

What You Don't Know Can Hurt You:

The Need for Further Public Deliberations on Alaska North Slope Petroleum Fiscal Regime Overhaul

A Report to the Alaska Public Interest Research Group

by

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I. Introduction

In January, Governor Frank Murkowski discussed various proposals for major changes in the state's role in oil and gas development and in the fiscal regime that determines the state, federal and industry revenue from that development. The proposals he presented focused on the following specific issues:

- (1) protracted negotiations with industry representatives regarding terms for construction of a natural gas pipeline from the North Slope, including (a) partial State ownership;
- (2) major revision to one aspect of the state's petroleum fiscal regime – the proposal to replace the value-based severance tax with a profits-based net profits tax proposal; and
- (3) purchase of a portion of the existing Trans-Alaska (oil) Pipeline System (TAPS).¹

Recognizing the importance of “getting it right,” the Legislature responded with commendable energy and focus. Unfortunately, however, it was clear from the outset, as many observers quickly noted, that the cards were stacked against an outcome that would serve the state of Alaska's long-term interests in two ways. First, from a substantive policy perspective, the governor's approach neglected important proposals relevant to the three issues he chose to consider:

- (1) alternative natural gas delivery vehicles and the proposal to tax undeveloped natural gas deposits to encourage development of that resource;
- (2) proposals already introduced in the Legislature to correct (rather than replace) the severance tax; and
- (3) ongoing challenges to existing TAPS tariffs by (a) independent shippers and (b), more recently, the state.

The second handicap was procedural.² Common sense and experience both suggest that oil revenue issues should be separated from natural gas negotiations because the complexities of each require clear focus and mastery of detail. Combining these distinct and separable issues is liable to dilute the focus of negotiators, to the detriment of the analysis necessary in the formulation and evaluation of proposals regarding these inherently complicated subjects. Understanding of (a) the possible effects of North Slope natural gas development on oil development and (b) the trade-offs between oil and gas both require clear understanding of the possible outcomes of oil development under a

¹ See, for example, Governor Frank Murkowski, “State of the Budget Address,” Jan. 12, 2006 (<http://www.gov.state.ak.us/speeches.php?id=2158>).

² These observations reflect the author's experience, based on more than three decades observing Alaska petroleum development as a newspaper reporter, state policy analyst and senior advisor to the governor on oil and gas policy and, later, as a consultant. Background information, including citations and reports on many of the issues discussed here, can be found at the author's web site, <http://www.finebergresearch.com>.

variety of scenarios that start with oil development on a stand-alone basis. But the Legislature has been asked to consider these proposals without that information. A major part of this problem is that the governor has, in effect, tried to force the Legislature to conduct its deliberations with a gun at its head: the threat that failure to accept the terms he negotiated with the major North Slope producers before he introduced his plan to the Legislature would kill the natural gas deal. And although legislators – and members of the public -- have bridled at this circumstance, the governor's strategy has been successful: Revision of the petroleum fiscal regime is taking place (a) with oil and gas measures combined and (b) inadequate information about the possible outcomes.

This report looks at the oil-related aspects of the proposals under consideration in Juneau and identifies significant shortcomings in the information base with which the Legislature is dealing, the effects of those shortcomings on the resulting policy deliberations and decisions and important issues that should be on the table, but aren't.

II. Areas of Concern

Review of the Legislature's extended discussion the proposed overhaul of one aspect of the state petroleum fiscal regime has identified the following areas of general concern:

