ARLO TUSSING
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STATE OF ALASKA
THE LEGISLATURE
LEGISLATIVE AFFAIRS AGENCY

POUCH Y STATE CAPITOL
JUNEAU, ALASKA 99801

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The attached transcript contains the remarks made by Mr. Arlon Tussing on October 17, 1973 before the Senate Resources Committee. It is a verbatim transcript of Mr. Tussing's remarks. There is occasionally a word missing or other minor gaps in certain places, which are due to the speaker's testimony being indecipherable at that point. However, it is believed that these occasions are rare and the transcript presents a fair picture of the thoughts expressed by the witness before the committee.

Senator John Sackett
Chairman
Resources Committee

Memorandum
October 17, 1973 CONFIDENTIAL

To: John Sackett

From: Arlon Tussing

These remarks are based upon a first reading of the pipeline legislation proposed by the Governor and do not reflect any presentation by the administration or other witnesses.

General Remarks

The Legislature should be aware that the Middle East fighting, together with the new price increase imposed by the Persian Gulf nations, have put the State of Alaska in an absolutely invincible bargaining position with respect to the oil companies. The expected profits of the companies from their North Slope holdings have probably doubled over the last year, and will continue to spiral upward as the domestic crude oil deficit grows and with the expected rise in prices of Middle East imports. There is not the slightest possibility that the companies would refuse to build the pipeline because of the State's failure to enact the Governor's legislative package or any part of it. You should also know that Senator Jackson has prepared, and has promised to introduce a bill to nationalize the Trans-Alaska pipeline if

litigation between the State and the companies delays construction. There is no warrant for the State of Alaska to make any economic concessions to the companies at this time; indeed, an opposite approach might well be considered.

The emphasis on economic measures is an important one. Where there are legal flaws in the existing State statutes dealing with pipelines, they ought to be remedied. Where there is even a possibility that such flaws could stand in the way of early pipeline construction, amendments ought to be considered. If there is to be further bargaining between the State and the companies (economic, political or legal), it is important to put the full onus for any postponement of construction on the backs of the companies and not upon State law or upon that popular whipping boy, the courts.

The state stands in two rather distinct legal relationships to the companies which are operating on the North Slope and which propose to build the pipeline. The State is, firstly, the sovereign, with taxing authority and the police power. As such it can tax and regulate oil and gas production and pipelines (to the extent that the latter power over pipelines is not preempted by the federal government), whether they are on State lands, federal lands or private lands. Secondly, the State is the landlord and royalty owner with respect to the producing properties on the North Slope and

the landlord with respect to pipeline rights-of-way across State lands. Different principles govern what the State may and may not do in these two capacities. Although the State as landlord is not necessarily on an equal footing in every respect with (say) a private landlord, it is among other things bound by the sanctity of contracts, including that of oil and gas leases.

The existing right-of-way bill asks for trouble because it confuses the State's two roles and attempts to use the State's sovereign power to achieve for the State as landholder privileges which are not available to other landholders. I do not have the legal expertise to say whether or not the State would prevail in a court test of the existing right-of-way leasing act, but as long as there are more straightforward ways to achieve the State's economic ends - ways that clearly respect the distinction between the State's two kinds of legal personae - there is no reason to resort to complex and novel formulas as laden with legal controversy as is the current law.

An often expressed objective of the original pipeline package was for the State to maintain control of its own destiny and to limit the ability of the major oil companies to control the State's economy and (implicitly) its politics. Many Alaskans would be willing to sacrifice substantial oil and gas revenues to advance this objective. The most

important elements in preventing company domination, however, are (1) an informed population, (2) a high level of integrity and detachment on the part of the State's elected and appointed officials and (3) an expert, professional and well-funded Division of Oil and Gas. The third we now definitely have. The second - integrity and independence of public officials - is probably most important because the information received by the public and the maintenance of an independent analytical and regulatory capacity depend upon it. If the Legislature wants to guarantee its own political independence and that of the State government, it might consider some very tough public disclosure, conflict of interest, and campaign financing statutes.

The Ad Valorem Property Tax

I see no problem with the general principle of an ad valorem tax. The arguments for the State's preemption of taxing authority over this kind of property are compelling, and need not be repeated here. The division of tax revenues between the State and its subdivisions is a purely political question which is outside my terms of reference as a consultant.

