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The attached transcript contains the remarks made by Mr. Milton Lipton on October 20, 1973 before the Senate Resources Committee. It is a verbatim transcript of Mr. Lipton'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

SENATE RESOURCES COMMITTEE

Special Legislative Session

October 20, 1973

Mr. Lipton

I'll try to get my introductory remarks to the point of the issues which you are considering here with respect to the legislation submitted by the Governor. First of all it is very obvious that there is considerable urgency in getting on with the construction of the pipeline. This is clearly evidenced by Congressional action to authorize construction. And I think the action by Congress implies not only an appreciation of the hightened concern by the nation as a whole for the potential contribution of North Slope oil to the nation's precarious balance in essential energy supplies, but also a feeling that it is imperative at this stage to avoid further unecessary delays on account of litigation in the courts. And I think that the same spirit, the desire to avoid unecessary delays, is reflected in the negotiations between the Governor and the companies. There is no doubt but that the State and the companies have a very common interest at least in getting on with the job.

You must independently review the proposed legislation in the light of the many issues involved so in my introductory remarks I would like to address myself to the question - what have been the major concerns which have impelled past legislation, to what extent are these concerns still relevant to the State of Alaska, and to what extent do the proposed changes in the legislation adequately take care of the concerns of the State and to what extent may you want to consider variations, deviations, or at least review what is being proposed.

The first thing that I would like to stress is the public interest that is inevitably and irrevocably involved in the pipeline. This is a circumstance which is unique to Alaska, it is of tremendous importance to Alaska and it just does not obtain elsewhere. This is one of the reasons why in your legislation you must be circumspect to a degree that perhaps other states need not be. The contrast between the pipeline that is proposed to be built along a corridor from the North Slope to Valdez contrasts with any other transportation circumstances in the lower 48 states. There was never a time when it was not possible, quickly and expeditiously, for any crude oil producer having a significant flow of crude oil without access to pipeline capacity to undertake to build a new pipeline. Or for any refinery without access to pipeline that would bring crude oil to

his refinery not to undertake the construction of a pipeline. There is today for example a very serious shortage of pipeline capacity into the Midwest area. CAP line, which until Alyeska was the largest undivided interest crude oil pipeline in the United States is expanding its capacity under different investments by the various companies participating. Its not a proportional expansion of capacity but to reflect their several needs. There are refineries located in the mid-continent area of the United States that have historically drawn their crude supplies from Oklahoma and Kansas where crude production is going down that are prepared to build their own pipeline from the U.S. Gulf area into the mid-continent area. There was a new fairly large capacity pipeline just completed to carry products from the gulf coast area to new consumer markets in the mid-west. So that although individual pipelines have, in a sense, a monopoly over their own rights-of-way and are regulated, the circumstances of investment construction in the lower 48 make it possible for competing or alternative forms of transportation to be provided. This is simply not the case with respect to the crude oil resources of the North Slope and the access to export markets in southern Alaska. That pipeline corridor will convey to whatever company builds that pipeline an

an irrevocable right for the transportation of crude oil. The state has tremendous interest in this pipeline. It has interest in seeing that the facilities are operated in the most economical, efficient fashion. That the facilities, whatever their capacity, may in due course be expanded to meet the needs either of incoming production or facilities provided to expand the delivery of crude oil, for example, to intermediate points within the State, such as Fairbanks. My point simply is that company interests may not always correspond in toto, or at a moment in time to the concerns that are of primary interest to the State.

I had the privelege of listening to Mr. Spahr's testimony before this Committee yesterday afternoon and I was quite impressed with his very careful and precise statement of how a company balances all of its investment decisions against their many alternatives, which means in effect that the economic interests of the State, from time to time and in various respects may not coincide with the inclinations of the individual companies who are participants in the pipeline.

