
From the desk of

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To: Oilwatch Alaska

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Re: Cambridge Energy Research Associates Reports to BP (*White Paper — Industry Context*; and *White Paper — Operations of the Trans-Alaska Pipeline System: Impact of the Merger Between BP Amoco and ARCO*, September 1999)

Overview

Last week BP began distributing two reports prepared by the Cambridge Energy Research Associates (CERA) for BP in September 1999. The first report described the global context of the proposed ARCO-BP merger, while the second discussed the impact of the proposed merger on operations of the Trans-Alaska Pipeline System (TAPS). Although the CERA reports contain useful background information about the oil industry in general (as well as some useful facts about Alaska operations), these reports describe the economics of oil operations in Alaska poorly and gloss over important merger-related problems. As a consequence, these reports obscure rather than clarify key aspects of the current policy debate in Alaska over BP's proposed acquisition of ARCO. Based on the following analysis, I believe these so-called "White Papers" can be more accurately characterized as white-wash.

White Paper — Industry Context

The first report expands on the theme that "the oil and gas business is undergoing a period of dramatic change, on a worldwide basis, in response to intensifying price cycles and increasing competition." The result of price volatility and competition from other fuels, the report argues, is a capital-short, cost-cutting environment. While the broad thesis is correct (in my estimation), three substantive defects undermine the report's relevance to the present situation in Alaska.

Consider, for example, the report's concluding paragraph, which contains this passage: "...the industry will continue to attract new players....As a result, restructuring will not shrink the industry to just a handful of parties." Alaska's oil patch consists of little more than "a handful of parties;"¹ that's why the Governor is presently searching for one company to replace ARCO as an independent competitor to BP. For this reason, I regard the CERA report's global conclusion as background information that unfortunately obscures important facts about the competitive environment in Alaska.

The lack of relevance of this report's basic theme to the situation in Alaska is not its only defect. CERA's "Hard Times in the Oil Patch" theme is supported by an oil price

¹ As a result of the consolidation during the 1990's, the number of major producers on the North Slope has shrunk dramatically. (In 1991, 14 of the nation's top 20 domestic liquids producers were pumping oil from the North Slope. If the ARCO and Exxon mergers are completed, only six of those 14 [BP, Exxon, Phillips, Unocal, Texaco and Oxy] will be producing on the North Slope at the end of the decade. As for new players, of the four new North Slope entrants, one was acquired by a major (Union Texas by ARCO) a second went into Chapter 11 bankruptcy (Forcenergy), the third has produced minimally (FINA at Badami) and the fourth has yet to produce (Anadarko).

forecast that emphasizes the probability that oil prices will decline precipitously in the year 2000, apparently stabilizing at prices anywhere from \$2.00 to \$7.00 per barrel below current prices.² The CERA report emphasizes its view that oil prices recently peaked and will drop through the year 2000, falling by more than \$5.00 per barrel (to approximately \$14.75 per barrel) by mid-2001. A year ago, when oil prices were dropping to the \$10.00-per-barrel range, virtually no forecasters anticipated the rocket rise to the current \$20-level. Other respected petroleum economists, such as Colin Campbell, are apt to be much more bullish than CERA in the long run. And at least over the last year, the optimistic forecasters have proven more correct. CERA should be the first to admit that nobody has a crystal ball; in 1984, CERA co-authored a study emphasizing the uncertainty of oil price forecasts and lambasting industry analysts for relying too heavily on those forecasts.³

Perhaps the most important substantive shortcoming in the CERA report to BP is the erroneous calculation of the government "take" from Alaska operations. CERA lists the entire TAPS tariff (shipping charge) as a cost to industry.⁴ In fact, the TAPS owners retain a significant portion of the shipping cost as profit, as CERA acknowledges in its second report.⁵ As a result of this miscalculation, CERA under-estimates the industry share of net revenue ("take") from Alaska operations and overstates "government take as percent of profit," erroneously estimating government "take" at 76%.⁶ According to CERA's "Industry Context" report, a 76% government "take" is "at the (high) edge of the competitive region."⁷ When corrected for TAPS profit, the rough estimate of government "take" falls to approximately 65%; I believe this correction would make Alaska significantly more competitive in the world environment than the report data indicate.

Whether the industry "take" is sufficient to make Alaskan operations competitive in the world environment is a crucial question for any investor — and, consequently, for those who make state oil policies on behalf of the people of Alaska. Those who must struggle with this question are poorly served when BP's "White Paper" errs by omitting a significant portion of industry profit from Alaska operations before comparing that profit to the government's "take."

