

TESTIMONY  
BEFORE  
JOINT HOUSE  
AND  
SENATE  
RESOURCES  
COMMITTEE  
1977/78

SENATOR POLAND, REPRESENTATIVE OSTERBACK AND MEMBERS OF THE  
JOINT HOUSE AND SENATE RESOURCE COMMITTEES OF THE ALASKA  
STATE LEGISLATURE.

I WANT TO THANK YOU FOR THIS OPPORTUNITY TO SPEAK TO YOU TODAY  
ON WHAT I CONSIDER A TOP PRIORITY THIS YEAR - A COMPREHENSIVE  
REVISION OF THE STATE'S OIL AND GAS TAXING SYSTEM.

FOR SEVERAL MONTHS MEMBERS OF MY STAFF MADE A COMPREHENSIVE  
REVIEW OF ALASKA'S CURRENT OIL AND GAS TAX STRUCTURE. THAT  
REVIEW CULMINATED IN A REPORT ENTITLED "ALASKA'S OIL AND GAS  
TAX STRUCTURE: A STUDY WITH RECOMMENDATIONS FOR IMPROVEMENT."

WITH THE PERMISSION OF THE CHAIRMAN, I WOULD LIKE THE DEPARTMENT'S  
STUDY TO BE MADE A PART OF THESE COMMITTEE'S RECORDS AND PROCEEDINGS.

BEFORE I GET TO THE SPECIFIC RECOMMENDATIONS AND BILLS INTRO-  
DUCED TO IMPLEMENT THOSE RECOMMENDATIONS, LET ME BRIEFLY  
SUMMARIZE THE DEPARTMENT'S REPORT. THE DEPARTMENT FIRST BY  
WAY OF BACKGROUND AND INFORMATION, SKETCHED OUT AN OVERVIEW

OF OIL AND GAS OPERATIONS IN ALASKA AS WELL AS DESCRIBED THE  
PRESENT ALASKA TAX SYSTEM. SECONDLY THE DEPARTMENT DISCUSSED  
PAST REVENUE EXPENDITURE PATTERNS AND MADE EXPENDITURE AND  
REVENUE PROJECTIONS OVER THE NEXT FEW YEARS. OUR PROJECTIONS  
OF OIL AND GAS REVENUES WERE BASED UPON THE ASSUMPTION  
THAT NORTH SLOPE OIL WOULD BE PRICED AS FREE MARKET  
OIL WITHOUT ENTITLEMENT PENALTIES. WE ALSO POINTED OUT,  
HOWEVER, THAT OUR REVENUES WOULD BE SUBSTANTIALLY SMALLER IF  
NORTH SLOPE OIL RECEIVED A DEPRESSED PRICING TREATMENT. AS  
YOU KNOW THE FEDERAL ENERGY ADMINISTRATION HELD HEARINGS IN  
WASHINGTON D.C., SAN FRANCISCO AND ANCHORAGE THIS WEEK ON THIS  
VERY QUESTION. AT THOSE HEARINGS WE HAVE TAKEN THE POSITION  
THAT NORTH SLOPE OIL SHOULD BE PRICED AS FREE MARKET OIL  
WITHOUT ENTITLEMENT PENALTY.

IN A THIRD PHASE OF THE REPORT, THE DEPARTMENT DISCUSSED  
SEVERAL PROBLEMS OR DEFICIENCIES WHICH WERE FOUND IN EACH OF  
THE STATE'S MAJOR OIL AND GAS TAXES. IN THE FOURTH SECTION  
OF THE REPORT, THE DEPARTMENT MADE ITS RECOMMENDATIONS TO

CURE THE DEFECTS, AND THEN ESTIMATED THE REVENUE EFFECTS  
OF THE VARIOUS RECOMMENDATIONS.

WITH THAT SUMMARY OF THE DEPARTMENT'S REPORT LET ME DISCUSS  
IN TURN EACH OF OUR RECOMMENDATIONS AS EMBODIED IN BILL FORM  
AND CONTRAST OUR PROPOSALS WITH OTHER BILLS WHICH ARE NOW  
PENDING BEFORE YOUR RESPECTIVE COMMITTEES.

LET ME START WITH WHAT I CONSIDER AS THE FIRST PRIORITY - A  
REVISION OF THE STATE'S SEVERANCE TAX. THESE REVISIONS ARE  
CONTAINED IN HB 321 AND SB 238. ALTHOUGH OUR SEVERANCE TAX  
PROPOSAL HAS SEVERAL PARTS, IT ESSENTIALLY ACCOMPLISHED TWO  
MAJOR GOALS. FIRST, IT PROTECTS THE STATE'S SEVERANCE TAX  
REVENUES IN THE EVENT OF ARTIFICIALLY DEPRESSED FEDERAL  
PRICING. SECONDLY IT PROVIDES TAX RELIEF TO PRODUCTION  
AT OR NEAR A PROPERTY'S LIMIT. EACH OF THESE GOALS ARE  
EXTREMELY IMPORTANT. AS YOU KNOW, THE FEDERAL GOVERNMENT WILL

SOON BE ESTABLISHING THE PRICING TREATMENT TO BE AFFORDED  
NORTH SLOPE OIL. BOTH THE STATE'S ROYALTY SHARE AND SEVERANCE  
TAX ARE DEPENDENT UPON THE "WELL HEAD" PRICE OF OIL PRODUCED.  
IF NORTH SLOPE OIL IS ALLOWED TO FIND ITS PLACE IN THE FREE  
MARKET OUR ROYALTY AND SEVERANCE TAX REVENUES ARE PROTECTED.  
IF, HOWEVER, THE PRICE IS SET ARTIFICIALLY BELOW THE FREE  
MARKET PRICE A PORTION OF THE STATE'S REVENUES WILL BE LOST  
UNLESS CORRECTIVE ACTION IS TAKEN. THE CORRECTIVE ACTION  
WHICH WE PROPOSE TO GUARD AGAINST THIS DEPRESSED PRICING IS  
TO RAISE THE CENTS-PER-BARREL FLOOR IN THE SEVERANCE TAX TO  
WHAT WE PROJECT TO BE A MID POINT FREE MARKET PRICE OF OIL ON  
THE NORTH SLOPE (\$7.50 PER BARREL) AND TO ESCALATE THAT FLOOR  
THROUGH TIME WITH A PRICE ESCALATOR. THUS IF AN ARTIFICIAL  
PRICE IS SET AT \$7.00, \$6.50, \$6.00 OR EVEN LESS, THE STATE  
WOULD STILL COLLECT SEVERANCE TAX ON THE BASIS OF THE FREE  
MARKET VALUE OF THE OIL. ACCORDINGLY WE MUST PROTECT OURSELVES  
FROM THE POTENTIAL DANGER OF DEPRESSED PRICING BY RAISING THE  
CENTS-PER-BARREL FLOOR THIS YEAR. IF WE WAIT AND THE PRICING  
DECISION GOES AGAINST US, WE MAY LOSE SUBSTANTIAL AMOUNTS OF

REVENUES DURING AN INTERIM PERIOD UNTIL CORRECTIVE ACTION CAN  
BE TAKEN. TO DELAY IN THE FACE OF THIS DANGER MIGHT RESULT  
IN A LARGE BUDGET DEFICIT FOR THIS NEXT FISCAL YEAR.

THE SAME DANGER TO THE STATE CAN ARISE THROUGH THE ACTIONS  
OF THE OIL CORPORATIONS THEMSELVES EVEN WITH A FAVORABLE  
PRICING DECISION BY THE FEDERAL GOVERNMENT. FOR EXAMPLE  
INTEGRATED OIL CORPORATIONS - OIL CORPORATIONS WHICH NOT  
ONLY PRODUCE BUT TRANSPORT, REFINE AND MARKET THEIR OWN OIL CAN  
ESSENTIALLY EFFECT THE WELL HEAD VALUE BY THE TARIFFS WHICH ARE  
SET FOR TRANSPORTATION OF ITS OIL AND BY THE CHOICE OF THE PLACE  
WHERE THE OIL IS REFINED. SINCE THE ALASKA WELL HEAD PRICE  
IS DETERMINED BY TAKING THE REFINERY PRICE AND NETTING BACK  
ALL THE TRANSPORTATION CHARGES TO THE FIELD, THE WELL HEAD VALUE  
WILL BE REDUCED AS TRANSPORTATION CHARGES ARE INCREASED. IF  
THE PIPELINE TARIFF OR TANKER TARIFF ARE INFLATED IT MAY  
SUBSTANTIALLY REDUCE THE WELL HEAD VALUE. BY INFLATING THE  
TRANSPORTATION CHARGES, THE INTEGRATED COMPANY CAN SHIFT THE

PROFITS FROM ITS PRODUCTION OPERATION TO OTHER PHASES OF ITS BUSINESS AND REDUCE ITS ROYALTY AND SEVERANCE TAX LIABILITIES.

THESE POTENTIAL ACTIONS MUCH AS FEDERAL PRICING WOULD EFFECTIVELY REDUCE THE WELL HEAD PRICE BELOW WHAT WOULD OTHERWISE BE THE MARKET VALUE OF THE OIL. BY RAISING THE CENTS-PER-BARREL TAX FLOOR YOU PROTECT THE STATE AGAINST THESE POSSIBILITIES.

THE SECOND MAJOR GOAL OF OUR SEVERANCE TAX BILL AFTER ASSURING THAT OUR SEVERANCE TAX REVENUES ARE PROTECTED FROM THE VAGARIES OF FEDERAL PRICING ACTIONS AND CORPORATE MANIPULATION, IS TO PROVIDE TAX RELIEF FOR PRODUCTION WHICH IS APPROACHING, OR IS AT, ITS ECONOMIC LIMIT. AS MENTIONED IN OUR REPORT THE SEVERANCE TAX CAN ACT AS A DISINCENTIVE TO CONTINUED PRODUCTION AS PRODUCTION FROM A PROPERTY REACHES ITS ECONOMIC LIMIT. A PARTICULAR PROPERTY'S ECONOMIC LIMIT IS NOT SOLELY A FUNCTION OF THE VOLUME OF PRODUCTION BECAUSE THE COSTS OF PRODUCING OIL MAY VARY SUBSTANTIALLY IN DIFFERENT REGIONS OF THE STATE. FOR EXAMPLE A WELL PRODUCING 1,000 BARRELS A DAY IN COOK INLET

MAY BE NOWHERE NEAR ITS ECONOMIC LIMIT BUT A WELL PRODUCING  
AT THE SAME RATE ON THE NORTH SLOPE OR IN INTERIOR ALASKA  
MAY ACTUALLY HAVE REACHED ITS ECONOMIC LIMIT BECAUSE OF  
THE HIGHER COSTS OF PRODUCTION AND TRANSPORTATION, IN THOSE AREAS.  
ACCORDINGLY A STAIR STEP APPROACH BASED UPON PRODUCTION LEVELS  
MAY WORK WELL FOR ONE PART OF THE STATE BUT NOT ANOTHER,  
THEREFORE HB 32L AND SB 238 PROVIDE A MECHANISM WHEREBY THE  
TAX RATE IS SCALED DOWN OR REDUCED AS A PARTICULAR PROPERTY  
REACHES ITS TRUE ECONOMIC LIMIT. THIS FEATURE ESSENTIALLY  
TAILORS THE TAX RATE SCHEDULE TO THE ECONOMICS OF EACH PRODUCING  
PROPERTY. INSTEAD OF STAIR-STEPS IT PROVIDES A CONTINUOUS  
SERIES TAX RATES FROM 10 PERCENT TO ZERO AND WHICH DECLINE AS  
PRODUCTION APPROACHES THE PRODUCTION LEVEL AT THE PROPERTY'S  
ECONOMIC LIMIT.

THERE WAS SOME SUGGESTION EARLIER IN THE WEEK BY MR. KILGORE,  
THAT THE ECONOMIC LIMIT FACTOR WAS DEFICIENT IN PRACTICE SINCE  
IT SEEMED TO RESULT IN HIGHER EFFECTIVE TAX RATES FOR SOME

PRODUCTION IN COOK INLET. THIS PRESUMED DEFICIENCY IS SIMPLY NOT TRUE. I BELIEVE THAT THE EFFECTS WHICH MR. KILGORE SPOKE TO WERE NOT BECAUSE OF ANY DEFICIENCY IN THE ECONOMIC LIMIT FACTOR BUT RESULTED FROM THE EFFECTIVENESS OF THE CENTS-PER-BARREL FLOOR IN PROTECTING THE STATE AGAINST THE ARTIFICIAL PRICING ACTIONS OF THE FEDERAL GOVERNMENT. IN THIS REGARD IT SHOULD BE NOTED THAT AS PRODUCTION BECOMES INECONOMIC IN COOK INLET THE PRODUCERS MAY APPLY AND RECEIVE PRICING RELIEF FROM THE FEDERAL GOVERNMENT. NO SUCH LUXURY IS GIVEN TO THE ROYALTY OWNER, - THE STATE - AS PRICING RELIEF WILL BE GIVEN ONLY TO THE WORKING INTEREST AND NOT ROYALTY INTEREST. THE FEDERAL RATIONALE FOR THIS POLICY IS THAT THERE WILL BE NO ADDITIONAL PRODUCTION AS A RESULT OF PRICING RELIEF TO THE ROYALTY OWNER. THUS PRICING RELIEF IS GIVEN TO THE WORKING INTEREST. CERTAINLY IF YOU COMPARE THE TAX RATES TO THE ARTIFICIALLY ADMINISTERED PRICE IN COOK INLET YOU WILL GET HIGHER EFFECTIVE TAX RATES. BUT AS STATED BEFORE, THE STATE SHOULD NOT BE CONTENT TO SIMPLY ACCEPT TAXES BASED ON THE

ARTIFICIAL PRICE SET BY THE FEDERAL GOVERNMENT BUT SHOULD  
INSIST ON A PERCENTAGE OF THE TRUE MARKET VALUE OF THE RESOURCES  
PRODUCED. IF THE TAX RATES ARE COMPARED TO THE TRUE MARKET  
VALUE OF OIL IN COOK INLET THESE HIGHER EFFECTIVE TAX RATES  
DISAPPEAR. THE ECONOMIC LIMIT FACTOR DOES WORK AS PLANNED  
TO SCALE DOWN THE TAX RATE AS THE PROPERTY REACHES ITS  
"TRUE ECONOMIC LIMIT". BY THIS I MEAN THE ECONOMIC LIMIT AS  
GAUGED BY THE MARKET VALUE OF THE OIL NOT THE ARTIFICIALLY  
SET PRICE. THUS USING THE TRUE MARKET VALUE OF OIL AS THE  
STANDARD IF THE ECONOMIC LIMIT FOR THE PROPERTY IS 100 BARRELS  
A DAY AND THE CURRENT PRODUCTION HAS DECLINED TO 200 BARRELS A  
DAY THE TAX RATE WILL BE SCALED DOWN BY 50 PERCENT. WHEN  
PRODUCTION REACHES 100 BARRELS A DAY OR WHEN IT IS AT ITS  
ACTUAL ECONOMIC LIMIT, THE TAX RATE IS ZERO.

LET ME ALSO POINT OUT SOME OF THE OTHER FEATURES OF HIB 321

AND SB 238.

THE BILL WOULD PLACE THE TAX ON GAS PRODUCTION ON AN EQUIVALENT BASIS AS OIL AND IT WOULD ESTABLISH A CENTS-PER-MCF FLOOR AT 6.4 CENTS PER MCF. THIS IS BASED UPON THE HIGHEST PRICE PAID FOR GAS IN COOK INLET. THIS FLOOR, AS THE CENTS-PER-BARREL FLOOR, WOULD PROTECT GAS SEVERANCE TAX REVENUES FROM DEPRESSED PRICING BELOW MARKET VALUE.

BOTH THE CENTS-PER-BARREL AND CENTS-PER-MCF FLOORS WOULD BE ADJUSTED BY AN INFLATION FACTOR SET OUT IN THE BILL.

IN ADDITION THE BILL WOULD PROVIDE FOR TAX ON FLARED GAS WHICH IS PRESENTLY UNTAXED. THE TAX RATE FOR THIS FLARED GAS WOULD BE TWICE THE CENTS-PER-MCF RATE. THIS WILL PROVIDE ADDITIONAL INCENTIVE TO THE PRODUCER TO CONSERVE OUR NATURAL RESOURCES.

WITH THAT DISCUSSION OF THE SEVERANCE TAX PROPOSAL, I WOULD LIKE TO CONTRAST OUR SEVERANCE TAX PROPOSAL WITH OTHER SEVERANCE TAX PROPOSALS WHICH HAVE BEEN INTRODUCED. THE OTHER SEVERANCE TAX PROPOSALS ARE SB 103 AND IIB 144.

FIRST, SB 103 AND HB 144 IN CONTRAST TO OUR BILLS DO NOT FULLY PROTECT THE STATE AGAINST UNFAVORABLE FEDERAL PRICING DECISIONS. THIS IS BECAUSE THE OTHER BILLS LEAVE THE CENTS-PER-BARREL FLOOR AT ITS PRESENT LEVEL OF \$6.10 PER BARREL. THUS THE CENTS-PER-BARREL FLOOR WOULD NOT KICK IN TO PROTECT THE STATE UNTIL THE WELL HEAD PRICE OF OIL WAS REDUCED BELOW \$6.10. THIS IS \$1.40 BELOW THE PROJECTED FREE MARKET PRICE OF NORTH SLOPE OIL. JUST THIS DIFFERENCE OF \$1.40 A BARREL IN THE SEVERANCE TAX FLOOR COULD COST THE STATE FROM \$100 TO \$200 MILLION DOLLARS A YEAR. TO PROTECT THE STATE AGAINST UNFAVORABLE FEDERAL PRICING AND CORPORATE MANIPULATIONS, IT IS NOT ENOUGH SIMPLY TO RAISE THE PERCENTAGE RATES SINCE ANY PERCENT OF AN ARTIFICIAL PRICE ONLY RETURNS THAT PERCENTAGE AMOUNT OF THAT ARTIFICIAL PRICE. TO PROTECT THE STATE, THE CENTS-PER-BARREL FLOOR HAS TO BE RAISED TO THE FREE MARKET LEVEL.

SECONDLY SB 103 AND HB 144 DO NOT ADEQUATELY PROVIDE TAX RELIEF TO PRODUCTION APPROACHING ITS ECONOMIC LIMIT. THESE BILLS ATTEMPT TO PROVIDE RELIEF FOR MARGINAL WELLS BY EXPANDING THE NUMBER OF STAIR-STEP TAX RATES AND BY APPLYING A ZERO TAX RATE IF PRODUCTION DECLINES TO 100 BARRELS A DAY. AS STATED EARLIER, THE STAIR-STEP APPROACH WILL WORK AT BEST ONLY FOR A PARTICULAR PART OF THE STATE. THUS THE STAIR-STEP SCHEDULE SET OUT IN THESE BILLS WILL PROVIDE RELIEF FOR COOK INLET PRODUCTION BUT WILL NOT PROVIDE RELIEF FOR OTHER AREAS IN THE STATE IN WHICH THE ECONOMIC LIMIT IS WELL ABOVE 100 BARRELS A DAY. FOR PRODUCTION ON THE NORTH SLOPE AND IN INTERIOR ALASKA WHICH HAVE HIGHER COSTS OF PRODUCTION AND TRANSPORTATION, THERE WILL NOT BE TAX RELIEF SINCE THE ECONOMIC LIMIT FOR THIS PRODUCTION MAY IN FACT REACH AS HIGH AS 1,000 BARRELS A DAY. THUS IN CONTRAST TO OUR SEVERANCE TAX PROPOSAL, SB 103 AND HB 144 DO NOT PROVIDE TAX RELIEF FOR MARGINAL PRODUCTION EXCEPT FOR COOK INLET PRODUCTION.

IN ADDITION SB 103 AND HB 144 DO NOT ADDRESS THE SEVERANCE TAX ON GAS PRODUCTION. THESE BILLS SIMPLY LEAVE THE TAX AT THE CURRENT 4 PERCENT OF VALUE WITHOUT PROVIDING A SEVERANCE TAX FLOOR TO PROTECT AGAINST DEPRESSED GAS PRICING. ALSO THE GAS FLARING TAX IN THESE BILLS MAY BE TOTALLY DEFICIENT SINCE IT IS NOT BASED ON A CENTS-PER-MCF BASIS BUT ON A PERCENTAGE OF VALUE BASIS. FOR EXAMPLE IT MIGHT BE ARGUED THAT GAS WHICH IS FLARED HAS ZERO VALUE OR PRICE SO ANY PERCENTAGE OF ZERO WOULD GIVE YOU ZERO REVENUE. ACCORDINGLY THE GAS FLARING TAX SHOULD BE BASED ON A CENTS-PER-MCF BASIS AS IN OUR BILLS TO CLOSE THIS POTENTIAL LOOPHOLE.

THUS WE BELIEVE THAT OUR SEVERANCE TAX PROPOSAL IS SUPERIOR IN THAT IT PROTECTS THE STATE AGAINST DEPRESSED FEDERAL PRICING; PROVIDES TAX RELIEF TO MARGINAL PRODUCTION IN ALL PARTS OF THE STATE; AND ASSURES A FAIR SEVERANCE TAX RETURN ON GAS PRODUCTION.

I WOULD LIKE TO NOW TURN TO OUR INCOME TAX PROPOSAL.

AS EXPLAINED EARLIER IN THE WEEK BY PROFESSORS ZEIFMAN AND  
AINSWORTH, THERE ARE TWO MAJOR PROBLEM AREAS WITH THE CURRENT  
CORPORATE INCOME TAX. THE FIRST PROBLEM IS THE ERODED FEDERAL  
CORPORATE INCOME TAX BASE WHICH ALASKA HAS INCORPORATED AS ITS  
OWN. OVER THE YEARS, CONGRESS HAS CONTINUALLY ERODED THE FEDERAL  
TAX BASE BY SPECIAL EXEMPTIONS, DEDUCTIONS, AND CREDITS WHICH  
DO NOT REFLECT NORMAL FINANCIAL ACCOUNTING. THE EROSION HAS  
BECOME SO GREAT THAT FEDERAL TAXABLE INCOME IS SUBSTANTIALLY  
BELOW THE NET INCOME WHICH IS CERTIFIED AND REPORTED TO SHAREHOLDERS.  
FOR EXAMPLE AS INDICATED ON PAGE 7 OF CHAPTER 5 OF OUR REPORT,  
A CONGRESSIONAL REPORT SHOWS THAT 5 MULTINATIONAL OIL COMPANIES  
PAID \$107 MILLION DOLLARS IN CORPORATE INCOME TAXES TO THE  
FEDERAL GOVERNMENT ON PRE TAX PROFITS OF MORE THAN 2.2 BILLION  
FOR AN EFFECTIVE AVERAGE TAX RATE OF 4.8 PERCENT. THE REPORT  
ALSO SHOWS THE FINDINGS OF THE CONGRESSIONAL STUDY, IN WHICH  
THE EFFECTIVE FEDERAL TAX RATE ON THEIR WORLDWIDE INCOME IS

SHOWN FOR SEVERAL OF THE MAJOR OIL CORPORATIONS. NEEDLESS TO  
SAY THESE EFFECTIVE TAX RATES ARE SUBSTANTIALLY BELOW THE  
FEDERAL STATUTORY TAX RATE OF 48 PERCENT.

THE SECOND MAJOR PROBLEM FOUND WAS THE MANNER IN WHICH THE  
CORPORATION'S TOTAL NET INCOME IS APPORTIONED TO ALASKA.  
CURRENTLY THE TOTAL FEDERAL TAXABLE INCOME OF AN ALASKAN  
CORPORATION PLUS THE TAXABLE INCOME OF ALL OF ITS UNITARY  
AFFILIATES AND SUBSIDIARIES ARE COMBINED INTO A TOTAL WORLD-  
WIDE TAXABLE INCOME FIGURE AND THEN THAT AMOUNT IS MULTIPLIED  
BY A 3 FACTOR FORMULA OF PROPERTY, PAYROLL AND SALES. THE  
PRODUCT OF THAT CALCULATION BECOMES ALASKA TAXABLE INCOME  
FOR THE ALASKAN CORPORATION AND IT IS TAXED AT THE 9.4 PERCENT  
NOMINAL TAX RATE.

THE PRESENT APPORTIONMENT FORMULA OF PROPERTY, PAYROLL AND  
SALES IS DESIGNED TO MEASURE THE ACTIVITY OF GENERAL MERCHANTILE  
BUSINESSES. IT DOES NOT ACCURATELY MEASURE THE ACTIVITIES  
OF NATURAL RESOURCE COMPANIES AND IT DOES NOT TAKE INTO

ACCOUNT THE UNIQUE CONTRIBUTION MADE BY NATURAL RESOURCES  
THEMSELVES. THE PRESENT DESTINATION-ORIENTED FORMULA DOES  
NOT GIVE ANY WEIGHT TO THE SCARCITY VALUE OF THE NON-RENEWABLE  
RESOURCE WHICH IS REALLY WHAT DETERMINES THE INCOME OR PROFIT  
FOR A NATURAL RESOURCE COMPANY.

THE TAX WOULD BE LEVIED ON AND WOULD BE MEASURED BY THE TOTAL  
WORLD-WIDE NET INCOME OF THE CORPORATION AND ALL OF ITS  
UNITARY AFFILIATES AND SUBSIDIARIES AS REPORTED AND CERTIFIED  
TO ITS SHAREHOLDERS AND THEN APPORTIONED TO ALASKA BY  
A 3 FACTOR FORMULA. IN ONE CLEAN SWEEP IT WOULD ELIMINATE ALL  
OF THE SPECIAL SUBSIDIES AND ACCOUNTING DEVICES WHICH ARE  
EMBODIED IN THE PROVISIONS OF THE INTERNAL REVENUE CODE.  
THUS THE INCOME WOULD BE BASED ON NORMAL FINANCIAL NET INCOME  
UNERODED BY ALL THE SPECIAL FEDERAL EXEMPTIONS, CREDITS AND  
DEDUCTIONS.

ADMITTEDLY THERE IS SOME FLEXIBILITY UNDER NORMAL ACCOUNTING  
PRINCIPLES FOR THE DETERMINATION OF NET INCOME THAT IS REPORTED

TO STOCKHOLDERS. WE BELIEVE, HOWEVER, THAT THERE ARE REAL  
DETERRENTS AGAINST MANIPULATING "BOOK INCOME" FOR STATE TAX  
PURPOSES. FIRST OF ALL, BOOK INCOME IS SUBJECT TO CERTIFICATION  
UNDER RULES PROMULGATED BY THE AMERICAN INSTITUTE OF CERTIFIED  
PUBLIC ACCOUNTANTS AND IS SUBJECT TO REVIEW BY THE SECURITIES  
AND EXCHANGE COMMISSION. IN ORDER TO MANIPULATE "BOOK INCOME"  
TO LOWER ALASKA TAX LIABILITY, IT WOULD HAVE TO BE DONE AT  
THE EXPENSE OF THE CORPORATION'S STOCKHOLDERS.

THE EFFECTIVENESS OF ELIMINATING THE FEDERAL EROSIONS THROUGH  
THE ADOPTION OF BOOK INCOME WAS DEMONSTRATED BY PROFESSORS  
ZEIFMAI AND AINSWORTH. THEY FOUND IN THE SAMPLE OF LARGE OIL  
CORPORATIONS DOING BUSINESS IN ALASKA THAT BOOK INCOMES EXCEEDED  
FEDERAL TAXABLE INCOME BY 1.6 TO 3 BILLION DOLLARS A YEAR  
OVER THE LAST THREE YEARS.

THE SECOND MAJOR REVISION IS A MODIFICATION OF THE UNIFORM  
APPORTIONMENT FORMULA OF PROPERTY, PAYROLL AND SALES. THE

BILL SUBSTITUTES AN ORIGIN ORIENTED EXTRACTION FACTOR FOR THE DESTINATION ORIENTED SALES FACTOR. THUS A NEW FACTOR WOULD BE ADDED TO THE APPORTIONMENT FORMULA AND WOULD BE MEASURED BY THE NET PRODUCTION OF OIL AND GAS IN ALASKA VERSUS THE NET PRODUCTION OF OIL AND GAS EVERYWHERE. THIS WILL MEAN THAT FOR THE FIRST TIME, THE AMOUNT OF INCOME ATTRIBUTED TO ALASKA WILL BE BASED UPON, IN PART, THE AMOUNT OF OIL AND GAS PRODUCED IN ALASKA.

ACCORDINGLY THE BILL PROVIDES A METHOD IN WHICH WORLD-WIDE

"BOOK INCOME" OF THE TOTAL UNITARY BUSINESS OPERATIONS WILL BE MULTIPLIED BY A FORMULA OF PROPERTY, PAYROLL AND EXTRACTION.

IN ADDITION, TO SPECIFICALLY MEASURING PRODUCTION ACTIVITY IN

THE STATE, THE SUBSTITUTION OF THE EXTRACTION FACTOR FOR THE

SALES FACTOR WILL RETURN A LARGER PORTION OF A CORPORATION'S

INCOME TO THE STATE. AND WELL THAT IT SHOULD SINCE THE TAX

SHOULD BE MEASURED BY THE SCARCITY VALUE OF OUR NATURAL RESOURCES.

THERE WAS SOME SUGGESTION EARLIER IN THE WEEK THAT THERE MIGHT BE A PROBLEM WITH THE DETERMINATION OF NET EXTRACTION FROM FOREIGN JURISDICTIONS IN WHICH THE CORPORATIONS WOULD BE ACTING AS ESSENTIALLY A CONTRACTOR AND HAVE NO INTEREST IN THE OIL ITSELF. THE REASON FOR THE CONCERN SEEMED TO STEM FROM THE FACT THAT A BREAK DOWN OF PRODUCTION MIGHT NOT BE REPORTED IN PUBLISHED FINANCIAL STATEMENTS. IN OUR EARLY CONSIDERATION OF THE EXTRACTION FACTOR, WE ANTICIPATED THIS POTENTIAL DIFFICULTY BECAUSE OF THE ABSENCE OF CONSISTENT FIGURES ON PUBLISHED FINANCIAL STATEMENTS. FOR THAT REASON WE HAVE HAD OUR MULTI-STATE TAX COMMISSION AUDITORS DETERMINE IF ADEQUATE RECORDS ARE AVAILABLE TO AUDIT WORLD WIDE NET PRODUCTION. IN CONNECTION WITH CURRENT AUDITS WHICH THEY ARE DOING IN OUR BEHALF OF SOME MULTINATIONAL OIL CORPORATIONS, THEY FOUND THAT ADEQUATE RECORDS AND DOCUMENTATION EXIST TO AUDIT THE PRODUCTION FIGURES WHICH WOULD BE REPORTED BY THE CORPORATIONS SUBJECT TO THE TAX. IN ADDITION WE NOW UNDERSTAND THAT INDEPENDENT PRODUCTION STATISTICS ARE REPORTED BY THE UNITED NATIONS AND THE OPEC COUNTRIES THEMSELVES.

ANOTHER EXTREMELY IMPORTANT FEATURE OF THE FRANCHISE TAX IS

ITS ABILITY TO INCLUDE IN THE MEASURE OF THE TAX THE ACTIVITIES

LOCATED ON THE OUTER CONTINENTAL SHELF. BY THIS FEATURE WE ARE

TAKING THE POSITION THAT IF ELEMENTS OF PROPERTY, PAYROLL AND

SALES ARE NOT ASSIGNED TO ANY OTHER JURISDICTION, THEN THEY

SHOULD BE ASSIGNED TO THE STATE WHICH HAS RECEIVED THE MOST

DIRECT IMPACT. IN ADDITION TO COMPENSATING THE STATE FOR THE

ECONOMIC IMPACT FELT BY THIS ACTIVITY IT PREVENTS THE CORPORA-

TION FROM ASSIGNING INCOME TO THE STATE OF NO WHERE. ALSO THE

PROPERTY AND PAYROLL FACTOR OF MARINE TRANSPORTATION SUBSIDIARIES

WOULD BE ASSIGNED ON THE BASIS OF THE NUMBER OF DAYS IN PORT.

LET ME NOW COMPARE BRIEFLY SB 236 AND HB 322 WITH THE OTHER

INCOME TAX BILLS WHICH HAVE BEEN INTRODUCED. SB 105 AND

HB 145 ADOPT AN APPROACH ENTIRELY DIFFERENT THAN THE APPROACH

WHICH WE HAVE TAKEN AND IS CALLED SEPARATE ACCOUNTING.

INSTEAD OF COMBINING THE ENTIRE NET INCOME OF THE UNITARY

GROUP OF BUSINESSES AND APPORTIONING THAT TOTAL INCOME TO THE

STATE BY AN APPORTIONMENT FORMULA, THE SEPARATE ACCOUNTING

BILL LOOKS ONLY AT THE SEPARATE INCOME AND EXPENSE OF A CORPORATE ENTITY DOING BUSINESS IN THE STATE. SEPARATE ACCOUNTING ESSENTIALLY SEPARATES THE NET INCOME OF THE BUSINESS INTO GEOGRAPHICAL UNITS. IN EFFECT, THE BUSINESS ACTIVITIES IN ONE STATE ARE TREATED AS IF THEY WERE CARRIED ON BY A TOTALLY SEPARATE BUSINESS.

THEORETICALLY, SEPARATE ACCOUNTING MEASURES THE NET INCOME OF THE BUSINESS EARNED WITHIN THE STATE. IN PRACTICE IT DOES NOT. THE REASON IT DOES NOT STEMS FROM THE WAY THAT LARGE MODERN BUSINESSES, ESPECIALLY LARGE INTEGRATED MULTINATIONAL CORPORATIONS, OPERATE.

THE ENTIRE ENTERPRISE IS OPERATED AS A UNIT WITH THE PROFIT BEING EARNED ONLY BY THE ENTIRE OPERATION AS A WHOLE. THUS THE WHOLE ENTERPRISE IS ACTUALLY MORE THAN THE SUM OF THE PARTS SINCE EACH PART IS ESTABLISHED ONLY TO CONTRIBUTE TO THE ENTIRE UNITARY BUSINESS. THE NET PROFIT IS ACTUALLY THE FINAL RESULT OF THE CONTINUOUS SERIES OF INCOME AND EXPENSE TRANSACTIONS AMONG THE VARIOUS COMPONENT PARTS OF THE BUSINESS.

WITH REGARD TO AN INTEGRATED MULTINATIONAL OIL CORPORATION,  
THE NET INCOME IS NOT EARNED BY ANY PARTICULAR PHASE OF THE  
OPERATION SUCH AS PRODUCTION, TRANSPORTATION, REFINING OR  
MARKETING. EACH SEGMENT CONTRIBUTES TO THE WHOLE, AND THE  
NET INCOME IS ONLY REFLECTED AFTER THE FINAL SALE AND THE  
CONTRIBUTION OF EACH PART OF THE BUSINESS.