- (A) At this point, legislators face the complex task of trying to figure out how the various bells and whistles on the tax proposals under consideration will work. But the toolbox the Legislature has been given is inadequate and that the time allotted is insufficient to do justice to the task at hand.
- The basic framework in which the Legislature is considering the overhaul to one aspect of the petroleum fiscal regime – the severance tax – is clouded by argument over basic information that needs to be laid out clearly as the starting point for policy formulation.
- (B) If the Legislature passes a petroleum profits tax (PPT) without ensuring that TAPS tariffs are reduced, a significant portion of the credits and deductions the state is offering to encourage new companies to become active on the North Slope will be offset by the penalty imposed on them by excessive TAPS tariffs.
- Excessive tariffs also reduce royalty and production tax payments while the pipeline overpayments – ignored in one of ADOR's two principal models and inadequately reckoned in the other – wind up in the hands of the pipeline owners.
- (C) Former administration officials familiar with the execution of oil and gas policy have warned that the shift to net profits will be a sinecure for lawyers and accountants.
- The importance of this problem is underscored by a 2005 doctoral dissertation on Alaska's royalty litigation (discussed in an article posted at the author's web site).
- (D) There is no compelling reason to rush to legislate under an imposed deadline, blind to the potential effects on a gas contract that may or may not materialize.
- Failure to "get it right" can stymie development, even while granting needless give-aways that could cost the state hundreds of millions of dollars a year.

III. Supporting Information

In support of the four general conclusions summarized in the preceding section, salient specific points regarding the Legislature's deliberations in Juneau are abstracted here.³

A. Inadequate Toolbox

- ADOR models underestimate industry profit from Alaska operations.
 - To the extent that administration and legislative consultants rely on ADOR data, their general conclusions (that there is room for additional taxation, and that the Senate's tax credits may be too generous) should be regarded as understated.
- BP's claim (tendered to the Legislature April 10) that its "breakeven barrel" makes no profit \$22.50 is highly misleading.
 - This analyst's April 23 report presents worksheets showing that \$22.50 per barrel BP would actually make more than \$5.00 per barrel
- In light of all the time spent on petroleum revenue issues to date, this kind of discrepancy concerning the basic information that is the starting point for public policy decisions is surprising, to say the least.
- The largest (but not the only) source of ADOR's understatement of industry net revenue is that ADOR calculates federal income taxes as if oil companies pay that tax at 35%. Companies typically pay significantly lower rates due to deductions and deferred payment provisions.
- ADOR uses two models: One obscures pipeline profits, the other omits them altogether.
- Pipeline and tax issues assume increasing importance as oil prices decline.
 - As noted above, the Legislature is confronted with radically different estimates of the economics of North Slope production at low prices.
 - The notion that the state must share the risk at low oil prices in exchange for sharing the gain at high prices is like trying to balance on a teeter-totter with Shaquille O'Neal: In light of the fundamental imbalance, it just doesn't work.

³ Citations and supporting information may be found in two articles posted at this writer's web site during the last week of April ([Misleading Oil Revenue Data Mask Importance of Pipeline Tariffs, Income Tax Calculations](#) and [Alaska North Slope and Associated Pipeline Operations for FY 2007 at Different Oil Prices and Federal Income Tax Rates](#)), and in the author's 2005 report, [The Profitability and Economic Viability of Alaska North Slope and Associate Pipeline Operations](#) (Prince William Sound Regional Citizens' Advisory Council, April 27, 2005).

B. Excessive Pipeline Tariffs

- Consideration of pipeline profits is important because three companies control approximately 95 percent of North Slope production and own a roughly similar percentage of TAPS. Under these unusual circumstances, excessive TAPS tariffs not only diminish state revenue but also handicap competition and future development by other companies.
- Under these circumstances, independent shippers must pay pipeline tariffs out of pocket; the TAPS owners, on the other hand, retain their pipeline payments – and the profit element paid by independent shippers.
 - The attached worksheets, discussed at the author's web site, suggest that, on a cash flow basis, a generous regulatory profit allowance and continuing pipeline tariff overcharges handicap independent producers by \$5.64/bbl. In other words, if BP breaks even at (say) \$10.00 per barrel, the independent shipper producing the same barrel would go underwater on at a market price of \$15.64 per barrel.
- Trans-Alaska Pipeline System (TAPS) costs are significantly overstated by the use of the 1985 TAPS Settlement Methodology (TSM), a complicated tariff methodology established in 1985 in a settlement between the Alaska Department of Law, on behalf of the state, and the TAPS owners.
 - The preponderance of TAPS oil is shipped under tariffs derived from the TSM agreement and approved by the Federal Energy Regulatory Commission (FERC) Under that agreement, the 2006 tariff is approximately \$3.98 per barrel.
 - In 2002, the Regulatory Commission of Alaska (RCA), which has authority to set tariffs for the small portion of oil shipped to in-state refiners via TAPS, ordered the pipeline owners to reduce tariffs under its jurisdiction to \$1.96 per barrel.⁴
- The administration's failure to tender legislation that addresses pipeline tariff issues is, in and of itself, a significant public policy decision.

