Analysis and Comment on March 5 Tariff Hearing:

State House Resources Committee Finds More to TAPS Ratemaking Issues than Meets the Eye

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Apart from the state's confirmation that hundreds of millions of dollars in potential refunds to the state ride on the outcome of challenges to the 2005 and 2006 Trans-Alaska Pipeline System (TAPS) tariffs at the Federal Energy Regulatory Commission (FERC), the paucity of information the administration provided the Legislature was the most unusual aspect of the House Resources Committee hearing in Juneau Monday, March 5. ***(1)***

Speaking from Anchorage, Jon Iversen, Director of the Department of Revenue's Tax Division, estimated that the state has more than $800 million riding on the outcome of the tariff case for the years 2005 through 2008. To this writer's knowledge, this was the state's first attempt to present a comprehensive public reckoning of the potential revenue at stake in current litigation over TAPS tariffs. Hearing long strings of numbers by teleconference about an unfamiliar and complicated subject is not the best way to evaluate a situation for public policy. When Rep. Paul Seaton asked if the director could give the committee anything in writing to look at, Iverson responded apologetically that his division had just started working on the issue that morning and had nothing to submit at that time. Later that afternoon, the Revenue Department official sent a one-page set of numbers down to Juneau showing the assumptions and calculations that summed, with interest, to a possible total of $818 million for the state. But by the time this information was available to legislators to review and digest, the hearing was over. In effect, legislators had been tossed a bone to gnaw on, but by the time they received it, chewing time had come and gone.

But what was most extraordinary about the March 5 hearing was what the administration did not tell legislators who convened to learn about this important case. To be sure, it appeared that the House Resources Committee had little idea of the inherent complexity of the TAPS tariff issues when legislators decided to hold hearings on a strongly worded FERC staff brief that castigated the TAPS owners. This commentary presents highlights of the hearing and adds information from the public record that may help the reader evaluate the way that the Department of Law handles its case management responsibilities. By its parsimonious presentation and responses, the Department of Law provided the committee an opportunity to experience first-hand the kind of problems their predecessors faced in their occasional forays into this arcane but important subject.

As the curtain rose on last Monday's hearing legislators found themselves in a strange theatre where even the best seat in the house offered a poor view of the stage. Attorneys working on the issue told the committee they couldn't talk about the details of the case because at this moment they were "deep into the details" of the litigation over TAPS tariff refunds for the years 2005 and 2006. **Exit stage left: All discussion of substantive information about that narrow complaint and any information about important peripheral and background issues outside that specific case but relevant to understanding the significance of the numbers on a sheet of paper that the legislators had not yet seen.**

The committee never got to the substance of the FERC staff brief that had piqued legislators' curiosity. There were seven briefs from seven parties, each with different factual and legal arguments, based on their interests in the outcome. For example, the RCA attorney explained that the quasi-independent state regulatory

agency's sole interest in this federal case was to preserve the state's right to set tariffs for its own in-state pipelines. ***Exit stage right: Information about the significance of the dollars at issue in the TAPS tariff - the very issues, so important to North Slope development, on which the RCA had labored for over a decade.***

Enter Stephen Brose, representing the TAPS owners, by teleconference from Washington, DC. Probably few watching had ever heard of Mr. Brose, but if any individual in that hearing can be said to have full understanding of the broad directions and the possibilities for billion-dollar side trips on the way to this theater, it would be this man. Just as surely as the fact of the $800 million at issue, the presence of Mr. Brose indicated keen TAPS owner interest in this hearing. Working carefully to ensure the best focus for his client, Mr. Brose described the FERC staff brief, which had torn up the carefully constructed fabric of the TAPS owners' case, as "the opinions of one lawyer." Senator Gene Therriault suggested that the FERC staff was not only a veteran player, but perhaps the only actor in this obscure drama without a dog in the fight. It remained for Andarko and Tesoro (A/T) attorney Robin Brena to point out that the FERC brief was in fact the staff product of an agency with more than a dozen lawyers. Lacking background information on TAPS tariffs, it was proving difficult for the legislators to find the bone, let alone get to the meat on it.

