

SB 201:

Separate Accounting of Oil and Gas Corporate Income Taxes

Senate Finance Committee
March 20, 2012

Senate Bill 201 would reinstate the separate accounting method of calculating corporate income tax paid by the oil and gas industry.

Under separate accounting, oil and gas companies pay tax on the income they earn within a particular jurisdiction as opposed to a share of their worldwide earnings.

This method is used by EVERY oil and gas producing nation in the world, including the United States, according to a March 9, 2012, analysis by Roger Marks, requested by LB&A.

It is also used by some U.S. states, including Oklahoma and Mississippi, and is offered as an option to O&G taxpayers in Louisiana.

Since oil production in Alaska began, the O&G industry has strongly urged the State to use a worldwide apportionment method for calculating their income tax.

- The O&G industry is the only industry in Alaska that uses this method.
- The income of other multinational corporations operating in Alaska is apportioned on a “water’s edge” or U.S.-only basis.

- In the mid-70s, Alaska realized that it would lose significant revenue under the apportionment method.
- After 63 hearings and 4 years of analysis and debate, the legislature adopted separate accounting in 1978.

Under AS 43.21, revenues generated in Alaska, less expenses, became the basis for the 9.4% state corporate income tax.

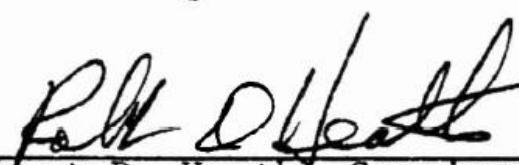
The oil companies sued. They lost in the lower court and appealed to the State Supreme Court.

Four years later, in 1982, the State reverted to the apportionment system because the legislature feared a potential cost of \$1.8 billion if Alaska lost.

12. The estimated total refund liability of the State
is:

<u>YEAR</u>	<u>ESTIMATED TOTAL REFUND LIABILITY</u>
1978	\$ 122,000,000
1979	311,000,000
1980	570,000,000
1981	<u>821,000,000</u>
TOTAL	\$1,824,000,000

Further your affiant saith naught.



Robert D. Heath, Commissioner
Department of Revenue

SUBSCRIBED AND SWORN TO before me this 27th day of
April, 1984.

At the time, the legislature saw that as too great a liability, given the treasury balance in 1981.

However, two years later, the state won on all points at the Alaska Supreme Court, and in 1986, the United States Supreme Court declined the oil companies' appeal request, stating there were no federal issues.



Separate accounting has never
been reinstated.

In 2000, the Department of Revenue estimated that Alaska lost \$4.7 billion between 1982 and 1997 because of the switch from separate accounting to apportionment.

**Comparison of Actual Oil and Gas Corporate Income Tax
Collected with Estimated Revenues using a Separate Accounting
Income Tax Approach
(In Millions)**

	Actual O&G Income Tax Collected	Estimated Separate Accounting Revenues	Difference
1982	242.50	837.62	595.12
1983	236.00	796.15	560.15
1984	265.10	782.86	517.76
1985	163.60	797.00	628.40
1986	181.00	341.00	160.00
1987	205.00	562.00	357.00
1988	198.00	396.00	198.00
1989	174.00	473.00	299.00
1990	208.00	598.00	390.00
1991	237.00	410.00	173.00
1992	189.00	385.00	196.00
1993	90.00	264.00	174.00
1994	98.00	219.00	121.00
1995	206.00	270.00	64.00
1996	281.00	408.00	127.00
1997	259.00	355.00	96.00
TOTALS	\$3,238.20	\$7,894.63	\$4,656.43

The DOR fiscal note for this bill also estimates that Alaska is losing about **\$250** million a year due to its use of worldwide apportionment as opposed to separate accounting.



Statements made over the past decade by oil industry executives support the conclusion that Alaska loses income using formulary apportionment.

“ ... Norway, the U.K., Alaska, Indonesia, all have relatively high, higher than average margins.”

Jeffrey Wayne Sheets, CFO and Senior VP of Finance for ConocoPhillips, in a 2011 Q3 conference call.

“Talk about Alaska, we like Alaska. . . .
Last year 240,000 BOE a day, **strong cash margins** in this area ... We'll invest \$350 million in exploitation this year, all at **very good returns.**”

From Greg Garland, Senior Vice President of Exploration and Production for the Americas with ConocoPhillips. Said on March 23, 2011.

“ ... Alaska's role in BP' s portfolio is to provide a **stable production base and cash flow to fuel growth elsewhere** in the business while improving margins and returns.”

Alaska Business Unit, Mid-Stream Alaska, Trans-Alaska Pipeline Pump Station Electrification Decision Support Package – Sanction, February 9, 2004, page 13

These statements are confirmed by information contained in Securities and Exchange Commission filings, which show that per BOE earnings in Alaska for ConocoPhillips are nearly double what they are in the Lower 48 or the rest of the world.