There is no way in which the State, through its regulatory machinery, can impose arbitrary or capricious demands upon the pipeline, either to deny them the right to do things or to compel them to do things, because the pipleline always has recourse to the state courts, under the due process of law, against capricious, arbitrary or confiscatory demands

made by a regulatory authority. There is likely to be a wide range of business transacted by that pipeline which involves intra-state commerce and which involves State interest in the totality of its commerce. And, to the extent that the State has an interest and can exercise jurisdiction, it would seem to us that the legislation enacted by this legislature should claim for the State such jurisdiction, subject both to the prior jurisdiction that the ICC may have, and subject also to court review of how the State exercises such jurisdiction as is available to it. But, I would not think that the claim by the State, in its legislation, to exercise regulatory jurisdiction, should be such a disabling factor that in advance they would say that we will not submit to the legislative exercise of this power and go ahead with the construction of our pipeline unless it has been previously reviewed in the courts. The exercise of the State regulatory authority is always available to them subject to judicial review. I would not think that this one, among the many issues would be the one that would be such a stickler that it would involve prior litigation and unecessary delays on the subject of the construction of the pipeline. This bears upon aspects both in the proposed amendments to the Pipeline Commission Act and certain proposed amendments in the Right-Of-Way Act.

The second overwhelming interest of the State I think is in the tariff which the pipeline will eventually establish.

The estimated costs of the pipeline goes up by leaps and bounds. The figure that is now being used in the range of 4 - 4 1/2 billion dollars which makes it both an incredible industrial undertaking and private investment. But it ought to be seen in context. There has been over the past three years, according to estimates, an increase of 3 billion dollars in the construction costs of the pipeline. On the other hand, the increase in wellhead values in Alaska, as measured only by the increase in postings already put into effect in California, are on the order of 60¢ a barrel, and 60¢ a barrel on 10 billion barrels of recoverable oil, means at least that the capital assets which underlie all of the incentives to construct this pipeline have gone up by about 6 billion dollars in the same period of time. Insofar as the economics of the pipeline are irrevocably tied in with the economics of crude oil production, the increase in the construction costs of the pipeline, occasioned by inflation, environmental considerations, regulation, etc. are not disproportionate to the tremendous increases in the value of Alaskan oil, which have already obtained by virtue of the run up in energy prices and crude oil values in California, and also with respect to foreign oil at the price which it can be

brought into the United States.

These higher wellhead values, reflecting world oil prices, are no reason for the legislature to have less concern than before about the relationship between a pipeline tariff and a wellhead price at which their severance tax and royalties are assessed. The mere fact that the oil is worth more is no reason for you not to insist that the maximum worth accrues to the State, and that it not be unecessarily depressed, even if its depressed from an unexpectedly high level by virtue of the tariff which is established on the pipeline.

It is not the issue that one questions the good will or the economics of the company. The real question has to do with how the State, given its economic interest, exercises its responsible legislative authority to protect the interests of the State in the event that company interests, for one reason or another, are found in such a way that the State feels its own interests are being bypassed. It is for that reason that we have felt very strongly that the State should be looking at a package of legislative means that not necessarily by themselves but together, would always conduce to the most favorable tariff, in light of the States economic interest.

One of the specific issues involved is one that came to the fore in the Right-Of-Way Leasing Act of 1972 was the percentage lease rental and the many provisions associated with it. If you recall our testimony last year, this was

one area in which we had certain reservations. It certainly was, to our mind, an imaginative approach on the part of the State, since the main intent and purpose of the percentage lease rental formula was not to raise revenue for the State. Quite the contrary, the intent and purpose was to hold out an alternative of pains or rewards to the pipeline participating companies. Pains in the form of a very high lease rental if they set too high a tariff, and rewards in the form of an appreciably lower lease rental if they set the lower tariff. We had however, considerable uncertainty as to what the company response would be to it. It was then very, very difficult and it remains very, very difficult to compute, company by company, the way in which the impact of the percentage lease rental would fall upon the company, not knowing in advance what the ultimate proportions would be between a company's equity in the pipeline and a company's equity in the crude oil, that is whether they were a net buyer or a net seller. And not knowing what the tax exposure was of individual companies with respect to income earned on production, which has the advantage of depletion allowance and the disadvantage of severance tax royalty, or what their income tax exposure might be on pipeline operations given accelerated amortization, investment tax credits, etc. This is a very difficult corporate computation. So there was considerable uncertainty as to whether the incentive that was intended in the percentage lease rental would actually

work.