One-half hour into the hearing, Juneau-based Assistant Attorney General Philip Reeves was invited to the table, where he introduced himself as the state's TAPS tariff case manager. Mr. Reeves, too, had a narrow focus. As he explained it, the state's sole purpose in this case was to ensure that TAPS tariffs were not discriminatory. Then he plunged into the arcane world of pipeline ratemaking, where a shipper's rights to equal access requires that different tariffs can be charged if the owner's costs can be justified and if the different tariffs do not unfairly penalize certain shippers. The state's complicated and abstract legal argument at FERC, as presented by Mr. Reeves, is that the existence of a large gap between the FERC tariff and the RCA tariff discriminates against interstate shippers, who are paying a higher tariff for the same service under the methodology the Department of Law and the TAPS owners had established in the 1985 TAPS settlement agreement. To correct this problem, the state argues, if the shippers and the RCA prevails in securing lower tariffs for in-state shippers under traditional rate-making calculations, then the appropriate remedy at FERC is for the commission to reduce TSM TAPS tariffs under its purview produced and sanctioned by TSM to a tariff level within what ratemakers call a "zone of reasonableness." **Exit (by any route available): any indication by the Department of Law to the elected representatives of its client, the state, that the state understands or believes the TAPS owners had been overcharging, to the detriment of independent producers and the state treasury. *(2)***

In this play with no program notes, most in the hearing room and on-line (except the lawyers involved in the case) probably were hoping that the person next to them understood the highly technical arguments better than they did. At this point it will be useful to recall two pieces of background information, unstated at the hearing, will be recalled:

- three transnational oil companies who own more than 95% of TAPS control a similar share of North Slope production; and
- it is generally understood, from the U.S. Supreme Court down, that the state stand in the shoes of the TAPS shipper by virtue of its royalty and tax interests. ***(3)***

It was evident that Mr. Reeves did not come to the hearing to discuss how the TAPS tariff was developed, or how it came to be so much higher than the $1.96 per barrel TAPS tariff set by the RCA in 2002. He said that he would leave it to shippers Anadarko and Tesoro, who were not parties to the 1985 agreement that produced the TAPS Settlement Methodology (TSM), to make their own arguments regarding the tariff rates produced under that methodology. The state's case manager went to such great lengths to differentiate the state's position from that of Anadarko and Tesoro that a momentarily confused Resources Committee Chairman Carl Gatto asked, "Then the state would not ask for refunds from past charges?" It seems highly unlikely that the chairman was the only person in the room who was confused curious course through the tortuous tariff thickets steered by the Department of Law.

A/T's Brena was happy to provide background information regarding alleged tariff overcharges in the TSM and their impact. Brena presented a packet of information with tariff information to help legislators understand how the TAPS tariff was constructed and how much money the TAPS owners were taking in, compared to how much they spent; why how his clients felt the state's 1985 deal with the TAPS owners had adversely affected public policy. According to the A/T lawyer, between 1977 and 2004 the TAPS owners had taken in about $60 billion but had only spent $25 billion in construction and operations, leaving $35 billion for taxes and profits. By Brena's reckoning, that was $14 to $18 billion more than standard ratemaking would have allowed (the portion of that excess collected between 2005 and 2008 was the source of the ADOR refund estimate discussed above). The A/T attorney told them that the TAPS owners had spent more than $20 million on this case to defend their higher tariffs. He also provided the committee with copies of the electronically filed case briefs - something that might have helped legislators identify the actors in the play they were watching unfold, had they received that information in time.

Whether it was due to the Department of Law's reticence or A/T attorney Brena's ability to summarize the result of his decades of experience litigating TAPS tariff issues, Rep. Gatto asked Brena - not the state's case manager - whether the Internal Revenue Service had ever sought additional income tax payment from the pipeline owners on tarrif-related issues. A/T's Brena responded that the he did not know of any. He noted, however, that the TAPS owners collected the anticipated cost of the eventual dismantling and removal of the pipeline and restoration of the 800-mile TAPS corridor (DR&R) on an accelerated schedule. Those collections included income tax payments. In 1988, he told the committee, the TAPS owners obtained permission from the IRS allowing them to take an income tax deduction for those payments, but the terms of the 1985 TAPS settlement agreement prevented return of past tariff overcollections based on those assumed payments, or the appropriate reduction of future payments. Reduction of the federal corporate income tax rate from 46% to 35% in 1986 increased the amounts ostensibly collected for income taxes but retained by the TAPS owners. According to Brena, the result was an unintended $800 million windfall for the TAPS owners. the windfall to the TAPS owners.