BECAUSE OF THE REALITIES OF MODERN BUSINESS OPERATIONS, A  
SEPARATE ACCOUNTING METHOD OPENS THE DOORS TO WIDESPREAD TAX  
AVOIDANCE. WITH A MULTIFACETED BUSINESS ACTING THROUGH  
DIFFERENT DIVISIONS, AFFILIATES AND SUBSIDIARIES, IT DOESN'T  
MATTER TO THE OVERALL ENTERPRISE WHETHER A PARTICULAR DIVISION  
IS SHOWN TO MAKE A PROFIT OR LOSS AS LONG AS IN THE END A  
PROFIT IS MADE FOR THE COMPANY AS A WHOLE. IN A REAL SENSE  
THE PROFIT OR LOSS OF A PARTICULAR DIVISION CAN BE MADE TO  
APPEAR ANY WAY THAT THE ENTERPRISE WANTS IT TO APPEAR.

FOR EXAMPLE, WHEN GOODS ARE TRANSFERRED FROM ONE DIVISION TO  
ANOTHER, THE AMOUNT CHARGED TO EACH SEGMENT OF THE BUSINESS

CAN BE ANYTHING THAT THE ENTERPRISE FINDS IN ITS BEST INTEREST TO CHARGE. LIKEWISE AS THE PARENT CORPORATION OR ANOTHER DIVISION PROVIDES MANAGEMENT, ACCOUNTING, LEGAL OR OTHER RELATED SERVICES FOR ANOTHER DIVISION OR AFFILIATE, THE SAME FLEXIBILITY EXISTS FOR DETERMINING THE AMOUNT OF FEES TO BE CHARGED. INCOME AND EXPENSE CAN BE EFFECTIVELY SHIFTED FROM ONE PART OF THE BUSINESS TO ANOTHER. THIS SHIFTING OF INCOME AND EXPENSE DOES NOT TAKE PLACE THROUGH A HANDFUL OF EASILY RECOGNIZABLE TRANSACTIONS, BUT THROUGH A SERIES OF THOUSANDS OF TRANSACTIONS A DAY WHICH AMOUNT TO MILLIONS FOR AN ENTIRE YEAR. ALSO, THESE TRANSACTIONS ARE MADE NOT JUST BETWEEN A HANDFUL OF CORPORATE ENTITIES, BUT THROUGH LITERALLY HUNDREDS OF DIVISIONS, AFFILIATES, AND SUBSIDIARIES. WITH SUCH A MYRIAD OF CORPORATE ENTITIES AND TRANSACTIONS, IT IS EXTREMELY DIFFICULT, TO SAY THE LEAST, TO DETERMINE WHAT IS THE "TRUE" NET PROFIT EARNED BY ONE ENTITY OR GEOGRAPHIC PART OF AN ENTITY.

AS APPLIED TO THESE SEPARATE ACCOUNTING BILLS, THE SAME PROBLEM OCCURS. THAT IS, THESE BILLS COULD OPEN THE DOOR TO WIDESPREAD TAX AVOIDANCE BECAUSE OF THE MANIPULATIONS OF INCOME AND EXPENSE WHICH ARE POSSIBLE.

AS WITH THE OTHER SEVERANCE TAX PROPOSALS THE SEPARATE ACCOUNTING BILL WOULD LEAVE OPEN THE POTENTIAL OF EROSION BY FEDERAL PRICING DECISIONS. FOR EXAMPLE UNDER THESE BILLS GROSS REVENUE FOR PRODUCTION OPERATIONS IS DEFINED TO MEAN THE WELL HEAD VALUE. IF FEDERAL PRICING DECISIONS SET A DEPRESSED WELL HEAD PRICE THEN THE GROSS REVENUES UNDER THE BILL WILL BE SUBSTANTIALLY REDUCED. LIKEWISE MANIPULATIONS BY TAXPAYERS OF WELL HEAD OR GROSS REVENUES ARE ALSO POSSIBLE BY THE TRANSPORTATION CHARGES WHICH ARE MADE FROM ONE AFFILIATE TO ANOTHER.

JUST AS THE GROSS REVENUE OR WELL HEAD VALUE CAN BE MANIPULATED UNDER THE SEPARATE ACCOUNTING METHOD, SO CAN THE EXPENSES AND DEDUCTIONS. THAT IS, THE CHARGES FOR SERVICES AND PROPERTY

FROM ONE AFFILIATE TO ANOTHER CAN BE MADE SO AS TO SHIFT PROFIT FROM ONE CORPORATE ENTITY TO ANOTHER. THROUGH SUCH SHIFTING OF INCOME AND EXPENSE BETWEEN THE ALASKA CORPORATION AND OTHER AFFILIATED CORPORATIONS, THE INCOME AND EXPENSE CAN IN A REAL SENSE BE MADE TO BE WHAT THE OVERALL CORPORATE ENTERPRISE WANTS IT TO BE.

THIS DEFICIENCY CANNOT BE CURED SIMPLY BY HIRING AN ARMY OF STATE AUDITORS. TO THE EXTENT OF REDUCED GROSS INCOME BY REASON OF DEPRESSED FEDERAL PRICING, THE STATE IS SIMPLY STUCK UNDER A SEPARATE ACCOUNTING APPROACH. IN ADDITION, TO FERRET OUT THE MULTITUDE OF INTERCOMPANY CHARGES AND OVERTURN THEM AS EITHER FRAUDULENT OR UNREASONABLE IS SIMPLY IMPOSSIBLE. WITH LARGE MULTINATIONAL CORPORATIONS THERE ARE VIRTUALLY HUNDREDS OF TRANSACTIONS A DAY BETWEEN DOZENS OF CORPORATE AFFILIATES. YOU SIMPLY CANNOT UNSCRAMBLE THESE TRANSACTIONS TO DETERMINE THE "TRUE" PROFIT EARNED IN ALASKA.

IN CONTRAST THE FRANCHISE TAX AVOIDS THESE EROSIONS AND MANIPULATIONS BETWEEN DIFFERENT SEGMENTS OF THE OIL INDUSTRY

AND BETWEEN AFFILIATED COMPANIES. IT AVOIDS THESE PROBLEMS BY COMBINING THE INCOME OF THE TOTAL GROUP OF RELATED CORPORATIONS. THUS THE GAME OF SHIFTING PROFIT FROM ONE CORPORATION TO ANOTHER IS AVOIDED SINCE THE ENTIRE NET IS COMPUTED AND NOT JUST FOR ONE CORPORATION IN ISOLATION. IT ALSO AVOIDS THE UNCERTAINTIES OF PRICE REGULATION OF THE PRODUCTION SEGMENT OF THE INDUSTRY, SINCE ALL SEGMENTS OF AN INTEGRATED COMPANY WOULD BE COMBINED AND THE OVERALL PROFIT OF UNITARY BUSINESS TAXED. THESE OTHER SEGMENTS OF THE INDUSTRY SUCH AS TRANSPORTATION, REFINING AND MARKETING MAY NOT HAVE PRICE REGULATIONS AND SO THE PROFIT MAY BE TRANSFERRED TO THESE UNREGULATED SEGMENTS. THE SEPARATE ACCOUNTING APPROACH WOULD NOT MEASURE THIS SHIFTED PROFIT. THE FRANCHISE TAX BILL WOULD. THE SEPARATE ACCOUNTING BILLS ALSO WOULD NOT INCLUDE IN THE MEASURE OF THE TAX, THE OIL AND GAS ACTIVITIES OCCURRING ON THE OUTER CONTINENTAL SHELF. IT WOULD SIMPLY ATTEMPT TO SEGREGATE THE INCOME GENERATED IN THE STATE. IN CONTRAST THE FRANCHISE TAX WOULD INCLUDE IN THE MEASURE OF THE TAX

PROPERTY, PAYROLL AND EXTRACTION LOCATED ON THE OUTER  
CONTINENTAL SHELF. I BELIEVE THAT IT IS IMPORTANT THAT THE  
STATE SEEK COMPENSATION FOR THE IMPACT FROM THIS ACTIVITY.  
THE FRANCHISE TAX WOULD COMPENSATE THE STATE AS A RESULT OF  
THESE ACTIVITIES TAKING PLACE OFF OUR SHORES. THE SEPARATE  
ACCOUNTING BILL WOULD ALSO NOT INCLUDE THE INCOME OF MARINE  
TRANSPORTATION SUBSIDIARIES TRANSPORTING OIL FROM OUR STATE.

CONTINUING ON, I WOULD NOW LIKE TO MAKE SOME COMMENTS ABOUT  
OUR PROPERTY TAX PROPOSAL. THIS IS CONTAINED IN SB 237 AND  
HB 323. OUR PROPERTY TAX PROPOSAL CORRECTS SEVERAL DEFICIEN-  
CIES IN OUR 20 MIL AD-VALOREM TAX.

ONE PORTION OF THE BILL WOULD STRENGTHEN THE VALUATION METHOD  
PRESCRIBED FOR PIPELINES AND ASSURE THAT THE TRANS-ALASKA  
PIPELINE WILL BE VALUED UNDER A FULL AND TRUE VALUE. UNDER  
THE PRESENT WORDING OF THE STATUTE, IT IS POSSIBLE THAT THE  
TRANS-ALASKA PIPELINE WILL BE VALUED ONLY AT ITS ACTUAL COST  
AND DEPRECIATED ON A STRAIGHT LINE BASIS OVER THE ECONOMIC

LIFE OF THE FIELD. WE FEEL THIS POTENTIAL OUTCOME WOULD BE  
DISASTROUS SINCE THIS ACTUAL COST-DEPRECIATED METHOD WOULD  
YIELD A VALUE SUBSTANTIALLY BELOW THE PIPELINE'S FULL AND TRUE  
MARKET VALUE. THE ARGUMENT FOR THIS DEPRESSED VALUATION HAS  
ALREADY BEEN MADE BY OTHER PIPELINE COMPANIES IN THE STATE AND  
THE DETERMINATION OF THE PROPER PIPELINE VALUATION METHOD IS  
NOW UNDER REVIEW BY THE SUPERIOR COURT.

OUR BILL WOULD ELIMINATE THIS POTENTIAL HAZARD BY AMENDING  
THE STATUTE TO INSURE A FULL AND TRUE VALUE OF PIPELINES  
WITH DUE REGARD TO THEIR ECONOMIC VALUE. THUS INSTEAD OF A  
VALUATION BASED SOLELY ON ACTUAL COST, THE VALUATION WOULD BE  
BASED UPON MORE REALISTIC VALUATION METHODS SUCH AS REPLACE-  
MENT COST APPROACH AND THE CAPITALIZED NET INCOME APPROACH.

IT SHOULD BE NOTED THAT THE COMPANIES WILL BE ALLOWED A RATE  
OF RETURN ON THE BASIS OF REPLACEMENT COST. IT IS ONLY FAIR  
THAT OUR TAX SHOULD BE BASED ON THE SAME BASIS.

SECONDLY THE BILL WOULD INCLUDE IN THE COVERAGE OF THE TAX  
SEVERAL IMPORTANT CATEGORIES OF OIL AND GAS PROPERTIES WHICH

ARE PRESENTLY EXEMPT FROM THE STATE TAX. THESE INCLUDE TANKERS,  
GAS PROCESSING PLANTS AND REFINERIES. GAS PROCESSING PLANTS  
AND REFINERIES WOULD BE VALUED AND TAXED AT THEIR REPLACEMENT  
COST. TANKERS WOULD ALSO BE VALUED AT THEIR REPLACEMENT COST  
EXCEPT THAT VALUATION WOULD BE APPORTIONED TO THE STATE UNDER  
A FORMULA OF DAYS IN PORT IN ALASKA VERSUS DAYS IN PORT  
EVERYWHERE. WE BELIEVE THAT A PORTION OF THE REVENUES FROM  
THESE IMPORTANT PROPERTIES SHOULD BE SHARED BY ALL ALASKANS.  
TANKERS, GAS PROCESSING PLANTS AND REFINERIES ARE SIMPLY  
EXTENSIONS OF THE PRODUCTION AND PIPELINE TRANSPORTATION  
PROPERTIES.

THE BILL ALSO AMENDS THE PROPERTY TAX STATUTE TO MAKE ABSOLUTELY  
CLEAR THAT TAXES PAID TO MUNICIPALITIES WHICH EXCEED THE  
MUNICIPAL LIMITATIONS ARE NOT CREDITABLE AGAINST THE STATE  
PROPERTY TAX.

I WOULD LIKE TO ADD A FEW COMMENTS ON OUR RESERVES TAX PROPOSAL.  
BECAUSE OF RECENT TAX CHANGES AND UNFORESEEN EVENTS, WE HAVE

DEVELOPED A SURPLUS IN FISCAL YEAR 1977. THIS SURPLUS IS  
SOMEWHAT ILLUSORY, HOWEVER, SINCE MOST OF IT REPRESENTS  
RESERVE TAX PAYMENTS WHICH WILL BE RECOUPED IN SUBSEQUENT  
YEARS BY OIL AND GAS COMPANIES THROUGH CREDITS AGAINST THEIR  
SEVERANCE TAXES. THE DEPARTMENT BELIEVES THAT IT MAKES SENSE  
TO REDUCE THIS YEAR'S TEMPORARY SURPLUS AND FREE UP ADDITIONAL  
REVENUES IN FUTURE YEARS. THE BILL WOULD DO THIS BY REDUCING  
THIS YEAR'S RESERVES TAX MILLAGE RATE FROM 20 MILLS TO 12  
MILLS. AT THE SAME TIME, HOWEVER, I AM PROPOSING THAT IF  
THERE IS A DELAY IN THE START-UP OF THE TRANS-ALASKA PIPELINE,  
THEN AN ADDITIONAL RESERVES TAX PAYMENT WILL BE DUE.  
  
THUS IF ON OCTOBER 1, 1977 THE TRANS-ALASKA PIPELINE IS NOT  
TRANSPORTING AT LEAST 600,000 BARRELS A DAY THEN AN ADDITIONAL  
8 MILLS WOULD BE IMPOSED. ALSO IF ON DECEMBER 25, 1977 THE  
TRANS-ALASKA PIPELINE IS NOT TRANSPORTING AT LEAST 1.2  
MILLIONS BARRELS A DAY THEN A RESERVES TAX WOULD BE IMPOSED  
FOR 1978 AT A RATE TO BE SET BY THE NEXT LEGISLATURE. WE

THINK THIS BILL IS IMPORTANT TO PRESERVING THE STATE'S FINANCIAL FLEXIBILITY DURING THE NEXT FISCAL YEAR.

IN ADDITION TO TAX CHANGES WHICH I AM PROPOSING FOR THE OIL AND GAS INDUSTRY, I AM ALSO PROPOSING A TAX MEASURE WHICH WILL PROVIDE SOME RELIEF TO INDIVIDUAL TAXPAYERS WHO ARE IMPACTED BY THE INCREASING COST OF ENERGY. AS A PART OF OUR TAX PACKAGE WE ARE PROPOSING A FUEL CREDIT FOR INDIVIDUALS TO TAKE ON THEIR INCOME TAX RETURNS TO ACCOUNT FOR THE HIGH COST OF ENERGY. THE CREDIT WILL BE EQUAL TO TWO PERCENT OF A PERSON'S HOME FUEL EXPENSES OR A MINIMUM CREDIT OF \$10.

ALL OF THESE BILLS TOGETHER REPRESENT A COMPREHENSIVE REVISION OF OUR OIL AND GAS TAX STRUCTURE. THEY CLOSE CURRENT LOOP-HOLES AND PROTECT THE STATE FROM THE FUTURE UNCERTAINTIES OF FEDERAL OIL PRICING AND CORPORATE MANIPULATIONS. I URGE THAT YOUR COMMITTEES REPORT FAVORABLY ON THESE BILLS.

IN JUDGING THE TAX MEASURES BEFORE YOU I BELIEVE THAT WE MUST NOT ONLY PROTECT OUR REVENUES IN THE SHORT TERM BUT ALSO INSURE SUFFICIENT RETURN FROM THESE NON-RENEWABLE NATURAL RESOURCES FOR FUTURE ALASKANS AS WELL. WE SHOULD NOT BE SWAYED BY THE ARGUMENTS OF THOSE WHO WOULD HAVE US RECOVER FROM OUR NON-RENEWABLE NATURAL RESOURCES ONLY AMOUNTS SUFFICIENT TO COVER TODAY'S OPERATING EXPENDITURES. WE SHOULD NOT BE THAT SHORTSIGHTED THAT WE FORGET THAT THE REVENUES FROM THESE RESOURCES BELONG TO SUCCESSIVE GENERATIONS OF ALASKANS.

ACCORDINGLY, IN DECIDING THE CORRECT LEVEL OF TAXATION LET US NOT FORGET FUTURE ALASKANS WHO WILL INHERIT THE STATE WHEN THE OIL AND GAS RESOURCES ARE DEPLETED. WE SHOULD WORK TO ELIMINATE THE LOOPHOLES AND POTENTIAL EROSIONS FROM OUR TAX SYSTEM AND SET A LEVEL OF TAXATION WHICH WILL RETURN REVENUES TO THE STATE FROM THOSE NATURAL RESOURCES FOR OURSELVES AND FUTURE GENERATIONS.

TESTIMONY BEFORE THE JOINT HEARING  
OF THE  
SENATE RESOURCES COMMITTEE  
AND THE  
HOUSE RESOURCES COMMITTEE  
OF THE

ALASKA STATE LEGISLATURE

BY

RICHARD M. DONALDSON

VICE PRESIDENT FOR GOVERNMENT AND PUBLIC AFFAIRS

THE STANDARD OIL COMPANY (OHIO)

AT JUNEAU, ALASKA

ON MARCH 24, 1977

CONCERNING PENDING OIL TAX PROPOSALS

Testimony Before The Joint Hearing  
Of The  
Senate Resources Committee  
And The  
House Resources Committee  
Of The  
Alaska State Legislature

By  
Richard M. Donaldson  
Vice President For Government And Public Affairs  
The Standard Oil Company (Ohio)  
At Juneau, Alaska  
On March 24, 1977  
Concerning Pending Oil Tax Proposals

Senator Poland, Representative Osterback and Members of the  
Resources Committees:

I am Dick Donaldson, Vice President for Government and Public Affairs of Sohio, The Standard Oil Company of Ohio. Most of us are acquainted and I expect that all of you know of Sohio's and BP's interests in Prudhoe Bay and the Trans Alaska Pipeline, so I won't waste any words of introduction summarizing them. I would underscore, however, our continuing and long term interests in the future of Alaska as companies engaged here and as people working for them, many of whom now live here.

With respect to the subject of this hearing and all of the tax proposals you may consider, I hardly know where to begin. I guess that my first response is one of "disappointment". Let me explain, because my disappointment is probably not what you might be assuming.

About a year ago I appeared before a joint hearing of your Committees here in Juneau. Other tax legislation was being considered then. At the end of our discussion that day, I urged

the State to take whatever time was necessary to assess and balance three things: the future revenues of the State, the future expenditures of the State, and the State as a place to do business since a substantial majority of the people of Alaska are engaged in or work for businesses of all kinds. I not only urged the State to consider these three things but also to determine a longer term taxing and leasing policy for the State that would serve all three needs. I stated that my company would be responsive to such policy studies and would participate in them if invited. I felt that such a policy assessment was long needed by all of us, and that since the State no longer had its back to the wall financially, it could and should take some time to do the job right.

I can tell you that I was pretty excited when I read the Governor's statement on March 31, 1976, to your Committees. He said that the State's taxing policy must accomplish the following objectives:

1. It must generate sufficient revenues not only to compensate the State for additional service costs attending such development but also to provide a reasonable additional "dividend" to Alaskans.
2. It must leave profits to investors sufficient to encourage their continued interest in Alaskan resource development, especially where high risks, such as those in the area of oil and gas development, are involved.

3. It must be reasonably responsive to national and world economic trends of the time.
4. It should not discriminate on the basis of ownership.
5. It must reduce uncertainty and encourage stable expectations about future resource tax and management policies.

I felt further encouraged when I read Senate Concurrent Resolution No. 101 which spoke of the "revenue needs of the state", "revenue from oil and gas leases and production from oil and gas", and the "effect of increased taxation \*\*\* on future oil and gas development in the state".

The thought that both the Administration and the Legislature were going to take a thoroughgoing look at State revenues, State expenditures and their impact on the private sector in Alaska was good news. On July 1, 1976 I wrote Gregg Erickson, Director of Research Services, Legislative Affairs Agency, identifying some of the subject areas these studies might examine, and sent information copies to Commissioner Gallagher and Commissioner Martin who were heading up the Administration's studies. A copy of that letter is attached to my testimony today as Attachment A, if you are interested in it.

During the summer and fall which followed not much appeared to be happening with these studies, or at least not very much was visible to us. Various consultants were hired and the word

that filtered out seemed to indicate that some of them were looking at additional revenue possibilities, but not much else. In October, I tried to stir up some interest again on the need for a longer term taxing and leasing policy for the State, its people and our industry. I spoke to the Fairbanks Industrial Development Corporation, the Anchorage Chamber of Commerce, the Anchorage Rotary, the Kenai Chamber of Commerce, and to the Bar Association here in Juneau. Again, the responses seemed affirmative.

Since the first of the year there has been a lot of new tax bills introduced for consideration by the Legislature, and I suppose that's to be expected in the first session of every new Legislature. My disappointment, however, was that there still had been no in depth study of the policy implications, of how such revenue measures might impact the longer term economy of the State that will depend a lot on continued, reasonable resource development.

Today, I'd like to summarize and give you copies of some of the work Sohio undertook in anticipation of responding to the State's policy studies. I will tell you about some other work we undertook which is still in progress and which I hope will be finished before too long. All of this bears on both the policy questions to be considered and the bills before your Committees.

First, let's take up the subject of new revenues to the State. Many times over the last few years we have been asked to project what our company and the State might receive from Prudhoe Bay and the Trans Alaska Pipeline. We knew that if we furnished the State projections of our own future earnings expectancies, the rules of the Securities and Exchange Commission would then require us to disclose such projections to the general public and to publicly and perpetually update those projections any time our internal estimates of the future changed. The burden of disclosing such projections on a perpetual basis and the potential liabilities to investors if such projections turned out to be wrong have led substantially all U.S. companies to decline publication of any earnings projections. Our counsel has advised against this too. Instead, and in order to be of some help to the State, we developed a hypothetical projection of tax payments to Alaska which would result from an assumed one-third ownership of Prudhoe Bay and the Trans Alaska Pipeline by each of three typical companies. None of these companies is intended to represent a company actually involved in the development of the field or the pipeline. Rather, the projections are intended to demonstrate the level of tax obligations which would result from the project being owned by companies varying in size and scope of overall operations.

This particular work was included in a paper entitled Sohio Submission One which was submitted informally to the Alaskan Administration and Legislature on October 28, 1976, and which I offer now formally as Attachment B to my testimony today. To summarize, this paper examined the Alaska state income tax under the allocation method of the Multistate Tax Compact and made illustrative projections of the substantial revenue that Alaska would receive as a result of the first ten years of operation of Prudhoe Bay and the Trans Alaska Pipeline. No oil or gas production from any other fields in Alaska, either existing or likely, were included in these projections. The projections of revenue included estimates of the State's royalty income and the tax receipts resulting from Alaska's present severance tax, reserves tax, ad valorem tax and state income tax. The projections showed that under present Alaska laws, and assuming a \$13.00 per barrel selling price in California, Alaska would receive from Prudhoe Bay and the Trans Alaska Pipeline average annual revenues on the order of \$1 billion without consideration of any factor for future inflation. If the selling price in California were \$10.00 per barrel, or \$16.00 per barrel, Alaska would receive annual revenues on the order of \$800 million or \$1.6 billion, respectively.

While that's a lot of money, even without the numbers being escalated for any inflation, we also wanted to know from a "fair

share" standpoint what part of the total revenues attributable to this Alaskan oil the State could expect to receive as compared to all other states in the U.S. which will buy, refine, transport and use it. Let me give you a few interesting statistics based on the Sohio Submission One example. Since the Prudhoe Bay field is located on state lands, Alaska would receive 100 percent of the royalty payments. Similarly, Alaska would receive 100 percent of the severance tax payments and 100 percent of the ad valorem tax payments. The reserves tax payments and the severance tax credits resulting from those payments are also strictly an Alaskan transaction. Since the field and pipeline are located in Alaska, though most of the sales of the oil will probably not be, the State will also receive state income tax payments amounting to 22 percent of the total income tax paid to all states in the U.S. Finally and at all three of the oil price levels assumed in Sohio Submission One which were intended to range over the probably market price, Alaska, as one state, would receive 75 percent of all revenues to be received by all fifty states from oil production at Prudhoe Bay.

Though Sohio Submission One looked at only one field and one pipeline, it does provide a lot of assurance that Alaska's revenue needs will be well covered in the years ahead.

This was confirmed directionally by the Report of the Department of Revenue to the Governor on Alaska's Oil and Gas Tax

Structure, dated February 11, 1977. Chapter IV of this Report states that the Department of Revenue has calculated a combined general fund and permanent fund balance at the end of fiscal year 1985 ranging from \$8.5 billion to \$8.7 billion, depending on which gas pipeline project is ultimately built to take gas from Prudhoe Bay. In any event, the State is looking forward to very substantial revenue surpluses. That has another implication for the legislation you are considering now. Any additional tax legislation will only add to the surplus.

The second piece of work Sohio undertook in anticipation of State studies on longer term tax and leasing policies was a comparison of the total tax burdens under the present laws in Alaska and other leading oil producing states. This work proved further the testimony I presented to you a year ago and was developed on the same factual base as we used in Sohio Submission One. We called it Sohio Submission Two and submitted it informally to the Administration and Legislature on January 21, 1977. May I offer it formally now as Attachment C to my testimony today.

Sohio Submission Two compares the projected total taxes that Alaska will receive as a result of the first ten years of operation of Prudhoe Bay and the Trans Alaska Pipeline with the total taxes which the State would receive if it had the tax structure of the other three leading oil producing states of Texas, Louisiana or

California. Since this was a comparison of the taxes of these states, Alaska's royalty payments were not considered in Sohio Submission Two. For comparison purposes, only the \$13.00 per barrel California selling price was used. This comparison, again under present law, confirmed that Alaska's tax burden on a project like Prudhoe Bay and the Trans Alaska Pipeline already equals or exceeds that of other oil producing states. Specifically, Alaska's present tax burden is 176 percent of the Texas tax burden, 99 percent of the Louisiana tax burden, and 111 percent of the California tax burden. Since state tax burdens represent a cost to companies engaged in oil exploration and production, the overall tax burden in one state compared to another is one of the factors considered by companies in deciding where additional oil exploration should be done.

Other comparisons in depth with the same import have been done by the Alaska Legal Committee of the Alaska Oil and Gas Association, and I think you will find them to be of interest.

There are, of course, other factors which influence decisions on where resource development will be carried on. Among these factors are the basic costs of finding, producing and transporting oil in various states or regions of the U.S. The third subject Sohio has been examining with respect to the State's long term taxing and leasing policy considerations is how the costs of

carrying on oil and gas development in Alaska and other areas of the country compare. We know from our general experience that there is a premium to be paid for working in the arctic and offshore, but we hoped to be able to document this and do so on a comparative basis. Good current data is difficult to come by. We are making progress, but not as fast as I had hoped, so I do not have finished work on that to offer you today.

The work so far confirms the premium cost factor of oil and gas development in the arctic and offshore. Let me give you a few examples. It costs two or three times as much to drill a well in Alaska as it would to drill the same well most places in the Lower 48. It sometimes costs more to ship a piece of casing to northern Alaska than the casing itself costs. Hourly rates for construction labor are substantially higher in the arctic, and the productivity is in many instances less than one-third or one-half of what you expect in other areas of the country due to the extreme weather conditions.

Last August, the Federal Energy Administration published a study that had been made of potential future developments of NPR 4.<sup>1/</sup> While this report was written in terms that were somewhat difficult for us to understand, at least two points seemed clear. The first one was that the costs are so high and risks are so great in the

---

<sup>1/</sup> "The Exploration, Development and Production of Naval Petroleum Reserve No. 4." published by the Federal Energy Administration August, 1976.

arctic that with present prices of oil in California, it would be uneconomic to develop oil in Naval Petroleum Reserve 4 unless a field or a cluster of closely located fields were found with a total reserve of one-half billion barrels of oil. The significance of this is startling when you consider that a one-half billion barrel field in the Lower 48 would be a real bonanza.

The second point in that report that struck us was the indication that at present oil prices, a 3-billion barrel field would earn a private investor an 8 percent rate of return. If the figures of this study are right, it is doubtful that anyone would undertake a venture like that for that level of economic return.

The three areas of our studies which I have summarized tells you about where we were when this session of the Legislature began. Since then, a number of proposals for additional Alaska taxes on future oil and gas operations have been introduced for consideration. We have tried to study all of these proposals, and have made a start on two aspects: their economic impact on our industry here and their legality. Because there are so many bills, I would like to comment on those that have been submitted by members of the Legislature as a group and on those that have been submitted by the Administration as a group. Specifically, the bills that I will be referring to as Legislative bills are those pertaining to severance tax, income tax, and the net proceeds tax. In connection

with those submitted by the Administration, I will be including the franchise tax, the property tax, and the severance tax.

The economic impact analysis produced some startling numbers. You will recall that in our Sohio Submission One and Sohio Submission Two we calculated what the tax income to the State will be from Prudhoe Bay and the Trans Alaska Pipeline under present severance tax, ad valorem tax and income tax during calendar years 1977 through 1986. We then made the same calculations assuming the taxes proposed by the Legislature were enacted, and also made them assuming the taxes proposed by the Administration were enacted. In each case we compared the results with the same leading oil producing states, Texas, Louisiana and California. The results of all this are set forth in Sohio Submission Three which is Attachment D to my testimony today and which I formally offer now as a part of your Committees' record.

You may want to examine Sohio Submission Three in detail, but let me highlight a few things for our discussion today. The hypothetical companies assumed to own all of Prudhoe Bay and the Trans Alaska Pipeline in Sohio Submissions One and Two were projected to pay the State \$5.5 billion from 1976 to 1986 under present Alaskan laws. You will recall that the \$5.5 billion figure represented revenues from the field and pipeline only, and did not include likely revenues from any other present or

future oil and gas development in Alaska. You will also recall that these figures have no factor in them for any inflation which will probably occur. The results are summarized in the following table, and show that Alaska would collect from the three companies about the same total amount it would if it had the tax structure of Louisiana on Alaska's books, 176% of the amount it would if it had the tax structure of Texas' laws, and 111% of the amount it would if it had the tax structure of California.

	<u>If Alaska had the taxes of:</u>			
	<u>Alaska</u>	<u>Texas</u>	<u>Louisiana</u>	<u>California</u>
Severance Tax	\$2,688	\$1,649	\$4,466	\$ 0
Ad Valorem Tax	2,038	1,459	684	4,202
Income Tax	9.4%? <u>753</u>	<u>0</u>	<u>382</u>	<u>728</u>
Total	\$5,479	\$3,108	\$5,532	\$4,930
Alaska as a percent of the other states		176%	99%	111%

In Sohio Submission Three, we first calculated the results if the Administration's tax proposals are enacted and found that the State's tax income just from Prudhoe Bay and the Trans Alaska Pipeline is non-inflated dollars would increase by about \$2 billion through 1986 over what it would be under Alaska's present tax laws. This would bring the total payments by the three companies in our analysis to \$7.5 billion. Comparing these results with the results under the tax structures of Texas, Louisiana and California

showed that Alaska's tax income would be 240% of the revenues produced by the Texas laws, 135% of the revenues produced by the Louisiana laws, and 151% of the revenues produced by the California laws. As Sohio Submission Three shows, that even the passage of one of the Administration's proposals significantly lengthens Alaska's lead over the other oil producing states.

If Alaska had the taxes of:

	<u>Alaska</u>	<u>Texas</u>	<u>Louisiana</u>	<u>California</u>
Severance Tax	\$3,283	\$1,649	\$4,466	\$ 0
Ad Valorem Tax	2,582	1,459	684	4,202
Income Tax	<u>1,591</u>	<u>0</u>	<u>382</u>	<u>728</u>
Total	\$7,456	\$3,108	\$5,532	\$4,930
Alaska as a percent of the other states		240%	135%	151%

The next thing we did in Sohio Submission Three was to calculate the results if the Legislature's tax proposals are enacted and found that the State's tax income just from Prudhoe Bay and the Trans Alaska Pipeline in non-inflated dollars would increase by \$3.6 billion through 1986 over what it would be under Alaska's present tax laws. This would bring the total payments by the three companies in our analysis to \$9 billion. Again, comparing these results with the results under the tax structures of Texas, Louisiana and California showed that Alaska's tax income would be 291% of the revenues produced by the Texas laws, 163% of the

revenues produced by the Louisiana laws, and 183% of the revenues produced by the California laws. And again, Sohio Submission Three shows that the passage of just one of the Legislature's proposals will significantly lengthen Alaska's lead over the other oil producing states.

If Alaska had the taxes of:

	<u>Alaska</u>	<u>Texas</u>	<u>Louisiana</u>	<u>California</u>
Severance Tax	\$4,219	\$1,649	\$4,466	\$ 0
Ad Valorem Tax	2,038	1,459	684	4,202
Income Tax	<u>2,774</u>	<u>0</u>	<u>382</u>	<u>728</u>
Total	\$9,031	\$3,108	\$5,532	\$4,930
Alaska as a percent of the other states		291%	163%	183%

In making the calculations in Sohio Submission Three we assumed a price of \$13.00 for oil in California, and included no factor for inflation. I realize that our treatment of price and inflation is conservative and that it is different from the way the Department of Revenue has done its work. The surpluses in 1985 for the General Fund and for the Permanent Fund which have been projected by the Department of Revenue and which I referred to above reflect some assumed increases in the price of oil and a factor for inflation. In any event, it seems likely that any increases in tax income which the State will realize if it enacts part or all of

the Legislative package or the Administration package will simply increase the surpluses. I don't know what the total surplus would then be, but it could be several times \$8.5 billion now projected by the Department of Revenue under the present laws of Alaska.

Most of you know that I have always been reluctant to argue legalities of proposed legislation. It sometimes produces more misunderstanding than help. It is, however, a subject of concern from time to time on the part of the Legislature itself, the Administration and our industry. As you know, we routinely review significant legislative proposals for legality. With the number of bills before this Legislature and the diversity of their concepts, we have only had time to make a preliminary review. For what it's worth and not to be argumentative, let me give you some first observations. They suggest that further legal analysis may be appropriate for both the State and ourselves.

In addition to the numerical facts of the matter, there are some circumstances in the overall setting which bear on the legality of further tax proposals. For about seven years or perhaps a little longer, the State has made persistent efforts to increase its tax revenues from oil and gas activities in Alaska, and particularly its expected revenues from Prudhoe Bay and the Trans Alaska Pipeline. The focus has been rather narrow and the principal burden has been

directed to a few larger companies who have come to the State to engage in oil and gas exploration, development and transportation. Most all of such taxes impact upon interstate commerce by reason of the fact that over 99 percent of the markets for this Alaskan industry are located outside the State. The results are the tax laws presently on the books here. It is generally recognized that these laws as now constituted will produce revenues far in excess of the State's revenue needs over the next decade and beyond. No revenue need justification has even been attempted for the new tax proposals now before this Legislature. The cumulative effect of all this raises questions whether further substantial taxes become a confiscation of an equity interest or a modification of royalty contracts after the leases have been sold. The cumulative effect raises the question of a demonstrable bias against interstate commerce that would lead a court to conclude that this package of taxes discriminates against and unduly burdens interstate commerce. Again, let me say that I am outlining these questions to point up some legal areas I believe we all should examine, and not to be argumentative.

