

State Ownership of TAPS: Why It Should Be Considered and How It Would Work

A Report to the Alaska Forum for Environmental Responsibility and Oilwatch Alaska

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April 9, 1999

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Introduction

This report gathers information from a variety of studies relating to Trans-Alaska pipeline System (TAPS) tariff issues to fulfill two basic purposes: (1) To help concerned citizens and policy makers understand the problems posed by centralized control of the Trans-Alaska Pipeline System (TAPS) by the major North Slope producers; and (2) To make the case for Owner divestiture and State purchase of TAPS as conditions of approval for the ARCO-BP merger.

The first part of this report discusses the proposed ARCO-BP merger in the context of recent developments on the North Slope and the importance of the Trans-Alaska Pipeline (TAPS) to that development. The second part makes the case for purchase of TAPS as possible solution to some of the major problems identified in this report that would be exacerbated by the ARCO-BP merger.(1) The conclusion summarizes the benefits of State take-over and operation of TAPS.

Part I: The Problem

A. The ARCO-BP Merger and Recent Developments on Alaska's North Slope

In its 1996 final report, the Governor's Oil and Gas Policy Council worried that "over 95% of non-royalty oil is owned by three major integrated oil companies (ARCO, BP and Exxon). Two of these companies operate all of the North Slope fields." The Council believed that "having more oil industry participants would be advantageous for the State," and that "Alaska would benefit from more oil and gas players - large, medium and small."(2)

Between 1991 and 1997, six major oil companies left the North Slope; five of them turned over North Slope leases with discoveries capable of production in paying quantities to ARCO and BP. This pattern suggested the possibility that the major TAPS Owners - ARCO, BP and Exxon - might be using the pipeline to drive out their competitors. During this period, another North Slope producer sold its production interests to a smaller company, Forcenergy. Exacerbated by an extended period of low oil prices in 1998 and the first two months of 1999, consolidation in Alaska's oil patch has continued. ARCO took over Union Texas; BP bought Amoco, a major U.S. producer with minor production interests at Endicott; Exxon and Mobil announced their plans to form the world's largest oil company; low oil prices recently pushed an over-extended Forcenergy into bankruptcy. If Forcenergy cannot emerge from bankruptcy as a viable company, the list of players on the North Slope will be narrowed still further. (3)

The result of this stunning consolidation will be a corporate powerhouse capable of determining almost single-handedly the future of Alaska's most important revenue-generating industry. With ARCO's interests subordinated to those of BP by the proposed merger, some observers believe that Exxon - at present the third major North Slope producer as ARCO's silent partner at Prudhoe Bay - might decide to

sell out and leave Alaska. Would any other company be willing to buy Exxon's interest in the North Slope? It has proven difficult for the State to regulate the North Slope effectively with just three major producers; the task would become virtually impossible if the field is narrowed still more.

Consider the power of the BP-ARCO combine to dictate its own economic terms: If BP-ARCO disagrees with the State's position on a fiscal matter or simply wants a greater share of the revenue from a new field, the proposed new international oil giant could threaten to divert its capital to projects elsewhere around the globe.

What environmental stipulations will be attached to new projects, necessary repairs, equipment upgrades and ongoing maintenance for the aging pipeline? What about double-hulled tankers, required by the Oil Pollution Act of 1990 under an incomprehensibly slow schedule? If the State asks BP-ARCO to spend more on these and other environmental amenities, the new behemoth might respond by directing its dollars to investment in places with less stringent environmental standards.

From industry jobs to development of North Slope natural gas, Alaskans will be directly affected by the decisions of one company. Because the new giant would be headed by directors based in London, the proposed merger also raises significant national security concerns. Apart from Alaska's interests, should ownership of one-fifth of the nation's domestic oil production and the land link to that production province be controlled by a foreign corporation?

Although North Slope production is in decline and oil prices dipped to historic lows during 1998, the economic stakes in the North Slope are extraordinarily high for all Alaskans. When I examined North Slope profitability last year, I discovered that during the 22 years since the North Slope and the pipeline operations began operating, those facilities have generated greater profits than any corporation in the nation, save one: Exxon itself. The environmental stakes are high, too. The three companies that reaped the lion's share of this bonanza also indulged in unnecessary and unwise cost-cutting, thereby delivering the worst oil spill in this nation's history. The industry was aided and abetted by lax oversight on the part of the State and Federal governments, who were also major beneficiaries of the money.(4)