The following information did not come out at the hearing: On April 13, 2000, the state House Oil & Gas Committee held a hearing to learn more about it. At that hearing to learn more about the 1988 IRS tax ruling. At that hearing, the Department of Law promised to get to the bottom of that issue and report back to the committee. The Department of Law later sent a follow-up letter that added little new information, but to the best of this writer's knowledge there has been no effort to recoup the windfall to the TAPS owners from this overcollection of DR&R funds.

The March 5 hearing had been going for nearly 90 minutes and was nearing its end when the Department of Revenue's Iversen took the stage to provide the estimate that refunds for the years 2005 through 2008 could provide the state treasury with as much as $818 million in additional revenue. The inclusion of the year 2008 further blurred an already complicated situation by introducing a future year, for which tariff and throughput were unknown, when the broad outlines for the first three years in his four-year grouping were quite well defined. Nevertheless, when Mr. Iversen described the sums at issue for the state in refunds for just the current four years, it began to come clear why the TAPS owners dispatched Mr. Brose, one of their best legal guns, to participate in the hearing, and why the TAPS owners had spent $20 million on this case. Mr. Iversen's numbers for 2005 through 2007 were roughly similar to those in this writer's Feb. 28 report; the differences between Iversen's estimates, prepared that day, and earlier figures offered to the press by the Department of Revenue in January, did not come up. ***(4)***

To listen to the state case manager's presentation, one might conclude that the state's possible refunds were nothing more than artifact of the difference between the RCA's determination that a "just and reasonable" TAPS tariff was $1.96 per barrel, while the recent TSM tariff was more than twice that. During the March 5 hearing, Mr. Reeves carefully steered discussion away from the reasons for the tariff differences. A/T attorney Brena told legislators that the A/T case was based on gross overcharges by the TAPS owners. But Mr. Reeves took great pains to separate the state case from that of the shippers and stated that rate discrimination - an argument that some believe is fatally flawed - was the sole basis of the state's case. As Mr. Reeves tip-toed around the case, TAPS owner attorney Mr. Brose assured the legislators the TAPS owners vigorously disagreed and would strongly defend their higher tariff. By virtue of this peculiar presentation, the state

seemed to be using an abstract ratemaking principle, a set of tenuous arguments and the mysterious difference between the RCA and TSM tariffs to secure a better deal for the state.

At the March 5 hearing, legislators were not told that every one of the state's initial protests of TSM tariffs at FERC in the last four years has included a challenge to the inclusion of specific items in the tariff. For example, one element of the state's 2006 tariff protest was the owners' attempt to recover in the TSM (interstate) tariff the costs of fighting the reduced intrastate rates. And in prior years the state had occasionally challenged items in the TSM tariff, usually for much smaller dollar amounts than the big-ticket items that produced the extraordinary gain to the TAPS owners and loss to shippers alleged by Tesoro and Anadarko. ***(5)*** And the state's filed brief (provided to the committee by A/T, not the state) suggests that the $1.96 per barrel RCA tariff "contributes at least its 'fair share' of earnings required to meet the maintenance and operating costs on TAPS and to yield a fair return on the property." ***(6)***

Occasionally during the hearing legislators tried to learn more about the sharply worded FERC staff briefing that had initially grabbed their attention, but they didn't get very far. Near the end of the hearing, Rep. David Guttenberg, asked this important question, based on his reading of the FERC staff brief: Could charges reduced on the in-state tariff be put back into the tariff on the interstate side? If the FERC staff was correct and if this provision of the TSM were allowed to stand, that poison pill could nullify any state gains from a reduced intrastate tariff. Mr. Iverson deferred to the Department of Law's Reeves, the case manager.

Silence on the teleconference line. Then a voice in the hearing room said, "He's gone."