White Paper — Operations of the Trans Alaska Pipeline System: Impact of the Merger Between BP Amoco and ARCO

Like its "Industry Context" report, CERA's companion "White Paper" on TAPS contains useful background information. But this "White Paper" concludes that "adequate safeguards are already in place to protect the interests of . . . current and future producers"

² *White Paper — Industry Context*, pp. 5-13.

³ Cambridge Energy Research Associates and Arthur Anderson & Co., *The Future of Oil Prices: The Perils of Prophecy* (CERA and Arthur Anderson & Co., 1984). According to that report, "since modern, long-term oil price forecasting began in the early 1970s, the consensus has been the norm — and, in each case, the consensus proved incorrect. . . the task is to uncover and appraise the uncertainties inherent in the forecast, and to develop planning mechanisms that help to anticipate and prepare for contingent development. . . . Putting uncertainty on center stage . . . can help to make companies less vulnerable to turbulence and surprise" (p. i.).

⁴ *White Paper — Industry Context*, p. 22.

⁵ *White Paper — Operations of the Trans Alaska Pipeline System*, pp. 6, 7.

⁶ *White Paper — Industry Context*, p. 22.

⁷ *White Paper — Industry Context*, p. 22.

by omitting all specific challenges to this very point and ignoring all studies that contain different conclusions. This failure is particularly surprising because the CERA claims that this "White Paper begins by putting TAPS in context before examining the various arrangements that safeguard the interests of other parties."⁸ Examples follow.

In its relatively lengthy introduction to the operation of TAPS and its regulatory framework CERA fails to inform readers that many informed parties have complained that when producers control the pipeline links to market (as is the case with TAPS), those producers are liable to use various practices to inhibit competition.⁹ As I noted in a 1997 report to Oilwatch Alaska calling for an antitrust investigation into TAPS, the president of the only company other than major TAPS owners ARCO and BP to operate a field on the North Slope cited pipeline tariffs as a primary reason for his company's 1993 departure from Alaska. Between 1991 and 1997, Conoco was one of six oil companies who ranked among the nation's 20 largest domestic liquid producers to leave production or discoveries capable of production on the North Slope. In five out of six instances the property was acquired by major TAPS owners ARCO or BP.¹⁰ Because CERA celebrates the effectiveness of pipeline regulation but fails to discuss substantive challenges to that regulatory regime, the consulting firm's so-called "context" is spectacularly and inappropriately one-sided.

Similarly, in its treatment of TAPS tariffs, CERA simply ignores the conclusions of analysts who have examined the complicated tariff framework and found that TAPS tariffs allowed under the controversial 1985 TAPS Settlement Methodology (TSM) are grossly excessive;¹¹ one study concluded that TAPS was a classic example of regulatory failure.¹² One need not accept the view of that the critics of TSM to recognize that the failure to discuss the bases for challenges to TSM reveals the bias of BP's so-called "White Paper."¹³

In 1973, the Federal Trade Commission staff warned that excessive tariffs were not the only mechanism by which a pipeline owner could use its position to injure competitors. According to that report, discriminatory practices involving storage and other

⁸ *White Paper — Operations of the Trans Alaska Pipeline System*, p. 1.

⁹ See: U.S. Senate Committee on Interior and Insular Affairs, *Preliminary Federal Trade Commission Staff Report on Its Investigation of the Petroleum Industry* (Washington, D.C.: Government Printing Office, 1973), p. 26. (93rd Congress, 1st Session; Committee Print; Serial No. 93-15.)

¹⁰ Richard A. Fineberg, *The Big Squeeze: TAPS and the Departure of Major Oil Companies Who Found Oil on Alaska's North Slope* (Oilwatch Alaska, October 1997), pp. ES-1 - ES-5; the statement of Conoco President Archie Dunham appeared in "Getting to the Future First," *Hart's Oil and Gas Investor*, August 1996 (Vol. 16, No. 8), p. 41.