Then there was the second problem about the pyramiding of lease rentals. Any rental payment that a pipeline company makes, insofar as it is subject to ICC jurisdiction and insofar as it sets its tariffs subject to the Icc rate making rule, if it pays a rental it is in effect able to recover that rental payment through the tariff. So that the higher the rentals are the higher the tariff would have to be.

Third there was the legal issue, and I think that, under the circumstances, where this has been made by the industry, one of the pivotal issues in their litigation I suspect that the legislature would want to consider very. very carefully the extent to which the percentage lease rental formula and all the provisions associated with it are essential to the interests of the State or whether there are other alternatives.

The second innovation that was introduced in the legislature last year and is now subject for your review, is the option of the State to buy up to 20% equity in the pipeline. Last year we were rather negative on the subject of 100% state ownership for reason which we would still enunciate. But we did feel that there was a very cogent reason for the State to have an option to buy a participation in the pipeline. in due course. What we had recommended, and what was enacted into your legislation last year, was an option to acquire up

to a 20% undivided interest in the pipeline. The reasons for that were, if the State exercised its option, it could use its ownership of some percentage, and it does not have to be a very large percentage, it could be less than 20%, to utilize its ownership of transportation facilities to leverage all tariffs downward. The State could set a tariff and say that this is an appropriate yardstick that others can follow. Or the State could set a tariff and if the tariff were lower than the company's tariff presumably all shippers would elect first to move their oil where the transportation charge is least, and on that basis the State would be in a position, with its relatively lower tariffs, to say that this is what determines the value of oil on the North Slope, and use that as the basis for its severance tax and royalty calculations, with the onus being on the company to prove that a higher tariff is necessary. Or if all else fail alternatively for the State to say we too will charge a high tariff and in effect we will recover in the profit on the oil that we move through our share of the pipeline what we may have lost through severance tax and royalty revenues because a high tariff depresses the value of the oil on the North Slope.

The attractiveness of the option provision was that having the option it would not have to be exercised.

That what the State could do by its option, plus what it might do through its taxing authority, that all of these would be conducive to a reasonable agreement between the companies and the State as to what a reasonable tariff would be, which might very well be at an ICC rate, depending on what ICC rate making policy is in 1977 and 1978. Or it might be somewhat lower, but at least it provides the State with a negotiating leverage and it would be one of those tools which hopefully the State would never have to exercise. The negotiations between the Governor and the industry have changes quite substantially the whole concept of the State's right to acquire an interest in the pipeline. Last year the company representatives were absolutely adamant that State ownership or State participation or State option were absolutely unacceptable and this was very largely couched in terms of the financing problems that would be posed.

I would like to call attention to arrangements that have been made elsewhere which involve government participation in a pipeline and a government option to buy. I'm referring now to an arrangement which has been made between a consortium of oil companies called SINCRUDE and the Province of Alberta in Canada having to do with the right to produce and transport a synthetic oil processed from the tar sands of the Athabascan tar belt. Will have to be a pipeline which connects the Athabascan Tar Sands Development

Project with the City of Edmonton where the oil will then move into other pipelines. The Province of Alberta is given, de nova, from start, an 80% equity in the pipeline. The companies which are participants in SINCRUDE commit their shares of the oil to that pipeline, without reservation. Secondly, and this does not have to do with pipeline but it has to do with an option, the Province of Alberta has an option to acquire, after the start of production, an undivided interest in the production itself, of not less than 5% and not more than 20%, with a formula that determines in advance what price will be paid by the Province of Alberta for the acquiring of that option.

I must be very careful to distinguish between the magnitude of what is involved here. The Alyeska Pipeline with an investment of some 4 - 4 1/2 billion dollars is a much larger pipeline facility than either the Athabascan pipeline or even the producing operations. There are differences in the magnitudes and degrees, but surely the principle of a definite participation in the pipeline, or the option to acquire a participation is not without precedent. If there are problems involved in the financing of the pipeline because there is an outstanding option for the State to acquire it, I would believe that those financing problems could be resolved if the terms and conditions of acquisition

under the option were spelled out. That is to say their investment, their costs, plus interest on their investment up to the time of the States taking over the pipeline, will be paid to them, and that the State thereafter undertakes commensurate obligations for whatever the outstanding debt may be.