B. Pipeline Regulation, the 1985 TAPS Tariff Agreement and Antitrust Issues

A key aspect of any challenge to the ARCO-BP merger is likely to be the control by North Slope producers of TAPS. Historically, oil pipelines have been regulated to prevent pipeline owners from discriminating against non-owners, thereby creating a barrier preventing market entry by non-owners of the pipeline. In 1977, the newly-created Federal Energy Regulatory Commission (FERC) inherited authority for oil pipeline regulation from the Interstate Commerce Commission. Because of its isolation and distance from potential markets, knowledgeable observers have viewed the Trans-Alaska Pipeline (TAPS) as a classic example of a pipeline with high

monopoly potential.(5) The proposed ARCO-BP merger places 72% of TAPS in the control of one company. The latest consolidation move on the North Slope raises this question: In view of the pattern of transfer of North Slope discoveries and production interests and discoveries to major TAPS Owners, unless TAPS is operated by an entity that does not have production interests on the North Slope, can Alaska reasonably expect companies other than BP to invest in the North Slope?(6)

The 1996 statement of Conoco President and CEO Archie Dunham after his company traded the Milne Point field to BP lends force to this question. In an interview with Hart's Oil and Gas Investor, Dunham said, "It broke my heart to trade Milne Point, but we had to do it. All the value of that property was taken away from us in the pipeline tariffs."(7) Conoco did not have an ownership interest in TAPS and was the only company other than ARCO and BP to operate a North Slope field. The real losers when Conoco left Alaska were the people of Alaska, whose State General Fund and Permanent Fund depend heavily on resources managed to maximize revenue by ensuring open competition on a level playing field.

If pipeline regulation fails, pipeline control then becomes an antitrust question. Although antitrust laws are broad, they are also vague, difficult to enforce and seldom used upstream. The Federal Trade Commission (FTC), which appears to have taken the lead for the Federal government in reviewing the recent round of oil industry mergers, typically considers the effects of a merger in terms of consumer-related issues, such as the competition in the marketing of gasoline. But even if there is no immediate, direct effect on the price at the gas pump, the Federal Trade Commission can consider the long-term anticompetitive effects of a merger.(8)

The departure of producers and potential producers from the North Slope during the 1990's strongly suggest that tariff regulation has not served to prevent anti-trust abuse by the major TAPS Owners. In dealing with TAPS tariff issues, the State of Alaska has never raised anti-trust claims. In this regard it may be relevant to note that in 1985 the Department of Law, then promoting the controversial TAPS Settlement

Agreement, agreed that it would join the TAPS Owners in defending that settlement against any legal challenge.(9) It is not clear whether the State's 1985 TAPS Settlement Agreement prohibits the State Administration from raising this question regarding TAPS. This is an important question because the FTC would give significant weight to the State of Alaska's position regarding concerns that the departure of ARCO and the increased dominance of BP as a threat to future North Slope development.

C. The TAPS Tariff and State Revenue

The TAPS tariff allows the Carrier (Owner) to recoup costs, plus a guaranteed profit. Unlike the shipper who owns the pipeline, a Non-Owner Shipper pipeline pays all pipeline costs out of pocket. Any excess charges captured in the tariff will increase the profits of the Owner-Shipper while reducing profits of the Non-Owner-Shipper. High tariffs are the principal means by which pipeline owners discriminate against non-owner shippers; that's why pipeline tariffs are regulated.(10)

By virtue of its royalty interest, the State of Alaska is, in effect, a Non-Owner-Shipper on TAPS. Because severance taxes are calculated in a manner roughly similar to that of royalty calculations, pipeline tariffs also affects severance tax collections. When royalty and severance effects of pipeline tariffs are combined, every dollar included in the TAPS tariff reduces State royalty and severance tax payments by approximately \$0.23. The general relationship between State revenue and TAPS tariffs can be seen in the following simplified tables.

Table 1.

Simplified State Royalty and Severance "Take"

(Pipeline Tariff = \$2.80) *

<i>Item #</i>	<i>Description</i>	<i>\$ per barrel</i>
(1)	Avg. ANS Price (1997)	\$18.98
(2)	Less Pipeline Tariffs	(\$2.80) *
(3)	Less Tanker	(\$1.35)
(4)	Wellhead (item 1 - [items 2 + 3])	\$14.83
(5)	∴ Royalty (item 4 * 0.125)	1.85
(6)	∴ Severance (item 4 * 0.15 * 0.875)	1.97

Adapted from: Richard A. Fineberg, *How Much Is Enough? Estimated Industry Profits from Alaska North Slope Production and Associated Pipeline Operations, 1993 - 1998* (preliminary report to Oilwatch Alaska, December 1998), "1997 ANS Profits Worksheet," p. 40.

* Pipeline tariffs include \$2.71 for TAPS and \$0.09 per barrel for North Slope "feeder" pipelines.

State production "take" from royalty and severance in the simplified example above is \$3.82 per barrel. Table 2., below, presents the results if the pipeline tariff is reduced by \$1.00 per barrel, to \$1.80.