The state's case manager had left the hearing - reportedly to catch a plane - and the department had not arranged for a backstop to field questions about a case estimated to be worth up to $800 million to the state. In the Department of Law's absence, the question bounced back to the Revenue Department folks in Anchorage. They repeated that they did not know the answer and would have to defer to Mr. Reeves.

Had the state's case manager been present, legislators might have learned that the Department of Law had in fact challenged the TAPS owners' attempts to recoup revenue reduced in the 2003 tariff under the RCA order by increasing the TSM-based interstate tariffs by a similar amount in the 2004 tariff. ***(7)*** From a December 2004 Department of Law press release, it appears that the state may have abandoned its 2004 tariff challenges in an effort to smooth the way for renegotiating the entire TSM settlement. Those negotiations were unsuccessful and the state launched a new challenge to the 2005 tariffs, which contained a 28 per cent increase over the 2004 tariff. ***(8)***

By the time the curtain fell, the March 5 hearing had raised many more questions about this important case than it answered. However, as the narrative presented here suggests, the significance of some of the questions that emerged from the March 5 hearing could only be apprehended with additional information the committee was not given and was unable to develop on its own. For example:

- The RCA order reducing intrastate rates was issued in 2002, but the significant state revenue riding on the difference between the RCA and TSM tariffs begins with the year 2005. What happened to the case for refunds for the years 2003 and 2004?
- Although each of the four state initial protests of TSM tariffs at FERC since 2004 include challenges to specific tariff items, the state's 2005 and 2006 protest currently before FERC appears to have been narrowed to the single abstract issue of rate discrimination - an argument that some believe may have a fatal defect. What happened to the specific tariff protest items that are not part of the state's brief on the 2005 and 2006 tariffs? ***(9)***

Like the question Rep. Guttenberg asked near the end of the hearing, these questions are important, but they are by no means the only issues pertaining to TAPS tariffs that deserve consideration. The Department of Law, despite its track record on this issue, may have credible answers to some of these questions. (Whether or not potential shippers and objective observers would agree with the Department of Law's answers is

another matter.) In any case, it appears from the March 5 hearing record that the Department of Law's lack of input to the Legislature helped keep this kind of important policy question out of the spotlight. This troubling circumstance leads to a pair of broader questions:

- As noted in this writer's Feb. 28 report and comment on that report (both written prior to the Mar. 5 hearing), between 1997 and 2004 the state argued on the side of the TAPS owners and in opposition to Tesoro's RCA challenge, to the detriment of the state's interests in lower TAPS tariffs. During this eight-year period, could the Department of Law have better served state interests by seeking legal ways to challenge TSM tariffs in a more effective and timely manner?
- When the state's elected legislative representatives hold an oversight hearing, do they have the right to expect better cooperation and more forthcoming provision of information than they received from the Department of Law March 5?

Like all good theatre, the March 5 hearing on TAPS tariff issues may have deeper significance than the events that made it to the stage. It may be tempting to think that the Department of Law's failure at the March 5 hearing to provide substantive information that would have helped legislators explore this complicated issue was a momentary aberration from the Palin Administration's stated intention to establish a more open platform for dealing with petroleum development issues. On the other hand, the documentary record on TAPS tariff issues during the past three decades suggests that the state's tariff management system has been broken, with the result that the state's TAPS tariff policies often fail to serve the state interests in securing its fair share of revenue and promoting competition on the North Slope. The difficulties the House Resources Committee experienced March 5 provide the 25th Alaska State Legislature with its own, first-hand opportunity to understand why past Legislatures were unable to get a clear focus on TAPS issues, even as the evidence steadily mounted that the Department of Law was headed in the wrong direction. In short, when the March 5 hearing is viewed in historical context, it is possible that the House Resources Committee has run into the ugly signs of an historical tariff management problem that festers within the Department of Law.