The principle of an option to buy is not without precedent. This consortium of oil companies, who together constitute the SINCRUDE group, contains within their membership of four, two; the Exxon Corporation, through Imperial Oil in Canada, and Atlantic Richfield, who are major participants in the Alyeska Pipeline. So that insofar as the purpose of an option still commends itself to the Legislature as a significant factor in the protection of the State interest, which probably may never be exercised but which nonetheless represents a prudent approach by the Legislature. I think it may also be considered that the precedents which have been transpired, and if necessary, agreement by the State in advance on what the formula for payment will be, so that it is carefully spelled out, I would think that at that stage of the game it should not be a completely inhibiting factor with respect to the financing of the pipeline.

The third broad area at issues has to do with taxation. Obviously the taxing power of the State is the ultimate power that the Legislature exercises with respect to any of the

issues which may be involved with respect to Alaskan oil.

There is now tabled before you two major tax measures, an ad valorem property tax and an amendment to the severance tax. No legislature can bind itself through its term of office, let alone bind future legislatures, so whatever is enacted in terms of tax legislation is susceptible to amendment at any time. Certainly an oil company, more than any company in the world, is aware of the taxing power of sovereign states or States. In the context of the package of legislation that is submitted to you, it would appear that any tax legislation that you enact in this Special Session of the Legislature, implies some kind of a commitment. Here there have been negotiations, tax proposals have been made, in a special session of the Legislature you are being asked to amend or pass legislation which seems to be part and parcel of a whole package of legislative items, and certainly the industry, no matter how much it feels is subject to amendment in the future, will not be remiss is recalling to this or subsequent legislatures, that what you enact today was part of a package.

Therefore it seems to me that this particular legislature ought to be especially careful in what it does in terms of their tax decisions, and certainly the legislative record ought to show that a present enactment represents the sense of the Legislature to the extent that it is able to look ahead and see the circumstances under which the tax will be

operative. From the visibility of today, I submit that 1977 and 1978 might not look at all the way you or I think its going to look with respect to the economics of North Slope production or the economics of exploration and development elsewhere in the State. So in a sense, if you are enacting tax legislation today, you must also be alert to the fact that the interests that the State will be looking at 3 - 4 - 5 years hence may appear very differently than the best perspective any of us can hope to have on the future from today. So that the tax legislation will be subject to review, no only as a matter of legislative perogative, but also as a matter of very basic equity as circumstances may be changing.

There are three categories of taxation which are relevant to your Legislature.

(1) The first is a severance tax with amendments set before you. We have always looked on the severance tax as a tax which captures for the State a portion of the economic interest in its natural resource, and which was sufficiently broad guaged so that it really wasn't directed to the production of one specific company or the production of any specific _____. Two to three years ago we felt that what the legislature did ought not to be constrained by the particular circumstances of Cook Inlet at that time, nor ought to be so flamboyant that it was directed entirely to the hectic

expectations of North Slope development, but that in a sense it represented a fair and equitible tax given the circumstances of current, prospective and future production out of Alaska. Out of that came your tax which was the percentage of wellhead value and which contained four different brackets which related to average wellhead activity.

Last year your severance tax underwent substantial change with the introduction of cents per barrel which was designed as a floor below which the State's revenue would not fall whatever transpired with respect to wellhead value of the oil.

There are two different ways of looking at the cents per barrel aspect of the severance tax. One is as a means of offsetting depressed wellhead values. That is to say, if the pipeline tariff is high and the wellhead value is depressed, then if you can't get it as a percentage of wellhead value then you get it as cents per barrel. It is a response to what you might have considered an unjustifiably high tariff which depressed wellhead value and hence your severance tax. Of course you can get that also by changing your schedule in percentage of wellhead values. But as an offset to cents per barrel, or the severance tax however its enacted, as an offset to the lowering of wellhead values through the high tariff, it is a blunt instrument because it affects every producer in the State with higher severance tax obligations irrespective of whether or not that producer is a member of the pipeline or not.