Table 2.

Simplified State Royalty and Severance "Take"

(Hypothetical Example; Pipeline Tariffs = \$1.80)

<i>Item #</i>	<i>Description</i>	<i>\$ per barrel</i>
(1)	Avg. ANS Price (1997)	\$18.98
(2)	Less Pipeline Tariffs	(\$1.80)
(3)	Less Tanker	(\$1.35)
(4)	Wellhead (item 1 - [items 2 + 3])	\$15.83
(5)	∴ Royalty (item 4 * 0.125)	1.98
(6)	∴ Severance (item 4 * 0.15 * 0.875)	2.08

Adapted from Table 1.

Due to the \$1.00 reduction in pipeline tariffs in this hypothetical and simplified example, the State production "take" increases by \$0.24, to \$4.06 per barrel. In other words, as a direct result of the pipeline tariff reduction, the State of Alaska an additional \$0.24 per barrel in royalty and severance payments.(11) The portion of the dollar reduction in pipeline tariffs that does not go to the State is divided approximately as follows:

- o Producers \$0.50 per barrel
- o Federal government \$0.26 per barrel.(12)

When you're dealing with more than one million barrels of oil per day, every day of the year, cents-per-barrel changes in the tariff can have significant revenue consequences. Therefore, from a fiscal standpoint (over and apart from the potential benefits of increased competition and improved environmental performance), closer look at the construction of the TAPS tariff and its effect on State revenue is therefore warranted.

D. Elements of the TAPS Tariff

The TAPS tariff is based on an annual total revenue requirement which is the sum of seven major tariff elements. Each element of the tariff is calculated in accordance with terms spelled out in the 1985 TAPS Settlement Agreement between the State and the TAPS Owners. The required revenues are charged to each barrel shipped through TAPS on a per-barrel basis. The seven elements of TSM are listed in Table 3, along with a rough estimate of the total revenue requirement and per-barrel share for each element in 1997. (The figures here are approximations; individual Carrier tariffs will differ due to factors such as the owner company's financing of capital costs.)

Table 3.

Elements of 1997 TAPS Tariff

(1.354 million bpd = 495.6 million barrels)

<i>TAPS Tariff Element</i>	<i>Total Revenue Requirement</i>	<i>Per-barrel Share</i>	
<i>Item #</i>	<i>Description</i>	<i>(\$ millions)</i>	<i>(\$ / bbl.)</i>
(1)	Operating Costs	\$494.0	\$1.00
(2)	Capital Costs (Depreciation)	87.0	\$0.18
(3)	State and Local Property Tax	\$64.4	\$0.13
(4)	State and Federal Income Tax	\$272.6	\$0.55
(5)	Recovery of Deferred Return	\$99.1	\$0.20
(6)	DR&R Allowance	\$8.4	\$0.02
(7)	After-Tax Margin	<u>\$307.2</u>	<u>\$0.62</u>
(8)	Total	\$1,332.7	\$2.70

Source: Estimated from Alaska Dept. of Revenue property tax worksheets and various other sources. (See: Richard A. Fineberg, *How Much Is Enough? Estimated Industry Profits from Alaska North Slope Production and Associated Pipeline Operations, 1993 - 1998* [preliminary report to Oilwatch Alaska, December 1998], "1997 ANS Profits Worksheet," p. 40.)

A brief explanation of each item collected as part of the tariff may be useful to the reader: Item #1 represents the cash Alyeska Pipeline Service Co. draws from the Owners for TAPS operations and maintenance. Item #2 is the repayment to the TAPS Owners for their investment in TAPS. Item #3 is the Oil and Gas Property Tax, which is based on the assessed value of TAPS. Item #4 is the revenue collected to pay State and Federal income taxes. Item #5 represents deferred income the owners collect in recognition of earlier capital costs. Item #6 represents the tariff

amount collected for future dismantling and removal of the pipeline and restoration of the right-of-way. Item #7 is the profit element. (13)

E. Are TSM Tariffs Excessive?

In a 1996 University of Wisconsin Master's Thesis, economist Antony Scott reported that the TSM tariffs exceeded reasonable, cost-based tariffs by large margins. TSM, Scott concluded, "deviates in important ways from conventional tariff methodologies." (14) According to Scott, over the life of the settlement, the tariff overcharges reduce the value of oil to the producers by so much that the State of Alaska loses \$4.5 to \$9.2 billion in royalties and taxes, while the Federal tax loss is \$1.9 to \$2.7 billion. Scott's estimates were stated in inflation-adjusted 1995 dollars. (15) His thesis is the most recent and most comprehensive of several challenges to TSM since the agreement was announced in 1985. (16)