¹¹ In discussing the "regulatory framework for TAPS tariffs" at pp. 6-8, CERA makes no mention of: Rudolph Bertschi, *Prefiled Testimony of Rudolph L. Bertschi* (Alaska Public Utilities Commission Staff Expert Witness, Docket No. P-86-2, December 17, 1986); James P. Love, *An Analysis of the TAPS Tariff Settlement* (prepared for the Speaker of the Alaska State House of Representatives, Sept. 3, 1985); Antony Gordon Scott, *The Trans-Alaska Pipeline System; The Consequences and Causes of Regulatory Failure* (University of Wisconsin at Madison, 1996 [Master's thesis]). pp. ii, 247, 258.

¹² *Consequences and Causes of Regulatory Failure*, pp. ii, 247, 258. Scott's 1996 Master's thesis or earlier studies, such as those of

¹³ As noted above, CERA's failure to incorporate the profit items noted in Table 3 at p. 7 of this report ("after-tax margin [\$0.66/bbl.] and recovery of deferred return [\$0.12/bbl., according to CERA) into its reckoning of industry profits in its first report calls into question the utility of these reports as "White Papers."

terminal facilities could be imbedded in the filed tariffs.¹⁴ Although ignored by the CERA report, the significance of this warning was made clear by a court case in Juneau 1998. After a three-week trial, the court awarded an independent tanker owner a \$10 million judgment in response to the tanker company's complaint that the Alyeska Pipeline Service Co. had illegally imposed financial conditions on its tanker, preventing the ship from calling at Valdez. That vessel would have been the only tanker in the TAPS trade not owned or chartered directly by a major North Slope producer.¹⁵

In discussing one controversial provision of the pipeline tariff rate structure — the pre-collection through the tariff of charges for the eventual dismantling and removal of the pipeline and restoration of the corridor — the "White Paper" omits all shades of grey and black by failing to explain to readers:

- (1) that these collections were described to the regulatory agencies as revenue-neutral (*i.e.*, DR&R collections were excluded from the rate-base on which profits were allowed and the collections were described to regulators as sufficient to cover the eventual dismantling costs), when in fact
- (2) the collection scheme allowed the companies to realize a staggering off-book profit, estimated at more than \$2 billion to date and approximately \$12 to \$16 billion over the life of the settlement agreement (in 1998 \$).¹⁶

CERA does note that "the existence of the DR&R obligation provides another reason for the carriers . . . (to) delay the time for dismantling the line."¹⁷ This indirect reference to the economic benefit to the owners of retaining the pre-collected DR&R funds may explain why BP may be reluctant to consider the request of environmental and public interest groups that TAPS DR&R funds be placed in escrow as a condition of the merger.¹⁸

To support its dubious assertion that the combination of regulation, settlements, inter-company agreements and market pressures adequately protect the interests of current and future shippers, CERA cites the fact that since the imposition of TSM in 1985 several new fields have been opened on the North Slope.¹⁹ By failing to consider the shrinking pool of players on the North Slope and information that might link the mass corporate migration from the North Slope to the historical problems associated with producer-owned pipelines, CERA turns its second so-called "White Paper" into a white-wash.

¹⁴ *Preliminary Federal Trade Commission Staff Report on Its Investigation of the Petroleum Industry*, p. 26.

¹⁵ "Memorandum of Decision and Order," in *Maritime Endeavor Associates v. Alyeska Pipeline Service Co.* (Alaska Superior Ct., Case No. 1JU-95-1141 CI), Sept. 30, 1998, pp. 20-21. See also: "Complaint," *Maritime Endeavor Associates v. Alyeska Pipeline Service Co., et al.* (including BP America and five other BP affiliates), (U.S. District Court at Juneau, Case No. J97-010 CV), May 27, 1997, *passim*. (Subsequent to the verdict in the Alaska Superior Court case, the Alaska Superior Court decision was vacated and the federal antitrust action was dismissed.)

¹⁶ For a current analysis of the gains to the TAPS owners from this provision, see Richard A. Fineberg, *Overcollection and Failure to Escrow TAPS DR&R Funds — Imputed Present and Future After-Tax Value to TAPS Owners of Excess DR&R Collections Under TSM* (report to the Alaska Conservation Alliance, June 24, 1999). For earlier analyses, see *Prefiled Testimony of Rudolph L. Bertschi*, pp. 63-70, and *The Consequences and Causes of Regulatory Failure*, pp. i, 59-68, 294-297.

¹⁷ *White Paper — Operations of the Trans Alaska Pipeline System*, p. 12.

¹⁸ *White Paper — Operations of the Trans Alaska Pipeline System*, p. 12.

¹⁹ *White Paper — Operations of the Trans Alaska Pipeline System*, p. 12.

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