A Legislative Research report issued yesterday compares net income per BOE from Alaska, the Lower 48 and the rest of the world from 2000-2010.

- Alaska average: \$15.10
- Lower 48 average: \$8.79
- Rest of world average: \$8.57

One cause of this difference in net income per BOE is lower value gas production in other jurisdictions intermingled with higher value oil production. But this intermingling is exactly what occurs with formulary apportionment.

Figure 3: ConocoPhillips: Net Income per Barrel of Oil Equivalent

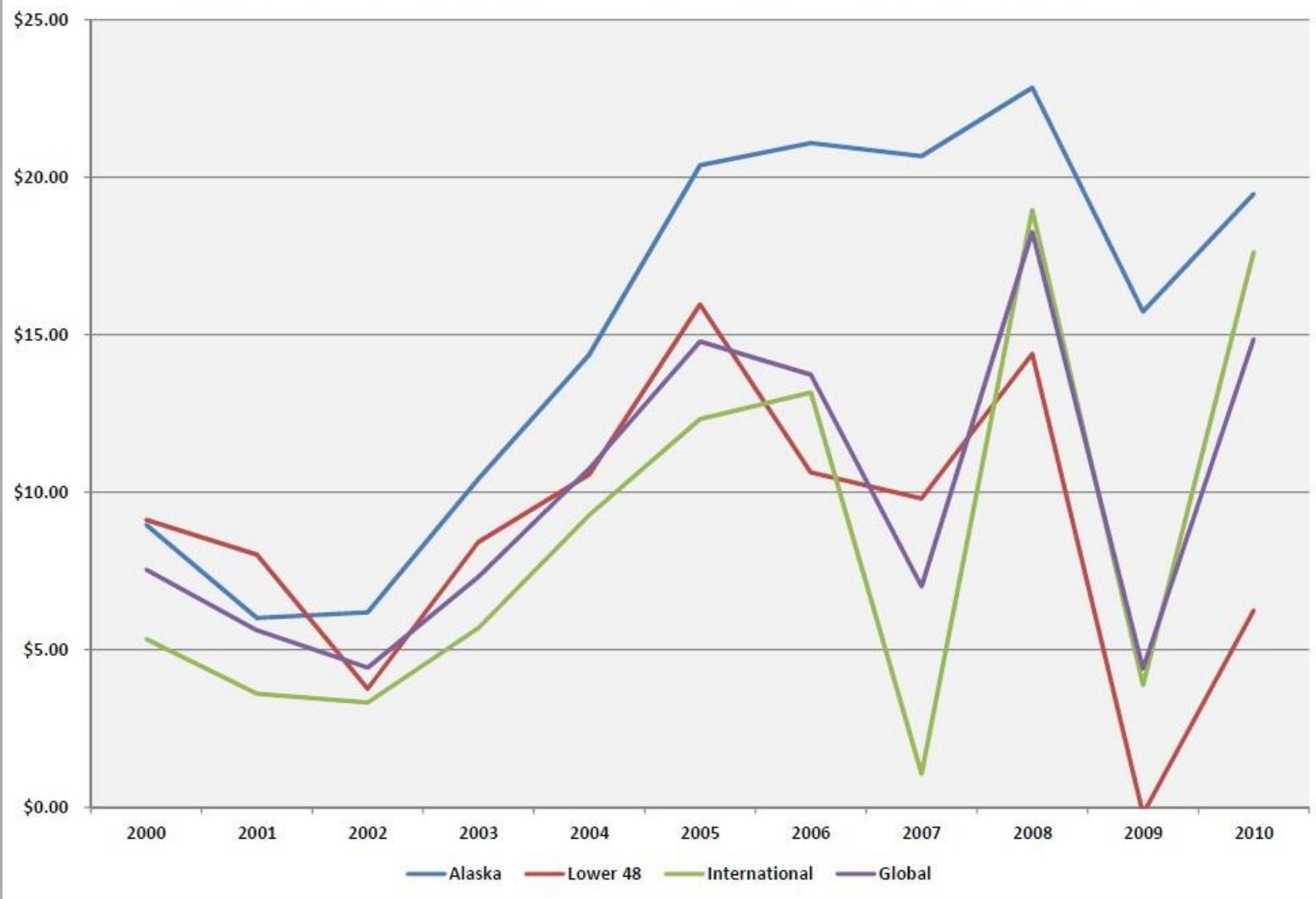


Table 2: ConocoPhillips: Net Income per Barrel of Oil Equivalent (BOE)