You may also be interested in some specific comments on the new income tax proposals before your Committees. My comments in this regard relate essentially to two legal concepts: fairness

and uniformity. Fairness to the taxpayer is of course something that should characterize all taxes that a government imposes. It takes on an added dimension, however, in the context of a federal system where, in addition to the exactions of the national government, a company can be obliged to contribute to the fiscal needs of as many as fifty state governments. If such businesses are not to bear a disproportionate share of the total tax burden, it is essential that the taxes imposed by each jurisdiction reflect a high sense of equity, of fairness, in determining the portion of the company's activities to be included in that state's tax base.

This concern for fairness is embodied in the federal constitution in the Commerce Clause and the Due Process Clause, and is at the core of the approach which the Supreme Court has charted in construing those provisions as they relate to state taxing statutes. A similar sentiment emanates from the Equal Protection Clause. Thus, for example, the U.S. Supreme Court has said that a multi-state enterprise should not be made to "bear more than its fair share" of the costs of state government, "that taxes imposed on income from interstate commerce (should) be fairly apportioned" between the States in order to avoid the risk of multiple taxation, and that the tax should be "a constitutionally fair demand by the State for that aspect of the interstate commerce to which the State bears a special relation." It is interesting

and somewhat refreshing that a matter so fundamental to our federal system should be governed in the final analysis by a simple, penetrating, common-sense inquiry: Is it fair?

Although, as one might expect, the precise dimensions of this "fairness" standard have not been fully spelled out, there are a number of decisions which shed some light along the way. For example, we know that it is not fair in terms of the Commerce Clause for a state taxing statute directly or indirectly to prefer local activity at the expense of interstate activity. The cases also tell us that it is unfair for a State to apply an imprecise apportionment formula which inflates the portion of the multi-state enterprise included in its tax base. We know that it is unfair for a State to adopt an apportionment formula so plainly inconsistent with that prevailing in other States that the logical and inevitable consequence will be that interstate income is subjected to multiple taxation.

In the light of these indications, it would seem appropriate for your Committees to give consideration to the provisions of each new proposal to ascertain how fairly each one treats the multi-state companies which are actively engaged in Alaska. With reference first to the proposed Oil and Gas Corporate Franchise Tax, there are several general lines of inquiry which I would recommend and which in turn will likely lead to further, more specific questions.

The proposed substitution of an "extraction factor" for the widely used "sales factor," would apportion the entire enterprise of a multi-state taxpayer according to a factor which measures only the taxpayer's oil and gas extraction activity. The essential problem with the extraction factor is that, unlike the standard three factors which measure activity common to virtually all profit-making endeavors and thus will generally result in a fair estimate of the portion of the taxpayer's entire enterprise related to the taxing state, the extraction factor is very narrowly based and thus seems wholly inappropriate to the task of apportioning the fruits of a multi-faceted interstate enterprise. As a result, this factor, in the case of Sohio, would apportion to Alaska income derived from a wide variety of our activities wholly unrelated either to Alaska or to oil and gas extraction, such as chemical sales, patent licensing, coal and uranium extraction, sales of plastic products and toothbrushes, and fertilizer sales, even though none of these activities will be reflected in either the numerator or the denominator of the fraction. I submit that this overreaches all bounds of fairness.

Moreover, as a result of the patent inconsistency of the extraction factor with the sales factor applied in the overwhelming majority of other states, the extraction factor will inevitably lead to multiple taxation of income derived from the sale or exchange of Alaskan oil out-of-state. Between Alaska and the

state of sale, for example, as much as 133% of this income could be taxed. This would well be the impact on Sohio and I ask you to consider whether this represents fair treatment of interstate commerce.

\_\_You may also want to refer to Tables A, B and C of Sohio Submission Three and particularly the line on each of those tables entitled, "Effective Composite State Income Tax Rate on Total Taxable Earnings". The jump in the percentages from those shown on Table A to those shown on Tables B and C are a pretty clear demonstration of the duplicative tax impact that raises the Constitutional questions.

A final point in reference to the franchise tax proposal which I think the Committees ought to consider is whether the effect of the \$250 million floor is to exempt local producers while concentrating the impact of the tax on the multi-state producers. I understand the interests which this provision is designed to protect and am sympathetic to them. But the legal question is can the actual effect of this be reconciled with the notion of fairness underlying the Commerce Clause.

In the same vein, both the net proceeds tax proposal and the separate accounting proposal should be subjected to the same careful analysis. In general, I hope the Committees will consider whether it is appropriate and fair to single out the oil industry from all other corporations in Alaska for such extraordinary tax

treatment. In particular, the deductions allowed under these proposals should be analyzed to see whether they discriminate between in-state and out-state expenditures, which I submit may constitute unfair treatment of interstate commerce.

Finally, I would like to refer briefly to the legal concept of uniformity which Alaska has endorsed by its adoption of the Uniform Division of Income for Tax Purposes Act and of the Multi-state Tax Compact. I submit that the proposals I have just been discussing amount to a major retreat from the principle of uniformity, especially in light of the unavoidable duplicative taxation which the extraction factor would generate. Moreover, the separate accounting and net proceeds proposals are difficult to reconcile with the Multi-state Tax Commission's view that the three-factor formula should, in the interests of uniformity, enjoy clear predominance over any alternative approaches. As the Commission has said in its proposed regulations under the Compact, separate accounting "may be invoked only in specific cases where unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results under the apportionment and allocation provisions contained in Article IV." Even under the Compact, departure from the three-factor formula is to happen, if at all, only on a case-by-case basis within the reasonable discretion of the Tax Commissioner. In this light, the Committees should ask

to what extent, if any, Alaska's statutory departure from the Compact in the case of the State's largest industry would be consistent with Alaska's continued membership in the Multi-state Tax Compact.

Well, where are we? I realize that I've given you a lot to think about. I don't mean to overwhelm you, but the subjects you are considering are pretty substantial in and of themselves. Let me try to tie it all together with five principal perspectives.

First, the State's needs for revenues are more than covered for the foreseeable future, and the past concerns about running out of money to meet current needs are no longer with you.

Second, the State's present tax laws concerning oil and gas exploration, production and transportation equal or exceed those in the other leading oil producing states. Any further oil and gas taxes will simply add to the State's projected revenue surpluses.

Third, the other costs businesses must pay for carrying on exploration, production and transportation in Alaska reflect the premium that must be paid in pursuing the potential of energy resources in the arctic. It is a penalty that Alaska itself must recognize in considering major new tax legislation, notwithstanding the high potential it has in energy resources. This is particularly true now when construction of the Trans Alaska Pipeline is winding down. Alaska is moving into what Robert R. Richards of the Alaska

Pacific Bank has recently called the "post pipeline plateau".<sup>2/</sup> He forecasts a "modest downturn" but not a "bust". He points out that the construction industry will experience somewhat of a setback in 1977, that retail and wholesale trade will level off in Anchorage and will drop significantly in Fairbanks, and that the State's economy in general will decelerate this year. A bright spot in the State's economy will be the Kenai region which will grow as a petroleum service and supply base for both Cook Inlet production and Gulf of Alaska exploration. He notes that Alaska's future remains bright because of its resource and other potentials.

Underlying this future, however, is the assumption of continued, reasonable resource development, and the positive incentives needed to assure its continuation. This subject was addressed in depth in Washington, D.C. last Monday, in San Francisco on Tuesday, and in Anchorage yesterday in hearings before the Federal Energy Administration on the appropriate pricing of Prudhoe Bay oil. I attended the hearings in Washington and Anchorage and would like to give you a report on the testimony of three witnesses. Their remarks recognized the high costs and risks of oil and gas development in the arctic, the need for positive economic incentives to encourage this work, and the important role Alaska will play in meeting the United States' needs for energy in the future.

---

<sup>2/</sup> "Economic Outlook for the Year 1977", Alaska Business Trends, Alaska Pacific Bank.

Commissioner Sterling Gallagher represented the State in the Washington hearing and made a fine presentation. In at least four places in his testimony he urged the FEA to provide "positive price incentives" at the wellhead in Alaska that would encourage future development. He recognized that this applied to developments now underway like Prudhoe Bay and to all future resource development in Alaska. He expressed real concern that other possible courses of decision by the FEA would "virtually guarantee that no other North Slope reservoir is developed and (would) create a pronounced disincentive for the State of Alaska and the Alaska Native corporations to make any more lands available for oil and gas leasing." He stated that "The North Slope is a frontier area, still largely unexplored and untested despite past and present exploratory work. Likely discoveries and development will be much closer to the threshold of economic visibility than is the main pool of Prudhoe Bay." With respect to Prudhoe Bay he noted that at the low wellhead prices possible under one FEA alternative, "the economic justification for developing even the main Prudhoe Bay oil pool would, if discovered today, be an 'iffy' proposition. And I can assure you that the likelihood would be nil for any further North Slope development other than that to which the companies are already deeply committed." I sat there and quietly cheered when the Commissioner concluded his testimony

saying, "Oil production decisions generally entail middle to long-term investments, and stability is more important in the decision than making ephemeral benefits that may be offered by FEA." I'm sure that you recognize that the interests of the State and those of our industry are identical in this, both before the FEA and generally speaking.

Senator Ted Stevens also spoke eloquently for Alaska in the FEA hearing urging the maximum incentives possible under present federal law.

The third witness before the FEA hearings in Washington that I want to report on was David P. Goodman, Managing Director of Morgan Stanley & Co. Incorporated, investment bankers in New York City. Mr. Goodman is also a member of the Energy Financial Advisory Committee to the FEA. His firm arranged over \$5.5 billion of the financing for Prudhoe Bay and the Trans Alaska Pipeline, and he personally had the responsibility for over \$5 billion of that amount. In the course of his work he has had in depth discussions with more than seventy major institutional investors regarding the financing of these and other large energy projects. His testimony before the FEA last Monday is Attachment E to my testimony here today, and I urge you to read the full account. There are several parts of his testimony to the FEA which bear directly on the business climate here in Alaska and which I would like to highlight for you.

With respect to the central issue on the pricing of Alaskan oil, Mr. Goodman made the following statement which he characterized as a strong one. He said that as a result of all the financing work he had been engaged in and all the discussions with institutional investors he had had,

"I have concluded that if the Administration establishes price control or entitlements treatment for (Alaska North Slope) crude which does other than allow it to compete in price with world oil in the United States market, this action will have a serious detrimental impact on investor's willingness to provide financing for the development of future energy projects, both for petroleum and other energy sources."

He noted that there were four areas of risk that lenders sought assurance on: that the oil was there, that the pipeline and terminal would work, that there would be a ready market for the oil, and that the overall project evidenced continued financial viability. He said that his firm had been able to answer most of the questions most investors had, but

"there was one risk which we were unable to eliminate in the minds of certain major, sophisticated investors, and they declined to participate in the financing partly because of it. That risk was that government would not permit (Alaska North Slope) crude oil to compete with world oil in the market place, but would place restriction on its price such as are currently under consideration."

A few moments later he said:

"That is why my firm feels strongly that unfavorable treatment for (Alaska North Slope) crude will adversely affect the ability of industry to finance future energy projects."

Mr. Goodman then turned to the risk elements of Alaskan North Slope development and the appropriate rate of return for projects like Prudhoe Bay and the Trans Alaska Pipeline. He said:

"These hearings are also investigating the risk elements of North Slope development and the appropriate rate of return for this project. Both of these subjects were obviously matters of great interest to investors. This project is one of the riskiest ever undertaken by industry. The important risks aren't those cited in the Mortada study. The cost of exploration before the Prudhoe Bay discovery well is insignificant compared with the risk undertaken by the industry in going ahead with the project under the Pipeline Right of Way Act. The participants were committed to complete the project no matter what the cost in the face of absolute federal and state controls over construction. Remember that this project had been delayed over four years by court intervention and government redesign. Compliance with these actions had already more than doubled costs. Yet the industry was forced to accept a set of stipulations far more exacting than any ever applied to such construction before, stipulations that many in the industry were concerned about being physically able to comply with, and to proceed with absolute authority vested in one man to halt construction or require design changes that could cause costs to skyrocket with no accountability for cost effectiveness. The industry undertook these absolute obligations, and costs did rise to the point where, if ANS crude is allowed to compete against world oil, the Mortada study and industry figures indicate that the project will earn a discounted return in the area of 14% to 16%.

"Mortada states that a return of 12% should be equitable. There may be some analogy to the returns allowed to regulated industries in Mortada's thinking, although even higher returns are allowed in risky start-up ventures there. But regulated returns involve an exclusive franchise wherein subsequent rate regulation assures such a return. No one is assuring the price of Alaskan or world oil.

"If we had projected a 12% return from the outset, I'm not sure that the project could have been financed. It's our experience that oil companies will not undertake a project involving any significant risk for a projected return of under 15%. The industry will earn returns of approximately 22% in the British North Sea, where they have experienced retroactive majority participation by the British government. The financial institutions who invest in the equity of the leased tankers for the Valdez trade will earn a discounted after tax return in excess of 15% with the benefit of a hell or high water, all events charter from the oil companies. Based on these facts, I cannot accept that a 12% return is equitable for a project of the magnitude and riskiness of the North Slope project.

"The aggregate earnings from the North Slope will be very large. It is one of if not the largest oil field ever found outside of the Middle East. But the costs are high and the rate of return will be modest, particularly bearing in mind the risk. If you want industry to be able to finance the development of major energy discoveries this country so sorely needs, particularly the smaller companies you want to favor in your OCS leasing policies, do not make the wrong decision in pricing ANS crude oil. It is critical with regard to establishing an overall energy policy, of which the issue of pricing Alaskan North Slope crude oil can be looked on as an important first step to retain the willingness of the private sector to provide financing of future energy projects."

From all of the foregoing, you can see that the health of Alaska's economy has some sensitivities which the present pricing determination of the FEA materially impact. Similar impacts can also come from substantial new state taxes on oil and gas exploration, development and transportation. The point is I hope you will

take as much care on your consideration of the various tax proposals as we all want the FEA to take on the pricing of Alaskan oil. This is also important to all the Alaskans whose trade and business depends directly or indirectly on continued, reasonable resource development right here in Alaska.

The fourth of the five perspectives I mentioned concerns the FEA hearings specifically. It is most appropriate for the State to appear in these hearings and urge the maximum price permitted under federal law for Alaskan North Slope crude oil. That position is based on the need for positive economic incentives for present and future resource development here. On the other hand, it seems utterly inconsistent to me for the State to be urging the need for major economic incentives in Washington and at the same time be seriously considering substantial new taxes on oil and gas in Juneau which would wipe out a big part of whatever incentives there are. May I suggest that these tax measures be given a good deal of study, that whatever tax measures may be appropriate for serious consideration be taken up in the next session, and that the State, our industry and other Alaskan businesses concentrate on critical decisions that are now before the FEA. I understand, but don't know, that the FEA is trying to come to judgment by June 1st. There is a good deal of work to be done there and I hope we can all concentrate on that.

The fifth, and the last perspective, comes back to the point of beginning. The State and the industry still need to resolve a longer term policy for oil and gas taxation and leasing. If nothing else, the events of the last year and the present problems confirm this. It's not too late. Can't we begin again and take a look at the whole picture? At least for Sohio, we're still ready to be responsive.

Thank you.

Richard M. Donaldson  
The Standard Oil Comrany (Ohio)  
Guildhall Building  
Cleveland, Ohio 44115  
March 24, 1977

Attachments:

- A - Letter to Gregg Erickson from Richard M. Donaldson, July 1, 1976.
- B - Sohio Submission One, October 28, 1976
- C - Sohio Submission Two, January 21, 1977
- D - Sohio Submission Three, March 22, 1977
- E - Statement of David P. Goodman, Morgan Stanley & Co. to FEA on Alaskan North Slope Crude Oil Pricing and Entitlements, March 21, 1977.



THE STANDARD OIL COMPANY

MIDLAND BUILDING, CLEVELAND, OHIO 44115

RICHARD M. DONALDSON  
VICE PRESIDENT  
GOVERNMENT AND PUBLIC AFFAIRS

July 1, 1976

Mr. Gregg Erickson  
Director, Research Services  
Legislative Affairs Agency  
State of Alaska  
Pouch "Y", State Capitol  
Juneau, Alaska 99811

Dear Gregg:

I have your letters of June 16 and 22, 1976, regarding the study you are preparing to undertake with respect to Alaska's longer term natural resource leasing and taxing policies.

These letters deal specifically with Alaska's income tax. While I recognize that the figures in these letters are hypothetical, the fact that "answers" have been calculated at the beginning of the study is somewhat disturbing. My experience has been that figuring out specific "answers" before the overall problem has been defined can preclude a study, unduly limit it or affect its objectivity. I certainly hope that none of these things happen as the proposed intersession studies hold out some promise of stability for both the State and our industry.

I am writing to give you some thoughts on three segments these studies could logically consider:

- Future revenues of the State
- Future expenditures of the State.
- Alaska as a place to do business from industry's perspective.

Set out below are some ideas that have occurred to me as starting points for things that could be considered in each of these subject areas.

#### Future Revenues

1. What are the ranges of revenues that the State government can expect to receive from all of its existing taxes-- including those that impact on natural resources and their related facilities; and from other sources such as bonuses, royalties, and the Federal government?
2. To what extent will these revenues cover a reasonable estimate of the State government's future money needs?
3. What are the leasing alternatives available to the State with respect to its natural resources, and what would be the ranges of revenues from such alternatives?
4. What are the taxing alternatives available to the State with respect to its natural resources and other sources, and what would be the range of revenues for each such alternative?
5. How do other states compare with Alaska in tax revenues, in tax rates and in the leasing of their natural resources?

#### Future Expenditures

6. What is a reasonable estimate of the State government's future money needs for various purposes and in total under a range of prospects with respect to its future business and commercial development?
7. What will be the financial impact of the recommendations in the Governor's recent management and efficiency review?
8. Are management and efficiency reviews in other areas of the State government needed and what financial impacts are they likely to have?

#### Business Perspective

9. What factors does business use in determining what it considers a worthwhile investment? How does it choose the location for its investments where choices are available?

10. How do business conditions in Alaska compare with those in other states, in terms of availability of resources to be developed, financing, employment, construction and operating costs, regulation, taxes, government attitudes and so forth?
11. What can be learned of business' reaction to significant or continuing changes in the factors listed in the preceding question?

I don't mean to imply that these are the only questions that should be considered, but offer them as some indication of the scope that ought to be examined in a meaningful study of Alaska's longer term tax and leasing policies.

In my testimony on March 30, 1976 before the Joint Hearing of the Senate and House Resources Committees, I suggested such a study and indicated that we would be responsive to such a study. In addition to studying the attachments to your letters, we are thinking about ways in which all the questions noted can be studied and discussed in a manner which would be meaningful and understandable.

These questions are not only of interest to the State government and our industry, but concern everyone in Alaska I can think of--the native regional corporations, other business and commercial interests in the State, labor, the financial community, and people generally. I hope that this study will seek advice on that broader base.

I understand that a study similar to the one the Legislative Council will consider is being initiated by the Administration under the direction of Commissioner Gallagher and Commissioner Martin. Presumably these studies will be coordinated to some extent. It seems appropriate to send the Commissioners copies of this letter and I hope you won't mind my doing so.

Sincerely,



Richard M. Donaldson

cc: Sterling Gallagher, Commissioner  
Department of Revenue

Guy Martin, Commissioner  
Department of Natural Resources

October 28, 1976

SOHIO SUBMISSION ONE

This paper is submitted for consideration by the Alaskan Administration and Legislature in the intersession studies each is now conducting concerning the long term oil taxation and leasing policy for the State.

The first subject of inquiry by the staffs working for the Legislature and the Administration on these studies concerns the nature, revenue potential and appropriateness of Alaska's present tax laws as they will apply to the Prudhoe Bay field and the Trans Alaska Pipeline (TAPS). One point of interest to the staffs in this area of inquiry is Alaska's state income tax and how it will apply.

This submission examines the state income tax of Alaska and makes projections as to what the income tax payments will be utilizing certain assumptions for the future operations of Prudhoe Bay and TAPS. However, since state income tax is only one part of the substantial total revenue Alaska will receive as the result of Prudhoe Bay and TAPS, the non-income tax revenues have also been calculated. These revenues include projections of the State's royalty income and tax receipts resulting from Alaska's severance tax, resale tax, and ad valorem tax. In addition, this submission points out certain relationships which exist within the present Alaskan tax structure.

Most of the larger companies in the United States are engaged in business activities in a number of states. Each of the states in which these companies do business expect to receive some state income tax

payments from them. Yet, if a company were to pay taxes to each state in which it operates calculated by applying that state's income tax rate to the total earnings of the company wherever earned, multiple taxation, or as the law states it, "duplicative taxation" would result leaving the firm with little, if any, after tax income. As companies became larger and did business in many states, there was a need for some method of equitably determining what each state's fair share of such income taxation should be.

The Multistate Tax Compact was set up by the states to ensure that effective and fair taxation of multistate businesses could be established among the various states. Today, most of the fifty states are members of the Multistate Compact, and Alaska has been a member since 1970 as a result of the Legislature's action.

States which are members of this Compact follow the Uniform Division of Income for Tax Purposes Act. Under this Act, the total taxable income of a company, wherever earned, is allocated to the various states in proportion to the amount of that company's business activity conducted in each state. This allocation is calculated by averaging three basic factors that take into account the extent of a company's business in a particular state: its physical property there, its actual sales there, and the number of its employees located in the state. The first factor is the percentage of the company's total physical property which is located in the state in question compared to all of its property wherever located. The second factor is the company's annual sales which occur within the specific state as a percent of the company's total annual sales. The third factor is the company's payroll costs incurred in the specific state divided by that company's total payroll for all of its operations.

The arithmetic average of these three factors for the state in question is multiplied times the company's total taxable earnings to arrive at the share of taxable earnings to be allocated to the state. This share is then taxed at that state's full tax rate. While any allocation of earnings among the states is probably not perfect, this particular system for doing so has been considered the fairest compromise approach that anyone has devised.

The Legislative Affairs Agency has asked us to provide it with a projection of what Sohio's state income tax payments to Alaska would be under the Multistate Tax Compact allocation method. Unfortunately, we are unable to provide this specific information because doing so would be equivalent to providing projections of Sohio's future earnings and create a number of other problems for us. The rules of the Securities and Exchange Commission would then require us to disclose such projections to the general public and to publicly and perpetually update those projections any time our internal estimates of the future changed. The burden of disclosing such projections on a perpetual basis and the potential liabilities to investors if such projections turned out to be wrong have led substantially all large U.S. companies to decline publication of any earnings projections. Our counsel has advised against this, and in view of the overall problems, we feel we cannot respond to the specific request and so advised the Legislative Affairs Agency.

However, in order to be of some help to the Legislative Affairs Agency and still follow our counsel's advice, we have developed hypothetical projections of tax payments to Alaska which would result from an assumed one-third ownership of Prudhoe Bay and TAPS by three typical companies.

None of these companies is intended to represent a company actually involved in the development of the Prudhoe Bay field or construction of TAPS. Rather, the projections are intended to demonstrate the level of tax obligations which would result from the project being owned by companies varying in size and scope of overall operations. Specifically, the three typical companies in our hypothetical example have the following assumed characteristics:

Company A - A California based marketing and refining company with no crude oil production.

Company B - A large integrated domestic company with significant petroleum production and transportation operations.

Company C - A major international company with substantial foreign operations.

The significant basic assumptions for each of these companies are summarized in the following table:

	<u>Company A</u>	<u>Company B</u>	<u>Company C</u>
Annual Sales (Millions)	\$3,700	\$8,200	\$24,500
Gross Property (Millions)	\$1,800	\$8,200	\$13,800
Total Employees	27,000	32,500	75,000
Taxable Income (Millions)	\$ 210	\$ 850	\$ 1,700

For the purpose of these tax calculations, it was assumed that a ratio of employees in Alaska to total employees would be equivalent to the payroll ratio since detailed data on payroll costs is unavailable. It was also assumed that the only business activities any of these three companies had in Alaska was its one-third ownership of the field and the pipeline.

Since a great deal of uncertainty surrounds both the future price of North Slope oil and future rates of inflation, the tax payments of the three companies were calculated in terms of constant 1976 dollars assuming three different California market prices: \$10.00/barrel, \$13.00/barrel, and \$16.00/barrel. (To put this range of prices in perspective, the price of foreign crude oil similar in quality to Prudhoe Bay oil is approximately \$12.30/barrel delivered to California.)

The characteristics of the Prudhoe Bay field and TAPS project determine the nature of the allocation factors used in this analysis. First of all, crude oil production is a very capital intensive operation. This has been accentuated in the case of Prudhoe Bay due to the high cost of Arctic development.

Secondly, Alaska's industrial development has not as yet reached, and may never reach, the stage where significant volumes of Prudhoe Bay crude oil can be consumed within the State. That being the case, the \$7.7 billion Trans Alaska Pipeline and Valdez terminal had to be constructed so that the crude oil could be shipped to other states where there is a demand for that oil. Without the demand in other states and the TAPS line, Prudhoe Bay oil would be of little value. These transportation facilities have contributed to the high capital costs of the project.

Finally, in most oil production and pipeline activities, the number of employees required for routine operations after the original construction has been completed is relatively small. This holds true for Prudhoe Bay and TAPS.

When these characteristics are translated into allocation factors, similar trends develop for each company. The Alaskan property factors of

all three companies are large relative to the overall scope of the basic companies' operations. The property factor for Company A, for example, is in the range of 65 to 70 percent and even for Company C, the major international, it is between 20 and 25 percent. On the other hand, the Alaskan payroll factor in all cases was assumed to be less than 2 percent of the companies' total employment. Finally, since Prudhoe Bay oil must be transported to other states for sale, an Alaskan sales factor of zero percent results.

The results of our analysis are summarized on the attached six tables. There are two tables, labeled A and B, for each of the assumed West Coast market prices, \$10.00/barrel, \$13.00/barrel, and \$16.00/barrel.

Referring to Table 2-A which summarizes the results of the \$13.00 per barrel market price calculation as an example, the annual state income tax payable to Alaska by each of the hypothetical companies for each year from 1977 through 1986 is listed along the top of the Table. These tax payments in total range from \$27.4 million in 1977 to almost \$90 million in 1985.

It is very important to bear in mind that all these figures are expressed in 1976 dollars and that no adjustment has been made for any inflation in any year which would increase the dollar figures received by the State. These charts can be adapted, however, to whatever inflation factors one thinks appropriate to get a more accurate projection of actual revenue expectancies.

The other revenues that Alaska would receive in addition to income tax have also been calculated for each year for these companies and displayed in the second segment of the A Tables in order to provide an overall picture

of the revenues produced by the present Alaskan tax structure. The figures in this segment are totals for the three companies rather than individual amounts for each company, since each company's share would simply be one-third of the total figures shown. Included in this segment are royalty payments, severance tax payments, reserves tax payments, and ad valorem tax payments. Also shown are credits against severance tax for the reserves tax payable in 1976 and 1977 to the extent of 50 percent of the severance tax as provided by Alaskan law.

The sum of the Alaskan income tax payments by the three owner companies and the other revenues represents a projection of the total revenues Alaska would receive as a result of the field and pipeline project in our hypothetical case. These annual totals are also listed on the A Tables. Using Table 2-A as an example again, Alaska's total revenue as a consequence of the field and pipeline would range from over \$600 million in 1977 to more than \$1.1 billion annually from 1981 through 1985 if the market price of crude oil were to remain constant at \$13.00/barrel. The comparable annual total revenues for a \$10.00 market price and a \$16.00 market price are displayed on Table 1-A and Table 3-A, respectively. The hypothetical case does not include any similar types of revenues from Cook Inlet development or future development in other parts of the State.

For comparison purposes, the total state income tax payments that the three companies would make to all the states in which they do business have also been calculated and displayed on the A Tables. These figures are based upon the total taxable earnings of the three companies, and they include the state income tax paid to Alaska listed along the top of the A Tables. As indicated on these Tables, the effective composite state

income tax rate on the total taxable earnings of the three companies, that is, all income taxes paid to all states, is around 6 percent. This is what one would expect, since income not allocated to Alaska is taxed by other states and the average state income tax rate of all the states in the United States is significantly below Alaska's 9.4 percent rate.

It is interesting to note that since the field and pipeline project is located in Alaska, Alaska's state income tax payments from the three companies will exceed 20 percent of the total income tax payments made to all states even though extensive activities are carried on by the three companies in other states. It is also interesting to note that this high percentage received by Alaska holds true for all three market prices of \$10.00/barrel, \$13.00/barrel, and \$16.00/barrel. This percentage is shown at the bottom of each of the A Tables.

Tables 1-B, 2-B and 3-B show the total revenue that Alaska will receive from each of the companies over the 1977-1986 ten year period.

These B Tables also point out what percent of the total revenue paid to all states resulting either wholly or in part from the field and pipeline will go to Alaska. Since the Prudhoe Bay field is located on state lands, Alaska would receive 100 percent of the royalty payments. Similarly, Alaska would receive 100 percent of the severance tax payments and 100 percent of the ad valorem tax payments. The reserves tax payments and the severance tax credits resulting from those payments are also strictly an Alaskan transaction.

In addition, since the field and pipeline are located in Alaska, the State will also receive state income tax payments as indicated above. Alaska's state income tax payments are a result of that portion of the total

taxable income from all operations of the companies which would be allocated to the state under the Multistate Tax Compact. As such, it reflects the income distribution to Alaska based upon property, sales and payroll factors, regardless of how or where the taxable income originated.

Using Table 2-B as an example, at a \$13.00/barrel California market price, Alaska will receive a total of \$756 million in income tax revenues. This would be almost 22 percent of the total state income tax paid on all the operations of the three companies.

When those income tax receipts are added to the other revenues listed on Table 2-B, it can be seen that Alaska will receive almost \$10.2 billion in revenues from 1977 through 1986. Those revenues will represent almost 75 percent of all the revenues going to all states, either wholly or partially as a result of the field and pipeline project. Again, as indicated by Tables 1-B, 2-B, and 3-B, this high 75 percent share holds true over the entire range of market prices from \$10.00 to \$16.00 per barrel.

In summary, the significant points that this three company hypothetical case confirms seem to be the following:

1. Under the existing Alaskan tax structure and royalty obligations, the State would receive substantial annual revenues from the three companies which in total are directionally representative of the actual ownership of the Prudhoe Bay field and the Trans Alaska Pipeline. In constant 1976 dollars, such revenues would average almost \$800 million per year as a consequence of this project alone if the California market price for oil were \$10.00 per barrel, and would exceed \$1.3 billion if that price were \$16.00 per barrel.

2. Such tax and royalty revenues to Alaska will represent approximately 75 percent of the total revenue paid to all states, including Alaska, resulting either wholly or in part from the Prudhoe Bay field and the Trans Alaska Pipeline.
3. Of the total revenues to be paid to Alaska attributable to this field and pipeline, the principal part of such revenues are due to State ad valorem taxes, State severance taxes, and State royalties which are 100 percent allocable to Alaska and to State income taxes, over 20 percent of which is allocable to Alaska under the Multistate Tax Compact.
4. With respect to the Alaskan State income tax, the State would receive payments at the full 9.4 percent rate of Alaskan income taxation on that portion of the three companies' total taxable income which is allocated to the State under the Multistate Tax Compact. This allocation would be based upon the extent of the business activity in Alaska measured by physical property in the State, actual sales within the State, and the number of employees located in the State.

The composite state tax rate on the total taxable earnings of the three companies will be approximately 6 percent. This is the portion of total taxable earnings the companies would pay as income tax to all the states in which they do business. This composite rate is lower than Alaska's income tax rate because the average state income tax in the United States is substantially below Alaska's 9.4 percent.

Alaska, however, would receive over 20 percent of the income tax payments which the three companies in our example would make to all states. That is a high percentage in light of the extensive business activities carried on by these companies in states other than Alaska.

The Standard Oil Company (Ohio)  
Midland Building  
Cleveland, Ohio 44115

October 28, 1976

HYPOTHETICAL THREE COMPANY OWNERSHIP OF PRUDHOE BAY FIELD AND TAPS  
REVENUE TO ALASKA AND OTHER STATES IF OIL SELLS FOR \$10.00/BBL. IN CALIFORNIA

TABLE 1-A

(All Amounts in Millions of 1976 Dollars)

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
<b>Alaskan State Income Tax Paid By:</b>										
A-California Marketing and Refining Company	\$ 2.4	\$ 15.3	\$ 21.0	\$ 21.6	\$ 21.3	\$ 21.7	\$ 22.8	\$ 23.7	\$ 24.4	\$ 23.3
B-Large Integrated Domestic Company	7.9	14.9	17.9	18.4	18.5	18.9	19.8	20.7	21.2	20.6
C-Major International Company	11.4	16.7	18.9	19.4	19.7	20.1	20.9	21.8	22.4	21.9
Alaskan State Income Tax Revenue	<u>\$ 21.7</u>	<u>\$ 46.9</u>	<u>\$ 57.8</u>	<u>\$ 59.4</u>	<u>\$ 59.5</u>	<u>\$ 60.7</u>	<u>\$ 63.5</u>	<u>\$ 66.2</u>	<u>\$ 68.0</u>	<u>\$ 65.8</u>
<b>Alaskan State Revenue Other Than Income Tax*</b>										
Royalty to State of Alaska	\$ 66.7	\$ 237.1	\$ 344.2	\$ 351.1	\$ 357.9	\$ 364.8	\$ 349.0	\$ 338.1	\$ 342.9	\$ 308.5
Alaskan State Severance Tax	82.5	219.4	274.8	274.8	274.8	274.8	274.8	274.8	274.8	256.5
Alaskan State Reserves Tax-- Paid	235.0	---	---	---	---	---	---	---	---	---
Severance Tax Credit	( 41.2)	(109.9)	(137.4)	(137.4)	( 31.5)	---	---	---	---	---
Alaskan State Ad Valorem Tax	190.0	208.2	219.5	215.6	211.4	206.8	203.6	202.9	196.1	184.0
Non-Income Tax Subtotal	<u>\$533.0</u>	<u>\$555.3</u>	<u>\$701.1</u>	<u>\$704.1</u>	<u>\$812.6</u>	<u>\$846.4</u>	<u>\$827.4</u>	<u>\$815.8</u>	<u>\$813.8</u>	<u>\$749.0</u>
<b>Total Alaskan State Revenue</b>	<u>\$554.7</u>	<u>\$602.2</u>	<u>\$758.9</u>	<u>\$763.5</u>	<u>\$872.1</u>	<u>\$907.1</u>	<u>\$890.9</u>	<u>\$882.0</u>	<u>\$881.8</u>	<u>\$814.8</u>
<b>Income Tax Paid to All States By:</b>										
A-California Marketing and Refining Company	\$ 9.7	\$ 60.7	\$ 82.4	\$ 84.0	\$ 82.4	\$ 83.1	\$ 86.6	\$ 89.2	\$ 91.1	\$ 87.1
B-Large Integrated Domestic Company	50.3	88.9	105.6	106.8	105.7	106.3	109.1	111.2	112.8	109.6
C-Major International Company	58.2	80.6	90.4	91.2	90.8	91.3	93.1	94.5	95.5	93.6
Total Income Tax Paid to All States	<u>\$118.2</u>	<u>\$230.2</u>	<u>\$278.4</u>	<u>\$282.0</u>	<u>\$278.9</u>	<u>\$280.7</u>	<u>\$288.8</u>	<u>\$294.9</u>	<u>\$299.4</u>	<u>\$290.3</u>
Effective Composite State Income Tax Rate on Total Taxable Earnings	4.8%	5.5%	5.7%	5.7%	5.7%	5.7%	5.7%	5.8%	5.8%	5.8%
Alaskan Income Tax Payments as Percent of Income Tax Payments to All States	18.4%	20.4%	20.8%	21.1%	21.3%	21.6%	22.0%	22.4%	22.7%	22.7%

\* Each owner company would pay one-third of the figures shown in this section.