Discussing the reasons that TSM was adopted, despite what he termed its manifest defects, Scott observed that TSM's departures from cost-based principles "appear to be concessions wrested from the State." Reviewing the history of the settlement, Scott concluded that those concessions were driven in large part by the State of Alaska's apparent fear of what he called FERC's "refusal to regulate." (17)

F. Effects of Excessive TAPS Tariffs

Scott's 1996 thesis lends credence to the possibility that TAPS has been used by its major Owners to restrict North Slope competition by offering a plausible explanation for the pattern of departures of major oil companies from the North Slope. By charging excessive tariffs, TAPS Carriers can reap excessive profits for their owner companies at the

expense of Non-Owner-Shippers. One possible example of this result is Conoco's departure from the North Slope. After years of unsuccessful attempts to challenge TAPS tariffs at FERC, in 1993 Conoco traded its North Slope properties to BP and left Alaska. (18)

G. The TAPS Tariff DR&R Provision

Apart from the possible consequences of excessive TAPS tariffs due to poor regulation, Scott's economic analysis confirms a second salient fact about the 1985 TAPS Settlement Agreement: Scott confirms that the TSM DR&R provision at Exhibit E of the Settlement Agreement (19) provided an additional gain to the TAPS owners of extraordinary proportions. (20) Inaccurately portrayed as revenue-neutral by the proponents of the settlement, the DR&R provision received little attention in the belated public reviews at the time of the settlement. (21) The staggering size of the DR&R windfall to the TAPS Owners resulting from this tariff element was not recognized until the Alaska Public Utilities Commission's Staff Expert Witness

quantified the gain to the Carriers in his December 1986 analysis.(22) According to Scott, " . . . in 1995 dollars, the carriers' DR&R 'fund' is between \$9-\$13 billion too large. The sum will grow larger still if the date when DR&R disbursements must be made is postponed" (rather than conducted between 2012 and 2015, as TSM assumed).(23) Because the TSM did not require the tariff collectors to escrow the DR&R funds, those funds passed directly into the hands of the TAPS Owners. That's \$9 to \$13 billion in pure windfall profit for the TAPS Owners, with all dismantling charges paid - over and above the annual profits tallied in Item 7 of the tariff in Table 3.

Under TSM, payments to reimburse the Owners for future DR&R outlays were collected on an accelerated or "front-loaded" basis under a fixed schedule set out in Exhibit E to the 1985 Settlement Agreement. The purpose of collecting DR&R in advance of actual outlays is to match those costs with barrels shipped. While there are clear public policy reasons for allowing a pipeline owner to recoup prior capital investment on a hyper-accelerated depreciation schedule - to free up capital more rapidly for further development, for example - there was no apparent or logical reason to accelerate collections for future cash outlays. But that is exactly what the TSM did.

In 1985 it was virtually impossible to estimate the correct amounts to pre-collect for DR&R. Even if the date of pipeline shutdown could have been known with certainty, three estimating factors necessary to calculating the correct pre-collection of DR&R through the tariff were uncertain or unknown at that early date: Specifically, the collected amounts in Exhibit E of the Settlement Agreement had to include adjustments to recognize assumptions regarding (1) the return the Owners would realize from the pre-collected funds during the intervening years between collection and expenditure, as well as (2) the rate of inflation during those years. Since the DR&R collections constituted income until the funds were expended, the pre-collected funds would be taxable; the DR&R collections were therefore "grossed up" by (3) the estimated income tax. The almost inevitable errors in all three early estimates created DR&R over-collections, resulting in a windfall of enormous proportions for the TAPS Owners.(24)

The difficulty in making DR&R estimates so far in advance of actual pay-out is most simply demonstrated by reviewing the third factor: The

Tax Reform Act of 1986 reduced the corporate income tax from 46% to 34%; by that time, the TAPS settlement had already been approved by FERC - including DR&R collections "grossed up" to include taxes calculated at the higher rate. Even though the higher tax rate would never be paid, the TAPS Shippers for the higher rate. Because there was no provision to reduce the DR&R collection schedule in the 1985 TAPS Settlement Agreement and the funds were not escrowed, the TAPS Owners were able to keep that money.

Through 1998, TAPS Shippers paid approximately \$1,535 million in TAPS tariffs for DR&R, or 98% of the estimated total DR&R tariff stipulated as part of the TSM. The after-tax value to the TAPS Owners of the pre-collected DR&R funds at the end of 1998 has been estimated to be \$4.07 billion (Scott's low estimate), \$4.56 billion (Scott's high estimate) and \$5.90 billion (APUC Staff Expert Witness, 1986).(25)

Part II: State Purchase, Operation and Management of TAPS

A. Introduction

The first part of this paper describes in general terms the operation of the TAPS tariff and the manner in which the operation of TAPS affects State revenue and North Slope oil development. Part II. of this paper explores three questions: (1) Could State take-over of TAPS resolve some of the problems identified in the preceding sections? (2) If so, is State take-over of TAPS is feasible? (3) What are the principal problems and policy implications associated with State take-over and operation of TAPS?

