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Alaska State Legislature

Senate

JUNEAU, ALASKA

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Senator Kay Poland, Chairman
Senate Resources Committee

Submitted herewith are the Preliminary Comments and supportive material of our analysis of the various options and implications involved in and surrounding the issue of Taxation of Leasehold Interests (SB 103 and SB 276).

The basic difference in the two Bills is that SB 276 offers a rebate of the monies paid, via future severance tax credits. As such, SB 276 must be regarded as mandatory lending. SB 103 does not offer a rebate and is a straight added tax on Industry. Both Bills adequately perform the purpose for which they were written, though SB 276 is the more flexible and can be adapted to either purpose.

Policy options discussed include:

A. Imposition of an added tax

B. Inclusion of other minerals

C. Credit against future severance taxes paid, and the immediate amending of the existing severance tax

D. Taxing vs borrowing

E. Effect on overall cash availability

F. Priority of action

We conclude with our recommendations as to priorities, as follows:

1. Pass SCR 27 urging a Beaufort Sea Lease Sale

2. Amend the Severance Tax (We include a proposed amendment)

3. Prepare a final version of SB 276 to be taken as a first order of business next session if lease sale bonuses and income from the amended severance tax do not suffice.

This report concludes the work to be performed under the limited directive given us. We would be pleased to continue this work on issues before the Legislature and your Committee, upon your request and authorization by the Legilative Council.

Very truly yours,

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PRELIMINARY COMMENTS
TAXING OF LEASEHOLD INTERESTS
SB 103, SB 276

SB 103 and SB 276 address the same issues, and it appears best to discuss the composition and implications of both bills simultaneously.

I. Background

The principle of taxing leasehold and ownership interests in land with proven mineral reserves is not new to the Legislature, but has been held in abeyance as an emergency measure.

During the Special Session of 1973, the Legislature kept the option alive by amending the severance tax laws to eliminate the language that the tax (severance) was "in lieu of all ad-valorem taxes that might be imposed upon property rights attached to or inherent in the right to produce oil or gas". During that session, the ad-valorem tax passed on production and transportation of unrefined oil and gas also left intact the option of taxing the property rights by the State, while at the same time foreclosing that option to local governments. Most of this action was formulated in the Senate and carried on through the Free Conference Committees.

II. Items Being Taxed

SB 103 and SB 276 both recognize this old option, but each

approaches it in a different manner.

SB 103 proposes to tax (a) oil and gas leases with proven resources, and (b) ownership interests in proven reserves.

Taxing of leases is possible if the Bill is clarified to mean any possessory right or interest in the lease. Obviously, the right to explore, develop, and produce is worth a great deal, depending upon the reserves contained therein.

Except on private lands, ownership interest in proven oil reserves are a different matter. Questions arise as to actual ownership of the oil until after production takes place.[1] The right to explore and produce is implicit, but the right to ownership is not. Obviously, the State cannot tax itself. The question was studied by the Attorney General's Office at our request. The Administration's Bill (276) recognizes this difficulty and is constructed to avoid it.

The purposes of SB 103 would be better served by taxing the possessory rights and deleting 015 (2) to help avoid challenge

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[1] It has been argued for example, that for the producer's expenditure of time, money, and material, the State will give the producer seven-eighths of the oil produced in payment for those efforts, but retains ownership until the contract is fulfilled.

in the courts, and providing further that administrative procedures not spelled out in the Bill can be devised.

In 58.190, pages 7 and 8, SB 276 defines "interest" to be of wide variety and scope and clearly defines the property being taxed as "any interest" in the proven reserves of a lease or property". By so doing it avoids the issue of who owns the oil or gas prior to production. It should also be noted that every person's interests in the lease is taxed, not only the original leaseholder. The operator is primarily liable.

We must conclude that of the two Bills, the taxable property is more clearly defined in SB 276 and, as a consequence, appears more defensible.

III. Type of Tax

SB 103 imposes a straight additional tax with an offset against any severance tax paid during a particular assessment year. There is no offset provided against any future tax to be paid. The tax begins five years after the date of the lease or when reserves are proven, whichever comes earlier. The tax continues indefintely or until repealed.