HYPOTHETICAL THREE COMPANY OWNERSHIP OF PRUDHOE BAY FIELD AND TAPS  
 STATE REVENUE DISTRIBUTION FROM 1977 THROUGH 1986 IF OIL SELLS FOR \$10.00/BBL. IN CALIFORNIA  
 (All Amounts in Millions of 1976 Dollars)

Type of Revenue	Company A California Refiner		Company B Large Domestic		Company C Major International		Three Company Total	
	Alaskan Revenue	As Percent To All States	Alaskan Revenue	As Percent To All States	Alaskan Revenue	As Percent To All States	Alaskan Revenue	As Percent To All States
Prudhoe Bay Royalty	\$1,020.1	100.0%	\$1,020.1	100.0%	\$1,020.1	100.0%	\$3,060.3	100.0%
Prudhoe Bay Severance Tax	827.5	100.0%	827.5	100.0%	827.5	100.0%	2,482.5	100.0%
Prudhoe Bay Reserves Tax--								
Paid	78.3	100.0%	78.3	100.0%	78.4	100.0%	235.0	100.0%
Severance Tax Credit	( 152.4)	100.0%	( 152.4)	100.0%	( 152.5)	100.0%	( 457.3)*	100.0%
Prudhoe Bay and TAPS Ad Valorem Tax	679.4	100.0%	679.4	100.0%	679.4	100.0%	2,038.2	100.0%
State Income Tax on <u>All</u> of Company's Operations	197.5	26.1%	178.8	17.8%	193.2	22.0%	569.5	21.6%
Total Revenue to State of Alaska	<u>\$2,650.4</u>	77.8%	<u>\$2,631.7</u>	72.3%	<u>\$2,646.1</u>	75.1%	<u>\$7,928.2</u>	75.0%

\* Includes credit for the \$222.3 million reserves tax paid during 1976.

HYPOTHETICAL THREE COMPANY OWNERSHIP OF PRUDHOE BAY FIELD AND TAPS  
 REVENUE TO ALASKA AND OTHER STATES IF OIL SELLS FOR \$13.00/BBL. IN CALIFORNIA  
 (All Amounts in Millions of 1976 Dollars)

TABLE 2-A

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
<b>Alaskan State Income Tax Paid By:</b>										
A-California Marketing and Refining Company	\$ 5.5	\$ 24.1	\$ 31.9	\$ 32.5	\$ 32.0	\$ 32.6	\$ 33.9	\$ 35.0	\$ 35.7	\$ 33.9
B-Large Integrated Domestic Company	9.5	19.2	23.4	24.0	23.9	24.6	25.6	26.6	27.2	26.3
C-Major International Company	12.4	19.6	22.6	23.2	23.4	24.0	24.9	26.0	26.6	25.9
Alaskan State Income Tax Revenue	<u>\$ 27.4</u>	<u>\$ 62.9</u>	<u>\$ 77.9</u>	<u>\$ 79.7</u>	<u>\$ 79.3</u>	<u>\$ 81.2</u>	<u>\$ 84.4</u>	<u>\$ 87.6</u>	<u>\$ 89.5</u>	<u>\$ 86.1</u>
<b>Alaskan State Revenue Other Than Income Tax<sup>A</sup></b>										
Royalty to State of Alaska	\$128.3	\$401.6	\$549.6	\$556.4	\$563.2	\$570.1	\$554.3	\$543.4	\$548.2	\$500.1
Alaskan State Severance Tax	82.5	220.7	298.9	302.6	306.3	310.1	301.1	295.6	298.2	272.0
Alaskan State Reserves Tax-- Paid	235.0	---	---	---	---	---	---	---	---	---
Severance Tax Credit	( 41.2)	(110.3)	(149.4)	(151.3)	( 4.9)	---	---	---	---	---
Alaskan State Ad Valorem Tax	190.0	208.2	219.5	215.6	211.4	206.8	203.6	202.9	196.1	184.0
Non-Income Tax Subtotal	<u>\$594.6</u>	<u>\$720.2</u>	<u>\$918.6</u>	<u>\$923.3</u>	<u>\$1076.0</u>	<u>\$1087.0</u>	<u>\$1059.0</u>	<u>\$1041.9</u>	<u>\$1042.5</u>	<u>\$956.1</u>
<b>Total Alaskan State Revenue</b>	<u>\$622.0</u>	<u>\$783.1</u>	<u>\$996.5</u>	<u>\$1003.0</u>	<u>\$1155.3</u>	<u>\$1168.2</u>	<u>\$1143.4</u>	<u>\$1129.5</u>	<u>\$1132.0</u>	<u>\$1042.2</u>
<b>Income Tax Paid to All States By:</b>										
A-California Marketing and Refining Company	\$ 22.8	\$ 95.1	\$124.7	\$126.2	\$123.3	\$124.7	\$128.4	\$131.2	\$133.0	\$126.5
B-Large Integrated Domestic Company	60.1	114.8	137.7	138.9	136.8	138.0	141.0	143.3	144.9	139.7
C-Major International Company	63.5	95.4	109.0	109.9	109.0	109.8	111.7	113.3	114.3	111.2
Total Income Tax Paid to All States	<u>\$146.4</u>	<u>\$305.3</u>	<u>\$371.4</u>	<u>\$375.0</u>	<u>\$369.1</u>	<u>\$372.5</u>	<u>\$381.1</u>	<u>\$387.8</u>	<u>\$392.2</u>	<u>\$377.4</u>
Effective Composite State Income Tax Rate on Total Taxable Earnings	5.1%	5.8%	5.9%	5.9%	5.9%	5.9%	5.9%	5.9%	5.9%	5.9%
Alaskan Income Tax Payments as Percent of Income Tax Payments to All States	16.7%	20.6%	21.0%	21.3%	21.5%	21.8%	22.1%	22.6%	22.8%	22.8%

<sup>A</sup> Each owner company would pay one-third of the figures shown in this section.

**HYPOTHETICAL THREE COMPANY OWNERSHIP OF PRUDHOE BAY FIELD AND TAPS  
STATE REVENUE DISTRIBUTION FROM 1977 THROUGH 1986 IF OIL SELLS FOR \$13.00/BDL. IN CALIFORNIA**  
(All Amounts in Millions of 1976 Dollars)

Type of Revenue	Company A California Refiner		Company B Large Domestic		Company C Major International		Three Company Total	
	Alaskan Revenue	As Percent To All States	Alaskan Revenue	As Percent To All States	Alaskan Revenue	As Percent To All States	Alaskan Revenue	As Percent To All States
Prudhoe Bay Royalty	\$1,638.4	100.0%	\$1,638.4	100.0%	\$1,638.4	100.0%	\$4,915.2	100.0%
Prudhoe Bay Severance Tax	896.0	100.0%	896.0	100.0%	896.0	100.0%	2,688.0	100.0%
Prudhoe Bay Reserves Tax--								
Paid	78.3	100.0%	78.3	100.0%	78.4	100.0%	235.0	100.0%
Severance Tax Credit	( 152.4)	100.0%	( 152.4)	100.0%	( 152.5)	100.0%	( 457.3)*	100.0%
Prudhoe Bay and TAPS Ad Valorem Tax	679.4	100.0%	679.4	100.0%	679.4	100.0%	2,038.2	100.0%
State Income Tax on <u>All</u> of Company's Operations	297.1	26.2%	230.3	17.8%	228.6	21.8%	756.0	21.7%
Total Revenue to State of Alaska	<u>\$3,436.8</u>	75.2%	<u>\$3,370.0</u>	72.2%	<u>\$3,368.3</u>	76.3%	<u>\$10,175.1</u>	74.5%

\* Includes credit for the \$222.3 million reserves tax paid during 1976.

HYPOTHETICAL THREE COMPANY OWNERSHIP OF PRUDHOE BAY FIELD AND TAPS  
 REVENUE TO ALASKA AND OTHER STATES IF OIL SELLS FOR \$16.00/BBL. IN CALIFORNIA  
 (All Amounts in Millions of 1976 Dollars)

TABLE 3-A

	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
<b><u>Alaskan State Income Tax Paid By:</u></b>										
A-California Marketing and Refining Company	\$ 8.6	\$ 32.4	\$ 42.4	\$ 41.9	\$ 42.2	\$ 42.9	\$ 44.3	\$ 45.5	\$ 46.3	\$ 43.7
B-Large Integrated Domestic Company	10.9	23.4	28.7	28.7	29.2	29.9	31.0	32.2	32.9	31.5
C-Major International Company	<u>13.4</u>	<u>22.5</u>	<u>26.3</u>	<u>26.5</u>	<u>27.0</u>	<u>27.7</u>	<u>28.7</u>	<u>29.9</u>	<u>30.5</u>	<u>29.6</u>
Alaskan State Income Tax Revenue	<u>\$ 32.9</u>	<u>\$ 78.3</u>	<u>\$ 97.4</u>	<u>\$ 97.1</u>	<u>\$ 98.4</u>	<u>\$100.5</u>	<u>\$104.0</u>	<u>\$107.6</u>	<u>\$109.6</u>	<u>\$104.8</u>
<b><u>Alaskan State Revenue Other Than Income Tax*</u></b>										
Royalty to State of Alaska	\$189.9	\$565.6	\$754.9	\$761.7	\$768.6	\$775.4	\$759.7	\$748.7	\$753.5	\$691.8
Alaskan State Severance Tax	103.3	307.6	410.6	414.3	418.0	421.7	413.2	407.2	409.8	376.2
Alaskan State Reserve Tax-- Paid	235.0	---	---	---	---	---	---	---	---	---
Severance Tax Credit	( 51.7)	(153.8)	(205.3)	( 46.6)	---	---	---	---	---	---
Alaskan State Ad Valorem Tax	<u>190.0</u>	<u>208.2</u>	<u>219.5</u>	<u>215.6</u>	<u>211.4</u>	<u>206.8</u>	<u>203.6</u>	<u>202.9</u>	<u>196.1</u>	<u>184.0</u>
Non-Income Tax Subtotal	<u>\$666.5</u>	<u>\$927.6</u>	<u>\$1179.7</u>	<u>\$1345.0</u>	<u>\$1398.0</u>	<u>\$1403.9</u>	<u>\$1376.5</u>	<u>\$1358.8</u>	<u>\$1359.4</u>	<u>\$1252.0</u>
<b><u>Total Alaskan State Revenue</u></b>	<b><u>\$699.4</u></b>	<b><u>\$1005.9</u></b>	<b><u>\$1277.1</u></b>	<b><u>\$1442.1</u></b>	<b><u>\$1496.4</u></b>	<b><u>\$1504.4</u></b>	<b><u>\$1480.5</u></b>	<b><u>\$1466.4</u></b>	<b><u>\$1469.0</u></b>	<b><u>\$1356.8</u></b>
<b><u>Income Tax Paid to All States By:</u></b>										
A-California Marketing and Refining Company	\$ 35.5	\$128.0	\$165.5	\$162.2	\$162.3	\$163.8	\$167.5	\$170.3	\$172.2	\$163.2
B-Large Integrated Domestic Company	69.5	139.7	168.9	166.5	166.7	168.0	171.0	173.4	174.9	167.8
C-Major International Company	<u>68.9</u>	<u>109.9</u>	<u>127.3</u>	<u>126.2</u>	<u>126.5</u>	<u>127.5</u>	<u>129.4</u>	<u>131.1</u>	<u>132.2</u>	<u>127.8</u>
Total Income Tax Paid to All States	<u>\$173.9</u>	<u>\$377.6</u>	<u>\$461.7</u>	<u>\$454.9</u>	<u>\$455.5</u>	<u>\$459.3</u>	<u>\$467.9</u>	<u>\$474.8</u>	<u>\$479.3</u>	<u>\$458.7</u>
Effective Composite State Income Tax Rate on Total Taxable Earnings	5.3%	5.9%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.1%	6.0%
Alaskan Income Tax Payments as Percent of Income Tax Payments to All States	18.9%	20.7%	21.1%	21.3%	21.6%	21.9%	22.2%	22.7%	22.9%	22.8%

\* Each owner company would pay one-third of the figures shown in this section.

**HYPOTHETICAL THREE COMPANY OWNERSHIP OF PRUDHOE BAY FIELD AND TAPS  
STATE REVENUE DISTRIBUTION FROM 1977 THROUGH 1986 IF OIL SELLS FOR \$16.00/BBL. IN CALIFORNIA**  
(All Amounts in Millions of 1976 Dollars)

Type of Revenue	Company A California Refiner		Company B Large Domestic		Company C Major International		Three Company Total	
	Alaskan Revenue	As Percent To All States	Alaskan Revenue	As Percent To All States	Alaskan Revenue	As Percent To All States	Alaskan Revenue	As Percent To All States
Prudhoe Bay Royalty	\$2,256.6	100.0%	\$2,256.5	100.0%	\$2,256.6	100.0%	\$6,769.8	100.0%
Prudhoe Bay Severance Tax	1,227.3	100.0%	1,227.3	100.0%	1,227.3	100.0%	3,681.9	100.0%
Prudhoe Bay Reserves Tax--								
Paid	78.3	100.0%	78.3	100.0%	78.4	100.0%	235.0	100.0%
Severance Tax Credit	( 152.4)	100.0%	( 152.4)	100.0%	( 152.5)	100.0%	( 457.3)*	100.0%
Prudhoe Bay and TAPS Ad Valorem Tax	679.4	100.0%	679.4	100.0%	679.4	100.0%	2,038.2	100.0%
State Income Tax on All of Company's Operations	390.2	26.2%	278.4	17.8%	262.1	21.7%	930.7	21.3%
Total Revenue to State of Alaska	<u>\$4,479.4</u>	75.0%	<u>\$4,367.6</u>	73.6%	<u>\$4,351.3</u>	78.3%	<u>\$13,198.3</u>	75.6%

\* Includes credit for the \$222.3 million reserves tax paid during 1976.

January 21, 1977

SOHIO SUBMISSION TWO

This is the second paper submitted by Sohio for consideration by the Alaskan Administration and the Alaskan Legislature in the studies each has been conducting concerning the long term oil taxation and leasing policy for the State. The first paper, entitled Sohio Submission One, was provided to the Alaskan Administration and Legislature on October 28, 1976.

By way of background, that paper examined the state income tax of Alaska under the allocation method of the Multistate Tax Compact and made illustrative projections of the substantial revenue that Alaska would receive as a result of the first ten years of operation of the Prudhoe Bay Field and the Trans Alaska Pipeline System (TAPS). Those projections of revenue included estimates of the State's royalty income and tax receipts resulting from Alaska's severance tax, reserves tax, ad valorem tax and state income tax.

In order to develop those hypothetical projections for the future operations of Prudhoe Bay and TAPS, it was assumed that equal one-third shares of that field and pipeline would be owned by three typical companies, none of which were intended to represent any company actually involved in that project. The assumed characteristics of the three typical companies which were used in Sohio Submission One were as follows:

Company A - A California based marketing and refining company with no crude oil production.

Company B - A large, integrated domestic company with significant petroleum production and transportation operations.

Company C - A major international company with substantial foreign operations.

Due to the degree of uncertainty surrounding both the future price of North Slope oil and future rates of inflation, the projections of Alaskan revenue contained in Sohio Submission One were calculated in terms of constant 1976 dollars, assuming three different California market prices: \$10.00/barrel, \$13.00/barrel, and \$16.00/barrel.

Among the significant findings of Sohio Submission One was that at the \$10.00 per barrel price, Alaska would receive average revenues of almost \$800 million per year from Prudhoe Bay and TAPS during the next ten years. At the \$13.00 per barrel and \$16.00 per barrel prices, Alaska's average annual revenues from this project would exceed \$1.0 billion and \$1.3 billion, respectively. These tax and royalty revenues to Alaska would represent approximately 75 percent of such revenue paid to all states, including Alaska, resulting either wholly or in part from the Prudhoe Bay Field and the Trans Alaska Pipeline. If some factor for inflation were applied to these projections rather than using constant 1976 dollars, the average annual revenues would increase accordingly, but Alaska's 75 percent share of such revenue to all states resulting from this project would not change.

The purpose of Sohio Submission Two is not to further examine either the "fair share" aspects of Alaska's taxation policy or the revenues the

State might expect as a result of Prudhoe Bay and TAPS. Sohio Submission Two takes the next step and compares the tax burden of such Alaskan tax laws currently on the books with the tax burden of the comparable tax laws of the other three largest oil producing states--Texas, Louisiana, and California. In the development of this comparison of tax burdens, exactly the same basic economic assumptions regarding the Prudhoe Bay Field and TAPS are used that were the basis for Sohio Submission One. Additionally, it is assumed again for this hypothetical case that one-third of this field and pipeline is owned by each of the three typical companies previously mentioned. In other words, the tax payments for each other producing state have been calculated by simply assuming that Alaska adopted the tax laws of that other state in lieu of the existing Alaskan tax laws. For comparison purposes, only the constant \$13.00 per barrel selling price in California is used. This is the midpoint of the assumed price levels which were used in Sohio Submission One. As in the previous paper, no attempt has been made to forecast future rates of inflation, and again, all the calculations and results are expressed in constant 1976 dollars.

Since this paper analyzes only the taxes of these oil producing states, the \$4.9 billion in royalty payments that Alaska would receive if oil sells for \$13.00 per barrel in California has been eliminated from the comparison. To simplify the comparison, Alaska's 1976-1977 reserves tax and future credit against severance tax payments have been deleted from this analysis. Since the reserves tax was enacted to alleviate Alaska's short term financial difficulties prior to initial production from Prudhoe Bay and since the reserves tax payments will be completely offset by future credits against severance tax obligations, it is not a

part of Alaska's permanent ongoing taxes, and it is the comparison of these states' ongoing tax laws that is the most informative.

The results of this analysis are displayed on the attached Tables 1, 2, and 3. Each of these Tables lists the principal Alaskan taxes which currently apply to petroleum activities in the state. These include the state income tax, the severance tax, and the petroleum property ad valorem tax. The payments which would be made to the State of Alaska over the 1977 through 1986 ten year period have been calculated and listed on each Table, along with the basis of calculation for each tax. The tax payments resulting from the comparable taxes of Texas, Louisiana, and California and their bases are listed on Tables 1, 2, and 3, respectively. Finally, each Table compares the total payment to Alaska for each tax as a percent of the total payment which would result under the comparable tax of the other leading oil production state.

Table 1, for example, is a comparison of the tax burden under the Alaskan tax laws with the tax burden under such tax laws of Texas, currently the largest oil production state in the U.S. As indicated on Table 1, the Alaskan state income tax payments of the three hypothetical companies owning Prudhoe Bay and TAPS would total more than \$750 million over the 1977-1985 ten year period. Texas, on the other hand, does not have a state income tax so, if the three companies were subject to Texas tax laws instead of the Alaska tax laws, the state income tax payments by the three companies would be zero.

The second section of Table 1 compares the payments which would be made from 1977 through 1986 by the three companies under the Alaskan

severance tax and ad valorem tax to those payments which they would have to make if they were subject to similar taxes in Texas. Since it is assumed that one-third of Prudhoe Bay and TAPS would be owned by each of the three typical companies, each company's tax payments would simply be one-third of the figures shown in this section. Alaska's severance tax would average 7.8 percent of the net wellhead value of the oil, i.e., the wellhead value after royalty payments are deducted. This results in total Alaska severance tax payments of almost \$2.7 billion over the ten year period. Since the Texas severance tax rate is only 4.6 percent of the net wellhead value, the total severance tax payments would be slightly more than \$1.6 billion over the same period. Therefore, the severance tax payments resulting under Alaska's current severance tax would be 163 percent of those resulting under Texas's current severance tax.

The present ad valorem tax rate of Alaska is equal to 20 mills and is applied to the valuation of all petroleum hardware. This would result in Alaskan ad valorem tax payments by the three companies of more than \$2.0 billion from 1977 through 1986. The ad valorem tax on production properties in Texas is equivalent to 2.5 percent of the net wellhead value of the oil produced. For pipeline facilities, the Texas ad valorem tax averages slightly less than 8 mills times the hardware valuation. Therefore, the total ad valorem tax payments which the three companies would have to pay if they were subject to these Texas tax laws would total \$1.46 billion from 1977 through 1986. As indicated on Table 1, the Alaskan

ad valorem tax payments over this ten year period would be 140 percent of those in Texas.

The sum of all these Alaskan tax payments made by the three companies from 1977 through 1986 would be almost \$5.5 billion. The comparable figures under the Texas tax laws would be only slightly more than \$3.1 billion. In summary, the Alaska tax burden would be 176 percent of that for Texas.

Table 2 compares in the same way Alaska's taxes with those of Louisiana, currently the second largest oil production state. Several significant factors concerning Louisiana's taxes are demonstrated by this Table. First of all, while the Louisiana state income tax rate is 4.0 percent, Louisiana has an oil depletion allowance equal to the lesser of 38 percent of the net wellhead value, or 50 percent of oil production taxable income. Furthermore, the state allows the deduction of Federal income tax payments prior to the determination of the state income tax liability. Therefore, income tax payments to Louisiana by the three companies would amount to \$382 million over the 1977 to 1986 period. The income tax payments under Alaska's state income tax over this same period would be 197 percent of this amount.

Another significant item highlighted by Table 2 is the total payments by the three companies of almost \$4.5 billion resulting from Louisiana's 12.5 percent severance tax rate, which is the highest oil severance tax in the U.S. As indicated on Table 2, the corresponding payments under Alaska's severance tax are 60 percent of those under Louisiana's severance tax. However, this difference in tax receipts

is almost completely offset by the fact that Alaska's ad valorem taxes are substantially higher than those in Louisiana, that is, 298 percent of such Louisiana taxes. When the total of these tax payments by the three companies is considered, the payments to Alaska of almost \$5.5 billion over the ten year period are 99 percent of the tax payments which would be made to Louisiana.

Table 3 compares the tax laws of Alaska to those of California, the third largest oil producing state. California's income tax rate of 9.0 percent is almost as high as that of Alaska, and the total tax payments by the three companies under either state's income tax law would be within \$25 million of each other for the ten year period.

As indicated on Table 3, the ad valorem tax payments under California's tax law would be about twice those paid to the State of Alaska. On the other hand, California levies no severance tax on oil production. When the total payments by the three companies resulting from these two taxes are compared for each state, the payments to Alaska would be 112 percent of those under California's method of taxation. Including the projected state income tax payments in these totals, the \$5.5 billion total ten year tax burden in Alaska would be 111 percent of the \$4.9 billion total which would result under California's tax laws.

Sohio Submission Two confirms the testimony by Sohio before the joint hearing of the Alaskan Senate and House Resources Committees that the burden of these tax laws already on the books in Alaska equals or exceeds the corresponding tax burdens of the other leading

oil production states. Using the hypothetical three company ownership of the Prudhoe Bay Field and the Trans Alaska Pipeline to illustrate the point, Sohio Submission Two affirms in a more precise manner that Alaska's current tax laws are 176 percent of those of Texas; 99 percent of Louisiana's; and 111 percent of California's.

It is respectfully suggested that Alaska's comparative tax position is one factor deserving careful attention if the State considers further changes in its tax laws, since such changes will affect the revenues flowing to the State government and the health of the State's economy, both of which will principally depend on reasonable resource development.

The Standard Oil Company (Ohio)  
1780 Guildhall  
Cleveland, Ohio 44115  
January 21, 1977

**HYPOTHETICAL THREE COMPANY OWNERSHIP OF PRUDHOE BAY FIELD AND TAPS**  
**COMPARISON OF THE TAX BURDEN UNDER THE LAWS OF ALASKA AND THE LAWS OF TEXAS - 1977 THROUGH 1986**  
*(This hypothetical case assumes oil sells for a constant \$13.00/BBL. price in California. All figures in millions of constant 1978 dollars.)*

	ALASKA TAXES		TEXAS TAXES		Payments Under Alaskan Tax Structure As A Percent of That Under Texas Tax Structure
	Basis	\$Millions	Basis	\$Millions	
<b>State Income Tax Paid By:</b>					
Company A - California Marketing and Refining Company	9.4% of Income Taxable by the State	\$ 295.2	0% of Income Taxable by the State	\$ 0.0	∞
Company B - Large Integrated Domestic Company	9.4% of Income Taxable by the State	229.4	0% of Income Taxable by the State	0.0	∞
Company C - Major International Company	9.4% of Income Taxable by the State	220.2	0% of Income Taxable by the State	0.0	∞
State Income Tax Subtotal		<u>\$ 752.8</u>		<u>\$ 0.0</u>	∞
<b>Other Taxes:<sup>a</sup></b>					
Severance Tax	7.8% of Wellhead Value after Royalty Payments	\$2,688.0	4.6% of Wellhead Value after Royalty Payments	\$1,648.9	163%
Ad Valorem Tax	Fluid and Pipeline - 2.0% of Hardware Valuation	2,038.2	Field - 2.5% of Wellhead Value after Royalty Payments Pipeline - 0.78% of Hardware Valuation	1,459.0	140%
Severance and Ad Valorem Tax Subtotal		<u>\$4,726.2</u>		<u>\$3,107.9</u>	152%
Total Tax Payments		<u>\$5,479.0</u>		<u>\$3,107.9</u>	176%

<sup>a</sup> Company A, Company B, and Company C would each pay one-third of the figures shown in this section.

HYPOTHETICAL THREE COMPANY OWNERSHIP OF PRUDHOE BAY FIELD AND TAPS  
 COMPARISON OF THE TAX BURDEN UNDER THE LAWS OF ALASKA AND THE LAWS OF LOUISIANA - 1977 THROUGH 1986  
 (This hypothetical case assumes oil sells for a constant \$13.00/BBL. price  
 in California. All figures in millions of constant 1978 Dollars.)

	ALASKA TAXES		LOUISIANA TAXES		Payments Under Alaskan Tax Structure As A Percent of That Under Louisiana Tax Structure
	Basis	\$Millions	Basis <sup>a</sup>	\$Millions	
<b>State Income Tax Paid By:</b>					
Company A - California Marketing and Refining Company	9.4% of Income Taxable by the State	\$ 295.2	4.0% of Income Taxable by the State	\$ 127.4	232%
Company B - Large Integrated Domestic Company	9.4% of Income Taxable by the State	229.4	4.0% of Income Taxable by the State	127.4	180%
Company C - Major International Company	9.4% of Income Taxable by the State	228.2	4.0% of Income Taxable by the State	127.4	179%
State Income Tax Subtotal		<u>\$ 752.8</u>		<u>\$ 382.2</u>	197%
<b>Other Taxes:<sup>b</sup></b>					
Severance Tax	7.8% of Wellhead Value after Royalty Payments	\$2,688.0	12.5% of Wellhead Value after Royalty Payments	\$4,465.6	60%
Ad Valorem Tax	Field and Pipeline - 2.0% of Hard- ware Value	2,038.2	Field - 0.4% of Wellhead Value after Royalty Payments Pipeline - 0.75% of Hardware Valuation	604.0	298%
Severance and Ad Valorem Tax Subtotal		<u>\$4,726.2</u>		<u>\$5,149.6</u>	92%
Total Tax Payments		<u>\$5,479.0</u>		<u>\$5,531.8</u>	99%

<sup>a</sup> Even though Louisiana's corporate income tax rate is 4.0%, the State has a 38% depletion allowance and allows deduction of Federal Income tax payments prior to the determination of state income tax payments.

<sup>b</sup> Company A, Company B, and Company C would each pay one-third of the figures shown in this section.

HYPOTHETICAL THREE COMPANY OWNERSHIP OF PRUDHOE BAY FIELD AND TAPS  
 COMPARISON OF THE TAX BURDEN UNDER THE LAWS OF ALASKA AND THE LAWS OF CALIFORNIA - 1977 THROUGH 1985  
 (This hypothetical case assumes oil sells for a constant \$13.00/BBL. prices  
 in California. All figures in millions of constant 1976 dollars.)

	ALASKA TAXES		CALIFORNIA TAXES		Payments Under Alaskan Tax Structure As A Percent of That Under California Tax Structure
	Basis	\$Millions	Basis	\$Millions	
<u>State Income Tax Paid By:</u>					
Company A - California Marketing and Refining Company	9.4% of Income Taxable by the State	\$ 295.2	9.0% of Income Taxable by the State	\$ 286.6	103%
Company B - Large Integrated Domestic Company	9.4% of Income Taxable by the State	229.4	9.0% of Income Taxable by the State	221.6	104%
Company C - Major International Company	9.4% of Income Taxable by the State	<u>228.2</u>	9.0% of Income Taxable by the State	<u>219.7</u>	104%
State Income Tax Subtotal		<u>\$ 752.8</u>		<u>\$ 727.9</u>	103%
<u>Other Taxes:<sup>a</sup></u>					
Severance Tax	7.8% of Wellhead Value after Royalty Payments	\$2,688.0	None	\$ 0.0	"
Ad Valorem Tax	Field and Pipeline - 2.0% of Hard- ware Valuation	2,038.2	Field - 7.7% of Wellhead Value after Royalty Payments Pipeline - 2.2% of Hardware Valuation	4,201.6	49%
Severance and Ad Valorem Tax Subtotal		<u>\$4,726.2</u>		<u>\$4,201.6</u>	112%
Total Tax Payments		<u>\$5,479.0</u>		<u>\$4,929.5</u>	111%

<sup>a</sup> Company A, Company B, and Company C would each pay one-third of the figures shown in this section.

March 22, 1977

SOHIO SUBMISSION THREE

In recent months Sohio has provided the Alaskan Administration and Legislature with two writings entitled "Sohio Submission One" and "Sohio Submission Two". Sohio Submission One sets out the revenues the State of Alaska might receive under its existing tax laws during the next decade. These figures were based on taxes that might be paid by three hypothetical companies, which were described in Submission One, under the assumption that in addition to its present operations each company would own a one-third interest in the Prudhoe Bay field and a one-third interest in the Trans-Alaskan Pipeline.

Sohio Submission Two compared the revenues Alaska might receive under its existing laws, as set out in the first writing, with the revenues Alaska would receive if it had the tax structure of either of three other leading oil producing states, namely, Texas, Louisiana, and California.

The purpose of Sohio Submission Three is to set out the taxes these three hypothetical companies would pay under two sets of assumptions; first, that the Administration's tax proposals became law, and second, that the Legislature's tax proposals became law.

This Sohio Submission Three consists of two parts. The first part describes our understanding of the existing laws and of the provisions of the proposed laws as we have used them in our work. The second part, commencing on page 8, provides comments on the results of our calculations as

HYPOTHETICAL THREE COMPANY OWNERSHIP OF PRUDHOE BAY FIELD AND TAPS  
 COMPARISON OF THE TAX BURDEN UNDER THE LAWS OF ALASKA AND THE LAWS OF CALIFORNIA - 1977 THROUGH 1986  
 (This hypothetical case assumes oil sells for a constant \$13.00/BBL. price  
 in California. All figures in millions of constant 1976 dollars.)

	ALASKA TAXES		CALIFORNIA TAXES		Payments Under Alaskan Tax Structure As A Percent of That Under California Tax Structure
	Basis	\$Millions	Basis	\$Millions	
<b>State Income Tax Paid By:</b>					
Company A - California Marketing and Refining Company	9.4% of Income Taxable by the State	\$ 295.2	9.0% of Income Taxable by the State	\$ 286.6	103%
Company B - Large Integrated Domestic Company	9.4% of Income Taxable by the State	229.4	9.0% of Income Taxable by the State	221.6	104%
Company C - Major International Company	9.4% of Income Taxable by the State	<u>228.2</u>	9.0% of Income Taxable by the State	<u>219.7</u>	104%
State Income Tax Subtotal		<u>\$ 752.8</u>		<u>\$ 727.9</u>	103%
<b>Other Taxes:<sup>a</sup></b>					
Severance Tax	7.8% of Wellhead Value after Royalty Payments	\$2,688.0	None	\$ 0.0	∞
Ad Valorem Tax	Field and Pipeline - 2.0% of Hard- ware Valuation	2,038.2	Field - 7.7% of Wellhead Value after Royalty Payments Pipeline - 2.2% of Hardware Valuation	4,201.6	49%
Severance and Ad Valorem Tax Subtotal		<u>\$4,726.2</u>		<u>\$4,201.6</u>	112%
Total Tax Payments		<u>\$5,479.0</u>		<u>\$4,929.5</u>	111%

<sup>a</sup> Company A, Company B, and Company C would each pay one-third of the figures shown in this section.

March 22, 1977

SOHIO SUBMISSION THREE

In recent months Sohio has provided the Alaskan Administration and Legislature with two writings entitled "Sohio Submission One" and "Sohio Submission Two". Sohio Submission One sets out the revenues the State of Alaska might receive under its existing tax laws during the next decade. These figures were based on taxes that might be paid by three hypothetical companies, which were described in Submission One, under the assumption that in addition to its present operations each company would own a one-third interest in the Prudhoe Bay field and a one-third interest in the Trans-Alaskan Pipeline.

Sohio Submission Two compared the revenues Alaska might receive under its existing laws, as set out in the first writing, with the revenues Alaska would receive if it had the tax structure of either of three other leading oil producing states, namely, Texas, Louisiana, and California.

The purpose of Sohio Submission Three is to set out the taxes these three hypothetical companies would pay under two sets of assumptions; first, that the Administration's tax proposals became law, and second, that the Legislature's tax proposals became law.

This Sohio Submission Three consists of two parts. The first part describes our understanding of the existing laws and of the provisions of the proposed laws as we have used them in our work. The second part, commencing on page 8, provides comments on the results of our calculations as

they appear in the attached tables.

Part 1 - Comments on Existing Laws and Proposed Bills

The bills we considered in the case of the Administration proposals pertain to the franchise tax and property taxes and production taxes. In the case of the Legislature's proposals, we considered the bills relating to severance tax and income tax and a bill pertaining to net proceeds tax.

The salient provisions of the bills compared to the existing laws are as follows:

SEVERANCE TAX

Existing Law

The present law provides for payment of the higher of a percent of value or a cents per barrel in the case of oil. In the case of gas the tax is a straight 4 percent of value. The tax on oil is on a graduated scale as follows: For the first 300 barrels per day produced by a well during a month, the rate of 5 percent of value or 16.875¢ per barrel; for the next 700 barrels, the tax is 6 percent of value or 20.25¢ per barrel; and for all production over 1,000 barrels the tax is 8 percent of value or 27¢ per barrel. If a well produces 10,000 barrels per day the tax would be 7.77 percent of value or 26.22¢ per barrel, at the rate provided in the law. The cents per barrel figures escalate based on the wholesale price index for crude oil.