B. Fiscal Parameters of State Purchase and Operation of TAPS

In broad economic terms, three aspects of the TAPS tariff stand-out. Through the mechanisms of front-loaded (hyper-accelerated) depreciation schedule and recovery of deferred return, capital investment in TAPS appears to have been largely repaid.⁽²⁶⁾ In addition, through the pre-collection of DR&R, the TAPS Owners have also received the use of a cash windfall estimated by Scott at the end of 1998 to be \$4.07 to \$4.56 billion. For property tax purposes, TAPS is valued today at approximately \$3.0 billion. Based on these figures, it makes sense for the State of Alaska to consider the purchase of TAPS and take-over of DR&R liability, along with the present value of the funds the TAPS Owners have pre-collected for that purpose.

If the estimated value of the TAPS DR&R collections is placed at the midpoint of Scott's estimates (\$4.31 billion), the net result of the transaction would be a transfer to the State of Alaska of TAPS and associated aspects, plus approximately \$1.31 billion in cash. That amount could be deposited into an escrow account for future DR&R expenditure; the escrowed, publicly-held TAPS DR&R fund would be supplemented, as necessary, in amounts to be determined by modeling.

In Table 4, the right-hand column shows the effect on the 1997 TAPS tariff of the tariff reductions resulting from State take-over and operation of TAPS on a non-profit basis. Under this regime, profit and income tax elements - tariff elements (5) and (7) - would no longer need to be collected. Even with a hefty per-barrel charge to cover additional capital expenditure and contributions to the DR&R fund, the resulting tariff reduction (item [8]) would allow the State to deliver oil to Valdez at a tariff well below that currently charged by the TAPS Owners, enhancing the competitiveness of North Slope oil while increasing State royalty and severance returns.

Table 4.

Revised Elements of TAPS Tariff

(Based on 1997 tariff, see Table 3, above)

<i>TAPS Tariff Element</i>		<i>1997</i>	<i>State-Owned</i>
<i>Item #</i>	<i>Description</i>	<i>Per-barrel</i>	<i>Per-barrel</i>
		<i>Share</i>	<i>Share</i>
		<i>(\$ / bbl.)</i>	<i>(\$ / bbl.)</i>
(1)	Operating Costs	\$1.00	\$1.00
(2)	Capital Costs (Depreciation)	\$0.18	\$0.18 *
(3)	State and Local Property Tax	\$0.13	\$0.13 *
(4)	State and Federal Income Tax	\$0.55	
(5)	Recovery of Deferred Return	\$0.20	\$0.20 *
(6)	DR&R / New Capital DR&R	\$0.02	\$0.49 *
(7)	After-Tax Margin	<u>\$0.62</u>	
<hr/>			
(8)	1997 v. State-Owned Tariff	\$2.70	\$2.00

Notes:

1997: See Table 3, above.

* Under a State-owned pipeline, it might be possible to guarantee this amount for an extended period; this would relieve the pipeline boroughs of fighting annually to secure appropriate valuation of TAPS for property tax purposes.

** These elements reflect minimum estimated tariff reductions; more detailed analysis and long-term modeling should result in further tariff reductions.

*** This element is set artificially high to cover future capital and DR&R amounts.

While modeling of fiscal effects of State operation of TAPS is beyond the scope of this analysis, it is possible to get a sense of the consequences of this proposal by making adjustments to the model presented in the author's 1998 report on TAPS profitability. For purposes of this analysis, the TAPS tariff elements in that report were altered for 1997 and 1998 calendar year operations by reducing the TAPS tariff to \$2.00 per barrel for each year through the tariff adjustments discussed in the preceding section. The tariff reductions resulting from State operation of TAPS increased State revenue in 1997 and 1998 by a minimum of \$85 million per year.(27)

C. State Management of TAPS

Even if the concept of State management of TAPS is attractive from a fiscal perspective, there are other policy questions to consider. Three important questions regarding State management of TAPS concern (1) effective management, (2) the related question of cost control and (3) environmental policy.

To operate TAPS, the State might set up a quasi-public corporation along the lines of the Alaska Railroad Corporation. In this case, the Board of Directors would be analogous to the TAPS Owners' Committee. The Alyeska Pipeline Service Co., which operates TAPS as the agent for the TAPS Owners, might be retained as the operating agent for a new State pipeline corporation.