C. The Sinecure (State Nightmare / Lawyer's Dream)

- The history of litigation over petroleum revenue in Alaska clearly demonstrates that unless legislation related to the petroleum fiscal regime is precisely crafted, industry lawyers and accountants will have a field day looking for unanticipated loopholes and finding ways to expand them. As they engage in this process, one can be equally certain that industry representatives will attempt to blame

⁴ The RCA has re-affirmed its 2002 order twice (see: Regulatory Commission of Alaska, "[Order Rejecting 2006 Intrastate TAPS Settlement Methodology Rates.](#)" Docket No. P-06-1[1], Dec. 16, 2005). and the State Superior Court has upheld the RCA's initial decision ("[Decision and Order.](#)" Amerada Hess Pipeline Corporation, et al. [Appellants] vs. Regulatory Commission of Alaska [Appellee], Case No. 3AN-02-13511 CI, Jan. 18, 2006).

bureaucrats for the myriad accounting problems they are obligated to their company shareholders to create and exploit.

- In 2003, this writer summed up Alaska's petroleum litigation experience in this way:

. . . . Over the past 25 years, more than one dollar out of every six that Alaska has received from North Slope oil development has been obtained through legal challenges to the industry's original payment. These challenges typically involved disputes over industry reporting of the value of the oil produced and/or the cost of producing that oil and transporting it to distant markets.

These cases were argued in different institutional forums. Royalty disputes proceeded directly from agency audits to the Superior Court of the State of Alaska's court system; tax settlements resulted from audit findings preliminary to proceedings before an administrative hearing officer of the Alaska Department of Revenue; pipeline tariff issues were handled by the Federal Energy Regulatory Commission (FERC) or the Regulatory Commission of Alaska (RCA, or its predecessors). It was not unusual for the same issue—and even the same set of facts—to be argued separately by different agencies, in different venues, and with different results. In sum, the cases were complicated—and, consequently, costly—to research, brief, and present.

– Richard A. Fineberg, in [Caspian Oil Windfalls: Who Will Benefit?](#), Ch. 3 (2003; footnotes omitted)

- A doctoral thesis on Alaska's 15-year royalty litigation, based on court records and approved by the Washington State University Department of History in August 2005, came to a similar conclusion. He summarized the royalty case as follows:

At first, the issue appeared to be a simple disagreement over the computation method, but Alaska subsequently expanded the charges to include fraud. . . .

Simply stated, the oil companies mastered the ability to manipulate their books to create artificially low profits. This amounted to fraud, to the tune of hundreds of millions of dollars. Their actions were a calculated gamble with minimal risk and three possible outcomes. First and best for the corporations was the possibility that they would not get caught. Second, if they got caught and were forced to pay they at least would have stalled the process, thereby reaping interest on their money during the delay. Finally, there was the chance that if caught they might be able to spend enough money over litigation to make the battle too expensive for the state. In doing so, they hoped to force a settlement for a lesser amount than rightfully owed.

– William R. Johnson, Jr., *Alaska v. Amerada Hess: Alaska Litigates for Oil Royalties, 1977-1992* (doctoral dissertation), Washington State University, 2005, pp. 244-245.

- The TAPS tariff settlement was supposed to end eight years of expensive and time consuming litigation over TAPS tariffs. A key document presented to the Legislature during the 1985 settlement review:
 - underplayed and obscured the potential refunds at issue;
 - emphasized the difficulty of collecting refunds; and
 - failed to mention a unanimous 1978 U.S. Supreme Court decision that established the right of shippers – and, presumably, the State – to collect any refunds due from the TAPS litigation.
 - [The 1985 TAPS Settlement: A Case Study in the Effects of Confidentiality on Information Available to Decision Makers in Oil and Gas Revenue Disputes](#) (Supplemental Report) (1990), p.18 and Appendix 1.