Administration's Proposal

The tax would be the greater of 10 percent of value or 75¢ per barrel, with the cents per barrel figure adjusted for changes in the Gross National Product deflator from and after the first quarter of 1977. The greater tax

rate is further adjusted by multiplying it by an "economic limit factor" for the purpose of reducing taxes on wells on properties which are approaching their economic limit. This economic limit factor is defined as one less the monthly rate of production at the economic limit of the property, divided by the current production from the property. The factor will be presumed to be one minus 100 barrels per day divided by total production per day, unless the owner can prove that this factor is not representative of the true economic limit. The economic limit factor will be changed if the operator can prove that his operating cost divided by the wellhead price would result in a lesser factor. A wellhead price for this purpose is determined by taking the landed price of imported oil on the West Coast and subtracting reasonable transportation costs from the field to the West Coast. The operating costs to be considered are set out in the proposed law.

With respect to gas, the tax would be the higher of 10 percent of value or 6.4¢ per MCF, providing that the cents per MCF will be adjusted by the GNP deflator from and after the first quarter 1977. These rates are subject to an economic limit factor, calculated in a manner similar to that described above for oil.

#### Legislature's Proposal

The legislative proposal provides for payment of the higher of a percent of value or cents per barrel of oil. In the case of gas the tax is a straight 4 percent of value. The tax on oil is on a graduated scale as follows: For the first 300 barrels per day produced by a well in a month, no tax; for the next 200 barrels, 4 percent of value or 13.5¢ per barrel;

the next 700, 6 percent or 20.25¢; the next 500, 9 percent or 30.38¢; the next 2,000, 11 percent or 37.13¢; over 3,500, 14 percent or 47.25¢. The cents per barrel figures escalate based on changes in the wholesale price index for crude oil from and after December 1973. If a well produces 10,000 barrels per day in a month, the composite rate would be 12.25 percent and the cents per barrel would be 41.346¢.

#### PROPERTY TAX

##### Existing Law

The present law provides for a 20-mill tax based on an assessed value equal to full and true value of the property. With respect to production facilities, the fair and true value is defined as actual cost during construction and thereafter as replacement cost less depreciation based on the economic life of proven reserves.

Full and true value of the pipeline is defined as cost during construction and then shall be determined with due regard to the economic value based on the estimated life of the proven reserves deliverable to the pipeline. However, if such reserves indicate an economic life materially shorter than the physical life of the pipeline, the full and true value is the actual cost reduced by straight-line depreciation over the life of the reserves. Under the law, the terms "actual cost" and "replacement cost" do not include capitalized interest or intangible drilling costs.

##### Administration's Proposal

The Administration proposes no basic change in the law with respect to production facilities. With respect to pipelines, the provision cited in the second to the last sentence above has been deleted. The law would

simply now say that the assessed value shall be "determined with due regard to the economic life of the property based on the estimated life of the reserves deliverable to the pipeline."

The property tax would apply to refineries and gas plants not now subject to tax. The basis would be replacement cost less depreciation based on the useful life of the property. It would also apply the tax to the tankers coming in to pick up oil at Valdez. This would be based on replacement cost less depreciation based on the useful life of the property. And based on the number of days the tankers spent in Alaskan ports compared to the total number of days the tankers spent in ports everywhere.

#### Legislature's Proposal

To our knowledge the Legislature has made no proposal with respect to property tax.

### INCOME TAX

#### Existing Law

Practically speaking, under the existing law of Alaska, the income tax rate is applied to a portion of federal taxable income allocated to the State of Alaska under a three-part formula involving sales, payroll, and property.

#### Administration's Proposal

The Administration's proposal would apply to any company whose gross receipts exceed \$250 million, 50 percent or more of which comes from one or more aspects of the oil and gas business. The taxable income of a company, part of which would be allocated to Alaska, would be the greater of taxable income as now computed or financial income before deduction of

any taxes based on income. The portion attributable to Alaska would be again determined by a three-part formula involving factors for property, payroll and extraction with extraction replacing the sales factor which is now used. The extraction factor would be the ratio, in terms of BTU's, of the oil and gas production of a company within the State of Alaska to such production everywhere.

#### Legislature's Proposal

The Legislature proposes separate accounting with respect to income tax. With respect to most oil companies operating in Alaska, their total taxable income in Alaska would consist of a combination of taxable income from oil and gas production, from oil and gas pipelining operations, and from other operations. The taxable income from oil and gas production would consist of the wellhead value of such production reduced by royalty, severance tax, property tax, operating costs, depreciation, interest, and exploration expenses.

Under this formula, depreciation would include a write-off of capitalized interest, less acquisition payments and property taxes which were incurred prior to the commencement of production. The interest would be interest not capitalized, allocated to the property based on the following formula: total interest times a fraction, the numerator of which is the book value of the field's fixed assets, defined by the book value of the fixed assets in the entire company.

The taxable income from oil pipeline operations would be calculated at 8 percent of the ICC valuation. In the case of gas pipelines the taxable income would be determined in accordance with FPC procedures as far as

interstate pipelines are concerned, and in accordance with the Alaska Public Utility Commission as far as intrastate lines are concerned.

The taxable income from all other activities would be the corporation's consolidated taxable income, minus the taxable income for oil and gas production and for oil and gas pipelines as outlined above, allocated to Alaska on the three-part formula.

NET PROCEEDS TAX

Existing Law

No such tax.

Administration's Proposal

None proposed.

Legislature's Proposal

There has been proposed an ad valorem tax based on income at income tax rates. The basis for the tax would be gross value minus certain deductions specified in the law. The gross value would be computed either at the wellhead or at some other point chosen by the Department of Revenue. There would be deducted from gross value royalties, transportation costs (if the valuation point is beyond the wellhead), operating costs incurred in the State, operating costs incurred outside the State or in lieu thereof 5 percent of expenses incurred in the State, taxes, depreciation, and geological and geophysical costs in areas outside the area of production. This latter item could be carried forward for ten years and may be included as an expense at no more than 20 percent per year. Income from operations other than production would continue to be taxed under the existing income tax law.

Part 2 - Results of Calculations

The results of our calculations are shown on attached Tables A through E. Tables A, B, and C show the amounts of each type of tax that will be paid each year from 1977 through 1986, under existing laws, the Administration's proposals and the Legislature's proposals, respectively. All of the figures are based on an oil price of \$13 00/barrel in California and are in constant dollars. We have not shown the reserves tax to be collected in 1977 nor the impact of the future credits against severance taxes, because our purpose here was to show the impact of on-going taxes. As a consequence of this, it will be noted that the figures for the existing laws shown in Table A are slightly different from those on Table 2-A of Sohio Submission One, which covered basically the same tax situation.

Tables D, E, and F compare the total of taxes estimated to be received by Alaska during 1977 through 1986 with those that would be received if Alaska had the tax structure of Texas, Louisiana, or California, respectively. They are, therefore, somewhat similar to the tables appended to Sohio Submission Three but in addition include comparisons of the total taxes under existing laws, the Administration's proposals and the Legislature's proposals.

Of particular note on Tables A, B, and C is the second line of numbers from the bottom entitled "Effective Composite State Income Tax Rate on Total Taxable Earnings." This is the composite income tax rate paid to all states by the three companies. It ranges from 6 percent under existing laws to 12 percent under the Administration's proposal and 15 percent under the Legislature's proposals. We found that calculating this composite rate was a difficult and imprecise task. But in any event, the 6 percent,

12 percent, and 15 percent were all calculated using similar procedures with respect to all states with the exception of Alaska. Therefore, the increase in these rates highlights the impact of the Administration's and the Legislature's proposals. If Alaska should move away from the three-factor formula now provided for in its law and in the laws of most states the duplication of taxes becomes obvious.

Tables D, E, and F indicate that, as a consequence of the Prudhoe Bay field and TAPS, Alaska will collect \$5.5 billion from 1977 - 1986 under its present tax laws from the three hypothetical companies. This is 176 percent of what it would collect under the tax structure of Texas; about the same as it would collect under the structure of Louisiana; and a little more (111 percent) of what it would receive under the tax structure of California. Figures in millions of dollars are:

	<u>If Alaska had the taxes of:</u>			
	<u>(Millions)</u>			
	<u>Alaska</u>	<u>Texas</u>	<u>Louisiana</u>	<u>California</u>
Severance Tax	\$2,688	\$1,649	\$4,466	\$ 0
Ad Valorem Tax	2,038	1,459	684	4,202
Income Tax	<u>753</u>	<u>0</u>	<u>382</u>	<u>728</u>
Total	\$5,479	\$3,108	\$5,532	\$4,930
Alaska as a percent of the other states		176%	99%	111%

If we assume the Administration's tax proposals are enacted, we note from the following table that the tax income of Alaska will increase about \$2 billion over what it would be under the existing tax structure for a

total of \$7.5 billion. We note further Alaska's tax income would be from 1-1/3 to almost 2-1/2 of what it would be under the laws of the other three states.

	<u>If Alaska had the taxes of:</u> (Millions)			
	<u>Alaska</u>	<u>Texas</u>	<u>Louisiana</u>	<u>California</u>
Severance Tax	\$3,283	\$1,649	\$4,466	\$ 0
Ad Valorem Tax	2,582	1,459	684	4,202
Income Tax	<u>1,591</u>	<u>0</u>	<u>382</u>	<u>728</u>
Total	\$7,456	\$3,108	\$5,532	\$4,930
Alaska as a percent of the other states		240%	135%	151%

If the Legislature's proposed tax bills are enacted, we note that the tax income will go to \$9 billion for 1977 to 1986. This would be three times as much as Alaska would collect under Texas law, over 1-1/2 times as much as under Louisiana law, or almost twice as much as under California law. Furthermore, we note that if the Net Proceeds bill were passed, the State would collect another \$90 million during this time.

	<u>If Alaska had the taxes of:</u> (Millions)			
	<u>Alaska</u>	<u>Texas</u>	<u>Louisiana</u>	<u>California</u>
Severance Tax	\$4,219	\$1,649	\$4,466	\$ 0
Ad Valorem Tax	2,038	1,459	684	4,202
Income Tax	<u>2,774</u>	<u>0</u>	<u>382</u>	<u>728</u>
Total	\$9,031	\$3,108	\$5,532	\$4,930
Alaska as a percent of the other states		291%	163%	183%

It should be noted again that all of these figures assume a constant price of \$13.00 for oil. We believe that in making some of its estimates of income, outgo, and fund balances the State of Alaska assumed some increase in the price of oil over the years. Comparisons of numbers should be made with this point in mind.

The Standard Oil Company (Ohio)  
1780 Guildhall Building  
Cleveland, Ohio 44115  
March 22, 1977

**HYPOTHETICAL THREE COMPANY OWNERSHIP OF PRUDHOE BAY FIELD AND TAPS  
REVENUE TO ALASKA AND OTHER STATES IF OIL SELLS FOR \$13.00/BBL. IN CALIFORNIA UNDER EXISTING TAX LAWS  
(All Amounts in Millions of Constant 1976 Dollars)**

TABLE A

	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
<b><u>Alaskan State Income Tax Paid By:</u></b>										
A-California Marketing and Refining Company	\$ 6.9	\$ 23.2	\$ 30.8	\$ 31.4	\$ 32.0	\$ 32.6	\$ 33.9	\$ 35.0	\$ 35.7	\$ 33.9
B-Large Integrated Domestic Company	10.1	18.8	22.8	23.4	23.9	24.6	25.6	26.6	27.2	26.3
C-Major International Company	12.9	19.4	22.2	22.8	23.4	24.0	24.9	26.0	26.6	25.9
Alaskan State Income Tax Revenue	<u>\$ 29.9</u>	<u>\$ 61.4</u>	<u>\$ 75.8</u>	<u>\$ 77.6</u>	<u>\$ 79.3</u>	<u>\$ 81.2</u>	<u>\$ 84.4</u>	<u>\$ 87.6</u>	<u>\$ 89.5</u>	<u>\$ 86.1</u>
<b><u>Alaskan State Revenue Other Than Income Tax*</u></b>										
Royalty to State of Alaska	\$ 128.3	\$ 401.6	\$ 549.6	\$ 556.4	\$ 563.2	\$ 570.1	\$ 554.3	\$ 543.4	\$ 548.2	\$ 500.1
Alaskan State Severance Tax	82.5	220.7	298.9	302.6	306.3	310.1	301.1	295.6	298.2	272.0
Alaskan State Ad Valorem Tax	190.0	208.2	219.5	215.6	211.4	206.8	203.6	202.9	196.1	184.0
Non-Income Tax Subtotal	<u>\$ 400.8</u>	<u>\$ 830.5</u>	<u>\$ 1,068.0</u>	<u>\$ 1,074.6</u>	<u>\$ 1,080.9</u>	<u>\$ 1,087.0</u>	<u>\$ 1,059.0</u>	<u>\$ 1,041.9</u>	<u>\$ 1,042.5</u>	<u>\$ 956.1</u>
<b><u>Total Alaskan State Revenue</u></b>	<b><u>\$ 430.7</u></b>	<b><u>\$ 891.9</u></b>	<b><u>\$ 1,143.8</u></b>	<b><u>\$ 1,152.2</u></b>	<b><u>\$ 1,160.2</u></b>	<b><u>\$ 1,168.2</u></b>	<b><u>\$ 1,143.4</u></b>	<b><u>\$ 1,129.5</u></b>	<b><u>\$ 1,132.0</u></b>	<b><u>\$ 1,042.2</u></b>
<b><u>Income Tax Paid to All States By:</u></b>										
A-California Marketing and Refining Company	\$ 28.7	\$ 91.8	\$ 120.2	\$ 121.6	\$ 123.1	\$ 124.7	\$ 128.4	\$ 131.2	\$ 133.0	\$ 126.5
B-Large Integrated Domestic Company	64.4	112.3	134.3	135.5	136.8	138.0	141.0	143.3	144.9	139.7
C-Major International Company	65.9	94.1	107.1	108.0	109.0	109.8	111.7	113.3	114.3	111.2
Total Income Tax Paid to All States	<u>\$ 159.0</u>	<u>\$ 298.2</u>	<u>\$ 361.6</u>	<u>\$ 365.1</u>	<u>\$ 368.9</u>	<u>\$ 372.5</u>	<u>\$ 381.1</u>	<u>\$ 387.8</u>	<u>\$ 392.2</u>	<u>\$ 377.4</u>
Effective Composite State Income Tax Rate on Total Taxable Earnings	5.2%	5.7%	5.9%	5.9%	5.9%	5.9%	5.9%	5.9%	5.9%	5.9%
Alaskan Income Tax Payments as Percent of Income Tax Payments to All States	18.8%	20.6%	21.0%	21.3%	21.5%	21.8%	22.1%	22.6%	22.8%	22.8%

\*Company A, Company B and Company C would each pay one-third of the figures shown in this section.

**HYPOTHETICAL THREE COMPANY OWNERSHIP OF PRUDHOE BAY FIELD AND TAPS**  
**REVENUE TO ALASKA AND OTHER STATES IF OIL SELLS FOR \$13.00/BBL. IN CALIFORNIA UNDER THE ADMINISTRATION'S TAX PROPOSALS**  
**(All Amounts in Millions of Constant 1976 Dollars)**

TABLE B

	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
<b>Alaskan State Income Tax Paid By:</b>										
A-California Marketing and Refining Company	\$ 31.3	\$ 67.6	\$ 84.5	\$ 84.6	\$ 84.2	\$ 83.9	\$ 84.3	\$ 83.6	\$ 82.1	\$ 76.0
B-Large Integrated Domestic Company	10.3	38.6	48.6	48.9	49.1	49.3	49.8	50.1	49.6	46.1
C-Major International Company	<u>19.3</u>	<u>33.9</u>	<u>40.9</u>	<u>41.4</u>	<u>41.6</u>	<u>42.0</u>	<u>42.6</u>	<u>43.2</u>	<u>43.1</u>	<u>40.7</u>
Alaskan State Income Tax Revenue	<u>\$ 60.9</u>	<u>\$ 140.1</u>	<u>\$ 174.0</u>	<u>\$ 174.9</u>	<u>\$ 174.9</u>	<u>\$ 175.2</u>	<u>\$ 176.7</u>	<u>\$ 176.9</u>	<u>\$ 174.8</u>	<u>\$ 162.8</u>
<b>Alaskan State Revenue Other Than Income Tax*</b>										
Royalty to State of Alaska	\$ 123.4	\$ 395.3	\$ 542.7	\$ 549.6	\$ 556.4	\$ 563.2	\$ 547.5	\$ 536.6	\$ 541.3	\$ 493.1
Alaskan State Severance Tax	99.0	275.1	365.1	370.1	374.7	378.9	369.5	362.1	361.9	326.9
Alaskan State Ad Valorem Tax	<u>254.4</u>	<u>255.5</u>	<u>273.2</u>	<u>269.3</u>	<u>265.1</u>	<u>260.5</u>	<u>257.6</u>	<u>257.1</u>	<u>250.6</u>	<u>239.0</u>
Non-Income Tax Subtotal	<u>\$ 476.8</u>	<u>\$ 925.9</u>	<u>\$ 1,181.0</u>	<u>\$ 1,189.0</u>	<u>\$ 1,196.2</u>	<u>\$ 1,202.6</u>	<u>\$ 1,174.6</u>	<u>\$ 1,155.8</u>	<u>\$ 1,153.8</u>	<u>\$ 1,059.0</u>
Total Alaskan State Revenue	<u>\$ 537.7</u>	<u>\$ 1,066.0</u>	<u>\$ 1,355.0</u>	<u>\$ 1,363.9</u>	<u>\$ 1,371.1</u>	<u>\$ 1,377.8</u>	<u>\$ 1,351.3</u>	<u>\$ 1,332.7</u>	<u>\$ 1,328.6</u>	<u>\$ 1,221.8</u>
<b>Income Tax Paid to All States By:</b>										
A-California Marketing and Refining Company	\$ 51.8	\$ 134.0	\$ 171.4	\$ 172.4	\$ 172.8	\$ 173.4	\$ 176.3	\$ 177.3	\$ 177.1	\$ 166.4
B-Large Integrated Domestic Company	63.6	130.3	158.0	158.8	159.7	160.6	163.1	164.7	165.2	157.6
C-Major International Company	<u>71.8</u>	<u>107.7</u>	<u>124.6</u>	<u>125.4</u>	<u>125.9</u>	<u>126.6</u>	<u>128.2</u>	<u>129.4</u>	<u>129.8</u>	<u>125.0</u>
Total Income Tax Paid to All States	<u>\$ 187.2</u>	<u>\$ 372.0</u>	<u>\$ 454.0</u>	<u>\$ 456.6</u>	<u>\$ 458.4</u>	<u>\$ 460.6</u>	<u>\$ 467.6</u>	<u>\$ 471.4</u>	<u>\$ 472.1</u>	<u>\$ 449.0</u>
Effective Composite State Income Tax Rate on Total Taxable Earnings	6.6%	10.5%	11.8%	11.8%	11.8%	11.8%	11.8%	11.8%	11.8%	11.4%
Alaskan Income Tax Payments as Percent of Income Tax Payments to All States	32.5%	37.7%	38.3%	38.3%	38.2%	38.0%	37.8%	37.5%	37.0%	36.3%

\*Company A, Company B and Company C would each pay one-third of the figures shown in this section.

**HYPOTHETICAL THREE COMPANY OWNERSHIP OF PRUDHOE BAY FIELD AND TAPS  
REVENUE TO ALASKA AND OTHER STATES IF OIL SELLS FOR \$13.00/BBL. IN CALIFORNIA UNDER THE LEGISLATURE'S TAX PROPOSALS  
(All Amounts in Millions of Constant 1976 Dollars)**

TABLE C

	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
<b><u>Alaskan State Income Tax Paid By:</u></b>										
A-California Marketing and Refining Company	\$ 22.3	\$ 76.5	\$ 104.3	\$ 104.5	\$ 104.9	\$ 105.4	\$ 102.9	\$ 100.5	\$ 101.2	\$ 93.7
B-Large Integrated Domestic Company	22.9	78.0	105.8	105.9	106.3	106.7	104.1	101.7	102.2	94.5
C-Major International Company	22.8	78.3	106.1	106.2	106.5	106.9	104.2	101.7	102.3	94.5
Alaskan State Income Tax Revenue	<u>\$ 68.0</u>	<u>\$ 232.8</u>	<u>\$ 316.2</u>	<u>\$ 316.6</u>	<u>\$ 317.7</u>	<u>\$ 319.0</u>	<u>\$ 311.2</u>	<u>\$ 303.9</u>	<u>\$ 305.7</u>	<u>\$ 282.7</u>
<b><u>Alaskan State Revenue Other Than Income Tax*</u></b>										
Royalty to State of Alaska	\$ 128.3	\$ 401.6	\$ 549.6	\$ 556.4	\$ 563.2	\$ 570.1	\$ 554.3	\$ 543.4	\$ 548.2	\$ 500.1
Alaskan State Severance Tax	113.9	344.4	471.2	477.1	483.0	488.8	475.4	465.0	470.1	428.9
Alaskan State Ad Valorem Tax	190.0	208.2	219.5	215.6	211.4	206.9	203.6	202.9	196.1	184.0
Non-Income Tax Subtotal	<u>\$ 432.2</u>	<u>\$ 954.2</u>	<u>\$ 1,240.3</u>	<u>\$ 1,249.1</u>	<u>\$ 1,257.6</u>	<u>\$ 1,265.7</u>	<u>\$ 1,233.3</u>	<u>\$ 1,211.3</u>	<u>\$ 1,214.4</u>	<u>\$ 1,113.0</u>
<b>Total Alaskan State Revenue</b>	<u>\$ 500.2</u>	<u>\$ 1,187.0</u>	<u>\$ 1,556.5</u>	<u>\$ 1,565.7</u>	<u>\$ 1,575.3</u>	<u>\$ 1,584.7</u>	<u>\$ 1,544.5</u>	<u>\$ 1,515.2</u>	<u>\$ 1,520.1</u>	<u>\$ 1,395.7</u>
<b><u>Income Tax Paid to All States By:</u></b>										
A-California Marketing and Refining Company	\$ 43.3	\$ 142.3	\$ 189.9	\$ 190.9	\$ 192.2	\$ 193.5	\$ 193.6	\$ 193.0	\$ 194.8	\$ 183.0
B-Large Integrated Domestic Company	76.5	169.2	214.1	214.7	215.8	216.8	216.3	215.3	216.7	205.1
C-Major International Company	75.5	151.8	189.3	189.6	190.2	190.9	189.2	187.3	188.4	178.3
Total Income Tax Paid to All States	<u>\$ 195.3</u>	<u>\$ 463.3</u>	<u>\$ 593.3</u>	<u>\$ 595.2</u>	<u>\$ 598.2</u>	<u>\$ 601.2</u>	<u>\$ 599.1</u>	<u>\$ 595.6</u>	<u>\$ 599.9</u>	<u>\$ 566.4</u>
Effective Composite State Income Tax Rate on Total Taxable Earnings	6.8%	13.1%	15.5%	15.5%	15.5%	15.5%	15.3%	15.0%	15.1%	14.5%
Alaskan Income Tax Payments as Percent of Income Tax Payments to All States	34.8%	50.2%	53.3%	53.2%	53.1%	53.1%	51.9%	51.0%	51.0%	49.9%

\*Company A, Company B and Company C would each pay one-third of the figures shown in this section.

TABLE D

HYPOTHETICAL THREE COMPANY OWNERSHIP OF PRUDICE BAY FIELD AND TAPS  
 TAX BURDEN UNDER EXISTING AND PROPOSED LAWS OF ALASKA AND THE LAWS OF TEXAS - 1977 THROUGH 1986

*(This hypothetical case assumes oil sells for a constant \$13.00 DBL price  
 in California. All figures in millions of constant 1976 dollars.)*

	ALASKA TAXES			TEXAS TAXES	ALASKA TAXES AS PERCENT OF TEXAS TAXES		
	Existing Laws	Administration's Proposals	Legislature's Proposals		Existing Laws	Administration's Proposals	Legislature's Proposals
<b>State Income Tax Paid By:</b>							
Company A - California Marketing and Refining Company	\$ 295.2	\$ 762.1	\$ 916.2	0.0	∞	∞	∞
Company B - Large Integrated Domestic Company	229.4	440.4	928.1	0.0	∞	∞	∞
Company C - Major International Company	220.2	388.7	929.5	0.0	∞	∞	∞
State Income Tax Subtotal	<u>752.0</u>	<u>1,591.2</u>	<u>2,773.8<sup>b</sup></u>	<u>0.0</u>	∞	∞	∞
<b>Other Taxes:<sup>a</sup></b>							
Severance Tax	\$2,688.0	\$3,203.3	\$4,218.8	\$1,648.9	163%	199%	256%
Ad Valorem Tax	<u>2,038.2</u>	<u>2,582.3</u>	<u>2,038.2</u>	<u>1,459.0</u>	140%	177%	140%
Severance and Ad Valorem Tax Subtotal	<u>4,726.2</u>	<u>5,865.6</u>	<u>6,257.0</u>	<u>3,107.9</u>	152%	189%	201%
Total Tax Payments	<u>\$5,479.0</u>	<u>\$7,456.8</u>	<u>\$9,030.8</u>	<u>\$3,107.9</u>	176%	240%	291%

<sup>a</sup> Company A, Company B, and Company C would each pay one-third of the figures shown in this section.

<sup>b</sup> If the Net Proceeds Tax Bill were passed this amount would increase by \$90 million.

TABLE E

**HYPOTHETICAL THREE COMPANY OWNERSHIP OF PRUDICE BAY FIELD AND TAPS  
TAX BURDEN UNDER EXISTING AND PROPOSED LAWS OF ALASKA AND THE LAWS OF LOUISIANA - 1977 THROUGH 1986**  
(This hypothetical case assumes oil sells for a constant \$13.00/BBL. price  
in California. All figures in millions of constant 1976 dollars.)

	ALASKA TAXES			LOUISIANA TAXES	ALASKA TAXES AS A PERCENT OF LOUISIANA TAXES		
	Existing Laws	Administration's Proposals	Legislature's Proposals		Existing Laws	Administration's Proposals	Legislature's Proposals
<b>State Income Tax Paid By:</b>							
Company A - California Marketing and Refining Company	\$ 295.2	\$ 762.1	\$ 916.2	\$ 127.4 <sup>a</sup>	232%	598%	719%
Company B - Large Integrated Domestic Company	229.4	440.4	928.1	127.4 <sup>a</sup>	180%	346%	728%
Company C - Major International Company	228.2	388.7	929.5	127.4 <sup>a</sup>	179%	305%	730%
State Income Tax Subtotal	<u>\$ 752.8</u>	<u>\$1,591.2</u>	<u>\$2,773.8<sup>a</sup></u>	<u>\$ 382.2<sup>a</sup></u>	197%	416%	726%
<b>Other Taxes:<sup>b</sup></b>							
Severance Tax	\$2,688.0	\$3,203.3	\$4,218.8	\$4,465.6	60%	74%	94%
Ad Valorem Tax	2,038.2	2,582.3	2,038.2	684.0	290%	378%	298%
Severance and Ad Valorem Tax Subtotal	<u>\$4,726.2</u>	<u>\$5,865.6</u>	<u>\$6,257.0</u>	<u>\$5,149.6</u>	92%	114%	122%
Total Tax Payments	<u>\$5,479.0</u>	<u>\$7,456.8</u>	<u>\$9,030.8</u>	<u>\$5,531.8</u>	99%	135%	163%

<sup>a</sup> Even though Louisiana's corporate income tax rate is 4.0%, the State has a 30% depletion allowance and allows deduction of Federal income tax payments prior to the determination of state income tax payments.

<sup>b</sup> Company A, Company B, and Company C would each pay one-third of the figures shown in this section.

<sup>c</sup> If the Net Proceeds Tax Bill were passed this amount would increase by \$90 million.

TABLE F

HYPOTHETICAL THREE COMPANY OWNERSHIP OF PRUDHOE BAY FIELD AND TAPS  
 TAX BURDEN UNDER EXISTING AND PROPOSED LAWS OF ALASKA AND THE LAWS OF CALIFORNIA - 1977 THROUGH 1986  
 (This hypothetical case assumes oil sells for a constant \$13.00/BBL. price  
 in California. All figures in millions of constant 1976 dollars.)

	ALASKA TAXES			CALIFORNIA TAXES	ALASKA TAXES AS A PERCENT OF CALIFORNIA TAXES		
	Existing Laws	Administration's Proposals	Legislature's Proposals		Existing Laws	Administration's Proposals	Legislature's Proposals
<b>State Income Tax Paid By:</b>							
Company A - California Marketing and Refining Company	\$ 295.2	\$ 762.1	\$ 916.2	\$ 286.6	103%	266%	320%
Company B - Large Integrated Domestic Company	229.4	440.4	928.1	221.6	104%	199%	419%
Company C - Major International Company	228.2	388.7	929.5	219.7	104%	177%	423%
State Income Tax Subtotal	<u>\$ 752.8</u>	<u>\$1,591.2</u>	<u>\$2,773.8<sup>b</sup></u>	<u>\$ 727.9</u>	103%	219%	381%
<b>Other Taxes:<sup>a</sup></b>							
Severance Tax	\$2,688.0	\$3,283.3	\$4,218.8	\$ 0.0	∞	∞	∞
Ad Valorem Tax	<u>2,038.2</u>	<u>2,582.3</u>	<u>2,038.2</u>	<u>4,201.6</u>	49%	61%	49%
Severance and Ad Valorem Tax Subtotal	<u>\$4,726.2</u>	<u>\$5,865.6</u>	<u>\$6,257.0</u>	<u>\$4,201.6</u>	112%	140%	149%
Total Tax Payments	<u>\$5,479.0</u>	<u>\$7,456.8</u>	<u>\$9,030.8</u>	<u>\$4,929.5</u>	111%	151%	183%

<sup>a</sup> Company A, Company B, and Company C would each pay one-third of the figures shown in this section.

<sup>b</sup> If the Net Proceeds Tax Bill were passed this amount would increase by \$90 million.

HEARINGS ON ALASKAN NORTH SLOPE PRICING AND ENTITLEMENT ISSUES

BEFORE THE FEDERAL ENERGY ADMINISTRATION

Monday, March 21, 1977

Statement of David P. Goodman, Managing Director of  
Morgan Stanley & Co. Incorporated

---

My name is David P. Goodman. I am a Managing Director of Morgan Stanley & Co. Incorporated, investment bankers in New York City. I am a member of the Energy Financial Advisory Committee to the Federal Energy Administration.

In Morgan Stanley's capacity as investment bankers to the Standard Oil Company (Ohio), Exxon Corporation, Mobil Oil Corporation and the British Petroleum Company, Limited, our Firm has arranged during the last two and one-half years over \$5.5 billion of financing for the development of the Prudhoe Bay Field and the Trans Alaska Pipeline System. I have had personal responsibility for over \$5 billion of this financing in a series of ten public offerings and two private placements of \$1,750 million and \$500 million. In the course of these financings, particularly the two private placements which were to finance a portion of Sohio and BP's interests in TAPS (the Trans Alaska Pipeline), I have had in-depth discussions with many major institutional investors regarding the financing of major energy projects.

As a result of these discussions, I have concluded that if the Administration establishes price control or entitlements treatment for Alaskan North Slope crude which does other than allow it to compete in

price with world oil in the United States market, this action will have a serious detrimental impact on investors' willingness to provide financing for the development of future major energy projects, both for petroleum and other energy sources.

I realize that this is a strong statement, but I would like to review with you some of the problems we faced and overcame in financing the North Slope project.

The companies which own the Prudhoe Bay reserves will likely spend \$14 to \$15 billion to develop the 9.6 billion barrels of oil reserves and transportation facilities needed to bring the oil to market. Expenditures of similar magnitude will be required to bring Prudhoe Bay gas reserves to market. Probably in excess of \$9 billion of financing for the oil project has been arranged since the Pipeline Right of Way Act was passed in January 1974, almost \$7 billion through the sale of securities, principally debt, and the balance through bank loans. Although all of the major Prudhoe reserve holders have done extensive financing, I will focus my remarks on Sohio and BP.

Sohio has about 53% of the Prudhoe oil reserves, and Sohio and BP will spend almost \$7.5 billion on the project, of which Sohio's share is \$6 billion. Since Sohio's non-North Slope assets are only about one-third of this amount, the bulk of these funds have been raised externally.

The most important financing steps for Sohio and BP were two

private placements for their TAPS affiliates, one of \$1,750 million arranged in the spring and summer of 1975 and one of \$500 million arranged in the summer of 1976. Seventy-seven institutional investors, including almost all of the major life insurance companies and public pension funds, savings banks and many private pension funds administered by trust banks, participated in these transactions. The loans represent the largest single investment for many of these investors.

In selling a private placement of this type, Morgan Stanley, as agent, prepares an extensive offering memorandum and sits down with the institutional investors to explain the project in great detail and answers any questions they have. It was through these discussions that we became aware of the concerns of investors which led to my previous conclusion. There were a number of risks that lenders sought assurance on: that the oil was there, that the pipeline and terminal would work, that there would be a ready market for the oil. The lenders obviously required a detailed economic analysis of the project, particularly since costs continued to escalate at an alarming rate during the construction period. We were able to demonstrate the continued financial viability of the project because during the same period world oil prices also increased dramatically. But Prudhoe oil is expensive oil, with development costs on the order of magnitude of \$12,500 per barrel per day.

Obviously, we were able to answer most questions these investors had since the Sohio/BP financings were by far the largest ever accomplished.

But there was one risk which we were unable to eliminate in the minds of certain major, sophisticated investors, and they declined to participate in the financing partly because of it. That risk was that the government would not permit Alaskan North Slope crude oil to compete with world oil in the market place, but would place restrictions on its price such as are currently under consideration. We cited the language of, and the legislative history behind, Section 8(g) of the EPAA which clearly contemplated that the President should consider special treatment for Alaskan North Slope crude to assure that its well-head price was high enough to provide incentive for future North Slope development. We pointed out the words of the law directing the President to exclude Alaskan North Slope crude from the composite price if the inclusion of high-priced Alaskan North Slope crude would lower the price for other upper-tier crude in the United States. Clearly the entitlements program was, in the words of the FEA, "designed to approximately equalize the cost of crude oil purchases" among refiners, and was never conceived of as a price control mechanism for crude oil. Yet the uncertainty of the prospect of these very proceedings here today was enough to cause important lenders not to participate in the most important energy project this country has ever seen. That is why my Firm feels strongly that unfavorable treatment for Alaskan North Slope crude will adversely affect the ability of industry to finance future energy projects. The prospect of a political decision in these hearings caused major investors to

eschew TAPS. Alaskan North Slope crude is new oil -- treat it as no worse than upper-tier oil at the well-head. Alaskan North Slope crude is very high-cost oil. Allow it to compete with world oil in the market place on the same basis as stripper oil, without detriment from the entitlements program.

