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LIPTON
Testimony

Pipeline Legis. ::
Sp. Session

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 evider Congressional action to authoriz 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.

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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 unexpectedl. 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; 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.

SENATE RESOURCES COMMITTEE

October 22, 1973 Hearing

TESTIMONY OF MR. MILTON LIPTON

The legislation that's directly before you is the Right of Way Leasing Act but before I address myself to that specifically, I would like to say something about the entire package of legislation. It has been stated by industry, of course, that it is a package and they will review whatever decisions come out of the Legislature as a whole. I think it's true even more so for the state than for industry that the whole complex of oil legislation that's before you determines the extent to which the interests of the state are protected or the extent to which the interests of the state are yielded.

I don't want to take too much time on other aspects of it and get to the Right of Way Leasing Act as quickly as possible. So let me start out by saying that, in our opinion, having looked at all the legislation carefully, having listened to a great deal of the testimony that was made before the various committees, we now feel that the pivotal piece of legislation which determines the extent to which any compromise is satisfactory to the interest of the state, is the Alaska Pipeline Commission Act. This is your regulatory bill, a strong bill that was enacted in the 1972 session of the legislature, a bill for which the government and industry have submitted proposed amendments which largely convert what had been intended by the legislature in the first instance as a regulatory bill into an entirely different instrument for

the state, namely a device whereby a commission of the state simply represents the state in hearings before the Interstate Commerce Commission. The amendment to the bill as proposed and as pointed out by Professor Witherspoon yesterday afternoon, in effect, specifically denies (if the amendment is passed) by act of the Alaska legislature any and all jurisdiction which the state of Alaska might in the normal course of events, exercise over pipeline activities in this state, if only a pipeline such as transAlaska subjects itself to or is subjected to the jurisdiction of the ICC.

Now let me explain the reasons for our thinking that this particular act, as it now stands, the Alaska Pipeline Commission, is one of the most important tools available to the state of Alaska in protecting its interest. First of all, the act that's on the books claims very extensive jurisdiction for the pipeline commission which is being established. The jurisdiction extends to various aspects of regulation extensions of services, connections, expansion of capacity, potential abandonments --- so that with respect to these various aspects of pipeline operations the state of Alaska claims jurisdiction for its pipeline commission. Secondly, it vests in this pipeline commission wide authority to pass upon the validity of tariffs which are set by the pipeline. There is no claim made in the existing act, which is on your books, that the state of Alaska can regulate tariffs for the movement of oil in interstate commerce. This falls within the jurisdiction of the ICC. But there will undoubtedly be movement of oil in intrastate commerce, as for example from the northslope

to Fairbanks. There will probably be movement of oil in intrastate commerce from the north slope to Valdez which will remain within the state, for example, if the state should contract to take royalty oil and sell it for a year or two years or five years to the Tesoro Refinery or any other refinery which may be then or in the future be constructed within the state. So the state need only claim jurisdiction over the operations of the pipeline which affect intrastate commerce and jurisdiction over tariffs which involve the movement of oil in intrastate commerce.

Now what's the value of this? Insofar as there may be in the future an issue over the tariff set by the pipeline and this has been pivotal to your deliberations for two years now, insofar as there should be an issue over the tariff, there has really to be two things -- one, a determination as to what the appropriate tariff is, and secondly, a decision by the state as to what it will do to try to enforce what it believes is an appropriate tariff. How does one go about determining what is an appropriate tariff for the pipeline? I don't believe that the legislature in its deliberation is going to want to tackle the job -- that fantastically difficult and complicated job -- of determining what is fair value on a pipeline -- what goes into the capital base and what is not allowed in the capital base, and of what rate of depreciation is appropriate, and everything else --. Or what is a fair return -- this is an incredibly involved problem which the ICC struggles with or avoids by not doing anything about it,

as the case may be. In any case this is really not a problem of the legislature.