The tax imposed by SB 276 also commences five years from initial entry and is an advance payment on the Gas and Oil

Production Tax (severance) imposed by AS 43.55.010 (a). The advance payments are credited against production taxes and are recovered through accrual and credit devices in 58.180 (page 6) and the new subsection 55.018 (page 8).

Under the terms of SB 276, as written, the advance tax payments may be recovered in two years of production. We suggest that if the Legislature adopts the taxing policy of SB 276, then the payback period should be not less than three years, preferably five years, in order to insure the State's liquidity.

SB 103 attempts to amend 43.56, which is the Ad-Valorem Tax passed by the 1973 Special Session, by including new taxable property described in a new subsection .015.

SB 276 writes a new Chapter 58 so as to clearly define intent of tax, property being taxed, and to keep away from the calculations needed to operate Chapter 56, which taxes exploration, production, and pipeline properties.

Chapter 55 (Severance Tax) is made subservient to the new Chapter 58 created by SB 276. AS 29.53.050 (b) (page 9) and AS 43.56.010 (c) are amended to maintain the status quo of the taxing powers of municipalities.

A special feature of SB 276 is that even if the Bill is passed no tax per se attains unless the Legislature imposes a levy by April 1 of each ensuing year. The tax is designed to self-destruct as soon as production tax equals the lease-hold interest tax. A better trigering device would be an automatic one based on a dollar residue level of the General Fund.

IV. Policy Options

A. Additional Straight Tax Oil and Gas Leasehold Interests.

If the Legislature wishes a Bill that imposes a tax on oil or gas leases without additional inclusions or future offset considerations, SB 103 amended as above will impose that tax. However, SB 276 is a far better written Bill that could be adapted to the purposes of a straight additional tax by the simple removal of 43.58.180 (page 6) and 43.55.018 (page 8).

B. Inclusion of Other Minerals

The Legislature may wish to consider taxation of all mineral leases or mineral properties in fee simple. Thousands of acres are now held in a speculative non-production status.

More germane to the option of imposing a tax on leasehold interests is the history of the Union-Marathon gas holdings in the Kenai Gas Field.

There, Union-Marathon held six trillion cubic feet of proven gas reserves in a totally uncommitted status for ten years until West Coast purchasers were forced into settling for a premium price. Firstly, the State was deprived of its severance income and secondly, the prevailing higher market price forced on the West Coast is also being passed on to the people of the Anchorage-Cook Inlet area.

Other properties of interest are the Kennicott Copper holdings in the Kobuk area, the vast placer gold holdings of U - V Industries throughout the State, the Beluga Coal leases, the variously owned iron ore holdings, etc.

C. Credit Against Future Severance Taxes Paid

If the Legislature decides to offset the tax imposed by SB 276 against future severance taxes, consideration should be given to raising the severance tax at this time to a level that can be sustained without change during the payback period, for the following reasons:

1. To raise the severance tax during a payback period leaves the State open to the accusation that the raise was to offset the offset. This may raise the spectre of discriminatory taxation and possibly develop a bad faith aura.

2. Alaska's severance tax is now well below the national average of 7%, and is declining. (See attached computations.) Present yield is 5.7%)

3. Under the system now in use, Alaska's severance tax cannot reach the 8% implied in the current statute, and will decline. (See attached computations.)

4. If deregulation of oil prices occurs and the windfall profits tax goes into effect, severance taxes are expensable against that Federal Tax, to the benefit of the State if it is done now before the door is closed by the Federal government.

5. We estimate that a straight 8% severance tax effective immediately will raise an additional 41 million in the next three years. A tax of 9% effective immediately would bring in an additional 76 million

dollars. A tax of 10% would result in an additional 110 million dollars.

6. Severance tax should be high enough to equal the revenue we could derive by taking the tax in-kind, selling crude on the open market and investing the money.

A proposed severance tax Bill is attached for consideration.

D. Taxing Vs. Borrowing

As written, SB 103 is a straight tax. If severance tax offsets are involved as in SB 276, it is mandatory lending.