One question that might be asked about this proposed legislation is the reason for exempting the so-called intangible drilling and development expenses. This item is made up primarily of the labor employed in drilling of wells and is not different in principle from the labor employed in

building a pipeline or any other structure. These outlays could be valued on a depreciated historical cost basis, on the same principles as other outlays for producing properties. Is the exemption proposed because the companies do not want to disclose their intangible expenses (which get special treatment under federal tax law), or are they just anxious that the principle of treating them like other investment costs never be established anywhere, lest the expensing of intangibles in federal income tax law be jeopardized? In either case the Legislature ought to know the reason and view it on its merits.

Right-of-Way Leasing

My preliminary remarks dealt with some of the objections to using right-of-way leases as a roundabout way --- a hostage, in effect --- to influence the State's combined royalty and tax revenues from oil and gas production. It confuses the State's roles as sovereign and as a quasi-private party to a commercial transaction - roles which ought to be kept distinct for a number of reasons. Whether or not the approach in the present Act would stand up in the courts, it is sufficiently questionable that it ought to be avoided if there are equally effective alternatives that are more conventional or more straightforward. The proposed amendment, however, goes out of its way to abdicate any authority of the State, in either its capacity as sovereign or as landowner, to regulate operation of the pipeline.

Page 4 of my copy of the Governor's proposal was missing, so I cannot refer accurately to sections and subsections on pages 5 to 11. The language of subsection (3) on page 5, which begins, "the imposition of common carrier status does not require . . . ", is not necessary to protect owners and operators from unreasonable and uneconomic demands by shippers, and appears to go far beyond the common law in permitting pipeline operators to evade their common carrier obligations.

Some modification of language or punctuation is necessary to make it clear that the word "which" at the beginning of line 7, page 6, refers to "pipeline" rather than to "lessee."

I shall comment on the common purchaser provisions, which the Governor proposes to remove from the right-of-way leasing act, separately under the heading of common purchasers.

The State's option in existing law to buy 20 percent of the pipeline is probably unworkable in view of the way in which the pipeline is to be organized, financed and owned. Once the line was built, transfer of a share to the State would be extremely complicated and would generate horrendous Lawsuits. The proposed substitute language (subsection 7 on page 7), however, is almost meaningless. Its only force is to establish instances in which the State would not have "an opportunity to negotiate." It is not clear what is the purpose of this provision.

There are still arguable grounds for the State to own a share of the pipeline, both (1) to protect its own royalty and tax interest against tariff manipulations, and (2) to provide a vehicle for shipment of oil by independent producers if the companies operating the pipeline are unwilling or unable to provide transportation on a nondiscriminatory basis. If this is the State's approach, however, the decision ought to be made positively now to buy into the pipeline on a specified proportion, before pipeline construction is started, and this decision ought to be coupled with the necessary organization, bonding authority, etc. to carry out the project. The option to buy in its present form is understandibly objectionable to the companies because of its potential use simply for harrassment.

It ought to be kept in mind that the State does have the ultimate power regardless of this legislation to condemn pipeline property for public purposes (provided it does so subject to law and pays the owners fair compensation), and to operate the pipeline as a state-owned public utility. It is not clear what benefits there would be in state ownership, but its possibility might be as much of a deterrent to abuse of private pipeline ownership as the option in statute to buy a part of the line. I am not sure that there is any point in raising the state ownership issue in any legislative form today, however, unless the State definitely intends to own

and/or operate all or part of the pipeline.

The Production Tax

Collection of a production tax, whether "cents per barrel" or a percentage of wellhead value is unquestionably within the authority of the State. There are no obvious legal difficulties in coupling a minimum cents-per-barrel tax with a proportional or graduated tax above this minimum.

Much higher prices can be expected for crude oil in the near future, and these prices will not be offset by higher development costs or additional exploration risks. The result will be vast windfalls for the operating companies. There is no economic reason the State could not levy a highly progressive severance tax --- one which takes 25, 40 or even 90 percent of wellhead revenues above a given level, for example $4.00 per barrel. I am not proposing such a tax, but in view of the quite successful demands of a similar magnitude by the OPEC countries, it would be surprising if Alaska did not reconsider its oil and gas taxation levels in the context of the new conditions.