But you have established in the existing legislation a pipeline commission which has jurisdiction to determine the fairness and adequacy of tariffs insofar as it involves intrastate commerce. It would do so by holding hearings. If a rate is filed for the intrastate movement of oil, your pipeline commission may accept that rate as it's filed, or it may protest that rate in which case it has administrative processes by which it holds hearings, by which if it renders a decision it must support and justify why that particular decision was issued. And it provides opportunity for the pipeline companies to protest any tariff decision, or any other decision of the pipeline commission, insofar as the pipeline companies believe that it runs counter to due process of law, which means that the administrative decision of your pipeline commission will be tested in your state courts, or if necessary in a federal court.

But if in fact, your own adminitrative and judicial process has come up with a tariff which is lower than the tariff set by the pipeline companies it can be then enforced upon the intrastate movements, and the legislature and the state of Alaska is in a position to expect that the companies will apply an equivalent tariff to interstate movements also. Now that may not be enforced but I put it to you that on the day that it is determined by the state of Alaska, through its administrative and judicial processes, that a tariff is appropriate

for the intrastate movement of oil from the north slope to Valdez -- if on that day the companies refuse to reduce the tariff, which means to increase the well head value on all the oil that moves in interstate commerce, then the problem of the legislature in recapturing the interest of the state is a simple one, at that point you have the taxing power and know exactly at what level and what rate to exercise it, because you have through the instrumentalities of your own legislation already created the means and device by which an appropriate tariff can be determined; by which your own courts will reject the findings of the pipeline commission if they are arbitrary, confiscatory or capricious, but if administratively and judiciously that tariff is upheld, then the legislature has the guidelines precisely how to go about recapturing the interest in the state through its incontrovertible sovereign powers - that is to say the power of taxation.

It's for this reason that we feel the regulatory bill is absolutely the heart of the entire package. Furthermore, it is our feeling, and here of course it's difficult to speak for companies because, as they said, they would go back and review the whole package, but insofar as the companies feel that there is a claim of jurisdiction by the state which is unconstitutional because it involves interstate commerce or insofar as they feel that there's a decision by your pipeline commission in an area where it has jurisdiction but which decision goes against the law because it violates due process, they always have recourse to the courts. They need not litigate this issue in

advance because the mere fact that this law is on your statute books and I'm referring to the 1972 pipeline commission act, the mere fact that this law is on the statute books does not impose in advance the kind of disabilities upon their intentions to construct the pipeline that will require extensive litigation at this state of the game. Furthermore, as we have pointed out at the previous sessions of the legislature where regulatory bills were before you, there is legislation to this effect on the books of other major producing states and these have never involved extensive constitutional issues so far as we know. Well then, this pipeline commission act we feel is the guts of any compromise which the legislature may wish to substitute in lieu of the compromise package which has been put before you by the executive department.

Now let me pass on then to the Right of Way, but before I do, let me say a few words about the other bills and then come to the guts of the legislation which is before you which is the Right of Way Leasing Act. There are three different tax measures before you and I don't believe that any of them are in any respect crucial to the willingness of the companies to abandoning litigation or to going ahead with the construction of the pipeline. The severance tax, of course is in the course of litigation and it's in course of litigation because the 1972 amendment to your severance tax law contains a royalty credit feature which the companies feel would establish a very unacceptable precedent if it were, first of all applied here, and secondly if it were emulated in other states. I think they're misguided in their concerns; I think the state of Alaska has very little interest, really, in maintaining the

royalty offset provision. It's applied actually by the state of Alaska in a very generous way so that the relatively high cents per barrel tax, which was imposed in your 72 legislation is evaded and reduced by virtue of the royalty credit. You could settle the legal issue in five minutes by repealing the royalty credit and leaving everything else stand, in which case the companies would be subjected to considerably higher taxation than they were previously and that they are in the governor's proposal. So that the removal of the royalty credit feature in your severance tax which the companies are so eager to obtain, we would surely recommend that the legislature give to them. Perhaps the easiest way of doing it is to give it to them by accepting the severance tax amendment which is before you. But I caution one thing: I don't believe that this is the time for the Alaskan legislature to enact a severance tax schedule, whether it's a percent of value at the wellhead or cents per barrel or a combination of both with the idea that what is enacted today is going to be appropriate to whatever the volumes and values of oil may be that are going to be produced in 1977 and 1978. So if you prepare to accept the proposed severance tax amendment as part of a compromise package, I would strongly suggest that it is part of the legislative record in your committee hearings and in your debate that in no sense does this represent a commitment on the part of the legislature that these particular tax rates are the rates which will obtain five and six and seven and eight years from today. We will have time to review that. So that in a sense what you are giving by accepting the proposed amendment to the severance tax is a willingness

on the part of the legislature to avoid extensive litigation on the royalty offset feature which we think is of very little interest to the state of Alaska, in any case.