Jurisdiction	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Average
Alaska	\$8.97	\$6.01	\$6.19	\$10.43	\$14.36	\$20.38	\$21.08	\$20.66	\$22.84	\$15.73	\$19.47	\$15.10
Lower 48	\$9.13	\$8.02	\$3.77	\$8.42	\$10.56	\$15.96	\$10.63	\$9.80	\$14.39	(\$0.20)	\$6.26	\$8.79
International	\$5.35	\$3.61	\$3.33	\$5.69	\$9.27	\$12.33	\$13.17	\$1.06	\$18.96	\$3.89	\$17.62	\$8.57
Global	\$7.54	\$5.62	\$4.43	\$7.32	\$10.75	\$14.79	\$13.73	\$7.02	\$18.26	\$4.39	\$14.86	\$9.88
Proportion of BOE Production												Average
Alaska	35.9%	47.6%	35.6%	23.6%	24.1%	22.0%	15.5%	16.6%	15.5%	11.9%	14.4%	23.9%
Lower 48	23.8%	19.6%	19.2%	18.8%	19.8%	19.1%	26.2%	30.9%	28.3%	22.2%	26.7%	23.1%
International	40.4%	32.7%	45.1%	57.6%	56.1%	59.0%	58.2%	52.5%	56.2%	65.9%	58.9%	53.0%

Notes: "Barrel of oil equivalent" expresses the amount of a given fuel required to equal the amount of energy contained in one standard U.S. barrel of crude oil (42 gallons). For instance, a generally accepted BOE approximation for natural gas is 5,800 cubic feet (5.8 Mcf). Please note, however, that the amount of energy provided by crude oil (or any fuel) varies by production location or, more precisely, the grade of oil produced. Therefore, BOE figures should be viewed as estimates. The figures in this table are the results of dividing net income by the aggregate BOE production of oil, natural gas, and natural gas liquids.

Source: Legislative Research calculations based on annual filings of form 10-K with the U.S. Securities and Exchange Commission posted to the EDGAR online database, <http://www.sec.gov/edgar/searchedgar/webusers.htm> .

Recently international oil industry consultant Pedro Van Meurs testified to this committee that he believes worldwide apportionment is cumbersome, an obstacle to new investment, and not in the state's best interest.

Pedro Van Meurs: “I have always been in favor of calculating the Alaska portion of the corporate income tax entirely on the revenues and costs attributable to Alaska and not to any other part of the world.”

Pedro Van Meurs on worldwide apportionment: “It messes up significantly the Alaska possibility for giving these kind of incentives, making these kind of rules, allowing international companies to benefit.”

Pedro Van Meurs on apportionment: “It makes the tax system very cumbersome to run. In fact, it is actually an obstacle to investment in Alaska because it is very difficult to explain to any newcomer how you even have to calculate your state corporate income tax.”

Pedro Van Meurs concluding statement on separate accounting: “It gives you far more political freedom to pursue the interests of the state the way the state wants to do.”

A review of the history of this issue is instructive as the legislature reconsiders separate accounting and other changes to our oil tax regime.

- In 1949, the territorial income tax enacted. This tax remain essentially unchanged until 1978.
- Income of multi-state corporations in Alaska was apportioned on the basis of three factors: property, payroll and sales.

- This method of apportionment was developed principally for mercantile businesses.
- Over many years, it became apparent that it **systematically under-calculates income attributable to oil production.**

The oil industry in testimony will likely tell you that Alaska should maintain formulary apportionment to be consistent with many other states, avoid the potential for duplicative taxation, and sidestep the administrative burdens associated with separate accounting.

However, all of the constitutional issues regarding duplicative and discriminatory taxation have been resolved, and the fiscal benefits of separate accounting clearly outweigh the costs and administrative challenges.

- According to the fiscal note submitted by DOR, separate accounting would have generated about \$250 million more in each of the 5 preceding fiscal years.
- The cost of administering the system are estimated to be about \$525,000/year, primarily to hire 4 new tax auditors.
- Thus the benefits are roughly **475** times greater than the costs.

TOP FIVE OIL COMPANIES
CORPORATE INCOME TAX COMPARISON

	2006	2007	2008	2009	2010	Avg.
Production Tax Value (PTV)	8,269,253,754	12,373,309,410	16,639,085,462	8,123,576,735	10,267,505,397	
Production Tax net of Credits	<u>1,648,686,505</u>	<u>3,486,434,327</u>	<u>7,121,145,726</u>	<u>2,033,891,379</u>	<u>3,023,427,665</u>	
PTV net of Production Tax/ Subtotal Production Income	6,620,567,249	8,886,875,083	9,517,939,736	6,089,685,356	7,244,077,732	
Transportation Income *	<u>(24,892,884)</u>	<u>186,438,182</u>	<u>(653,974,506)</u>	<u>(456,078,939)</u>	<u>(454,804,489)</u>	
Taxable Income (A)	<u>6,595,674,365</u>	<u>9,073,313,265</u>	<u>8,863,965,230</u>	<u>5,633,606,417</u>	<u>6,789,273,243</u>	
Tax @ 9.4% (B)	619,993,390	852,891,447	833,212,732	529,559,003	638,191,685	
Actual Corporate Income Tax Paid (C)	<u>630,307,274</u>	<u>570,389,248</u>	<u>642,563,992</u>	<u>293,204,318</u>	<u>385,633,537</u>	
Difference (B - C)	<u>(10,313,884)</u>	<u>282,502,199</u>	<u>190,648,740</u>	<u>236,354,685</u>	<u>252,558,148</u>	<u>190,349,978</u>
Effective Tax Rate Paid (C / A)	<u>9.6%</u>	<u>6.3%</u>	<u>7.2%</u>	<u>5.2%</u>	<u>5.7%</u>	