One recurring problem with respect to severance taxes (or royalties) levied as a proportion of wellhead value is the valuation of oil or gas at the wellhead, where arms-length sales are lacking or rare. In general, the operators will be carrying their own oil through their own pipeline and selling it to their own refining divisions. In such a case the declared

wellhead value or transfer price is not a real price but is an accounting fiction chosen to minimize the company's consolidated liability for taxes and royalties. Where the sum of production tax and royalty rates is low at the margin, the depletion allowance (which is applicable only to income from production) encourages the integrated companies to take their profits in production rather than in transportation or refining. This tendency means that the companies will declare relatively high wellhead prices, which are in the State's interest.

It is not always in the companies' interest to maximize wellhead values, however. As the sum of royalties and production tax rates is increased, it is increasingly important that wellhead values not be unilaterally set by the companies and uncritically accepted by the State. Recognition of this problem was of course one rationale for the existing right of way leasing law. Some remedy to this situation seems to be available in existing and proposed state law, but the Administration ought to be able to explain carefully and completely how any remedies will or do work, and how the State expects to combat any unrealistically low transfer pricing.

One question that ought to be explored thoroughly is whether it is in the State's interest to imitate federal tax law in every respect --- particularly whether the percentage depletion allowance, the expensing of intangible drilling costs, etc. This Session is not the time for such a new and

complicated issue, but a study Senator Jackson has requested from the Library of Congress in behalf of the U.S. Senate's Energy Study will be the most complete consideration of the tax preferences for oil and gas yet published. This study will be available early in 1974, and will be of considerable value to Alaska's Legislature.

Conservation Tax

There are no apparent problems with the oil and gas regulation and conservation tax. Because its revenue would go into the general fund and is not earmarked for these specific activities, however, the segregation of this tax in a separate bill with a special name is just semantics.

Common Purchasers

The kindest thing to say about this bill is that its provisions will never be used. It does not cope with the problem that created the demand for common purchaser legislation in the first place, and addresses a problem which is unlikely ever to arise. The bill, in essence, forbids a petroleum purchaser to discriminate among sellers. The problem however, is that pipeline owners, by virtue of their monopoly over transportation, are alleged to compel independent producers to sell to them in the field at prices less than the value of their oil. The discrimination at issue is not among sellers, but between the oil of the pipeline owner's affiliate (which is not sold in the field), and that of independents (who must sell in order to dispose of their oil).

The existing law at least recognizes and addresses itself to the real problem though perhaps not effectively.

In any event, a civil penalty of $100 to $1,000 can simply be regarded as a cost of doing business. If the conduct in question would bring a disruptive outsider to heel, it could well be a rewarding investment. If either common carrier or common purchaser legislation is to have any effect, the Legislature ought to consider at least creating (1) a private cause of action for recovery of triple damages, and (2) the possibility of injunctive relief.

Perhaps the problem is one that can never really be solved under a regime of shipper-owned pipelines. Even if common carrier requirements are strictly complied with, it is always cheaper for the pipeline owner to ship an additional barrel of his own oil through his own pipeline than it is for an independent to ship his oil through a pipeline he does not own. The outsider pays the tariff (which is always higher than the cost of shipment) and the owner pays the cost (even though his books say he paid the tariff. He paid it to himself!) So, given equal prices at the downstream end of the pipeline, the pipeline owner can always offer to buy the independent's oil in the field for a better price than the owner can get by selling it at the other end of the pipeline and paying the transportation tariff. If the common carrier requirement can be evaded, of course, the pipeline owner can get by with a

lower price than the independent could have got by selling at the pipeline outlet.

Pipeline Commission Act

Whether the State has concurrent regulatory jurisdiction with the federal government over oil pipelines is a serious legal question, and I am at a loss to know why the Administration would not want this issue to be litigated. If the State lost the case, its remaining authority would be no less than provided in this bill, and might well be greater.

There is no way in which litigation over the regulatory authority of the Pipeline Commission could hold up pipeline construction; it is difficult to conceive of a cause of action the companies could advance until the Commission issued an order which conflicted with federal jurisdiction, and such orders would not commence until the pipeline began operation.

The assertion that new attention in Congress to anti-trust and common carrier problems assures an effective ICC surveillance of pipelines is at best naive.

Concluding Remarks

I want to reemphasize that these are first reactions upon a first reading of the proposed legislation. Despite occasional strong language, my remarks are provisional, and my conclusions may change as I am exposed to advocates of the legislation and have an opportunity to study the proposals

more carefully. There is one conclusion that I do not expect to change, however. These bills need not be considered as an inseparable package; they each ought to be examined on its own merits.