These hearings are also investigating the risk elements of North Slope development and the appropriate rate of return for this project. Both of these subjects were obviously matters of great interest to investors. This project is one of the riskiest ever undertaken by industry. The important risks aren't those cited in the Mortada study. The cost of exploration before the Prudhoe Bay discovery well is <sup>compared</sup> insignificant with the risk undertaken by the industry in going ahead with the project under the Pipeline Right of Way Act. The participants were committed to complete the project no matter what the cost in the face of absolute federal and state controls over construction. Remember that this project had been delayed over four years by court intervention and government redesign. Compliance with these actions had already more than doubled costs. Yet the industry was forced to accept a set of stipulations far more exacting than any ever applied to such construction before, stipulations that many in the industry were concerned about being physically able to comply with, and to proceed with absolute authority vested in one man to halt construction or require design changes that could cause costs to sky-rocket with no accountability for cost effectiveness. The industry undertook these absolute obligations, and cost did

rise to the point where, if Alaskan North Slope crude is allowed to compete against world oil, the Mortada study and industry figures indicate that the project will earn a discounted return in the area of 14% to 16%.

Mortada states that a return of 12% should be equitable. There may be some analogy to the returns allowed to regulated industries in Mortada's thinking, although even higher returns are allowed in risky start-up ventures there. But regulated returns involve an exclusive franchise wherein subsequent rate regulation assures such a return. No one is assuring the price of Alaskan or world oil.

If we had projected a 12% return from the outset, I'm not sure that the project could have been financed. It is our experience that oil companies will not undertake a project involving any significant risk for a projected return of under 15%. The industry will earn returns of approximately 22% in the British North Sea, where they have experienced retroactive majority participation by British government. Financial institutions which invest in the equity of the leased tankers for the Valdez trade will earn a discounted after-tax return in excess of 15%, even though these financings are backed by "hell-or-high water," all-events charters from the oil companies. Based on these facts, I cannot accept that a 12% return is equitable for a project of the magnitude and riskiness of the North Slope project.

Gentlemen. The aggregate earnings from the North Slope will be

very large. It is one of, if not the largest oil field ever found outside of the Middle East. But the costs are high and the rate of return will be modest, particularly bearing in mind the risk. If you want industry to be able to finance the development of major energy discoveries this country so sorely needs, particularly the smaller companies you want to favor in your CCS leasing policies, do not make the wrong decision in pricing Alaskan North Slope crude oil. It is critical with regard to establishing an over-all energy policy, of which the issue of pricing Alaskan North Slope crude oil can be looked on as an important first step, to retaining the willingness of the private sector to provide financing of future energy projects.

Thank you.

QUESTIONS AND ANSWERS  
RICHARD DONALDSON - SOHIO  
March 24, 1977

SENATOR COLLETTA - Dick, referring to Page 30, your statement on utterly inconsistent factor of the State urging major economic incentives before FEA in these taxing proposals before us gets subjective opinion to how damaging those would be in decision by FEA?

RICHARD DONALDSON - There are several parts, I guess, in answer to that Senator Colletta. We have been working the FEA question in Washington for about two months, calling on various members of the staff, talking with Mr. O'Leary himself, \_\_\_\_\_ we've talked with James Schlessinger on several occasions. We have called on members of Congress, chairmen of committees and their staff, generally trying to lay the foundation on kinds of things you think they ought to be talking about, focusing on this maximum incentive. The first part of the answer, I guess, is you begin to get a feel of where the balance is, and what additional help can mean in striking a balance so that the answer hopefully comes out of the maximum price possible under law for Alaskan crude. In the course of this work, we have encouraged others, not just in our industry, but who rely on energy in various ways to study it, reach their own conclusions and express their opinions to the government on this. They are doing so. I was just delighted to see Alaska as a State government:

beginning to participate in this. You don't know how important it is to have not just another oil company coming in in a sovereign state, representing people. It puts a different element into the balance for which there is no substitute, and quality of advocacy that Alaska has been bringing to this, I felt it very good. My testimony reflected that. We have not yet gotten into the conference where the political questions of consumerism, a something for nothing kind of price will be raised. A pretty good record has been made so far in hearings in Washington, San Francisco, and in Anchorage, and I'm very concerned that we lose the essence of Alaskan advocacy that is an important thing in this bounds. It could be lost if, for example, the State appeared disinterested. It could be substantially reduced if somebody in Washington said "hay, you guys are down here arguing for the best price, but you're taking away at home". If you want to put it bluntly, why should the rest of the consumers in the lower '48 simply raise prices so you can raise taxes. The inconsistency of the position undermines the position as an advocate \_\_\_\_\_ State brings to this right now. I'm probably remiss in not reporting to you the fact that, and I don't mean this in a critical way, that there is a feeling in Washington that Alaska always wants some special treatment, and anything that doesn't stimulate that reaction that can temper judgement the wrong way ought to be avoided. So when you boil it all down, Senator Colletta, I think we need as an industry, and the State needs

in its own interests, as many positive advocates down there right now as we can. The FEA is going to make its decision, the President may make his recommendations toward the end of May or the early part of June that seems to be where they're pointing, so the next couple of months are pretty critical. I can't guarantee that I'm right. We're in the trenches on this and following it very very closely, and we need all the help we can. In this one, our interests simply are not enough. My suggestions in this testimony is intended as a friendly one. The State of Alaska gives up nothing in its sovereignty by deferring judgement on major tax questions now. I think some of them deserve more study, but I don't think you lose anything by saying we will come back to it next year and we will be cross-examining you, and we expect you to be responsive SOHIO, but I think it's a bad choice of tactics to ignore what is the big issues now for all of us, FEA pricing, and run down this, what is an important trail, but a side trail a long way from the main issue. That's a long response and I guess I'm only communicating feeling. For whatever it's worth I believe that's where we are.

SENATOR COLLETTA - During the gas hearings, Judge Litts decision came to the floor by a gentleman who gave extensive comprehensive testimony on interpretation of what that man was saying, and the \_\_\_\_\_ of what he was saying in this one

interpretation was that the credibility of Alaska is so laced with greed that whatever we do is just suspect, and what I want you to tell me is that I can gather from what you're saying on Page 30 here, if you perceive this attitude as far as oil is concerned why these people are going to make a decision is Alaska projecting an image of total greed?

RICHARD DONALDSON - I don't think dealing with issues like this at the National level, the State should feel apologetic. Obviously, someone who is a cynic can give it a translation of greed, but you could present the same position in a much more acceptable way which I think is much more honest in the responsibility of State government, and I'm not trying to pretend I'm the State Governor, but let me express it this way. The State of Alaska is made up of people who live here, who are doing many things. Some of them work for the Governor. Most of them, maybe 75% of them work in the private sector so called of businesses or maybe they're just employed there. Almost all of those in the private sector one way or another directly or indirectly have the success of their business in part, maybe a large part, and the success of their remaining employed dependent on the resource development here, because it is your biggest industry and we're proud to be a part of it. Now what you're saying in Washington to me doesn't come across as greed. What you're saying is "look, in terms of the interests of the people in our State, we want to keep

our businesses relatively profitable. We want to do it over many years, and we recognize that a key thing in that is having a continued resource development, not tearing up the State, but in a planned way that goes forward on a continuing basis that keeps things humming, so men here of the FEA, we've come to Washington to tell you that we're concerned about people in Alaska who need to be employed, and we know that to do that, you have to have some incentive on oil and gas prices in the \_\_\_\_\_ that will permit this activity to move forward. The second thing you can say without any apologies, if you look at the resource potential in Alaska, and what it contributes potentially is the whole country's needs in terms of energy, but we have a very responsible part to play, and that can't be done unless you have a fairly high incentive in the terms of the price decision which you have to make. So yes, there's an element of self interest, but it's all of our self-interests for people in the lower '48, people in the private sector who incidentally over the long haul bringing revenues into a state government provide the services that people need. I don't think you have to make any apologies for that. That is kind of how I would do it if I were representing the State, and that's the essence of what the Governor, the Commissioner of Revenue, Senator Stevens has been saying. I think that they would be a little more persuasive even though they have been good, if they talked a little more

about the private sector, and the concern for that here in Alaska. Most of you have lived or worked in the private sector before you put on your legislative hats. This is so, and I think arguing that and urging that, and saying it's important leaves you nothing to apologize for.

REPRESENTATIVE ELIASON - Dick, somewhere earlier in your presentation, you were tying in the surplusses and the needs of revenue relationship to extraction taxes. Now, I can relate the need for on-going programs to cover the services of the people in a relationship to income taxes and property taxes, but would you elaborate how surplusses or the need of income relates to a one time non-renewable resource and extraction tax?

RICHARD DONALDSON - Right now, I'm working on a committee that is a part of the National Petroleum Council in Washington. It's an interesting committee to work on because it's made up of members of our industry, members of organized labor, environmentalists, consumers, professors from academia, people in government. To try to get all those people around one table and agree on something like a national energy policy is what the committee is supposed to be doing, and we've made some interesting progress, and one of the things that we had been wrestling with at first, and it's responsive to your question,

is how do you treat something that seems finite. In other words shouldn't you take more because it is finite. That's really your question \_\_\_\_\_, and to pull two things out of all those weeks of discussion might be of interest to you and will help. The first is our ability to underestimate our energy reserves of all kinds has always been infinite, and what has happened is we have looked harder, brought better technology, new horizons on-shore, off-shore. We have kept pushing out the finite of what we know exists in energy supplies. I have a 1916 article from a magazine in my files, kind of a collectors piece that absolutely predicted that in 1925 we were going to run out of oil and gas, and no question about it, it had the figures, it had dates, it had a projection. You know, you can read that same article today, and all you've got to do is change the dates, and numbers and a couple names. Now, in a sense, fossil fuels have a finite quality, but I have to tell you that what we know may be very limited, our horizons are in close. The history of our industry is keeping and pushing those horizons out, so part of the answer to your question is let's don't assume today to know everything that's there because the history of our whole industry \_\_\_\_\_.

The second thing that's important to it, there is a dual responsibility of government, if you don't mind putting it that way. On the one hand, you have to raise sufficient revenues from businesses and citizens where you are responsible to pay for the services they need, and you can bank some ahead,

and you are fortunate today if you can do it, but you have another responsibility and it's not to be so over-reaching, if you will, in the running of a government that you put a total chill, or a substantial chill, on the private sector because most people out there are in it for a living, and paying the taxes too, and so what you have is a very tough problem in government, and I don't envy you for a minute, of trying to hit some kind of a balance between government, taxes, and stimulation of the private sector so that it runs on its own, and that's exactly what we've got here. What I was trying to reach here, and probably didn't do it too well was saying you've done a good job in covering your future revenue needs. You're bills are paid for a couple of decades, there's no question about it, and I think there's time here needed to say what about the other side? What about the private sector? Where is the bounds? And, it's suggesting that you think about this policy and how it effects the private sector. I'm saying it kind of meshes in with the two problems that we have here in Alaska today that are the big ones. The FEA pricing decision is one, and this policy balance is the other. My whole testimony, when you boil it down simply says one thing, let's all work on the pricing problem with FEA this year, if you will until that's solved, and meanwhile so we don't prejudice that, let's take this policy question head on and try to answer that. Then you see how the two blend and you can go forward on both simultaneously

without prejudicing either one.

REPRESENTATIVE ELIASON - I guess what you're really saying then is that we're morally right in charging an increased tax upon a non-renewable resource, and extraction tax compared to an ordinary property tax or income tax approach?

RICHARD DONALDSON - All I'm suggesting is, and I don't know what the right numbers are, the laws help somewhat, the economics help sort it out somewhat, but the real point of focus, if you're going to do a good job, is to remember you've got a public sector and a private sector in the State, and overhanging the whole thing right now is this Federal Energy Administration question.

I have come today to be as frank as I can because we're trying to work on both, and I can't do anything less than tell you where we are and what we're worried about.

REPRESENTATIVE ELIASON - Of course, we really don't know what our future incomes are going to be either, and you're saying we have our bills paid for a number of years down the road, but we really don't know that particular point until the FEA makes that determination.

RICHARD DONALDSON - I don't either, and yet every study that I have seen shows very substantial surplusses in your treasury in the mid '80's, and the only question is how big they are, not whether they will be there. So directionally what you're saying is we've got a great piece of life insurance out there ahead of us. Maybe we should take a few months, or most of the year and sort out these other questions so we don't lose anything by taking the time.

SENATOR RADER - Madam Chairman, following along the same line as Representative Eliason, and in fact, I think it's exactly the same point, the Governor in his State of the State message to the legislature, and I think also in his budget message, spoke of a general policy which would involve the argument that the State has in trust these non-renewable resources such as oil, and that all of the revenue, at least 25% which is our permanent fund referendum, but he urges that 100% of the revenue which comes from royalty be saved and set aside and not used for the ongoing purposes of government, and that we impose taxes to handle which you consider to be our normal ongoing needs. You're a lawyer, I'm a lawyer, so lawyers would say we have the trust and he's arguing that the corpus of the trust, the body of the trust to be preserved, and that for the State to carry on its day to day activities, it must have the tax proposals that he has suggested in order to balance his budget. Now, if you adopt the Governor's argument

I suspect that the tax proposals that he's suggested may be correct that you'd have to have those to balance the budget. I don't know that that's the case, but at least he's said that that's the case. Do you, and I think this is exactly the same question as Mr. Eliason is addressing himself to, to what extent do we have an obligation to not invade the the corpus, so to speak? To what extent do you think we should raise taxes if we are going to completely keep the corpus in trust? How do you meet that argument?

RICHARD DONALDSON - Let me give you an example. Let me take myself and the way the finances of my family run. Some of the income on our family comes from my salary, some of it comes from investments, not too many that I have made, dividends, maybe a little appreciation on it, some comes from interest on my savings account, but it comes in at an overall flow, so to speak, in the family treasury. Now, I haven't made any decisions that I can stand with very long for the whole future of the rest of my life, I'm only going to bank my interest in dividends and not spend it if there's some other need. Sometimes, I have to dip into that where there's situations in the family. Sometimes I can put a little of the salary away too, and I stay flexible on that. Now, let's translate that into the State if it is translatable. The State has income strains from several sources. Many sources actually, but we will say basically to the tax and royalty. In a sense it's nice to put some by for problems that you can't foresee

now that the State will have. The idea of having a kind of permanent fund, particularly if it's used as a development type fund for sources and capital that wouldn't otherwise be available. It's a very good thing. Let me digress just a moment as an example. Suppose there had been a big copper strike somewhere up in the center part of the State, and it's a commercial load, and there's no transportation there and there's no town, but industry said, we'd like to come in and develop that, but put stipulations and requirements on. It would be a nice thing to have a fund that would say, well, industry normally puts in the mines, the processing facilities, and if they can get at the tide water they'd have to come up with the ships and take it from there, but maybe a fund that could establish a town and transportation systems and maybe even port facilities, the kind of thing that this permanent fund, just like you have some reserved in your own savings account can take up. On the other hand, if I draw too much out of my business and destroy the business or make it less profitable, I'm hurting my family too, aren't I? So the State has a balancing job at the other side. If it tries to draw too much into the savings account and destroys the general flow of income from oil and gas, maybe it hasn't made the best decision in managing those funds. So in a sense, the state's no different from my family. You've got to check the flow coming in and the flow going out, and be able to

adjust somewhat from time to time if you're going to run it intelligently. In answer to your question specifically, the idea of some kind of a permanent fund is a development resource for the State, not to help us necessarily, but other Alaskan's participating in that. I have no idea personally what the right size is, except that I would want to stay flexible if I were running it for my own family. On the other side, I don't want to prejudice the income. You see, that's the other question. If you set it all aside to the permanent fund, you may be very comfortable about those fat balances, but if there's no future out there, in ten years or fifteen because it's been discouraged, has it been the right decision? This is why I think, John, that we need to take a look at it.

SENATOR RADER - Alright, then that brings us to the next question. Should we, I note that Mr. Tanzer for example, compares our situation with tax loads that have been imposed by other governments, places where the oil industry has been nationalized in some places and so on and so forth. Your comparisons are primarily to other states. You did mention the North Sea situation, I think, a little bit, but in thinking of our own terms in terms of the future of an oil industry in Alaska, to what extent should we consider the international method of taxation or exappropriation or whatever might be the situation?

RICHARD DONALDSON - Well, I guess there are three questions that you have rolled into one. First we have considered Alaska versus other states because all states are subject to the same federal body of tax law that simply simplifies the presentation. There's no intention to mis-lead. Secondly, when you compare other country's situations what you are really doing is comparing the total tax burden in other countries, and sometimes they have only one government, not several levels, and you add up whatever they have, and if you compare that, and compare it with what we have which is the sum of federal, State and local, in doing that kind of comparison, we've done some work on that and Ken Schowlater can get it for the committee if you'd like to have it, what you find is that the total tax burden in the United States of Federal tax law, Alaskan tax law, and local tax law is very comparable to the burdens that you find in these other countries that Dr. Tanzer likes to refer to. The third thing, you can look at any kind of tax mechanism to raise revenue, and the ingenuity on that, you know it's really only limited by the time that somebody has thought of that you can research, but the key question is less the mechanics than the total burden, and if the burden becomes such that you tone down the economic activity that you also want, obviously, it's the burden that's the key to watch, not the mechanics. There's an interesting article as an editorial in the Anchorage paper last night talking about Indonesia. They over-reached, the industry shutdown. They tried to come back, and I guess those negotiations have fallen

off again. There isn't anything magic in saying well this is what they're doing someplace else in the world. What you really have to look at is the economics of the situation, and does it stimulate the activity you want? I don't know what's right or wrong, but I know the economics is worth it where it's all sorted out. You might say we'd have one tax in Alaska, not fifteen or three or four, and one tax generates the revenue and provides the economic activity, fine. What is the problem though in most state activity is that there is the need in other states, a terrible need for revenue. They don't have enough to run schools and things. You're fortunate here, so they keep looking for different kinds of taxes, and playing the game because it's a different tax, maybe nobody will mind, but here when you're doing planning of an economic nature for the state's longrun, I think it's incumbent upon you to look at the whole scene, all the taxes and the burden, and do the kind of comparative stuff that we try to do for you. If you do your own, you won't come out with any different numbers, though maybe you'll accept it.

SENATOR RADER - Just one more question if I might, Madam Chairman. One of the goals of the Governor's package was to capture some of the impact and activity from the Outer-continental Shelf development, the franchise tax is, I think, what he called it. Address yourself to that problem. I suppose you wouldn't care if you had a franchise tax that didn't change the total burden, and also include the Outer-continental Shelf.

As again, you're saying it's not the mechanics, it's the burden that you're worried about.

RICHARD DONALDSON - It's kind of a hard question to answer. You get into kind of a speculative area that you're just not sure where you are. Let me try this Senator. When you go into an area for resource development, as a company what you're looking at is the potential there for development, the costs and investments you have to throw at it, and you look at tax burdens and whatever it's called charges, franchise tax, or whatever, you do look at that. You also look at how many winners and losers you might expect in drilling holes here and there. You make some judgment, probably imperfect because there's much you still don't know whether it's worth the risk against other places. In this area of OCS development of what burdens should be assumed for impact for example on the coastal lands you tend to support this. You get some very tough questions, at least three that come to mind that you ought to sort out. Whatever it is, I suspect any industry that goes in there, they expect to pay a share of that impact cost. Maybe a little more than a fair share, that also seems to be the pattern, but they also have the option of not to go, and how that gets traded out many times is a matter of negotiation. I think there is a problem however of asking somebody to come in. You say, we want you to pay on day 1 what we will guess the total impact cost to be over the whole

life of your project. In the first place, that's not discounted for the time in the future when the impact will occur. There's no \_\_\_\_\_ economically in that advance payment. The second point is, suppose you're calculation of the advance is wrong. You don't find anything. You don't have any large development. You have a large string of dry holes. You've put a premium or a penalty if you will going in that would discourage a lot of people, and I think the answer, and this is only personal, not our company view, what you need is a system to say you've got a fair business cost, just like you pay your fuel bill or hire a guy to run a cat for this type of impact. I'd say it would be difficult for a company to say well, that's not right, that's fair, that is a business cost. But then you come to the second phase that says what's fair, and you say well, we had so many people coming in, we need so much land, we will pay these taxes, and then you have other service industries come in to support that. They too have a share of that impact cost, so you need a system that kind of allocates that over the whole thing. We've got a lot to learn in this area, and I suspect all of us will spend a good deal of time, but again you run the risk of making a mistake of trying to do something well and guessing wrong, and deterring other things that you really want to happen. I hope that's helpful.

SENATOR COLLETTA - On page 2, you were excited about the Governor's policy objectives on any new tax, Dick, and you enumerated the

five points that he made. Would it be fair to ask in the proposals that are before us, how many of these points do they fall short of?

RICHARD DONALDSON - You don't have any easier questions, you'd rather I'd answer do you? Alright lets take a flier at it. I think it's a fair question. Item one, sufficient revenues to compensate the State for additional service costs pending such development. Let me pause right here, I'll come to the dividend part in just a moment. If any of the forecasts of future revenues from lets say Prudhoe Bay or the pipeline are valid, over the next three years we will be paying from 75% to 120% of the State's total budget. It seems to me that that first standard is well covered just by one project. I'm not saying that you don't want more, but at least in terms of covering your costs, we're probably more on payment, and I'm not saying that to be argumentative. In terms of dividends, I don't know what the Governor had in mind, what he's saying is we'd like to bank a little bit for the future. What you do say is if you have that surplus, maybe it's eight and a half million dollars in the mid 80's I don't know. There's at least a suggestion that the dividend is being paid. Maybe it's not enough, but this is one of the areas that you would have to discuss. I can't say it's short, but there's at least a good down payment on it and maybe some area for discussion. That's really the hardest part of the answer. Point two - I'm not sure that any consideration has been given to the

profits to investors to keep them \_\_\_\_\_, and back later on in the paper where I was quoting the stuff from Morgan Stanley and the cost of business here, there is at least a first offering on the subject, not enough consideration has been given to that. Perhaps we ought to have some discussion and we are all interested in having that go forward. Point three - We must be reasonably responsive to the National and world economic trends of the time. Things that come to mind when you read that is the cost of energy on a BTU basis that is going up all over the world, and the need to generate supplies of energy of all kinds, particularly domestically here in the United States to try to meet more of those here at home so that we're not at the mercy of the foreign cartel. I think Alaska at least at the moment is responsive to this because it is just about to contribute to the United States energy supply, the oil flow from Prudhoe Bay, and nobody can say that that's small. On the other hand, as far as future participation, there hasn't really been much movement in the State in the last three years to significantly encourage future contributions, and you know the lead time is long. We hope for a Beaufort Sea lease, we hope for a Gulf of Alaska, and I think that needs to be dusted off and you would probably comply with that, if compliance is the question, by moving ahead on those things. The FEA question, you see, your participation in that, I think is being responsive to National need because if you get a higher price and stimulate this development, you see, you've got a part of that and

that's another place that I've tried to encourage you to do it. Nondiscrimination on the basis of ownership - well here I guess our industry feels like that wonderful line from Fiddler on the Roof. Remember when Tevia the father was standing out on the road, he looked up at the heavens and said "Lord, it's nice to be the chosen people, but do you have to do this every time"? I'm sorry about that, sometimes a joke is better than \_\_\_\_\_.

I must reduce uncertainty and encourage stable expectations about future resource tax and management policies. One of the problems, here and many places in the country, not just here has been the instability of governments relations with industry in energy, and as this testimony started and finished, it was really almost begging you again, say let's sit down and look at this policy to find some stability. We've done pretty well on some of these, Senator Colletta. Others I think, needs more work.

GEORGE SILIDES - Mr. Donaldson, I've been invited to ask you a couple of questions as counsel to the committee, and I notice, and I almost hesitate to ask you this question, but I do think that there is a table missing which would have made a rather fine report, or perhaps even better, but I notice that in the report in your comparison between taxes paid among the states, that is the percentages, your comparisons, of course, are in

actual dollars paid, and I don't see a table which includes the factor of doing business. Now, you indicated, of course, you made a very excellent point about how much more it costs your company to do business in Alaska. The corollary, of course is that it costs the State of Alaska to do business here also including the municipalities and everyone else. Have you a table which takes that into consideration? If I might give an example of what I'm speaking of, we'll use the State of Louisiana because it makes the numbers come out even, if for example, it costs 50% more to do business in the State of Alaska than it did in a third of Louisiana, then it could be argued that our taxes are not 99% of Louisiana's but only 66% of Louisiana's. Have you made that type of table in comparison?

RICHARD DONALDSON - This is the area that I have said that we hadn't completed, and what we're trying to do is to get comparative data, which is very hard to get, that would compare cost of findings and producing and transporting oil to different regions of the country. You remember about a year ago, we gave you a couple of maps and showed you some things. We've been trying to develop this comparative cost data in public figures. You can get pieces of it, but we haven't been able to get something that you could put all together. The pieces that we have, and this is sort of a preliminary report, if you will accept it that way, tend to show that there is a premium, a higher cost for doing business in the Arctic and off-shore

than in other states, and when you are looking at a company making your business decisions, what you do is tend to add two basic factors. You say, okay, there is a potential here that we would like to explore that we would guess going in would have two billion barrels of oil, just to take a number off the ceiling, and we know that the cost of that if we carry it through would be X and X is probably twice what it is in some other place. We also know what the tax burden would be. Let's say that's Y, now we add up X and Y versus the return. We say now that's a good risk investment, or no, we just don't want to touch it, even if the oil is there. The cost is not there, so we approach it from this standpoint, why this comparative data, we think would be helpful if we could get together. I'm not sure we can yet, we've worked on it for about six months, so we have some of the pieces but not all. You could say alright, let's consider how Alaska stands up with an oil well in west Texas or some off-shore work in California or something off the East Coast. Let's just see how we compare as a risk potential, risk reward type from other places in the country, and what I think this will show is that Alaska has a high development potential, but that it has to have better potential in resources than other places in the country because the costs are higher, and what that comes down to is this, you begin to see the margin of profitability shrink as you go farther off-shore or further into the arctic today. What that means to me for purposes

of bills that you have here, is that everytime you push that thing closer together by additional taxes.

We were told a few weeks ago that, how does it feel to work for an industry that has no risk, and I said how did you derive that? The man said, well, if you look at the earnings they are very stable. I couldn't wait to get back to Cleveland and talk to Charlie Plumb who is our Vice-President for Accounting who has worked very hard to spread out these peaks and valleys of income and whatever so that you have some of these finance reportings that are consistent. Charlie, I said, you did a swell job on accounting, but you've made me real proud \_\_\_\_\_, and this is one of the little \_\_\_\_\_ that I just couldn't get over. On the pipeline itself, you find the oil and you know the market is there, and you think you have the technology to connect to, so in a sense you say a lot of the risk is taken away, and in a sense that's so because that's what project financing is all about, but when you get into the building and the design, the financing, the calculations of how to engineer something like this, it's sort of like going past the first grade and thinking you know how to add and subtract and suddenly you realize that out there is something called analytical geometry and calculus, and there's a whole string more of things you don't know. What we've had to do is to work through all of that the first time out in a project like this in the Arctic where there's no precedence for it in the whole world. Now, we've had a lot of experience building pipelines, and we've brought that to the table, but there's

a lot that we didn't know, and what is really happening, if you will recall is that through delay, the inflation involved in it, stipulations laid on by government for things that will be done in this line, increasing labor costs which you can anticipate \_\_\_\_\_ the actual cost of this pipeline, the things that are almost beyond our control has gone up 400% during the time of this project. Fortunately the cost of the oil in the world market has gone up 400% approximately too. What has happened in this is that probably more of my grace than anything else, the increase in price for oil has covered the increase in cost of the project. This is proved out, and I think we reported this to you in testimony a year ago that are going in anticipated return on a DCF basis in 1970 was about a 14 to 16% range. In 1974, we ran it again. A whole lot of things have changed and all these prices have gone up, but they are still all in about a 14 to 16% range. When we calculated for you a year ago, it was still in that range, not by anything more than chance frankly, so while we've had to invest four more dollars for each one we anticipated, the return in the market will be about four, but the profitability dollar per dollar hasn't changed, and you know who's been the real recipient for this windfall in products? Happily, it's the State of Alaska because you don't have any investment money in it. Your tax rates are still there on the books and you get a same percentage from a larger income plus. I think it's great that you do. I don't begrudge it, it's just a factor.

GEORGE SILIDES - Madam Chairman, if I might just one more time. Dick, that's a very complex subject, and I know that everytime we talk about it, we can go on for hours and I'll let it go for now, but there's something coming up that we're going to have to face in taxation, here, now, we've all heard a lot about the surplus of Alaskan crude on the west coast, and what to do with it whether it should go to Japan, or go to the gulf coast, and so on. Now, we anticipate of course when the pipeline was first built that we probably \_\_\_\_\_ to Cherry Point, or Long Beach and let it go at that. Now you're anticipating building a pipeline to the east coast from California. Are we going to have to share in that pipeline construction cost?

RICHARD DONALDSON - To some extent yes, but probably not as much as you're worried about. The reason is this. There will be a lot of new exploration and development in oil in Alaska and on the west coast. As we get some stability, I hope in national energy possibly. People with refineries begin to build new refineries to replace old ones or perhaps expand existing ones that will handle \_\_\_\_\_ in sour crude of the Alaskan type, so you may see more oil finding a home on the west coast than you could now guess today, but they will also find more offshore on the west coast, and maybe on shore, and the crying need for all of this is on the eastern part of the country. Now the reason I say worry a little bit less is that the country needs west and east

transportation. Pipeline transportation has historically been the best one to move oil in bulk at the lowest cost, and the project we have, we think tends to follow that precedent, but it doesn't mean that the only oil going through that pipeline will be Alaskan oil. There may be some. There may be some offshore California oil. There may be \_\_\_\_\_ oil, a lot of different oil, but you should recognize that the existence of that pipeline is a real plus to the State of Alaska and to us because it provides an escape valve to a market. Oil can move on to the next most economic spot, and this means it's worth more, maybe not quite as much as it would on the west coast, but a lot more than if it didn't have those facilities, and one thing that sometimes I think we tend to forget is the driving economics on us is to sell the oil at the best price that we can, and if you chose to take royalty on some of it, that's fine, but if you say that's a lot of risk, we have to do it for you under the leases, and our driving force is to get the same best price and you've got kind of a double piece of insurance here.

REPRESENTATIVE ELIASON - Even with the unknown costs, double costs, what was the return anticipated originally then on the investment?

RICHARD DONALDSON - I'm pulling these numbers out of my memory. In the files of your committee from last year, you will find testimony that I gave, and I think it was on March 29,

1976. In that testimony are the actual numbers. I'm just suggesting that's in your file. The rate of return really held almost constant through that six year period even though all this change was going on. That just happened, it wasn't planned. The original cost in the field and pipeline was much much less than it is now, and what you had going in was on those costs and on the value of oil in the world at that time. Now, you're talking about three and four dollar oil not thirteen dollar oil. A rate of return for each dollar invested was on a 14-16 base. What happened was that both sides of the equation kept going up, and the three times we studied it '70, or '72, '74, and '76 there was a little change in the numbers, but it was still within that range. Now that was a range of 14-16%. You have to understand we have a driving force to go ahead with that project because we can foresee a shortage of oil in the United States in the near term, and SOHIO was an oil deficient \_\_\_\_\_, so what we were looking at was the return at the low end of what would be a normally acceptable range, but we were willing to do it because it was the source of supply and you can't run this business without supply. Less than that, you're getting down into the utility area, and what you have is a guaranteed market and a guaranteed source, it's sort of like you've got the coal pile there burned, and you don't have all this uncertainty that you have in oil exploration. When we look ahead to the kind of thing that David Goodman

addresses, what kind of return do you really look at as a company? If you're going ahead, and you look at the risk elements, some are more or less in different places. You may see a range that bottoms out at about 15% and you may have something as high as 25% or maybe even a little more to be an acceptable risk in this area of our business.

Now, when you put up a gasoline station, you know marketing and all the things that Ken has in his experience, the risk factor is there, but not nearly as much, so you might say you'd accept something in the 15% range, but going into the new frontier area or offshore, you at least like to have the expectancy of going in or something toward the upper end of that range, so \_\_\_\_\_ is just what Mr. Goodman's testimony is characterized to be, it's a utility rate of return, and he does distinguish it there.

REPRESENTATIVE ELIASON - I guess what bothers me is that when you analyze the project, your stay is relatively the same, but when he testified, if they had known there's was going to be so low, they might not have been able to finance to start with.

RICHARD DONALDSON - What he's saying is that \_\_\_\_\_ was right. \_\_\_\_\_ was wrong. If we had said it was 10 or 12% going in, you probably wouldn't have done it. Our number said it was 14 - 16% and that's enough of a difference to say okay, we'll take the risk and go. Does that answer it?

REPRESENTATIVE ELIASON - Not really?

RICHARD DONALDSON -- I guess I don't understand. At the back of our testimony, Attachment E on Page 5, at the bottom of the page, you have the paragraph that begins Mortata states. This is from Mr. Goodman's testimony, and what he is saying is Mortata states that 12% is equitable. Mr. Goodman goes on to say, no it isn't, they couldn't have financed it on that basis, and what I've added to that which then caused the confusion was our estimate going in was higher than Mortata and we decided to go ahead. So I think if you look at this section here, it probably would answer the question.

SENATOR RADER - What kind of objective evidence, what would be the thing that would show up where the state is at or above a reasonable taxation rate considering the cost, the risk and also the expectations of perhaps a bonanza \_\_\_\_\_ occasionally. I can see how if we get too high the activity just doesn't occur. There is no oil industry here. If we're too low, there's going to be a lot of oil industry here. How would you objectively measure, for instance, you know if you were running a department store, why, you could say our sales have dropped off, but if you were at General Motors or somewhere else there would be some objectives tests that we could use here as to whether or not we're approaching a reasonable tax level when you consider profitability, risk, the possibility

of a bonanza, the stability even of the government with which you're dealing which is the State government, which I'm sure has to be cranked into part of your concern here. What kind of evidence would you have - no more exploration, no more interest in drilling, no more lease bidding, or what?

RICHARD DONALDSON - It's easy to see, if everything stopped. You could say, well, that's too much. It's a little harder to sort it out when it's something other than that.

SENATOR RADER - Or even if everything stops, I guess it might mean there wasn't enough oil here to make it worthwhile for anybody to.....

RICHARD DONALDSON - Okay, I think the first thing you have to recognize is that most all of the studies have indicated that a high probability of the new resources are in Alaska. Some of the numbers that I have looked at have said that maybe in the \$13 or \$14 price for world oil, if Alaskan oil was allowed to compete with that, you would expect over the next thirty years that perhaps as much as 33% of all the oil found in the United States could be found in the north of Alaska or south of Alaska offshore. It's a tremendous potential, so I think you first have to start with the assumption that most people believe that it's here. It's other places too, but there's a lot here, so that's not quite

the equasion. The second thing is that you don't have either a go or no go. We've had to adopt the Tanzer proposal last year. Some people testified before your committee that we shut the State down. You might have had that case. What is more likely is how do you sense the business activity. There are a couple ready barometers. One is called Caparik, and the other is called Lisbern and that's marginal economics today. Obviously if you raise tax, it keeps it off the \_\_\_\_\_ list in some people's judgment. On the other hand, if world oil prices moved up a dollar or so, and Alaskan oil is allowed to be in the market place in that level, and delivered, then these two fields or strata may well come in and develop a pipeline. There's another thing that you can measure it, drilling activity is one, on the other hand if you're not leasing any lands, that tempers it, but let's assume there's reasonable lease land available. I think dealing with various \_\_\_\_\_ corporations, and the willingness of companies to enter into exploration arrangements there is another barometer, and what you look at is many things. You get a sort of feel from the pulse, but the key thing is, given the cost of doing business and giving the cost of the tax burden, the economics in total is so diminished as to reduce the attractiveness of it, and the only way I know you can solve it is to have some discussions with people about some cases, and there is some proprietary data, but you can begin to get a feel. I have a feeling you're close to or possibly over the line, but that's my own personal feeling.