Now, the severance tax of course is one of your important weapons. I mentioned in previous hearings before this committee and elsewhere, that eventually your income tax is an important thing but that's not up for discussion. It's not an appropriate time for the legislature to review your state income tax legislation although I strongly urge that at one of your sessions you review with your commissioner of revenue your entire concept of corporate income taxation here in the state. The conservation tax bill which is before you, I think is unncessary. We had recommended that the conservation tax which had been on your statute books in the past be eliminated and simply subsumed within your severance tax. It's an added piece of legislation that we don't feel strongly about one way or the other, but it complicates the whole process of paying and collecting monies as between the state and the industry. On the ad valorem tax, as we see it, this is a revenue measure designed largely to yield income to the state over interim years before Prudhoe Bay production begins, before the pipeline is completed. It falls within the province of the legislature to decide how, when and under what conditions it wants to raise that amount of money.

It's the combination then of a strong regulatory bill and the fact that you have continuing flexibility and authority

to tax via your severance tax or eventually through your income tax that we believe yields the greatest control by the state over the operations and the tariff determinations of the pipeline so as to protect the interest of the state.

Now let me get on the Right-of-Way Leasing Bill. We have gone through this bill chapter, book and verse, section, sub-section and paragraph and I think we are prepared to sit down with this committee and other committees of the legislature to discuss it in detail. I don't believe we have time to go through each and every aspect of this here, but I will report on those which we feel are most critical to whatever compromise package comes out. The first issue, as we see it, involving any amendments to the Right-of-Way Leasing Act is how much of the regulatory power that the state wants to exercise shall be done by indirection in the form of stipulations and agreements as conditions of leasing. The industry is challenging the 1972 Right-of-Way Leasing Act in the courts on constitutional grounds, claiming that in effect regulation achieved by indirection which cannot be exercised by the state directly is an illegal exercise of the leasing powers of the state of Alaska. This is one of the major issues under litigation. We obviously are not in a position to pass any judgment whatsoever on the merits of the case in litigation. I think there is a spirit of compromise abroad, I see it very much in the proposals of the Governor's Office, I'm not quite sure I see that much spirit of compromise

in what the companies are proposing in their package, but nevertheless, there is a spirit of compromise abroad and certainly we would feel strongly, and I hope the legislature does also, that it is desirable to avoid unnecessary prolongation of litigation, and the possibility that such continuing litigation may delay the start of construction. So if it is possible to avoid litigation without unduly sapping the legislative enactments that are vital to the state interest, we would feel that there is some merit in the legislature going ahead with the executive departments decision that a compromise is now in order. So on then to the question of the regulatory items which are introduced into the Right-of-Way Leasing Act by virtue of stipulations as a conditions of lease. One, the most important one in our opinion, which is largely eliminated is in section 120 (a) (3) that's the common carrier section. For many reasons it is of importance to this state that it is understood beyond any doubt that the transAlaska pipeline is a common carrier; a common carrier not only for purposes of regulation of interstate oil movements by ICC but a common carrier also for purposes of regulation by your pipeline commission. There is merit, that as a condition of the lease the pipeline stipulates that it is a common carrier period --without reservations, without qualifications, or anything else. Now this is so common, this is so common in state and federal regulation, that it is really surprising to me that any amendment to the existing Right-of-Way Leasing Act should in effect qualify the common carrier status here. It says first of all, that there will be common carrier if the