In either case, eventual profitability will be reduced and corporate taxes will also be reduced.

Mathematically it appears that a straight tax on lease-hold interests without offsets results in a greater total eventual return to the State in terms of dollars when combined with a corporate tax on the remaining profitability. It is also simpler. It will also probably be described as onerous.

Mathematically it appears that if an offset against future severance tax is given, the total eventual return

to the State in terms of dollars will be less than if the State borrowed the money on its own account - if such borrowing can be made constitutionally possible.

E. Effect on Cash Availability

Regardless of whether the Legislature passes a leasehold interest tax with or without a rebate provision, the effect on cash availability for other purposes, such as exploration and development will be immediate and, possibly, regressive.

We are advised by industry spokesmen that the delayed implementation device in SB 276 does not alter this condition because, if the Bill is passed, funds must be encumbered and set aside for the eventuality of implementation. Though industry adds lease bonus monies to their list of shortfalls, we do not believe they will be affected as bids on each parcel offered will be strictly on the merits of acquiring the parcel based on its production potential.

The need to secure and/or encumber monies for tax payments under either SB 103 or SB 276 affects all holders of possible reserves, including the Native and other cor-

porations or persons. Any attempts at exclusion of any group will open the door to a charge of discriminatory taxation.

F. Priority of Options

With regard to both the need of the State to secure additonal revenues and of probable feeling that the oil and gas producer should also be accomodated when not inimical to the interests of the State, the following appears as a reasonable priority of action at this stage of discussion:

1. Pass SCR 27 urging a Beaufort Sea lease sale.

2. Amend the Severance Tax.

3. Prepare a final version of SB 276 so that it can be passed as a first order business at the next session.

1975 SEVERANCE TAXES

Cook Inlet	=	1036/day	@	5.8%, declining
Granite Point	=	523/day	@	5.4% declining
McArthur River	=	2069/day	@	6.9%, declining
Middle Ground	=	714/day	@	5.6%, declining
Swanson River	=	686/day	@	5.6%, declining
Trading Bay	=	457/day	@	5.3%, declining

NATIONAL AVERAGE IS 7%

Prudhoe = 10,000/day initially @ 7.77%
with a decline commencing the third year from initial production

Other = 2000/day initially @ 6.85%
with a decline commencing the third year from initial production.

EFFECTIVE YIELD OF PRODUCTION TAX AT VARIOUS LEVELS

300	x	5	=	1500	Bbls		Rate
700	x	6		4200	1000	@	5.7%
1000				5700			
500	x	8	=	4000	1500	@	6.47%
1500				9700			
500	x	8	=	4000	2000	@	6.85%
2000				13,700			
500	x	8	=	4,000	2500	@	7.08%
2500				17,700			
500	x	8	=	4,000	3000	@	7.23%
3000				21.700			
2000	x	8	=	16,000	5000	@	7.54%
5000				37.700			
2500	x	8	=	20,000	7500	@	7.69%
7500				57,700			
2500	x	8	=	20,000	10000	@	7.77%
10,000				77,700			

F.Y. 1976 and F.Y. 1977

1) 29 : 5.7 = x : 9.0 = 45.8-29 = +16.8
8.0 = 40.7-29 = +11.7
10.0 = 50.9-29 = +21.9

F.Y. 1978

2) 180 - 29 = 151

151 : 7.7 = x : 8.0 = 156.9
9.0 = 176.5
10.0 = 196.1

	Prudhoe		C.I.	
@ 8%	(157	- 151) +	11.7	= +17.7
9%	(176.5	- 151) +	16.8	= +42.3
10%	(196.1	- 151) +	21.9	= +67.0

Totals For F.Y. 76, 77, and 78

3) @ 8% 11.7 + 11.7 + 17.7 = 41.1
@ 9% 16.8 + 16.8 + 42.3 = 75.9
@ 10% 21.9 + 21.9 + 67.0 = 110.8

CI 76 CI 77 (CI+P) 78

} Extra income if Variance is Valid

C.I = Cook Inlet
P = Prudhoe.