SENATOR RADER - Let's take the Caparik and the Lisbern formations. As I understand some of them are underlying the \_\_\_\_\_ formation. So in other words, you actually have leases right now on those sands. Do you have any production wells on them at all? How much exploration have you done on them?

RICHARD DONALDSON - Some.

SENATOR RADER - I would assume that the reason you don't have any production is because at the present posture of pricing and tariff and market, that it's not worthwhile.

RICHARD DONALDSON - and texture and quality of oil, it's not economic or marginally economical.

SENATOR RADER - You can sight then, I suppose to this committee then as a concrete fact that at least a sand of that marginal quality is not readily producible under the present circumstances.

RICHARD DONALDSON - Probably so, it's something we keep looking at because there's a lot of oil there.

SENATOR RADER - Because again, we don't know what the federal government is going to do here in three months or six months, nor do you know what the State government's going to do.

RICHARD DONALDSON - But we have told them that they take some of these actions out of their pricing decisions that take all essentially lower the value of Alaskan oil delivered may have wiped out Caparik and Lisbern. In the same sense, I have tried to point out to you that tax passed here in the State have exactly the same economic effect directly.

SENATOR RADER - Are you continuing to explore these other sands or not?

RICHARD DONALDSON - The exploration thing is not my area, Senator. I suspect we can give you some information on that, but I'm really not qualified to speak on that particular point. Yes, we are doing some exploration up there, but the details, I'm just not familiar with.

SENATOR RADER - You sighted the willingness of the corporations to go into joint ventures with the native corporations or to explore for a percentage. As I understand it, some of those contracts provide for a 50% return to the native corporation of the net profitability as well as an over-ride of a normal \_\_\_\_\_ . Am I in error on that or not?

RICHARD DONALDSON - I'm not familiar with all of the terms of the leases. Some of the companies that are engaged in that could respond to you. All of those however are the product of negotiation. What we have in these other cases

are leases that were entered into some years ago, and all this stuff has come on and now going in on new negotiations. Maybe one corporation can negotiate a better contract than another. You'd have to look at the individual transaction, the prospects in the area, and really ask someone whose involved in that to give you comment if they would.

SENATOR RADER - Can you think of any other objective evidence of when we were hitting the top or near the top or below it?

RICHARD DONALDSON - I can't at this point. I'm just getting loggy, but it's a fair question, and maybe one we ought to give some attention to and see if we can do it. The kind of thing that you get into in your own studies if you're trying to devise a longer term policy that you say okay that's the rule of the game, I understand and I will either go or not on these judgments that you have to make.

SENATOR RADER - I appreciate the fact that no matter what we did on a tax policy probably Prudhoe Bay would be produced mainly because even if you're losing money, you would have to minimize your losses. If you've got ten billion dollars up there, and you were only going to end up with the final return of 9 billion, you'd still have to do it because you only lose 1 billion that way instead of by damming the whole works of ten. So it isn't a question then really of the producability of Prudhoe Bay, that's going to happen no matter

what we do.

RICHARD DONALDSON - But, how that's treated is a big signal to the rest of us of what else do you want to do? I don't mean that in a threatening way, you just listen very carefully.

SENATOR RADER - I make that statement only because people say well you know they're not going to pull out, and I can say of course they're not going to pull out, but neither are they going to pull in.

RICHARD DONALDSON - Tom Williams, in his testimony addressed this to some extent, and if he's scheduled to testify here, you may want to ask him that question. I'm not trying to load it on Tom, but he's given some attention to this, and I think it would be of help to you.

SENATOR HUBER - Dick, considering Alaska taxes, you say we may already have gone over the motor line, and the fact that the State is going to have a surplus revenue according to your figures which I may not agree with, when do you plan on applying for an Alaska State subsidy to help you out?

RICHARD DONALDSON - No comment.

SENATOR HUBER - There are a few other points that I would like to touch on, although Senator Rader touched on most of

the points. In fact most of them that I had intended to, Madam Chairman. Speaking of the taxes that are now proposed, if we can get back to that for a minute, considering that your good presentation that you've made on the stands that Alaska takes in every way with FEA. Picture the proposals before us, would in your opinion try to take more than 9.4% net income tax that's been on the books since before you started doing business here. Would you care to single them out for us? I didn't know that there was any that had intended to do that?

RICHARD DONALDSON - Well, it's always 9.4% applied as to what?

SENATOR HUBER - To net profitability.

RICHARD DONALDSON - All of the income tax proposals by their structure have the duplicate tax effect with the result that all the taxes that our company would pay in income tax to all states in which we do business, would probably mean that we were paying tax on 133% of our income of course in another way about a third of our income becomes the extraction factor on the other approaches are taxed twice. What we had in these numbers here is proof in numbers though it's a hypothetical case. We get into our own company numbers if necessary and prove numerically that there's a double tax. Now, interestingly enough in the law, the Supreme Court said is that the principal is that there shouldn't be any duplicate tax or not a lot, so

if you can prove it, then you've got a pretty good case, and all I was trying to suggest to you rather than argue these was that the principal is against duplicative tax and the numbers that we have drawn on our hypothetical case on the statutes that you have proposed tend to confirm that it is clearly different. That is all that I want to call to your attention. I suggest that if there is some repair work to be done in the income tax statutes, that you may not want to increase the burden, but prepare the tax within the burden and avoid the duplicative effect. This type of tax reform it seems to me might be appropriate for the State at this point in its history so that it does go forward on kind of a stable basis that people can understand and make your judgments on as businesses.

SENATOR HUBER - I'd like to continue Madam Chairman. Does SOHIO, Dick, object to paying 9.4% on a true net income the same as they would have to if they were strictly an Alaska corporation?

RICHARD DONALDSON - Yes, you asked where these are. I fortunately had this open to where the subject is. In Attachment C, if you will look at Tables IA, IB, and IC. I'm sorry, I have the wrong table. Senator, I can't lay my hands on it right this minute.

SENATOR HUBER - Rather than hold it up, I'd consider if you'd let us know that later. As I understand your testimony, probably at least 9.4% or more can probably be taken by most of these tax proposals that we're talking about.

RICHARD DONALDSON - The numbers that I was trying to find for you went like this. As a single taxpayer, as a company, paying taxes to all the states in which we do business, we were paying an effective income tax rate on all of our income, in all states at about 6%. Now that would include in this example the Alaskan tax of 9.4%, the California tax at 9%. Texas has none, but the average tax burden and income tax under present law now and under the \_\_\_\_\_ tax compact is about 6%. The only thing we change when we ran our second case and our third case on the Administration franchise tax proposal and the legislative proposals for income tax, all the legislative proposal income tax came out about the same. Was it the 6% in the case of the Administration's proposal jumped to someplace between 11 and 12%, and in the case of the legislative proposal jumped to someplace in the nature of 14 to 15%.

SENATOR HUBER - That doesn't apply of course to the net proceeds tax. That's engineered not to do that, is that correct?

RICHARD DONALDSON - I think it didn't make too much difference in the total burden. Now Ken has found it here. This is in

Table A, B, and C which are attached to Attachment B, and table A, in effect gives you this three company comparison under present law. At the bottom of the page you will see two lines of percentage figures, and the second line up from the bottom which reads effective composite State income tax rate on total taxable earnings shows you that 5 - 6% burden under present law. On the next page under Table B, the same line which is the Administration's tax proposal, shows the change of having their income tax replaced. You see it jumps to about 11.8%. On the next page where you look at the legislative factors, it jumps to 15 or 15.3%. On the next page where you look at the legislative package, it jumps to 15 or 15.3%. Those are the figures which tend to confirm in numbers the duplicative tax effect, but what we're really looking at here is the total burden, Senator.

SENATOR HUBER - Madam Chairman, Mr. Donaldson, when you started your Prudhoe Bay operation and you went into the pipeline operation, hasn't it in all your financing and everything been figured that you had a 9.4% net income tax liability in Alaska on your profits?

RICHARD DONALDSON - On some cases we ran, we did do that, yes.

SENATOR HUBER - Didn't this allow you for the last two years to borrow over 1 million dollars a month, SOHIO alone based

upon that as part of the package?

RICHARD DONALDSON - Yes, but you have to realize other things have changed in the equation. Your severance taxes have changed, ad-valorem taxes have changed, income taxes have changed, and the reserve tax, and what you have to do on the continuing basis is look at all of the pieces not just one tax and say that your whole case was based on that assumption, \_\_\_\_\_ what was based on all of it.

SENATOR HUBER - Now, you're not planning on us continuing our reserves tax are you?

RICHARD DONALDSON - No. In fact there is a bill before your committee that I think came down in the Administration's package or was proposed by it. I did not comment on it although I should. Let me take just a moment and I will do that. This is the proposal that would reduce the millage on the reserve tax this fiscal year from 20 mills to 12, and what that does is reflects the Administration's judgment as I understand it, that 12 mills is needed to cover any deficit this year, not 20, and the philosophy of it is that you should borrow no more of your future than you need. I would support that bill partly because it means we'd pay less in reserves tax, but also because I think it follows the philosophy of the reserves tax covering your needs in this interim period

until the pipeline starts, and I would hope that of all the bills that you've got on your table, you might push that one out of your committee and through the legislature, and it does make good sense. If there are no further questions, I thank you for your patience.

SENATOR HUBER - I've got one last one, Madam Chairman. Dick, considering both the physical and the political conditions, where in the world is it more profitable to explore for oil now than in Alaska?

RICHARD DONALDSON - The North Sea.

SENATOR HUBER - I'm sure the Britishers would like to hear that.

RICHARD DONALDSON - They're doing it. There's a lot of play there. In fact, about a year ago, I was privileged to fly over to one of those developments and tour some of them, they're exciting. I flew over a place called Cruzen Bay where the British are building \_\_\_\_\_ field and the pipeline comes to shore. The pilot banked around and said that's where the pipeline comes ashore. I said I can't see it, he said that was the point.

SENATOR HUBER - Madam Chairman, it's interesting to note that last year's total tax package as it was adjusted, this was the terrible one that had the excess value tax added to it.

When it was finally adjusted, and it provided as much money as we're talking about on the Administration proposal this year, it's noted that it was adjusted down to do no more than the British government does in the North Sea area.

RICHARD DONALDSON - The return on investment there is about 22%. Ken Schowalter reminds me that about 40% of the North Sea areas prospects have been leased and are being developed, and the question is why? Obviously the incentives are there. That's another major \_\_\_\_\_ that's kind of an interesting thing.

SENATOR HUBER - I wonder if it has anything to do, Madam Chairman, with the British Petroleum Oil Company being partly British crown financed and the terrible crunch that they have on the petroleum industry.

RICHARD DONALDSON - I can't answer that question. There are many companies developing the North Sea, some separately, and some in conjunction with each other. BP is active in it, but it is only one of several. As far as its relationships with the government here, it's an arm's length, and I have talked to some of the men who have been in those negotiations, and it's been very difficult and has taken a lot of patience, and they have worked out something that probably has led to this development. We haven't been able to quite accomplish that here, and that's what I'm hoping to work on in the next year. Thank you.

QUESTIONS AND ANSWERS IN TESTIMONY  
OF COMMISSIONER GALLAGHER, DEPARTMENT  
OF REVENUE FOR THE JOINT SENATE-HOUSE  
RESOURCES COMMITTEE MEETING ON OIL AND  
GAS TAXATION (24 MARCH 1977)

Senator Radar - Madame Chairman, Commissioner, your testimony on the pricing problems, state's position, governor's position, that we do need a maximum well-head or a maximum price to encourage further exploration and development. Aren't your bills which are calculated to persist for barrel and so and so forth as you say to protect the state against federal pricing manipulation or corporate manipulation, let's say take the federal pricing manipulation. Aren't you saying then that under one set of circumstances if the pricing goes bad which means that the companies have no incentive to develop further that we are going to add further burden to that disincentive by a cents per barrel floor so to speak so as to protect the state's revenues?

Commissioner Gallagher - If the federal government is so foolish as to lower the well-head value down to \$4.30, I don't think the state should be any part, have any part of that policy.

Senator Radar - Well but then our policy makes it even more burdensome from the point of view of the further exploration or development of petroleum in the state because we revert to a cents per barrel floor so that the, the very policy that you are adopting here to protect our budget, and I understand why you are doing it, it is because you want to protect our budget, but it, if the course is completely inconsistent with

any state policy which would be to encourage for the petroleum development. If that happened.

Commissioner Gallagher - I don't agree with that Senator. One of the things that we've done to encourage petroleum development and one of the things we talked about in our testimony was about the marginal fields. Prudhoe Bay will be produced at \$4.30.

Senator Radar - Well it would be produced at \$2.00 maybe because it would minimize their losses, but if your talking about the excuse me, go ahead.

Commissioner Gallagher - But Kuparik and Lisburne will not be produced unless they receive substantial return because its an incremental decision. One of the things that we tried to address in our tax policy where these marginal fields they are one and two billion barrel marginal fields. The tax rate under our tax proposals, we would actually lower the taxes on those fields, in fact encourage further production in the state.

Senator Radar - Do you disagree with the a analysis that was presented by a, Mr. Ronaldson SOHIO here as to where are our tax, our total tax burden relates as against Louisiana, California, and Texas?

Commissioner Gallagher - Yes I do, in looking at some of those numbers, I and we haven't run all the numbers ourselves but it seems to me that they've mixed a few apples and oranges and got fruit salad and I can see alot of the numbers they say they are in constant dollars but the only way I can get to some of those

numbers is using current dollar basis.

Senator Radar - Well you agree though that such an analysis is rather important to us don't you?

Commissioner Gallagher - I would, I would, I agree that that analysis is important. We attempted to do that in this tax study but due to only getting two man years into the study, we didn't have time and it takes substantial amount of time to do that sort of study.

Senator Radar - But if that is an important decision, then the fact that we haven't completed that study, if you do take the issue with the a SOHIO approach and perhaps you are correct, I am not saying that you are not but, but you agree that that is important information in this decision making process. A and we disagree with it but we don't have one of our own. Wouldn't that argue that fact alone would argue in waiting until we have that information before we made that decision, wouldn't it?

Commissioner Gallagher - We could provide you with that information so next year, I think it is a real danger to sit around and wait while, let the federal government do things to us.

Senator Radar - Alright then, let me ask you this then. For purposes of balancing our budget this year, we could do that with your ad valorem tax, could we not?

Commissioner Gallagher - I believe, well lets put it this way.

Senator Radar - Go ahead, I was going to say we balanced it the last several years that way, and we could do it this year too, couldn't we?

Commissioner Gallagher - You mean the reserves tax?

Senator Radar - Reserves tax yes.

Commissioner Gallagher - I assume we could, I don't favor extending the reserves tax off into the future though. To me it's a bad policy, it's a poor tax and I would like to see it die a natural death.

Senator Radar - But from the point of view of balancing your budget this year you could do it that way, as we have in the last couple of years.

Commissioner Gallagher - Well you could also by raising the cents per barrel to a free market value and also do the same thing.

Senator Radar - Yes, but here's our problem. Neither the state nor the industry knows what incentives or disincentives may occur because of the federal pricing, and yet you are suggesting that we make tax decisions in which we all agree that that federal pricing is very very important if we are at all concerned about the future attractiveness of Alaska as an investment for petroleum industry.

Commissioner Gallagher - Well, one of the things that we have tried to address in our testimony has been directed in all these

hearings toward getting the maximum production out of Alaska. Our tax policy is also directed in that and it addresses these marginal fields.

Senator Radar - Well but, but if the federal government were so foolish as to pursue this policy that you said that we should not have participated in then your floors make it even more difficult as far as the petroleum industry is concerned or as far as the producing marginal wells in Alaska is concerned, isn't it?

Commissioner Gallagher - Well, if they were that foolish, I don't see why we should be a part of that foolish action.

Senator Radar - It seems to me like we are adding on to it and not detracting from their fool hardiness, if they are foolish.

Commissioner Gallagher - If you know, if they did do this there wouldn't be an incentive to developing another Prudhoe Bay, so you know.

Senator Radar - Well but we are adding to whatever, we are adding to the difficulties in the production of whatever fuel might be found by adopting the floors that you are talking about here. Are we not?

Commissioner Gallagher - Not necessarily you may find one down in the Cook Inlet with the free market value should be substantially

above that.

Senator Radar - No.

Commissioner Gallagher - Also the economic limit factor comes into play on these large fields.

Senator Radar - Let me ask you if we're talking about an industry who doesn't know the value that they are going to get from their product and isn't going to know until next year, then how do we develop a stable tax policy at this time, that is dependent upon that? It seems to me as though, and I don't have any answer except that you can balance your budget with the other method. And I also recognize the difficulties of the credits in the future, on that. But at least when we come back here a year from now, when we start talking about the profitability or the non-profitability or the incentives or disincentives, won't we be talking about something that we can relate to the real world at that time, that we can't relate to the real world now?

Commissioner Gallagher - I think our policies to the real world, that's what we are trying to address in fact, if the real world says you should price the energy supply at the alternative market, the alternative market may be \$20.00 a barrel, the alternate energy supplies. The OPEC countries are actually being very nice to the United States and not taken up the alternate energy supply cost. If you want to go to the real world we should maybe put our policies up at \$20.00 a barrel.

Senator Radar - But we can't do that as a state.

Commissioner Gallagher - You could set a cents per barrel that was based on \$20.00 which is the alternate energy cost. That's the real world.

Senator Radar - Well but that option isn't available to us, to tax at that rate, is it?

Commissioner Gallagher - Under a cents per barrel floor, of course, it is. Also, Senator, the FEA may open the pricing decision every ninety days after 1/1/78 or there after. I really doubt that they are going to make a decision on April 15th. I think you will not see a decision until somewhere around June 1. I really expect them to wait and see what the tariffs are, the initial tariffs are before they make some sort of decision.

Senator Radar - That's all. Thank you Madame Chairman.

Senator Colletta - Commissioner do you have one of these in front of you?

Commissioner Gallagher - Yes, I do.

Senator Colletta - O.K., On page 2 and you know just for the purposes of conversation and let's assume that you develop your tax package with the governors' standards, as to what they should include, now I think my question could be simply answered in two steps. First if you do agree that the industry says that they have between fourteen

and 16% worth of return on this project.

Commissioner Gallagher - I don't agree with that, but other than that.

Senator Colletta - O.K. with the assumption then the new tax proposals increase the tax by what percent?

Commissioner Gallagher - About 18% over all five bills.

Senator Colletta - What will their profitability be now that's different between that 14 and 16 percent?

Commissioner Gallagher - I reject number one the 14 to 16 percent that has the risk, under the Mortaida Study they multiplied all the assets by 4 to get the risk factor that may be appropriate to do an exploration work but it may not be important in doing other sort of work, you know the development work. If you want to use the Tanziers 33% or 35%, I don't think that is going to make 1 or 2 percent difference.

Senator Colletta - Commissioner I think I am going to try it another way. But anyway, the governor said it must generate sufficient revenues not only to compensate the state for additional service costs, attending such development but also to provide a reasonable additional dividend to Alaska. Now I would suspect you have computed that dividend in there. Can you tell me what the dividend is?

Commissioner Gallagher - The dividend to Alaskans? Well let me take you through the Prudhoe Bay numbers and maybe, you know I can work it right off the top of my head. We can talk about the dividends to various people. If you had a million two barrels a day there is four hundred and thirty eight million barrels of oil produced each year, three hundred and sixty five times one two, have you got your slide rule with me, times four hundred and thirty eight million times seven dollars and fifty cents per barrel is right on about three billion two. Is that correct, somewhere in there, less one eighth which is our royalty share. So that brings it down to four hundred million, three point two gets down to two billion eight, and let's subtract off the operating costs for the field, about three hundred and fifty million, four hundred million, let's say four hundred million we'll up it fifty million over the estimates, and that makes it down to two four. And let's say the State of Alaska through it's severance taxes takes another four hundred million, that brings it down to two billion and lets say our income taxes in effect takes us down a hundred and eighty, another hundred and eighty million, that leaves a billion eight left to share between the federal government and the oil industry. And so you have, before tax, you have a billion eight on a three billion dollar investment. Lets say they have three billion dollars investment. That's a nice return for oil industry too. One point eight billion dollars pre-tax on three billion dollars is a nice rate of return. Now they might claim that they pay forty eight percent taxes, I, you can look at SOHIO'S last report that was shown in their annual report and they showed they had effective tax rate of under ten percent. One of the things that they

happen to have is about three billion dollars of carry forwards of investment credits that will cancel off, pretty well wipe out at least fifty percent of their tax liability for the next five years. And they all have substantial investment credits so they should have developed substantial investment credits to be carried forward for the next several years, so whatever the effective federal tax rate is, you know, let's say they do pay three hundred million dollars income tax they still get in a billion and a half return on a three billion dollar investment, that's a fifty percent return per year. That's, I would take that, any day.

Senator Colletta - O.K. now, you know, we lost the Chinese and now your gettin to me, I'm understanding the last part of what you said and that's the part that a you know, I still want to come back to, a all of these companies collectively it seems and most of these reports we read, range within a two to teen percent, at least all I've seen, with the exception of one that happened last year, that say that this thing will return to those investors somewhere between this fourteen and sixteen and are you working under the assumption that they have thirty-five to fifty?

Commissioner Gallagher - Well I just, I don't want to go in and talk Chinese because there's a large difference between a, between income you report to your shareholders and discounted in cash flow, because one of the cash flows is, you know discounted

at some high rate of return to lower the number and it isn't fair. But I just demonstrated for accounting purposes it would show a fifty percent at least a fifty percent return. Now a discount in cash flow would be substantially below that because those values are, are reduced through time, for the investment. The major difference between Mortuada's investment and the investment Tanzier, like I pointed out was that one uses a risk multiplier factor that multiplies the assets by four times instead of three billion dollars investment they had, they used a regular return on twelve billion dollars investment and that's how you got a sixteen percent rate on a twelve billion dollar investment and you know, my numbers there kind of match out.

Senator Colletta - O.K. Commissioner I've got one other area that I need clarified and that's item five the governor's policy statement that it must reduce uncertainty and encourage stable expectations about future resource tax and management policies. If in fact these taxes did pass, would these be the last ones, would we be creating a stable future resource?

(GAP)

Commissioner Gallagher - a premarket price. Let's say Cook Inlet was priced at a premarket price. This tax would hit McArthur River at a higher rate than it would Prudhoe Bay because it's actually more profitable. Now the East Trading Bay Unit which is decidedly less profitable, it would tend to treat that fairly. What's coming into a play here is the cents per barrel floor. Yes, our written tax rate on East Trading Bay Unit is probably one third of what the cents per barrel floor should be. Now, that oil if we wanted to go after Cook Inlet it should be maybe priced at fifteen dollars

which is the price for Swede a 348 gravity on the west coast, we are only going to 7 1/2 because of Prudhoe Bay, so we are not being inconsistent, we are giving them a break.

Senator Colletta - Thank you Madame Chairman.

Senator Huber - Well, Senator Radar brought it up, I think that it's only fair to ask a ask of Sterling because we do need to get down to the nitty gritty of it. Sterling do you think that the Walter Leavy Associates have the best possible advice for the State of Alaska's interests, or do you think other economic consultants may have something to offer too?

Commissioner Gallagher - I've always appreciated the, I, of Dr. Mead, but you know there are consultants and there are consultants. They give you a good point of view Mead gives you a good point of view. I think there could be a whole series of people in that could give you worth while information.

Senator Huber - In other words you don't think we should base it all on one consultant.

Commissioner Gallagher - That's correct. I think you, you know, we have economists in the Department of Revenue, we should listen to those economists too.

Senator Huber - Obvious on the Walter Leavy Companys advice which we have been receiving quite heavily lately about removing the cents per barrel, do you disagree strongly on that?

Commissioner Gallagher - Absolutely.

Senator Huber - And do you, do the other consultants that you have hired agree with you on this?

Commissioner Gallagher - Of course they are hired by me.

Senator Huber - No some of them weren't hired by you. How about the other ones? How about the other ones on the cents per barrel?

Commissioner Gallagher - I don't know what Mead says. You know, he isn't here before you. I wish Tom Fink was here today, Madame Chairman.

George Silides - Commissioner a, I have a couple of easy ones and then a couple of little more difficult ones, I'll give you the hard ones first if I may. You've touched on them, but I will have to ask them again because I wasn't entirely sure on them and it's a matter of mechanics on the bills. It's been pointed out that the foreign income taxes constitute a large part of the pre-tax book income for international oil companies, and that these taxes are likely to decline sharply in the future as providing the producing governments take over and the companies become contractors and purchasers of crude from governments rather than from concessionaires, and income tax payers. Now, the questions on that is, as you recall this was mentioned a couple of days ago, you touched on it again tonight. Now wouldn't this work to erode Alaska's tax base under the proposed legislation

that is your franchise tax? And wouldn't it work to erode the tax base more if companies would measure foreign operations, let me say that again, and wouldn't it work to erode to tax base more for companies with major foreign operations than for those with only small scale foreign operations?

Commissioner Gallagher - Well Let me say, talk a minute about where the shifting centers are in the world. It's true that I think, I believe, Saudia Arabia gives the companies nine cents for every barrel they raise after they pay for expenses. I think that's what Saudia Arabia gives. And those wells are fifteen thousand or twenty thousand barrel well days with nine cents goes up in a hurry. But alot of profit centers are shifted to other areas of the business. If you will look at the transportation business for integrated companies you might find the profit center is shifted there. Federal government has, may have a oil head put on price ceilings on the well head. They also have it on some refined products but not the whole barrel. Infact the lower end of the barrel is pretty well decontrolled and they receive whatever price they want. You know, all sorts of ends of the business you can transfer your profits to.

George Silides - I'll just take it for what you said Commissioner. Well let me ask you someting - -

Commissioner Gallagher - Infact you know, it's quite obvious to me that the federal government is trying to encourage the shifting of profit centers away from production into refining and sales.

George Silides - But don't think that the fact that the companies are taking their payment as in-kind as it were, does it make any difference in the, to your bill?

Mr. Messenger - I believe I remember the comment that Mr. Kilgore made earlier this week and to the extent that the difference between some of the difference between book income and federal tax would book income before taxes and federal taxable income to the extent that some of that difference represents a foreign taxes. If those foreign taxes reproduce that would reduce that difference between book income and federal taxable income I believe that there would still be a substantial difference between, still, between federal taxable income and it would be still, in our interest to adopt book income because there is still a lot of other erosions from book income in the Internal Revenue Code Book.

George Silides - Well, I understand what you are saying Mr. Messenger but your answer is basically yes, that it does erode some if that happens.

Mr. Messenger - Yes, but it is still better in the federal tax reform.

George Silides - I see, Madame Chairman if I may ask the second question then, another question. Do you have any idea how much income your proposed legislation would apportion to Alaska as against what might be measured by separate accounting as proposed in the Senate Bill 105 for example, once Prudhoe Bay is in operation

that is if we, if incometax law really and truly represented the 9.4 percent tape.

Commissioner Gallagher - I think it should be essentially the same. We pick up some additional features though like the days in port like 50% of the income from the transportation subsidiaries assigned to Alaska and things like that. So I'm it's hard to compare it. Also ours would pick up the OCS.

George Silides - I see. Well in that regard Madame Chairman that brings up another question then. I notice that you mentioned the days in port and of course you were talking about, and you were mentioning also that brings to mind your ad valorem tax or your hardware tax. If you put a tax on the tankers aren't you increasing the cost of transportation, and if you are increasing the cost of transportation doesn't that lower the well-head price?

Commissioner Gallagher - Yea but, you only give up twenty cents on a dollar.

George Silides - What you are telling me is that the differential is what counts? Since we are on the hardware tax, there are some refineries a couple of refineries in at North Kenai and there is one going on up now, being built now in the North Pole, hardly can be termed world scale refineries, especially the one at the North Pole. If you tax these refineries who will be paying that tax in the long run? If we are trying to encourage a refinery say in the North Pole area to, so that the people in the interior can get the same price for oil, fuel oil as they do in Anchorage, aren't you giving with one hand and taking away with another?

Commissioner Gallagher - That's possible. Also they may be export refineries too.

George Silides - The North Pole an export refinery?

Commissioner Gallagher - Not the North Pole ones, obviously not.

George Silides - But the SOCAL one?

Commissioner Gallagher - I know some piloteers for it.

George Silides - The SOCAL one?

Commissioner Gallagher - Yea.

George Silides - Are they export?

George Silides - I'm just curious. And another question on hardware then, I'm presuming that the same answer you gave on the tankers (inaudible) tankers goes for the increase tax on the pipeline.

Commissioner Gallagher - The increase tax, there is no increase tax on the pipeline.

George Silides - Well, under your system there would be a greater take because --

Commissioner Gallagher - No we're just trying to cure our court case.

George Silides.- I see.

Commissioner Gallagher - We already think we have it.

George Silides - One final technical thing again Madame Chairman. Are you aware Commissioner that in addition to the Walter J. Leavy Associates finding a flaw in only part of your severance tax bill, did you know that the Research Division of Legislative Affairs Agency has also found essentially the same flaw?

Commissioner Gallagher - I don't, that is not a flaw. That is the cents per barrel for coming in and playing a part there. It works exactly like it is intended. Those fields that are, where the formula works out to be 50 percent of what the phenomenal rate should be, is in fact 50 percent.

George Silides - Well Commissioner, I'm just calling it to your attention so that you maybe can talk to Mr. Erickson because he feels like the Walter J. Leavy Associates does that the bill is not fulfilling the function that you designed it for and I'm only bringing it to your attention. I'm not in the position, I don't know enough about it to argue about it.

TESTIMONY OF MR. RICHARD KILGORE  
OF WALTER J. LEVY CONSULTANTS CORP.  
FOR THE JOINT SENATE AND HOUSE  
RESOURCES COMMITTEE MEETING ON  
OIL AND GAS TAXATION - MARCH 21, 1977

CHAIRMAN POLAND - We will bring the meeting of the Senate and House Resources Committee meetings to order. We have with us as our first witness this morning, our consultant from the firm of Walter J. Levy, Mr. Richard Kilgore. We have asked Mr. Kilgore to address us this morning on the net income tax bills and those closely associated thereto. We will break at 10:00 AM, and will resume again this afternoon at 1:30 PM.

For those who are sitting behind me, if you'll raise your hand so that Mr. Farleigh can notify me if you have a question, you will be recognized, and with that I'd like to welcome Mr. Kilgore back to Alaska and let him take over.

RICHARD KILGORE - Thank you Senator Poland. I think it is appropriate since I am the leadoff witness, that I present here this morning what I call an overview of tax legislation.

CHAIRMAN POLAND - Mr. Kilgore, for the record, would you identify yourself.

RICHARD KILGORE - Yes. I'm Richard Kilgore. I'm Director of Research for W. J. Levy, Consultants. I've been with the firm for about fourteen years.

What I'm going to attempt to do here this morning is to provide what we would call an overview. I'm not really going to go into very much detail about the individual pieces of legislation, at least the specific provisions of them, and concentrate more on the approaches, the alternatives, and so on. Most of my remarks will have to do with income taxation, but I also have some remarks on severance taxation if we have enough time; and I'd like to say a little bit in the end about a total tax package - total tax regime in Alaska because the whole thing is obviously more than a sum of these parts if it has to do with the impact of the total program.

I'd like to look at the major areas of taxation and really consider the alternatives presented to you because they are quite diverse, and give you our appreciation, really, of the major pros and cons this time of the major pieces of legislation, of the major approaches and the kinds of pros and cons, advantages and disadvantages which we think you legislators should be looking at and asking questions of witnesses as you go along. We will be available as I say, for specifics later.

As many of you may recall, our firm has been urging upon the legislature, for many years, that it review its corporate income tax, and especially to do this before Prudhoe Bay Production really comes on and you have major questions of taxation there. We have pointed out in the past, and I think it's fairly well known now the problems of apportionment under the present regulation, and I don't really think we have to get into that in detail. We ourselves did our own analysis of how the present system might work for Prudhoe Bay. Taking data submitted by SOHIO, in submission 1 at the request of the legislature, and very roughly what it turned up was that if one applies the present system, that is the three factor apportionment system with sales and property, and payroll, what you turn up in the way of income apportion to Alaska is roughly one quarter of what the producing income and the pipeline income would be. Saying that another way - if the present system were applied to Prudhoe, using as I say, data supplied by SOHIO, what you would get is an effective rate of taxation instead of something like 9.4% - an effective rate of taxation, roughly a quarter of that, two to two and a half percent, so there are obviously problems with the present system, and as I say, I won't burden you with too much of that as I think by this time it's fairly well known by everyone.

Now, you at the present time have before you three different bills, basically two different approaches, but three different bills designed basically to deal with this problem of the inappropriateness of the present formula. The first is the bill submitted by the Governor, and this comes out of the work of Professors Zeifman and Ainsworth, and a report done by the Department of Revenue. This is SB 236, and HB 322. We basically feel that this is quite an imaginative and new approach, and involves basically two features: A change in the tax base, and a modification of the apportionment formula. I'll come back to that. Second, we have a bill on separate accounting introduced by the subcommittee on leasing and taxation, and third we have the net proceeds bill introduced again this year which reads to similar, and I guess even identical, to the net proceeds tax of last year. So we have three bills basically, I'm going to say, on two approaches, and let's look at some of the pros and cons of these. I should say at the outset that like many things in the field of taxation, no one approaches his ideal here, there's no magic answer to this that's going to come out, and one approach is not just going to stand out that is uniquely better than any other one. It's just not the case. So there's clearly room for debate, and for your careful look at these approaches. So first let's look at this Governor's bill coming out of the Zeifman and Ainsworth work.