the commission so determines at the time the lease is issued. I don't think this should require a determination by the commissioner. Under these circumstances the pipeline is a common carrier -- without hearing, without determination, or anything else. Secondly, I don't think it is necessary in the Right-of-Way Leasing Act to stipulate what obligations fall upon a common carrier and certainly not to qualify the obligations incumbent upon a common carrier. 120 (a) (3) says that it will accept, convey, transport without discrimination, crude oil. This is something which will be covered by your pipeline commission in the course of regulation if it is a common carrier. Certainly not in advance to limit the jurisdiction over a common carrier by your own pipeline commission by saying that the imposition of common carrier status does not require the lessee to accept tenders of crude oil, except at points where there exists public, etc. etc. Do not qualify the obligations of a common carrier. This is a function of your regulatory agency and insofar as your regulatory agency in its individual decision from month to month or year to year may either deny rights to a common carrier or impose obligations upon a common carrier which the pipeline owning companies feel are unduly onerous, they have recourse to the courts. So I don't think that one should qualify the obligations of a common carrier. I think that your 120 (a) (3) should simply stipulate that as a condition of obtaining a right-of-way over state lands, the lease for the right-of-way over state lands, the pipeline carrier itself, submits itself as a common carrier. Not only for the ICC

jurisdictional purposes but for the purposes of the exercise of jurisdiction by your pipeline commission.

120 (a) (4) in the recommended legislation removes the common purchaser provision from your 1972 legislation. At that time it was a permissible feature of your law. In place of the removal of the common purchaser status as a condition of leasing, the Governor has sent down a special bill that would make it possible to establish under certain conditions and subject to certain provisos, common purchaser status for companies owning the transAlaska pipeline. We do not feel now and we felt for a long time that there is real doubt as to how important common purchaser provision is in the state of Alaska, under the conditions where your oil is being produced and transported. Common carrier, yes, because it provides access to transportation and an equitable basis for everybody who is able to achieve production in the new state. Common purchaser for many reasons we have reservations about whether to leave it or not. The bill which is proposed to you we think is a weak and rather attenuated version of a common purchaser act, as it is applied in other states in the United States. Our recommendation at this stage of the game would be that you can afford and should yield the common purchaser provision as a condition of right-of-way leasing and probably simply pass over this special piece of legislation which establishes a common purchaser provision and hold that over to future sessions of the legislature as not being important at this time. When and as common purchaser provisions become meaningful in the conditions of the state of Alaska, at that

time to enact not the legislation that's proposed by the Governor, but a strong common purchaser act which is appropriate to the circumstances at such time. You will have ability and time to do that in the future. I don't think it's an essential point of the compromise, either from the companies' standpoint or from the State's standpoint.

I'm bringing before you here only major things or illustrative aspects of it. 030 - 040 -- these are repealed in the proposed amendment. In the proposed amendment to the Right of Way Leasing Act 1972, section 2 repeals 030-040. Now, 030-040 in the act that is now on the books governs the abandonment of or reduction or impairment of service and temporary emergencies services, and so on. It has to do with the authority that the state claims for itself and buttresses that authority by virtue of this being a condition of the lease. I would think that it might be appropriate, again in the spirit of compromise, that 030 and 040 be retained but that the language be rewritten to say that insofar as these are imposed upon the carrier, that they are in accordance with the jurisdiction and orders of the Interstate Commerce Commission or the Alaska Pipeline Commission, as is appropriate to the case. Which means in effect that the companies, although they are governed by these two clauses, nonetheless know that these two clauses are in accordance -- what is obligatory upon them is in accordance with the regulations that may be promulgated, either by the ICC if it involves interstate commerce or by the Alaska Pipeline Commission if it involves intrastate commerce. I put these out only as illustrative of the

aspects of regulation within the Right of Way Leasing Act which is at issue in the courts -- where we think either the state should stand firm, such as in the matter of common carrier, or where we think the state may very well yield. In general I would think that insofar as the state can achieve a right of way leasing act which avoids litigation but does not give up essential rights which the state still retains through, and I repeat, the combination of a strong regulatory bill and the ultimate enforcement of state regulation through its taxing power, that the legislature can yield on certain of these items in the Right of Way Leasing Act.

This by no means exhausts the regulatory aspects, but in the interest of time I want to move on to other things and as I said we're prepared to go through section by section with our specific recommendations to you.