* Using FERC Form 6, Net Carrier Operating Income. Certain companies may include Transportation activities outside of Alaska.

(A) Taxable income does not include apportioned other income.

(C) Certain 2006-2008 returns are audited and/or amended.

- It's true that until the 1970s, Alaska lacked the resources and staff to administer a corporate income tax effectively.
- Returns were generally accepted as filed and field audits were never conducted. However, that is not the case today.

As the development of Prudhoe Bay approached, interest within the legislature on appropriate methods of taxation increased.

Legislative consultants warned that Alaska would receive little income tax from the O&G industry, not only because of the apportionment formula, but also because the state tax was based on federally taxable income, which usually amounted to very little.

They argued that income tax should be tied to profitability, rather than production, property, payroll, sales, or other variables which do not represent the health or viability of the industry.

These arguments are true today.

Since little of Alaska's oil is sold
in state, the sales factor, which is
still part of the formula, minimizes
income generated from Alaska.

The property factor is also not as reflective of value as one might expect. It does not include the value of oil or gas in the ground, and facilities are valued at their original cost, not their value today.

Formulary apportionment also fails to recognize the greater profitability of production, compared with refining or retail sales.

It doesn't reflect that not all facets or areas of a company are equally profitable.

In addition, formulary apportionment treats companies with the same earnings (those doing business only in Alaska and multinational corporations) differently.

“The three-factor formula bestows a benefit on multistate oil companies that is not shared by other Alaskan businesses. It allows those corporations to pay tax on only a fraction of their Alaska income, which substantially lowers their effective tax rate...”

State of Alaska brief to Alaska Supreme Court, April 27, 1984

During the hearings on AS 43.21, legislators asked about this:

- Senator John Huber: “Does SOHIO object to paying 9.4% on its true net income the same as they would have to if they were strictly an Alaskan corporation?”
- SOHIO Vice President Richard Donaldson: “Yes”

In 1977, the Department of Revenue acknowledged some of the drawbacks of formulary apportionment, including:

1. the federal tax base on which it is based (for U.S. corporations) allows for significant and undesirable erosions in the tax base;
2. the policies underlying many federal tax exemptions, credits and deductions are irrelevant to or inconsistent with state objectives; and
3. none of the property, payroll or sales factors truly represent O&G producing activity in Alaska.

During the same period, the O&G industry made many of the same arguments heard today about ACES.

They said separate accounting :

1. would have an adverse impact on exploration and development investment in Alaska;
2. was unnecessary because Alaska already imposed one of the highest tax burdens of any state on the O&G industry; and
3. illustrated the instability of the Alaska business climate.

- Exxon released a “Business Climate Analysis” showing Alaska ranked 47th and 48th out of the 50 states on 2 important measures of business friendliness.
- The company argued that separate accounting would make it worse.

Despite O&G industry opposition to separate accounting in Alaska, it's interesting to note that elsewhere they have sued to be able to use this methodology.

Even in Alaska, industry has sued in support of the right to use separate accounting.

(See *State of Alaska v. Amoco Production Company*, 676 P. 2d 595, Supreme Court of Alaska.)

Separate accounting has several additional benefits the sponsor would like to highlight:

1. It doesn't tax a company until that company makes a profit. Under apportionment, companies begin to pay taxes as soon as they set up shop in Alaska. In this manner, separate accounting encourages new business development.

2. If a company invests in Alaska, it drives down that company's corporate income tax. It is an incentive to additional investment.
3. If oil development in Alaska becomes less profitable than elsewhere, that change in profitability is reflected in the corporate income tax. Under that circumstance, it would result in a well-deserved tax cut for the oil industry.

4. The separate accounting methods proposed in SB 201 are nearly identical to methods used by other states, the IRS, and other nations. They are also consistent with OECD model treaties.

In closing, as the State argued in 1984 to the Alaska Supreme Court, separate accounting “foregoes the surrogates and assumptions of mathematical formulas and looks instead at actual revenues and costs of in-state operations.”

State of Alaska brief, April 27, 1984, page 41.

It is a fair and equitable method of assessing corporate income taxes that is used successfully around the world and in other U.S. states.