. presence, any special TAPS section should be officed in Washington.

There is certainly room for savings using in-house personnel. Current budget projections estimate $4.8 million as the cost of briefing and appeal using outside counsel, who presently bill at an average rate of $125 per hour. AGO attorneys cost far less per hour and typically perform work of a quality equal to the best the private bar can offer.

But the attorneys who built the TAPS trial record should be able to handle the briefing and appellate work with greater speed and authority than attorneys who come to the record cold. They are already located in Washington D.C. with facilities and support personnel in place. And they can readily and easily be terminated if we settle during the appellate process.

JAY S. HAMMOND
GOVERNOR

STATE OF ALASKA
OFFICE OF THE GOVERNOR
JUNEAU

January 28, 1982

The Honorable Wilson L. Condon
Attorney General
State of Alaska
Pouch K
Juneau, AK 99811

Dear Wilson:

This letter follows upon our conference of Monday afternoon, January 25, 1982, during which we discussed the current status of your ongoing TAPS settlement discussions with B.P. Pipeline Company. I understand from you that the other major TAPS owner companies -- ARCO, Exxon, Sohio -- have not shown any interest in negotiating on any basis which might be acceptable to the State. Accordingly, if negotiation efforts are to continue, for the time being at least they will have to proceed only with B.P.

You have reported B.P.'s counter-proposal of a 1982 tariff of $4.75 per barrel, 40 percent of which would escalate with the rate of inflation. I understand from you that, under an assumption of 8 percent annual inflation continuing over the next 10 years, this counter-proposal is the equivalent of an average tariff rate of $3.90 expressed in 1982 dollars. I further understand that this figure is somewhat above the $3.70 target I tentatively set for you in my authorization letter of December 9, 1981, but that it reflects major concessions from B.P.

In order that settlement discussions may continue, you have asked for my authorization to make a counter-offer to B.P. and for some additional room within which to negotiate. Based on your recommendations, which have been seconded by my advisors and by Commissioner Williams, I authorize you to make the following counter-offer to B.P.: a 1982 tariff of $4.35 per barrel, 40 percent of which would escalate with the rate of inflation. I understand that, keyed to the 8 percent inflation assumption, this is the equivalent of a 10-year

average tariff rate of $3.58 expressed in 1982 dollars. You are further authorized to represent my willingness to recommend to the Legislature a settlement as high as $4.45 per barrel for 1982, 40 percent of which would escalate with the rate of inflation. This I understand to be the 10-year average equivalent of $3.66.

As before, I reserve my full rights, powers and intent to confer with State legislative leaders and my advisors within the Executive Branch and the Governor's office before finally committing to any settlement proposal. Although I may have the power to irrevocably commit the State to a settlement figure on my own authority, it is my present intent and desire not to do so until I have conferred with legislative leadership and have at least received their reactions to any settlement proposal that is both acceptable to B.P. as well as provisionally acceptable to me.

Thank you for another informative briefing.

Sincerely,

Jay S. Hammond
Governor

JAY S. HAMMOND
GOVERNOR

STATE OF ALASKA
OFFICE OF THE GOVERNOR
JUNEAU

December 9, 1981

RECEIVED
Department of Law
Juneau, Alaska
DEC 16 1981
AM 7,8,9,10,11,12,1,2,3,4,5,6 PM

Wilson L. Condon
Attorney General
State of Alaska
Pouch K
Juneau, AK 99811

Dear Wilson:

This letter follows upon our conference of Tuesday afternoon, December 8, 1981, during which we discussed the current status of the TAPS litigation before the Federal Energy Regulatory Commission and your recommendations regarding our entering settlement negotiations with the pipeline owner companies. In preparation for that conference my staff and I have read your comprehensive 92 page Briefing Paper dated November 23, 1981, including the supplemental tables attached to it.

Based on the considerations you have discussed in the Briefing Paper and your judgments (shown on the tables) as to the likely outcomes of pursuing the administrative process to its conclusion, I am in agreement with you and expressions from the legislature that the State would be well-advised to settle the TAPS litigation if it can do so on an advantageous basis. Accordingly, I hereby give you the following authority to pursue negotiations with the pipeline owner companies and any other parties to the proceedings:

As per the recommendation of yourself and Commissioners Katz and Williams, you are expressly authorized to advance a settlement proposal to the pipeline companies of a $4.11 tariff rate commencing on January 1, 1982, and continuing for the next 10 years until December 31, 1991. Furthermore, 20% of this $4.11 figure would be allowed to escalate year-by-year at the actually experienced rate of inflation. I understand from you that, under an assumption of 8% annual inflation continuing over the next 10 years, this authorized settlement offer is the equivalent of an average tariff rate of $3.17 expressed in 1982 dollars.

I also understand that you do not anticipate that this offer will be acceptable to the pipeline companies, but rather you see it as merely a step to move the negotiating process along. After you make this $4.11 offer any further firm

offers or counter offers you may wish to make must be made with my expressed approval. Based on your written presentation and our discussions to date, I am tentatively setting as your negotiating goal a 10 year settlement not to exceed the equivalent of an average rate of $3.70 expressed in 1982 dollars and premised on an 8% inflation assumption. You understand that my expression of this negotiating goal is not a present commitment by me to accept such a figure as a settlement in the event the companies should be amenable to such a figure. I reserve my full rights, powers and intent to confer with State legislative leaders and my advisers within the Executive Branch and the Governor's Office before committing to any final settlement proposal other than the one specifically authorized by this letter.

Thank you for the detailed briefing you have given me, and good luck with the ensuing negotiations.

Sincerely,

Jay S. Hammond
Governor