The second major issue in the Right of Way Leasing Act is the percentage lease rental formula. There are two different impressions abroad as to the purpose of the percentage lease rental formula. Prof. Witherspoon yesterday afternoon suggested that he looked upon it as a revenue measure for the state. That if, in fact, the value of state lands were to be appreciated by the construction of the pipeline then the state like any other owner of land should be in a position to bargain for a fair share of the value of the land when it is being put to a superior use. I have no quarrel with this in principle; however, our position always has been that the leasing of state lands for pipeline right of way should not be regarded as a revenue device by the state of Alaska. We have always recommended that the interest of the state of Alaska is in the lowest possible cost transporta-

tion and the state of Alaska should not in and of itself undertake measures which inherently tend to increase costs of transportation, insofar as producing operation in the development of Alaska's resources provide the base for state taxation. It should be other than through the rentals of the right of way leasing of state land. So we have always urged the lowest reasonable rental for the commitment of state land to right of way. I would point out, for example, that even private property insofar as it's condemned by eminent domain for public utility or pipeline purposes does not convey even to a private owner any right or any entitlement to the enhanced value of land if it's put to other use. So we would recommend that however one looks at the rental for right of way lease that this not be regarded by the legislature as an aspect of its taxing power or as a means of gaining state revenues. That comes from other taxing devices in the state.

The other aspect of the percentage lease rental provision in the right of way leasing bill was that it was to be looked upon as an alternative -- either pain of paying or inducement to the companies to bring their tariffs down to a level which is compatible with the interests of the state; that is to say, a tariff that is lower than the maximum it might obtain under the ICC rate-making rule, certainly high enough to be rewarding for their investment and their risks but a level which is appropriate to the circumstances of pipeline operation in the state. And insofar as they increased their tariffs above a certain level, they were in effect subjecting themselves to the pains of progressively higher lease rental.

This was the percentage lease rental formula. This is one of the major items under litigation. For very obvious reasons the companies regard this as not only as something which is onerous to their circumstances in the state of Alaska but a precedent that if it were followed could lead to all kinds of things in their operation elsewhere. We have reservations about the effectiveness with which the percentage lease rental formula would operate for its major purpose, that is to say, in and of itself to induce the companies to bring the tariff down. It might for some companies, it might not for others. The extent to which it does for any of them would be largely contingent upon their respective equities in the pipeline as sellers of transportation services and in production as buyers of pipeline transportation services. There is an element of unpredictability in the operation of it. And while it was from the beginning, in our opinion, an imaginative and constructive approach and we're not saying even today that if properly effective it might not be a useful tool in right of way leasing legislation; but in the context of the violent litigation associated with this aspect of the right of way leasing bill, with the chances that continued litigation over this aspect of the bill may delay construction of the line, and on the presumption that what you have is not an emasculative regulatory bill but a strong regulatory bill, then we would feel that the legislature could give on the percentage lease rental and adopt the alternative to it as is proposed in the amendment to the Right of Way Leasing Act of 1972 by the Governor's amendments. Again, I say

that there are questions about how effectively it would operate in practice. Notwithstanding, there might be reasons for the state to hold to its case, to fight through the issue of litigation, if there weren't such a sense of urgency about getting the pipeline built, if there might not be such a large cost to the state in litigating. And whatever is done by way of amending the Right of Way Leasing Act in order to assuage the fears and concerns of the pipeline companies, either because of what it does or the precedent that it sets, I would say that what the legislature may do in terms of amending the Right of Way Leasing Act, in our opinion should be contingent first upon the retention of a strong and effective regulatory bill, that is to say Alaska Pipeline Commission Act. A strong regulatory bill which is backed then also by the state's taxing power and so that although you yield another tool in the entire package of legislation which was designed in 1972 to effect and enforce the state interest, really yielding to industry concerns, you do so here in the interest of avoiding undue litigation and the danger of delay on the pipeline.