The Legislature should follow the House Resource Committee's lead by continuing to explore the state's management of TAPS tariff issues aggressively for three compelling reasons:

- 1. Excess TAPS tariffs inhibit independent development on the North Slope - a serious and ironic problem when the state is offering inducements to potential petroleum explorers in hopes that they will come north and find the additional gas necessary to ensure the economic viability of a natural gas pipeline from the North Slope.
- 2. State revenue from North Slope natural gas development depends heavily on the appropriate design and structure of the natural gas pipeline tariff. The a challenge perhaps even more daunting than that of the oil pipeline tariff.
- 3. Under the 1985 TAPS settlement agreement, the period for renegotiation of TAPS tariff terms quietly began January 1 of this year. In view of the failed TSM negotiations in 2004, the estimated historical loss to the state treasury of more than $3.0 billion due to excess TAPS tariffs ($4.5 billion in 2007 dollars) and a current estimated loss of $404 per minute (more than half a million dollars per day), this is not a problem the state can afford to bungle or continue to talk to death.

Endnotes: March 5 Hearing Analysis and Comment

(1) The March 5 hearing can be accessed on KTOO, Gavel-to-Gavel (http://www.ktoo.org/gavel/stream.cfm, "audio archives").

(2) During the week of March 5 attempts to reach Mr. Reeves at his office were unsuccessful and phone messages were not returned.

(3) *Trans Alaska Pipeline Rate Cases (Mobil Alaska Pipeline Company, et al. v. United States, et al.)*, 1978 (436 US 631 [56 L Ed 2d 591]).

(4) For discussion of the difference between this analyst's pre-hearing figures and an estimate of the 2007 tariff effects ADOR offered to the press in January, see discussion in the conclusions to this writer's March 2, 2007 commentary, above.

(5) Federal Energy Regulatory Commission, "Order Accepting and Suspending Tariffs, Subject to Refund, and Establishing Hearing and Consolidating Hearings," 13 FERC Par. 61,322, Dec. 29, 2005. Additional examples are discussed in the author's report, *The Big Squeeze: TAPS and the Departure of Major Oil Companies Who Found Oil on Alaska's North Slope* (Oilwatch Alaska), 1997, pp. 5.1 - 5.9. The TAPS owners' attempt to charge the intrastate tariff litigation costs to the interstate tariff is mentioned in various public documents. *(See material in Footnote [9], added on April 18, 2007.)*

(6) State of Alaska, "Initial Post-Hearing Brief of the State of Alaska" (FERC Docket No. ISO5-82-002, etc.), Feb. 16, 2007, p. 86.

(7) State of Alaska, "Protest, Complaint and Petition by the State of Alaska for Investigation into the Proposed 2004 TAPS Tariffs and Intervention in Any Subsequent Proceedings" (Federal Energy Regulatory Commission, Docket No. ISO4-98-000, etc.), Dec. 11, 2003.

(8) For additional information on the state's 2004 tariff protest, see footnote 15 of this writer's Feb. 28, 2004 report and remarks in the commentary, above.

(9) A major state protest item that did not appear in the state's Feb. 16, 2007 brief on 2005 and 2006 tariffs and was not discussed in Juneau March 5 concerns alleged tariff overcharges for the TAPS Strategic Reconfiguration (SR) program. Originally estimated to cost $250 million, at last report the TAPS owners had spent more than twice that amount on the SR program. According to the state's 2007 protest, those overcharges were the result of imprudent decision-making, inadequate design and incorrect cost assumptions, resulting in cost overruns that should be excluded from the tariff (State of Alaska, Protest and Petition for Investigation into the Proposed 2007 TAPS Tariffs bv the State of Alaska and Intervention in These and Any Subsequent Related Proceedings, Dec. 13, 2006, pp. 13-19). According to press reports , FERC separated SR from other parts of the tariff case in 2006, but now the parties are considering how and whether to reintegrate the various tariff issues. (Rose Ragsdale, "End in sight for massive TAPS pipeline upgrade: Owners reveal completion date for Strategic Reconfiguration Program at Alyeska Pipeline Service Co. to federal regulators," Petroleum News, April 15, 2007, p. 4). The state did not fare well when major issues such as initial cost overrun claims and DR&R payments were separated from general tariff deliberations during the early 1980s. Most initial cost overrun charges were dropped in the 1985 settlement, while DR&R issues were never fully considered after their initial separation. *(This footnote was added April 18, 2007.)*

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