Cost control, already a problem for the TAPS Owners, could become an even greater problem under State ownership. However, pipeline managers could use the same techniques to promote cost savings that Alyeska now uses. At present, Alyeska managers remind employees that the success of future North Slope development depends on holding transportation costs down so that Alaskan oil can compete on the global market and employees receive year-end bonuses for cost-savings and safety. Public managers could continue to make effective use of both techniques.

From an environmental standpoint, there are two apparent benefits of State take-over and management of TAPS: (1) In day-to-day operations, under public ownership the TAPS operators would be under less pressure to cut corners because they would no longer be hammered by the cost-cutting demands of shareholder-conscious executives on the TAPS Owners Committee. (2) As TAPS shutdown nears (at some point in the future), the State is liable to face this dilemma: The North Slope producers may determine that the need to commit funds for DR&R (previously collected but not escrowed) will deprive those companies of capital that might otherwise be used to extend temporarily the life of the North Slope. In this situation, the State may be sorely tempted to back down environmental requirements to restore the pipeline right-of-way to pre-construction condition.

D. Putting It All Together: Four Critical Questions Regarding the Proposed Merger and State Take-Over of TAPS

By increasing control of TAPS to 72% (where key decisions of the TAPS Owners Committee require a 70% majority), the proposed ARCO-BP merger invites consideration of the question of monopoly control of TAPS. More broadly, is the possibility that control of TAPS by its major Owners has stifled open competition on the North Slope a significant public policy concern? Implicit in the 1996 endorsement of competition by the Governor's Oil and Gas Policy Council is the belief that open competition enhances the State's public policy goals by allowing companies with different investment strategies, different technical strengths and different environmental attitudes to enter the North Slope market. Following this line of reasoning, the first question is:

1. What constitutes sufficient proof, for public policy purposes, that the major Owners of TAPS have used (and/or will use) the pipeline to inhibit competition?

If policy makers believe that TAPS has been used to stifle competition to a significant degree, the next question would be:

2. Are there legal remedies?

It should be noted that sufficient proof for a policy maker that TAPS has functioned to inhibit competition might not be sufficient proof to prevail in court. Putting legal imponderables aside for the moment, consideration of the possibility that TAPS will function to inhibit competition leads to the following questions:

3. Should the North Slope producers be required to sell

a. All of TAPS?

or

b. A portion of TAPS?

The body of studies arguing that TAPS tariffs under TSM are excessive combine with the departure of Non-Owners from the North Slope to provide strong indication that TAPS has functioned to inhibit competition. To the extent that the concerns discussed in this briefing paper are based on a pattern of past behavior, it follows that requiring ARCO-BP to divest ARCO's share of TAPS (22%) will merely perpetuate - rather than correct - the unhealthy situation that has led to BP's domination of North Slope development.

4. Should the prospective buyer be:

a. An independent pipeline company?

or

b. The State (perhaps acting through a quasi-independent commission or authority)?

From a fiscal perspective, there are two reasons to favor a State take-over. First, the preliminary analysis presented here suggests that the State can operate TAPS at a significantly lower tariff than a private corporation. Additionally, despite its guaranteed profit on TAPS, an independent company might be reluctant to buy TAPS because that company would be acquiring the TAPS DR&R liability without the funds to perform that obligation (98% of the DR&R money has already been collected, but the funds were not escrowed).(28)

E. The State's Role in TAPS Divestiture Issues

With both the TAPS right-of-way agreement and the tariff agreement itself coming up for review during the next decade, the State of Alaska might have leverage to redress problems associated with monopoly control of TAPS, as well as certain inequities in the TAPS tariff structure, such as DR&R. As indicated above, however, the State (or at least the Administration) may have some difficulty approaching this question due to its agreement to defend the 1985 TAPS tariff agreement against any

litigation. If the State Administration now finds its hands tied by the language of its 1985 agreement to the TSM, concerned citizens and policy makers might want to devise a strategy that would provide some measure of State support for an antitrust challenge to the conduct of the TAPS Owners in implementing TSM. In this event, it might be useful to consider the following questions:

- * The State Administration has been in litigation since 1985 challenging aspects of the implementation of TSM.(29) Can the antitrust effects of TAPS the implementation of TSM be challenged without violating Section 1-3 of the TAPS Settlement Agreement?**
- * If the State Administration must defend TSM under its 1985 agreement, does the language of that settlement prevent the Alaska State Legislature from challenging provisions of the agreement?**
- * If the State Administration must defend TSM under its 1985 agreement, does the language of that settlement the Alaska Permanent Fund from challenging provisions of the agreement?**
- * If the State Administration must defend TSM under its 1985 agreement, does the language of that settlement prevent the Alaska State Legislature from creating an independent authority that can challenge TSM provisions?**
- * FERC approved the TAPS settlement in part on the basis of estimates regarding financing of TAPS dismantling, removal and restoration (DR&R) that were impossible to make at that time or arguably false; can this fact be used to nullify the TSM (including the requirement that the State of Alaska defend TSM)?**

While it is not possible to answer this line of questions definitively without additional legal analysis, it may be useful to consider them in the public dialogue concerning the State of Alaska's public policy options with regard to the proposed ARCO-BP merger.