The third aspect of the Right of Way Leasing Act to which I'd like to refer is the option to buy a percentage interest in the pipeline. The option to buy a percentage interest in the pipeline. I will not take time now to review the reasons why we have supported the insertion of the option to buy in the 1972 legislation. I think they're fairly familiar and

they've been reviewed I believe in previous sessions of this committee. We still feel that the option to buy a percentage interest is an important feature of right of way leasing. I think that insofar as the companies have allowed the purchase by the state of an interest in the pipeline to appear as a condition of the lease, even in the proposed amendment by the Governor, suggests that it is not a disabling aspect of the legislation from the standpoint of constitutionality of the legislation -- I don't know. But certainly the alternative which appears in the legislation which is section 120 (a) (7), the alternative which is substituted in the proposed legislation in our opinion represents nothing whatsoever for the state.

I think to amend the Right of Way Leasing Act to include the amended 120 (a) (7) would be to retain nothing for the state in this respect. I certainly would not recommend that part of the amendment. An opportunity to negotiate for an equity in the pipeline under highly qualified conditions, means that the state has an opportunity to negotiate when it serves the interests and purpose of the companies, which is really not what is intended in the option to buy as contained in the existing law. We do feel, however, that the legislature should give very serious consideration to the advice laid before it by Mr. Spahr of Standard of Ohio, that the option as it stands in the

legislation today may pose difficulty to the financing, or at least the financing at attractive terms, of the pipeline. Because of the uncertainty in the minds of prospective lenders as to what the capacity of the state as a possible future owner of a share of the pipeline may be to carry out obligations for the debt that is incurred at the time of construction which carries over and then may have to be shouldered by the state if the state buys the pipeline. I can appreciate that concern. But I would like to point out first of all -- and I have said this in general and I like to be very specific -- that there are precedents for this. The illustrations that I have made before various committees of this legislature the last two days, I would like to refer to very specifically here. There is the agreement between a consortium of oil companies called Syncrude and the province of Alberta in Canada which determines the basis upon which they get the lease to produce oil from the Athabasca tar sands and transport that oil via pipeline from Athabasca to Edmonton where the oil would enter into the major pipeline systems that traverse Canada and enter the United States. First of all, this has to do with ownership of the pipeline. This synthetic crude pipeline shall be constructed and owned as to an undivided 80 percent thereof by Her Majesty and/or an entity or entities hereafter formed by Her Majesty.

So that from the start, the province of Alberta is being given 80 percent participation in the pipeline. Now, an eighty percent participation in the pipeline--where is the oil going to come from? The province of Alberta is going to finance its 80 percent share of the pipeline just as a private company would. But how do you finance construction of a pipeline if you are not sure you are going to have the oil to put through? The lessees, and her Majesty, and the respective assignees of any interests in the Syncrude projects will dedicate their respective shares of the Syncrude oil recovered from the project to the Syncrude pipelines. That is to say, where the oil being produced by that project is committed to the pipeline irrespective of the fact that Her Majesty's government, that is to say in the province of Alberta, has 80 percent interest in the pipeline. So the percent of interest in the pipeline is there, the difference, of course, being that the state of Alaska in its Right-of-Way Leasing Act had wanted an option.

Now the issue of an option comes up. In this same agreement between the Syncrude consortium and the province of Alberta, the lessees, the Syncrude group including Exxon through Imperial Oil Canada, Atlantic Richfield (these are familiar names to you), Cities Service, and Gulf Oil--these lessees hereby grant Her Majesty an irrevocable option to acquire an interest in the Syncrude project. This is in the producing operation including the project sites, the leases and rights granted thereby, and all facilities acquired or constructed as part of the Syncrude project, which interest may equal undivided percentage interest of not less than 5 percent and up to and

including 20 percent. The option may be exercised at any time during the period from the date hereof and up to and including that date which is 6 months after the date of start of production or the 31st day of December 1982, whichever is the earliest.

Now as to how this is paid for, the payment by the government of Alberta to the members, the private companies, that make up Syncrude: Such costs shall be computed (in accordance with the accounting manual) on the basis of all of the costs which they, the companies, have incurred up to the date of the exercise of the option and shall include interest compounded annually at 8 percent. No portion of such costs shall be attributed to the reserves of leased substances. The province of Alberta could thus be buying in at what is the investment costs of the company plus the payment of 8 percent interest for all time that is elapsed. An interest in the producing operation of between 5 and 20 percent.