As a revenue measure, every severance tax bears on producing profits. But it bears on it indirectly, that is to say it is a percentage of gross value. And as a revenue measure it comes out of producing profits, but it can be a different proportion of producing profits depending upon the relationship for individual fields and individual companies and individual circumstances, of the relationship between gross value and net value of the oil. Therefore it is not an income tax though it does fall upon it. It is a revenue raising measure that is always available to the State and is susceptible to whatever rates the State may want to impose, which the State can adjust whenever it chooses if it is dissatisfied with wellhead values. But this is an economic judgement.

The royalty offset feature in the last amendment of the severance tax was obviously a legal issue of considerable general concern to the industry. Because what it implied to the industry was that here in Alaska, and potentially elsewhere, royalty payments which they entered upon by virtue of contractual lease arrangements, might in effect be changed by the State enactment of severance tax legislation.

You can of course achieve whatever level of tax income from the State directly for severance tax or even higher severance tax to offset what you consider to be a loss of royalty income, not by a royalty offset but simply by a high

severance tax.

The legal attack upon your last severance tax enactment could be voided by a very simple amendment, that is to simply eliminate the royalty offset and leave all the old schedule, in which case the industry would be paying a very considerably higher severance tax than they paid under their old tax or they are paying under the governments proposed legislation. To avoid the legal issue of the royalty offset is something I think well worth considering, because you can exercise your severance taxing power at any time.

(2) The ad valorem tax is very clearly to raise revenue for the State and particularly as an interim source of revenue and is one among various ones that you might consider. The only thing that I would like to mention about it is the observation that an ad valorem tax imposed upon a pipeline is recoverable by its tariff. It is a cost of doing business by the pipeline and under ICC regulations, and I suspect under your own State of Alaska Public Utility regulations, an ad valorem tax becomes a cost of doing business and therefore can be added onto the tariff.

By way of rough calculation, on a 4 1/2 billion barrel pipeline a 20 mill rate would yield about 90 million dollars per year in tax revenue ad valorem tax on the pipeline itself, which in effect would mean about 20¢ per barrel addition to the tariff. The ad valorem tax would be passed on to someone else in the tariff of the pipeline. Insofar as the pipeline

tariff is higher and the wellhead values are lower, the State itself would bear 20% of the burden of the tax because it would reduce the royalty severance tax income. The tax would become a burden on those producers on the North Slope who are not participants in the pipeline but who have to transport oil because the tariffs to them will be higher. They would bear a portion of the burden in proportion to the amount of oil that they produce and ship relative to the amount of oil that is produced and shipped by companies who are also participants in the pipeline. The rest of it would be borne by the pipeline companies themselves as its passed back to the cost of transportation of their own crude oil.

The same holds true not only for the ad valorem taxes that the pipeline will pay in 1978 when the pipeline is in operation, but I suspect that the same thing holds true for all the cumulative ad valorem taxes that the pipeline will be paying between 1974 and the start up of operations, because those taxes are also recoverable costs of doing business and in due course will have to the companies as pipeline operators in their tariff.

All of which is not a reason in and of itself for you to say no more ad valorem tax. This all depends on when you want your revenues and how you best decide the State can raise its revenues.

(3) Finally, a few words about what I think is the most important aspect of taxation which is available to the State, that is your State income tax.

I think the Legislature, in due course, its certainly not required at this Special Session of the Legislature, must review its legislation to insure that incomes earned in the State are within reach of the State's income taxing power. This does not imply anything about the way you levy income tax, or whether there are any changes, but it does imply that you will scrutinize your income tax legislation very carefully.

In the end the income taxing power of the State is the means by which the State can insure that there is in the future a reasonable partition, or sharing, of what are the ultimate economic benefits of resource production in the State. I'm not only talking about crude oil but I'm talking about what hopefully will be a major exploratory and development program now that lands are beginning to be available for the reopening of leasing operations. Through your income taxing power you have the final means by which the State can decide, but not arbitrarily, never by itself, because its all subject to the essential incentives of investment by private companies in exploration and development. But within these limits the State has a means to participate in a reasonable and equitable way in the benefits that will come from Alaskan resource development.