III. Conclusion: Why Should the State of Alaska Buy TAPS?

Purchase of TAPS under terms similar to those outlined in this report would give the State of Alaska the ability to accomplish the following major policy objectives - without cash outlay:

- * deliver oil to Valdez at tariff rates below those charged by the TAPS Owners under TSM, thereby (1) enhancing the competitiveness of North Slope oil in the world market and (2) increasing annual oil revenue receipts severance tax and royalty receipts;**
- * manage TAPS to ensure competition;**
- * ensure that the pipeline communities receive a stable (rather than a declining) revenue stream in lieu of property taxes;**
- * ensure that cost-cutting does not affect environmental performance (a current and chronic problem on TAPS); and**
- * escrow DR&R collections, reducing the inevitable pressure on the State, created by the present DR&R arrangement, to trade performance of DR&R obligations for latter-day investment that would prolong North Slope production.**

FOOTNOTES

1. This report suggests that the ARCO-BP merger should not be approved without complete divestiture of TAPS by North Slope producers and companies with working interest in North Slope production; because other problems associated with the proposed merger are not considered, this report does not make a recommendation for or against the proposed merger.
2. Alaska Oil and Gas Policy Council, Report to the Governor (Juneau: Office of the Governor, February 1996), p. 11.
3. Portions of this background material are drawn from: Richard A. Fineberg, "BP-Arco merger bums stakes for us all," Anchorage Daily News, April 6, 1999 (electronic edition). For the departures from the North Slope between 1991 and 1997 of major oil companies who found or produced oil on the North Slope, see Richard A. Fineberg, *The Big Squeeze: TAPS and the Departure of Major Oil Companies Who Found Oil on Alaska's North Slope* (Anchorage: Oilwatch Alaska, 1997), pp. 5.32-5.49.
4. For economic analysis of North Slope production and pipeline operations compared to major U.S. corporations see: Richard A. Fineberg, *Praise the Pipe and Pass The Money: Facts and Reflections on Big Oil in Alaska Ten Years after the Exxon Valdez Spill* (published by the author, March 1999) , pp. 17-22 and *How Much Is Enough: Estimated Industry Profits from Alaska North Slope Production and Associated Pipeline operations, 1993 - 1998* (Anchorage: Oilwatch, December 1998 [preliminary report]).
5. For a summary of U.S. pipeline regulatory history, see *The Big Squeeze*, pp. 3.1-3.5, 3.16-3.19 and 3.24-3.26.
6. Inter-state shipments through TAPS are regulated by the Federal Energy Regulatory Commission (FERC); intra-state shipments are regulated by the Alaska Public Utilities Commission (APUC). Pipeline regulation takes place principally in the form of approval of tariffs, or maximum per-barrel shipping charges, which are filed annually at FERC and at the APUC. TAPS tariffs are filed in accordance with a formula known as the TAPS Settlement Methodology (TSM), which was established in 1985 by an agreement between the State and the TAPS Owners (Carriers), ending a decade of tariff litigation. FERC approved the TSM formula through the year 2011, with renegotiations beginning in 2006. For intra-state shipments, APUC approved TSM historically but declined to endorse the tariff framework for future years; at APUC, TAPS tariffs are approved annually on an interim or ad hoc basis, subject to challenge. In 1998 Tesoro Alaska Petroleum Co. initiated a proceeding at APUC challenging the lawfulness of TSM tariffs because TAPS tariffs were excessive.
7. Leslie Haines, "Getting to the Future First" (interview with Conoco President and CEO Archie Dunham), *Hart's Oil and Gas Investor*, (reprint provided by Conoco Public Affairs Dept.). Dunham also noted that consolidation was also a factor in Conoco's departure.

8. The U.S. Justice Department and the FTC have concurrent authority over key provisions of federal antitrust laws and coordinate their handling of antitrust issues to avoid duplication of efforts (see: *The Big Squeeze*, pp. 3.3 - 3.5; the inter-agency working relationship is described in U.S. Department of Justice, Antitrust Division Manual, "Chapter VII: Antitrust Division Relationships with Other Agencies and with the Public," September 1, 1983, pp. VII-1 through VII-6 [first issued August 27 1979]).