Why do I introduce this? Simply because I'm trying to suggest that there is precedence where the companies are prepared to undertake both to accept government participation in the pipeline and whereby companies are prepared to accept an option for governments to participate in what is essentially private operation. That the financing of this project does not seem to be inhibited whether by the government's participation in the pipeline or by the government's option to acquire an interest even in producing operations. Now I grant you that there is a very significant difference in the capital costs of the two projects. The TransAlaska pipeline will probably involve an aggregate initial investment on the order of ten times as much as the Syncrude operation. But that doesn't mean that

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individual bond holders are lending ten times as much money. The problem of the bondholder, whatever the number of dollars, always is what security lies behind; what security is there which insures that the viability of the operation will provide for interest and sinking fund contributions. To get back to the crucial point, if the option is retained in the Right-of-Way Leasing Act, the existing legislation may be amended so as to stipulate in advance, first of all, what the basis of compensation will be so that there is clear protection that no member of the Trans Alaska group will in effect suffer deterioration of its capital position by virtue of the exercise of the option by the state. And that in negotiating that option, the commissioner shall be prepared to enter into such stipulations by the state as provides the assurance necessary for the indebtedness that bondholders will be entering into prior to any possible exercise of the state's option. We feel that the right of the option to obtain an equity is a useful aspect of the entire package of legislation which you enacted in 1972. We think there may be a question about the way it is now written, whether or not the companies have as much, what shall I say, protection for their borrowing capacity as they would like to have. This protection can probably be provided both in the legislation where it refers to the terms at which the price will be paid and in the lease negotiation itself where the commissioner is authorized to give certain commitments on the part of the state of Alaska. Existing legislation also requires considerable other steps before an option can ever be exercised, including the positive act by the legislature and a referendum by the people of the

state of Alaska if there is to be debt financing. So I think there can be fair protection all around.

This again, represents in our judgment an approach to the issues which confront the state of Alaska. The issues being, must you continue litigation and risk the fact that prolonged litigation may result in delay in the pipeline? Or must you accept a negotiated package of legislation such as submitted to the legislature by the Governor? Or is there an alternative package of legislation which in your judgment represents the protection of the vital interests of the state of Alaska insofar as resource development and pipeline development is concerned, and probably represents a package which the industry can accept? It may pose uncertainties for industry but insofar as they may be obliged or feel they want to litigate, they need not do it in advance but can start construction of the pipeline and be prepared to litigate specific aspects of it as they become relevant. For example, if your pipeline commission, sometime in the future, issues an order which is deemed to be an unreasonable, in violation of due process, the companies can protest such order in the courts, and upset it if their protest is upheld. I think that what we are suggesting here is in the spirit of the negotiations between the Governor and the companies. It certainly represents a yielding on the part of the legislature, if our recommendations are followed, which go a considerable way to meet the issues posed in litigation by the companies. But I do believe it retains for the state of Alaska in two critical areas--namely the regulatory bill and the ultimate ability to enforce the intentions of regulation by the state's taxing

powers. Plus the retention in the Right-of-Way Leasing Act of certain conditions including the common carrier provision. It means yielding on what had been one of the most provocative and imaginative aspects of the legislation which is percentage lease rental. It means compromise on the option to buy so as to provide certain added protection for the companies. In our judgment, I think that this combination of action by the legislature would secure the interests of the state, and in our judgment (of course we are not in a position to speak for the companies) might not be wholly attractive to the companies, but we would think that they would not litigate to the extent that it would involve delay in the construction of the pipeline.

D R A F T

Judiciary Committee amendment to House Bill 7, "An Act relating to common purchasers of oil and providing an effective date."

Page 1, line 29:

Strike the words "the size and"

Page 2, lines 4 - 5:

Strike the words "a purchaser is purchasing from a field and"

Page 2, line 17:

Strike the word "cannot" and substitute the word "may"

Page 2, lines 21 - 22:

Strike the words "or on the basis of a producer taking its own production"

Page 3, line 8:

Strike the numerals "100" and "1000 and substitute, respectively, the numerals "1,000" and "10,000"

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