- The briefing on which the governor made his final decision approving the final TAPS settlement in October 1985 incorrectly reduced the potential revenue from a litigation victory and increased settlement gains, making continued litigation seemed far less attractive an option than it really was. When the error was discovered, administration personnel tried to recover and destroy all copies of the erroneous briefing document; an altered, public version was released several weeks later that omitted critical sections and corrected the erroneous data on which the governor had been briefed. Officials of both the Departments of Law and Revenue later denied that the public version of the document was changed from the erroneous confidential document.
 - *The 1985 TAPS Settlement*, p.31 and Appendix 3.

D. Getting It Right

- In an April 22 letter to the Legislative Budget and Audit Committee, respected international consultant Daniel Johnston has suggested that the major producers at Prudhoe Bay and Kuparuk are liable to be the greatest beneficiaries of the proposals under consideration.
 - Johnston suggests a 30% production profits tax with 20% credits for Prudhoe Bay and Kuparuk, with a progressive increase at prices above \$40.00 per barrel.
 - For new fields, Johnston recommends a 20%/20% production tax.
 - Noting that \$40/bbl. prices are “glorious” for the industry and highly profitable – almost regardless of the tax rates being discussed, Johnston recommends high progressivity: “Considering the history of oil prices and . . . today’s high prices it is impossible for me to contemplate a neutral or even a mildly progressive system.”⁵

⁵ Johnston’s April 22, 2006 “Dear Legislators” letter was provided by a member of the Legislature.

- According to Johnston, the lower levels being considered under a “one size fits all” approach are the product of a strange and unfortunately narrow debate about such a small increase in taxes that “the oil companies must be ecstatic.”
- Johnston, who is widely regarded as a contract expert, also states, “I could not in good conscience make a decision about the oil taxes without knowing the gas pipeline terms that have been agreed between the producers and the Administration.” Without that information, he asks, “How can we claim to have exercised due diligence?”
- Former Revenue Department official and state contract oil litigator John Messenger has suggested that, instead of establishing a new tax regime that is liable to provoke extended litigation, the state should fix the broken severance tax, whose nuances are already familiar to administrators. Messenger joins a phalanx of knowledgeable former state officials who warn that the proposed shift from a value-based production tax to a net-profits-based tax creates a framework that is a sinecure for attorneys and accountants.
- Even the administration’s primary consultant, Dr. Pedro Van Meurs, recommends a higher tax than the governor proposed and supports progressivity that the governor failed to introduce.
- Van Meurs has also stated that some versions of the legislation under consideration offer excessive credits that will unduly penalize the state at foreseeable future prices.
 - Van Meurs warns that in view of the historical volatility of oil prices, prudence dictates that the state should prepare for and understand the fiscal consequences of low price scenarios.

IV. Conclusion and Recommendation

The need for additional efforts to correct the governor’s original, inadequate proposal for overhaul of the state petroleum revenue regime is evident in the concerns expressed by the international experts retained by the administration and the Legislature, whose judgment, on balance, is that the Legislature’s proposals represent a too-small step in the right direction. Concern is further heightened by the questions raised by former Department of Natural Resources officials, who left the department en masse after the governor fired the commissioner for questioning the course of the negotiations.

The situation today bears striking similarity to the conditions that set in motion three decades of onerous litigation in motion to secure underpaid royalties and taxes. In order to minimize the possibilities for a new round of expensive and time-consuming petroleum litigation, clear understanding of the details of proposed changes to the petroleum fiscal regime must extend to the fine print. When even the most basic benchmark data create confusion that masks important policy questions, prospects seem dim for a product that will produce equitable results and will be clear and easy to administer.

With the clock running down on the governor's misguided schedule and on the Legislature's 121-day general session, the process of petroleum fiscal regime overhaul has come to an important crossroads. Instead of the customary bicameral wrangling over competing proposals, it is time for the Legislature to put on the brakes and consider its next steps carefully. To minimize the possibilities for unanticipated consequences, the Legislature should create a checklist of critical issues against which the proposed legislation can be evaluated. Legislation of this importance and complexity should not move forward until it has been evaluated against that list. Responsible stewards of Alaska's resources can do no less.