9. Sec. I-3 of the TAPS Settlement Agreement reads: "State and TAPS Carriers shall cooperate, each at its own expense, in securing all necessary governmental approvals for this agreement and in defending against any litigation affecting the validity and enforceability of this Agreement, or any provision thereof." Settlement Agreement between The State of Alaska and ARCO Pipe Line Co., BP Pipelines Inc., Exxon Pipeline Co., Mobil Alaska Pipeline Co., Union Alaska Pipeline Co. with Respect to the Trans Alaska Pipeline System (submitted to FERC in Docket OR 78-1), June 28, 1985. (Although the State must defend the TSM, the State may challenge the tariffs filed under TSM if it has reason to believe those tariffs were not filed in accordance with TSM. For discussion of TAPS tariff litigation at FERC since the 1985 settlement, see *The Big Squeeze*, pp. 5.1-5.23.

10. See *The Big Squeeze*, pp. 1.1-1.5.

11. The actual relationship between the State "take" and the pipeline tariff will be slightly different due to factors removed from this simplified example, such as the reduction to severance taxes by the Economic Limit Factor, or ELF. Typically, the state "take" increases or decreases approximately \$0.23 for every \$1.00 change in the tariff. For a more detailed description of the distribution of revenue from a barrel of North Slope crude oil, see *How Much Is Enough?*, pp. 9-26.

12. *Ibid.*

13. For description of tariff elements, see: State of Alaska and United States Justice Department, Explanatory Statement of the State of Alaska and the United States Department of Justice in Support of Settlement Offer (Federal Energy Regulatory Commission, Docket No. OR 78-1, June 28, 1985).

14. Antony Scott, *The Trans-Alaska Pipeline System: The Causes and Consequences of Regulatory Failure* (Master of Science Thesis, University of Wisconsin-Madison, 1996), p. 12.

15. *Ibid.*, pp. 125, 131.

16. For a summary of other TSM critiques (including two by the author of this report), see *The Big Squeeze*, pp. 4.16 - 4.24.

17. Ibid., pp. 28, 196. Scott also concluded that "if nothing else, this case study presents an example of how not to conduct public policy" (p. 257). "The settling parties," Scott observed, "unnecessarily clouded the picture." He pointed out several ways that the absence of clear, basic information about key aspects of TSM made analysis more difficult. For example, he concluded that "carrier returns under TSM are opaque" and that "TSM dramatically obscures what carriers earn from the pipeline" (pp. 28, 38, 262).

18. Scott, pp. 169, 252. Scott's assertion of a possible link between TAPS tariffs and Conoco's departure predated the public statement of Conoco's president and CEO noted above.

19. For DR&R terms, see: Settlement Agreement, Sec. II-4 and Exhibit E and Explanatory Statement of the State of Alaska and the United States Department of Justice in Support of Settlement Offer, pp. 30-31.

20. Scott, pp. i, 59-68, 259-260.

21. For an analysis of public review of the TAPS settlement, see: Richard A. Fineberg, *The 1985 TAPS Settlement: A Case Study in the Effects of Confidentiality on Information Available to Decision Makers in Oil and Gas Revenue Disputes* (Alaska State Legislature [Supplemental Report]), Feb. 5, 1990.

22. Rudolph L. Bertschi, Prefiled Testimony of R.L. Bertschi (Staff Expert Witness testimony, in Alaska Public Utilities Commission Docket No. P-86-2, Dec. 17, 1986), pp. 63-70 and Exh. RLB-15, Schedules 1 and 2 (reprinted in Richard A. Fineberg, *Hidden Billions: The TAPS DR&R Provision* [prepared for Stan Stephens, August 1992], pp. 47-57).

23. Scott, pp. 259-260.

24. See: Bertschi, Fineberg and Scott, op. cit.

25. Scott, Tables A1.4 and A1.5; Bertschi, Exhibit RLB-15, Sched. 2.

26. More research in this area is needed. In the few available public accountings of TAPS tariff elements, the distinction between capital funds that repay original investment and those earmarked to cover subsequent capital investments in TAPS is not always clear. When these distinctions are clarified so that the resulting elements can be modelled to assure appropriate capital repayment on investment, the likely net effect will be to reduce the tariff significantly (see Table 4, below).

27. This is a minimum estimate. Further research and modelling of the TAPS capital structure is likely to result in further tariff reductions. (See preceding footnote.)

28. In 1992 an investment analyst told the author he had recommended that an investor not buy North Slope production interest because DR&R liability issues on the North Slope had yet to be decided. In the case of TAPS, the problem would be magnified.

29. For summary of tariff cases litigated at FERC, see *The Big Squeeze*; see also correspondence between the Alaska Attorney General, the author and Oilwatch Alaska, October-November 1997, various dates.

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