Basically, as you see, there are two features to this legislation. One is a change in the tax base, and the second is a change, as I say, in the apportionment factors themselves. The present system as you probably know, uses federal taxable income. That's its base, and takes a portion of that federal taxable income. This new proposal involves a switch to book net income before income taxes as reported by oil companies to their stockholders. Now, there are certain clearcut advantages or pros for the State in this switch in tax base from taxable income to book net profits. First of all, figures are readily available from annual reports. This concept of income is reported by most companies or at least most of the major companies that will be operating as oil producers in Alaska. Second, as you will hear, I'm sure, from Professor Zeifman and from the Revenue Department, there are fewer so called erosions than in federal taxable income, that is under federal taxable income rules there are various kinds of generous accounting rules allowed to companies which works to reduce the amount of income on which they pay taxes, and you're fairly familiar with this too, I'm sure. Such things as intangible drilling expenses are under federal tax law, can be treated as expense items, not as capital items, and this involves large write-offs. The federal government allows accelerated depreciation and so on, and companies in their book accounting

rarely, if ever, expense intangibles or use accelerated. They use normal kinds of depreciation under normal accounting rules. So very clearly switching in this direction results in a higher tax base than federal taxable income, and this obviously throws up more income to the State of Alaska. But switching from taxable income to debt book income does have problems. It is not without problems. I'll just enumerate a few of these. Later we can talk about these in more detail. Even within acceptable accounting principals there's a certain flexibility, obviously, to companies in respect to how they report income, the kind of deduction and so on. Inventory gains and losses are often treated differently by companies, and they have some choice in this. Currency changes, how they are affected by currency changes, gains and losses, they are often treated differently by companies. Incidentally, some of these factors which resulted in different kinds of accounting don't always even show up in company annual reports. If they're not material, they may not even be stated within a company annual report. One would probably have to go beyond that, if one wanted to see the effect of these factors. There is also a certain amount of flexibility in accounting for write-offs. When does one realize a loss, if one has some sort of venture that is going bad, at what point do you write the thing off as a total loss? There is a certain amount of flexibility in this. Companies at times will use what is sometimes

called the "blood bath" approach to accounting. When things really go wrong, and you have a lot of losses, there is a tendency to just write it all off in one year, and take all the bad at one time. Of course, the company doing this, it would effect the tax base that Alaska would be looking to in this approach. But, I don't think any of these while they present problems in switching to book income are probably disabling. Revisions could also be a problem. Companies at times change accounting procedures, and will then revise their book income and various parts of this back through time, and this would cause problems also if one does this, if there's a later revision, do you then change your tax base, and so on. So this presents problems. I think perhaps, a more serious problem in going to pre-tax book income has to do with how one arrives at that. Now, normally pre-tax income, if you went to a company annual report, what you would do was take net income after taxes and add back all income tax payments, and that's apparently what is proposed here in this piece of legislation. That would include all income taxes including income taxes paid to foreign governments. This looks to us like it could really present problems, and it raises questions about what sort of a tax base you are really reaching when you look at pre-tax book net income. If you'll take the annual report of a company like EXXON which is going to be an operator in Prudhoe Bay, is going to be a producer there, also a company that has very large foreign operations and pays very large

foreign income taxes, it is very interesting to see what has happened in the past to those foreign income taxes, and then I would like to talk about what may happen in the future to foreign income taxes and how this might effect the tax base that you'd be using if you should go to net book income under your appropriate income tax.

If you look at the annual report of EXXON or any other oil company operating in the foreign field, what you will find is that over the past few years, and particularly the years '73 and '74, there was a very sharp buildup in foreign income tax payments. That is tax payments to foreign producing governments such as the Saudi-Arabs in Iran, and so on, and the result of this huge increase in foreign income tax payments this had build up, as you all know, had to do with the increase in OPEC prices. OPEC dictated very substantially higher prices. These higher prices were obviously not intended to benefit the companies, but to benefit the producing governments themselves, and so what the producing governments did was take a large part of this income generated by the very much higher prices and tax it away from the oil companies in the term of income taxes. Some of it they called royalty, some of it they called income tax, but there was a very large income tax component to this, and this resulted in very large increases in foreign income tax payments

by oil companies. And, if Alaska had been on this system which involves using book income, what would have happened over these years is that Alaska would have benefited from a huge increase in pre-tax income from a company such as EXXON, and this would have resulted in large part, not after tax profits EXXON earned, but because of its income tax payments to foreign government. So Alaska, over this period, would have benefited from a very short run up in pre-tax income because of income tax payments by oil companies to foreign governments. It would have worked to the benefit of Alaska, had Alaska been on this system. But now, if we look ahead, we find the concession terms are changing in the middle east and elsewhere, and almost all foreign areas. Foreign governments have increasingly taken control of producing operations themselves. When the companies remain, they remain as producers and operators, but they serve in increasingly different roles. They serve as contractors, not as concessionaires, and under this new type of system, payments to the producing governments tend not to be in the form of income tax, they tend to be in terms of purchase of oil, purchase at market prices with the companies being compensated in terms of service fees for their continuing operations in these countries. So what is beginning to happen is these huge payments to foreign producing governments are increasingly not called income tax payments, they are called purchases,

purchases of oil from the Saudi Arabian State Oil Company for example, and already if you look at the annual report of a company like EXXON, you will see that we have a decline already in 1975, and I guess when the 1976 annual report of EXXON is out, you will find another decline in foreign income tax payments, so what had happened in foreign oil markets would have worked to the benefit of Alaska over the past few years, but now would be working in the other direction. That is EXXON may have a relatively constant after tax profit on its foreign producing operations in countries such as Saudi Arabia, but its pre-tax will be going down. Why? Because it won't be making income tax payments to the Saudi's or other foreign governments. It will be purchasing oil and this would effect the pre-tax profit. So you could have a declining base from this kind of thing.

Now, I dwelled at some length on this because it's interesting. What it demonstrates is that when you use this approach, you do have some problems, and you have things happening outside Alaska which effects the tax base that you are going to reach an apportion part of, but it's very much affected by the things that have nothing to do with profitability in Alaska. And this, I think, the foreign income tax things, are a good illustration, and they are an important one,

and that's why I spent some time with this. So under this kind of system you would have things effecting net book income that really have very little to do with Alaska, and this is something of a problem, and one doesn't know for the future how these various kinds of changes would effect it, and what I'm talking in foreign income taxes probably will work to the disadvantage of Alaska. Other things that we may know nothing about could work the other way. So moving to book income as a concept had truly some advantages. You'll have obviously a higher income that you are trying to take a part of, but it's not without problems. We can discuss those more at some later point. The second part of this approach has to do with a change in the apportionment formula. What has been suggested here in the legislation is changing from sales to extraction, and there are some very clear advantages to Alaska in this obviously. The extraction isn't oriented measured and is production measured in Alaska, and is obviously more appropriate than a measure such as sales where a large part of sales of crude oil in Alaska are not made within Alaska, but they are made without Alaska. So this kind of a move will clearly apportion more income to Alaska, and is certainly a step in the direction of higher appropriate income tax receipts for the State of Alaska. Now here again, although this step obviously works in the direction of favoring Alaska and higher income tax payments to the State,

there are technical problems as well that you should be aware of, and especially in foreign areas. Net production of companies is not always so easy to define, and net production as set out in the annual reports of the oil companies may not quite match Alaska's definition. The legislation before you does define net income in certain specified ways. The production figures that you get from the companies may not always match, and there may be problems of meeting your definitions, especially in foreign areas such as Indonesia, for example, where companies work under contracts. The concept of net production is not the same as the simple system where one has the simple royalty that one takes off, and it may be difficult to define what really is net production. What is production of a company? What is purchased oil? So that moving in this direction has some benefits for the State, but it obviously is not without problems.

In general, we feel that this approach, this one and rather novel new approach for the State has certain advantages. I sum these up by saying it will clearly increase Alaskan tax revenues. It works better in a sense, and why it does is quite obvious. Book income is higher than taxable income. Extraction is a better measure than sales, so you throw up more income to Alaska. If you throw up more income it

obviously means you are moving closer, hopefully, to getting something like 9.4% of what will be the producing income in Alaska. And although the administration end of it is not quite so simple as it looks, initially, and for some of the reasons that I've set out here, it obviously has some administrative advantages over other approaches. It is somewhat simpler, and this is certainly an advantage in this approach. Now the real basic disadvantage that we feel to this whole approach is that while it would get higher income apportioned in Alaska, one doesn't really know out of this system, how close one would get to true profitability. That is, how much income in Alaska and how close that is to what seems to be extensive profitability in Alaska. This is very difficult to know, very difficult to know how close it is. In total and company by company, it's difficult to know how the thing will actually work.

We ourselves tried a very simple approach to try to see how close it would come, and what we did, and anyone can do this, if one takes the annual reports to say, the three major companies that will be producing on Prudhoe Bay, ARCO, EXXON, and SOHIO, takes the latest data available for them, and that's the 1975 annual reports of these companies, (the 1976 one is not out), and then simply adds to that data for Prudhoe Bay, profitability, production, and so forth for Prudhoe Bay, and rather than make our own estimates

for that, again we turn to the data submitted by SOHIO, in SOHIO submission 1, so what we attempted to do was simply combine the data for Prudhoe Bay/Alyeska as contained in SOHIO submission 1, with the company's latest annual report data, and then attempted to see how this new approach would work that is using as our tax base pre-tax book income and then using a property factor, payroll factor and an extraction factor, and this is a very rough approximation obviously, but what happens when one does that, you find out that this apportionment formula does not apportion all the income that is assumed for Prudhoe Bay and Alyeska. It does not apportion it all, and more interesting than that, what you get is if you look at the three companies, just to see how three companies of this type would fare under this system, you get quite different results for the different companies. That is, some companies, at least one of the companies, you would get a fairly high porportion of the income earned in Alaska by this approach. From another company, you would get quite low percentage of it, so that one could, at least this little illustration suggests, that one could have companies with exactly similar operations in Alaska such as for example ARCO and EXXON, and get very different tax liabilities for the two companies, and we think this looks to be a potential disadvantage. You say this is only an illustration and one doesn't know what would be thrown out of this approach, but it does suggest

that what you may be getting in the way of apportion income and income tax payments may be off the mark of what profitability really is. So, we receive that as kind of the key draw back to this. You go in the right direction, but you don't know where you really are. Some people could be underpaying income taxes, other people could be overpaying, and how it would balance out to the State as a whole, it's difficult to say.

We would make this suggestion. If the legislature decides that this new approach in the bill submitted by the Governor is the approach it wants, and it might well because of ease of administration or whatever reasons that one chose this, we would suggest that perhaps the legislature might want to consider at the same time that it did this, that it ask or require of the Department of Revenue that it provide every year, estimates of profitability on oil and gas production within Alaska, perhaps with input from company, I don't know, but estimates by Revenue, the best estimates they can make and how much is made on oil production, pipelining or whatever in Alaska, so that the legislature can take this information, set it against the income tax receipts it's actually getting, and try to get some measure of how this thing is really working, that is how well is it achieving its goal of identifying income in Alaska.

Perhaps such reports could even have data by company not identified or something of this sort so that one could also, so that the legislature could evaluate over time how well it was working company by company. So that if you take this approach, we suggest that you might want to consider also getting some sort of information estimates out of the Department so that you would be in a position to evaluate in subsequent years how well it seems to be working.

Moving from this approach to a second and quite different approach to income taxation, take a look at direct accounting. Now, in principal of course, direct accounting is getting around some of these problems of apportionment. It's going directly at a measure of how much income there is from oil and gas operations in Alaska, so that in principal at least, if it can be done in a reasonable way, it does not suffer from the defects of this other approach. It is trying to measure directly what you really want to tax, in total in company by company, and we've always felt if it was legally possible to do this, and it were administratively possible to do this, this would seem to be the logical approach to taxation. Now, the problem as will be pointed out by many other people who will be testifying in here is that there are

problems of administration. There clearly are, and they are real. There are various problems of how one allocates expenses to Alaska, how does one look at and evaluate inter-affiliate sales, and things of this sort, corporate overhead and how much is allocated to Alaska, and so on. So that there are very real administrative problems to this approach, even though it is a more straight forward approach. It requires, on the part of tax administrator's rules, regulations, rather extensive ones, and obviously involves audit capabilities. One has to audit. There is a lot more auditing under this approach, and so on. And a lot, I think, has been said in the reports by the Department of Revenue and by Professors Zeifman and Ainsworth about these administrative problems. What we would urge the legislature to do though is really to try to weigh these very carefully. This is the major drawback, the administrative problems in this more direct more logical approach, weigh very carefully just what are the magnitude of these problems? How difficult are they to handle? How many people will be involved? How much money would have to be spent and so forth. How difficult is it really? And what seems to me the attempt you have to get some judgement as is to weigh whether the difficulties in administering this thing are really worth the effort. It is a difficult thing, really, to assess, and I think that in assessing these kinds of things, one can't necessarily

look for parallels elsewhere or general problems of separate accounting or direct accounting in other states. I don't think you can put too much weight simply on the fact that companies sometimes favor separate accounting. I think when you're looking at the difficulties here, you've really got to look at the circumstances of the oil producing operations in Alaska and try to get some handle on this by looking at that, not by looking at parallels elsewhere. Try to assess \_\_\_\_\_ ask questions on how to assess, how difficult it would be for the oil producing industry in Alaska. That's what we're talking about.

I won't really spend much time on the net proceeds. It was an attempt last year, really, an indirect attempt at direct accounting by a separate oil and gas production tax. It based, although differing in some respects from separate accounting and from the separate accounting bill, it's basically the same approach as direct accounting. So I think if one is going the route of attempting directly to estimate or tax income in Alaska, one would worry about the differences between the net proceeds and the separate accounting tax, but more important, I think, are the two basic approaches to income taxation in Alaska, and what you're going to have to do is weigh very carefully the pros, cons, advantages and disadvantages of these two basic approaches to a problem inherent in the present corporate income tax

regime in Alaska as it applies to oil and gas production.

Chairman Poland, I had planned at this time to go on with some comments on severance tax. I don't know whether you would want to break for questions on corporate income taxation or go on.

CHAIRMAN POLAND - Do any members of the committee have any questions that they would like to ask Mr. Kilgore at this time?

SENATOR HUBER - Madam Chairman, I thought that Dick might want to make some comments on the data base which you gather by a net proceeds tax approach that you may not find available in the other ones. That's been a major consideration by Levy Company and Associates, helping to develop that particular item.

RICHARD KILGORE - Okay, this is one of the obvious. Looking at this and direct accounting, this is one of the aspects to it. And the net proceeds things, you are doing it on kind of a property by property basis. You are not aggregating everything as you might under certain separate accounting approaches, and having access to that kind of information

would be of use to the State, because it does give the State some feel for profitability of individual properties, ranges of profitabilities, what are cost value relationships in various fields, and so on. And that is of value obviously in designing or further modifying the tax regime in Alaska.

CHAIRMAN POLAND - Any questions? Very well, Mr. Kilgore. We will go on to the severance tax at this time then.

RICHARD KILGORE - I believe our firm is on record as saying that this really is an appropriate time to review your severance tax. We have major new production coming on in Prudhoe Bay, and this production which is obviously quite different in character from that you have now in Cook Inlet. The second reason is that our office has been concerned for some time about the way the present tax works for Cook Inlet production receiving old oil prices. We've been concerned about this, and we think that the legislature should appropriately review this at this time. And I'll come back to that.

Now you have two bills - two severance taxation bills before you, but before I turn to the bills themselves, I would like to review with you certain principals we feel you should keep in mind in reviewing severance

tax legislation. First of all, we've said this before, but I will say it again, severance tax is something that one, a tax which the State cannot really expect to continue to raise endlessly without running into serious problems because of the nature of the tax itself. The tax is a tax on gross value or it's affixed per barrel tax of some sort for unit tax. It does not directly take into account the cost of production, nor net profitability of production. Cost relationships between prices or values and cost can vary considerably amongst producing fields and areas, and where costs are very high, severance taxes, being gross taxes can seriously impinge on profitability and at the extreme they can even result in shutting down production. So, there really are limits on how far the State should think in terms of pushing up severance taxes because of the nature of the tax. We have always felt that as a rule of thought that Alaska severance tax should probably not go above the highest rate in other major producing states, and the highest rate in other producing states per comparable kinds of production, and I think this is probably still a reasonable rule, to keep a severance tax within bounds. Second, given the potential problems with a gross tax such as a severance tax, we have always urged some protection for lower productivity or higher cost wells. This kind of advice goes back to our first written report for the legislature back in January of 1970

where we urged a step schedule which the State later adopted, and your current law does have a step schedule, and does provide some protection for lower productivity wells. So that the two principals basically are not pushing severance tax, try to provide some protection for lower productivity, higher cost wells. Now, you have two bills before you at this time that in principal seems to follow these guidelines. One submitted by the Governor, and the other by the subcommittee on leasing and taxes. While each raises overall severance taxes, neither bill goes above an effective rate higher than Louisiana's 12 1/2 percent on oil. Basically, they are in line with our first guideline, and both of the bills attempt to deal with the problem of higher cost wells, but we feel with different degrees of effectiveness.

The tax subcommittee's bill is basically an extension of the current law. It adds higher well productivity brackets than you presently have, and for the higher well productivity brackets, puts in higher rates of taxation, and at the same time, that bill lowers the rate at the lower end of the brackets. That is lower productivity wells would pay lower taxes under this subcommittee's bill, and this is in line with our second principal.

Now the Governor's bill developed out of the recommendations of the Department of Revenue, introduces a new and rather novel approach. An economic limit factor which attempts to deal with the economic impact of severance tax on high cost wells, and what it does instead of having a step schedule, in a sense it has a continuous schedule, so that the nearer a well is to very low levels or to its economic limit, the less tax it pays. The further it is from that limit the higher it pays. And in principal, this is a very sound thing. But we have reservations about how this particular bill would work in practice. And it appears to us, that despite the intent of the bill, it could work in the direction, and probably would work in the direction of considerably higher taxes, for example, on various Cook Inlet wells in the low well productivity ranges. So despite its adherence to what we feel is a good principal, the way the bill was drafted, and the way it appears to work on our own calculation, it does not seem to achieve its aim. And I think this is something we can take up in more detail when we come to that, and we certainly would illustrate how this appears to work to us. So despite a good principal, it would appear to not meet that principal, and I would feel that is a problem with that particular bill. Despite a good attempt, it doesn't seem to work.

Now, the other thing of concern to us is that both of these severance tax bills which we have before us retain an escalating sense - \_\_\_\_\_ feature in them. That is, if the value of wellhead value is lower than a certain amount of cents per barrel, it's the cents per barrel tax which has effect, whichever is higher a percentage of value or a certain amount of cents per barrel. Now, this tends to work in a direction of putting a very high effective severance tax rate on Cook Inlet wells that are getting the old oil price. That is that price which is being held at low levels by the federal government. They pay a cents per barrel tax because that is higher than the percentage of value, and that cents per barrel tax works out to a very high percentage of the value of production, so this present tax and both of the taxes being proposed as alternatives have this feature. High effective rates of taxation on Cook Inlet wells have old oil prices. Not only that, but since they have escalation features in them, the present legislation and the two bills being proposed have escalating features, this gets worse over time. That is the cents per barrel tax goes up, and this feature of high effective rates of taxation for these wells continues. Incidentally, if you make your calculations, you will find out that the Cook Inlet wells producing and getting old oil prices and low productivity wells will pay a higher effective rate of taxation than will Prudhoe Bay wells, than very productive Prudhoe Bay wells under cents per barrel. And this feature would

get worse with escalation. We think the legislature should seriously consider, if not eliminating this feature, that is if not eliminating the cents per barrel, and you may not because this would result in some loss of tax revenues for the State. If you don't feel you can do that, you might want to consider at least putting a halt to further escalation in the cents per barrel tax, that this feature of the taxation, I don't think is really what was intended in the beginning just doesn't continue to get worse over time.

Now, I would like to conclude by saying a little bit about the total tax package in Alaska because I think you will be hearing a lot about this from many people, and while you obviously are going to be evaluating the merits of different approaches to corporate income taxes, the different approaches to severance taxes, you will also have to be concerned with the impact of the total package of oil and gas taxation in Alaska. Severance tax, corporate income tax, property taxes, and so on, the whole range.

Industry witnesses, I'm sure, are going to talk at some length about this, and it is obviously of special importance: The total tax package and how it affects the oil and gas industry is important along with sensible approaches to each part. You obviously do not want to

destroy the oil and gas industry in your state. Here it seems to us, there ought to be two basic considerations when you're looking at the sum of all taxes in the state. Obviously you don't want the sum of all taxes in the State on oil and gas to be really an extreme burden on profitability or the prospects for profitability on successful ventures here. You don't want to do violence to the economics of ongoing oil and gas producing operations. But this is a difficult thing to measure. What may be a larger tax burden in Alaska, while in one state versus another, really can't be considered simply in the absolute. That is how much cents per barrel in total is being paid, and what really matters, obviously, is how the total sum of all the taxes paid by the industry relate to their profitability. What may be greater total taxes in one state, in a more profitable environment may be less of a burden than lower seller taxes in other states. So it has to be considered against the background of what appears to be profitability, and the second principal, another obvious one, I guess, is that you obviously don't want a total tax system which put together really discourages ongoing exploration in your State and the development of your resources.

Now those are two very, very broad principals, and there really are no easy answers as to exactly how the sum total of the package of taxes in the State can be set against

these two, which we think are very important criteria. It is a difficult assessment really to make, and reasonable men can obviously differ in their assessments as to the effect of a total tax package.

In our role as consultants to the legislature, we will do our best to assist and advise you in what is, we think, a difficult task of assessing oil and gas tax legislation.

CHAIRMAN POLAND - Thank you Mr. Kilgore. I don't really think that we have time for questions right now. We will be going into session right away. The Senate has a very light calendar this morning, and what I had hoped to do was for us to come back at 11:00 AM and continue with any questions that we might have or discussions with Mr. Kilgore. This afternoon we will hear from Professor Zeifman and Professor Ainsworth at 1:30 PM. Senator Huber.

SENATOR HUBER - Yes. I'd like to ask that Mr. Kilgore look into a couple items before he comes back. I think most of us here have heard Dick or Milton at least 10 or 15 times criticize the cents per barrel floor that we have in our severance tax, and of course, what I'm looking for is something to replace it, so that we can listen to this, we know that \_\_\_\_\_ cause in certain cases some unfairness,

but we need something to replace it in case the percentage of wellhead value is eroded by either federal action or other economic factors to where we have the old "bugaboo" negative wellhead value or something that is approaching that, so we would need something to replace that as a floor if we're going to work on that particular area. I wanted, maybe, Dick to look into that and give us some recommendations in that area because it must appear to him like we completely ignore him when he talks on that subject.

RICHARD KILGORE - We have given some thought to this. What we are talking about is a floor which protects you in case the general price level goes down, but also one which does not impose this particular problem on old oil production in Cook Inlet. We have given some thought to this.

(Chairman Poland adjourned the meeting at 9:55 AM)

\*\*\*\*\*

TESTIMONY OF MR. RICHARD KILGORE  
OF WALTER J. LEVY CONSULTANTS CORP.  
FOR THE JOINT SENATE AND HOUSE  
RESOURCES COMMITTEE MEETING ON  
OIL AND GAS TAXATION - MARCH 22, 1977 (AM)

RICHARD KILGORE - I appreciate the opportunity of coming back so fast, and what I'd like to do is fire my remarks, really, to the corporate income tax issue and amplify on the very brief remarks I made yesterday morning, and also comment on what appeared to be some differences with other testimony yesterday. What I propose to do is review again in more detail, really, the pros and cons of the two basic approaches to income tax which are before you. I want to make it clear at the outset, though, that it is not our role here to advocate one approach or another. Basically, we see our role as giving you an appreciation of how we see the pros and cons, and advantages and disadvantages of these two approaches, what they seek to accomplish, how well they seem to accomplish the goals that they are intended for, and leaving it to you to make the final judgment. So I don't want my remarks to be construed as advocacy of either separate accounting or apportionment to modified apportionment approaches, and so on. I think, and I'd also really like to get down to basics on some of this, and I think maybe we lost some of the basics in some of the testimonies yesterday. I think it is important to appreciate at the outset that our concern here, my concern, your concern, is not really with how apportionment or separate accounting work in general in other

states for other industries and so on, what we are concerned with here is not with these approaches as general approaches to income taxation, but what we're talking about is their applicability to the oil and gas industry in Alaska. This is what we're talking about, and I think we have to keep this in mind. Not how well it works for other states, but why other people use it, and so on. If you will remember our original concern with the approach that you now have, the three factor approach that you now have with your income tax system didn't have anything to do with general worth, its general ability, and its general applicability. It had to do with how this thing specifically worked toward the oil and gas industry in Alaska, and this is how this whole question of reviewing your income tax came up, and it appeared to us, and we have testified many times, that the approach didn't seem to work very well for oil and gas operations in Alaska, that is in a portion, a very much smaller amount of income to Alaska than would appear to be earned by the oil and gas industry on producing operations and pipeline operations in Alaska. Now, if the oil and gas industry in Alaska were small scale, and I guess this really wouldn't matter, you probably wouldn't be very much concerned with it, and you probably also could view it as if it doesn't work for the oil industry, it probably works well for other industries, maybe for other industries it apportions more than you might expect, and so on if they wash out. But, as

you all know, the oil and gas industry will be by far the biggest income producing industry in Alaska as far as we all can see, so it obviously is of very considerable importance to you. It is important to you, I think, that you have a tax structure which gets you something like your 9.4% of what appears to be the profits generated by oil and gas operations in the State of Alaska, so we have to keep in mind, we're really talking about these two approaches very specifically in the context of oil and gas in Alaska, not as general approaches. Now, I noted the other day that Professor Zeifman argued against separate accounting at one point, and one of his arguments, I think repeated a number of times, was that a good reason for not adopting separate accounting was that no state has adopted it as a general approach to income taxation. This was an argument against separate accounting. Now, basically, I don't find that a very persuasive argument. First of all, we're not talking about other states, we're talking about Alaska, and we're not talking about general applicability to all industries, we're talking here about oil and gas, and I don't think anybody has suggested that the State of Alaska should adopt separate accounting as a general approach to income taxation in the State, and certainly the two bills before you, Senate Bill 105 on separate accounting, and Senate Bill 202 on net proceeds, both of these are clearly

intended to apply only to the oil and gas industry in Alaska, so I don't find this a very persuasive argument against separate accounting, and I think we have to keep this in mind. Conversely, just because a number of states use this three factor apportionment formula, I don't think it's a particularly persuasive reason for applying it in Alaska if it isn't appropriate to your oil and gas producing industry.

Now, I'd really like to get down to basics here. Starting off by considering what do we really mean by income in oil and gas operations in Alaska. Is it really so scrambled up by other activities of multi-national, multi-state enterprises that it just can't be unscrambled? Are we really talking about some kind of affliction which can never be put together and that we really just shouldn't bother with it? What is this income in Alaska that we're attempting to identify? Well, let's look first at what the industry does in Alaska. It comes to Alaska, it explores Alaska, hopefully finds oil or gas. It develops those resources, transports them to a point of export in the State, be it Valdez, Cook Inlet, or whatever - at least a bulk of the oil or gas does that, and then it moves into consumption in other states. Now it is true that a lot of this kind of activity and what goes on in this whole process does take place within the integrated scheme of operations of major oil companies. In fact, in many cases the final sale of the oil produced in your state

may not be a sale between third parties until it actually gets to the gasoline pump in California, for example, that may be the first point at which the sale is made, and the rest is within integrated operations. But what does this imply about income earned in Alaska? Is there a concept of income earned in Alaska, if this is the process by which a lot of your oil really moves. Well, I would put it to you that your oil when it leaves the State of Alaska does have a value. It will have a value, and it will have a value that's highly visible. We don't know what the FEA is going to do on the pricing of Prudhoe Bay oil, for example. But it may very well be that they will establish a value at Valdez for example. It may be that they will set a wellhead value. If they set a wellhead value, we can add on a pipeline charge, and we can have a value of oil as it leaves Alaska. So, basically, it's this value of oil leaving Alaska that is identifiable which is really the final revenues from producing oil and gas in this State. These are the revenues which you can identify as being earned by oil and gas producing operations in Alaska. Obviously when you are talking about a net income, you're talking about deducting various kinds of costs. Exploration development costs, pipeline costs, operating costs, amortization of capital costs and the like. The large number of these costs are incurred in the State and can be identified as incurred in the State.

Some of them are obviously some of the costs incurred to produce your oil. To get out of the State are the costs which are incurred elsewhere. Corporate overheads, obviously, a certain amount of corporate overhead time has to do with planning for the oil producing operations in Alaska. Some of the services which are provided to the operations in Alaska come from outside the State, and these are just some of the areas where accounting problems arise, but still these are within reason, identifiable also. So the income we're really talking about identifying in taxing is the value of the oil leaving the State of Alaska and an appropriate allowance for the various costs involved. Now the question for you, with your consideration of income tax, is which of these approaches really identifies income as we seem to see it and say that it is earned by the oil and gas industry by virtue of their operations up here. Which one is going to identify a portion of income which you apply your 9.4% tax. You'll get an appropriate tax on that income. Now, as I discussed yesterday, there are basically two approaches, and those are the approaches which are before you. One is apportionment, and this is where the approach is to look at the total income available, total income earned by a company, and try to work some fraction which gets applied to that total income, gets you income in Alaska. The other

approach is basically separate accounting which goes back to those revenues and cost categories that I discussed just a little while ago, and attempts directly to identify them and come up with income in Alaska, and the question is which of these seems to identify and work best that has come closest to identifying what would appear to be the true income on operations in Alaska, but not only that, taking into account also cost difficulties of tax administration, and that cannot be ignored. An approach which gives you the perfect answer and which is extremely costly or impossible to do in practice, obviously is not the kind of tax that you want.

Now, I'll start with apportionment. You have an apportionment formula in place in your tax laws today. You have Senate Bill 236, which is a modified version of an apportionment formula, but still an apportionment formula nonetheless, and the approach is to start, as I said, with total income of the company before taxes, under your present law, taxable income. This proposal suggests shifting it to book income, but nonetheless starting with the total income earned by an enterprise. The next step in apportionment, whether it be the one you have now or a new one, is to develop a fraction to apply to this total income in a corporation which hopefully when applied, brings back to Alaska an

appropriate amount of income. Now, you do that by taking factors that appear to be indicative of income generating activities, such things as properties, payrolls, sales and the like. These are things which indicate income producing activities are taking place, and what you do is you take ratios of these in the State to the total. Now, the question is does this really work? Does it correctly assign income to Alaska, or maybe \_\_\_\_\_ when does it work? When would this give you the kind of answer that you would hope to throw up? Well, it would work if roughly the same income is generated per unit of these income identifying factors in Alaska, as in Alaska and outside Alaska. These are the circumstances under which it appears to work. That is, just let's take one factor for a moment. Let's take property, if income is proportional to property in Alaska as it is elsewhere. That says in effect, if rates are returned the same in Alaska as they are elsewhere. If that's the case, and then you take the ratio of property in Alaska to the total, then you will allocate, and apply that to the total income of corporation, you will correctly bring into Alaska the amount of income that's earned there. That's if the ratio of income, in this case the property is the same inside Alaska as it is outside Alaska. And the same would go for the other factors. If you're looking at payrolls, if income to payrolls are the same in Alaska and outside, then this would be the correct factor for

allocating income in Alaska. Now, it's obvious, I guess, to anybody looking at any of these factors, it's unlikely that they will be identical in Alaska and outside Alaska. Rates of return aren't the same. You need fewer people and payrolls under some circumstances to generate income in Alaska and elsewhere, and so on. So that the apportionment approach basically says factors are not perfectly going to be the same in Alaska and outside, and therefore work perfectly, so what do we do? We take a number of these factors. Three in this case and we average them, and hope that that will give us an overall fraction which will appropriately apportion income into Alaska when applied against the total income of a corporation operating here. It averages somewhat obviously better than any single one of these factors taken by itself. Now, the question is how well it really works even when you average these factors, and how much better will it work if you move from the factors that you have now, to an extraction factor. Professor Zeifman was asked in testimony yesterday, how well his approach would work in Prudhoe Bay and Alyeska. Now, his answer was that his approach would be more effective because it takes into account the whole picture. All the profitability of the corporation was the answer. In a more general vein he also said that in reviewing the disadvantages of separate accounting, in my review of the

disadvantages of separate accounting, I didn't mention the most important disadvantage of separate accounting, that is again that it didn't look at the whole pie, it didn't look at the total income of the corporation. So he was saying first of all that his approach would seem to work better for Prudhoe Bay and Alyeska because it looks at the total income of the corporation. And he also said this is one of the disadvantages to separate accounting. Now, it seems to us that looking at the whole pie, that is the whole income of the corporation, all of the income it generates everywhere, it in itself has no value, unless the apportionment you come up with that you apply to this whole pie, the fraction that you apply to it, really works to get the appropriate amount of income in Alaska. What we're saying is that simply looking at the whole pie, looking at the total \_\_\_\_\_ of the corporation in and of itself is no virtue. Its only virtue only works if the apportionment formula of the fraction you apply to it is appropriate and brings it in, and I think that's very important to appreciate, simply looking to the whole income of the corporation doesn't say that this is an appropriate approach of getting a lot of income as it were.

Now, you remember our analysis all along, with the present system you have looked at these factors and tried to come up with how appropriate they really were. We pointed out

that if you looked at the payroll factor, it was relatively \_\_\_\_\_ . You have relatively few people on payrolls in the kind of functions that you will have in Alaska in the oil and gas industry. Very few payrolls for production for pipeline and so forth relative to the income generating, so we were critical of this particular fact. In sales, it's been pointed out are often zero in Alaska. Sales are made outside Alaska. Property, that to us appeared to be a better factor. That is, you have very heavy investment here in Alaska to generate the kind of income that you are going to generate, but our analysis said that property being a better factor couldn't make up for these other ones. Now, Senate Bill 236, this new approach, substitutes extraction for sale, and this is clearly an improvement. Oil production is a good measure of generation of income, and therefore it is a better factor. But the question remains, does even this modified apportionment formula do the job? Not just get more revenues, which it clearly will, and the other part of the approach is moving to book net income also will get more revenue, and it's not simply a question of does it get more revenue, does it really get the income apportioned to Alaska that is appropriate? This still remains the question. And this is what I said yesterday, the biggest drawback to the whole apportionment approach and even a modified apportionment approach as proposed

here, is that it is unclear how close you will come to true profitability through this approach. It's a very elusive and very uncertain thing, and it appears to us there's by no means a guarantee that this will happen, and this we see as the most serious drawback to this approach, and there are really two aspects to the question of whether appropriate income is apportioned to Alaska under this approach. One has to do with how much in total is apportioned to the State of Alaska. If you take each of the individual companies, apply this approach, apportion income to Alaska, sum it up, how close does that come to the overall profitability of the industry operating in Alaska, the profitability as I laid it out before. And the second question is, how does it work for individual companies. That is, we apportion use this approach for each individual company operating here. How close does the apportionment formula come to apportioning appropriate income to Alaska for individual companies. Does it work well for some companies, not well for other companies, and so on? If this is the case, that works unevenly amongst the companies, then you have a question of equity of taxation. So these are the two aspects that are important, and this is an uncertain thing and difficult to really try to come to grips with. How well would this thing do the job? Now, I stated yesterday that our office had done some illustrative analysis to try to get some handle on this question. We had been somewhat reluctant to put this

formally on the record and discuss with you a little bit about the results, what I saw as the major results that came out of this thing yesterday, but we were somewhat reluctant to lay out because there are a lot of caveats involved in what we did, and when you put this thing into the public record, it's often used without regard to the caveats which are very important, and we hate to see those get lost. I have been asked if we would put this formally into the record, and I'm going to do so now, and I would then like to discuss it with you including all the caveats and get those on the records. I would like to distribute this to you at this time and discuss it. I would like to spend some time on this. I hate to burden you too much, as I say, I want to make it clear in your own minds exactly what we have here and what we don't have. Now what we have done, we have labeled very carefully a hypothetical illustration. Because it is a hypothetical illustration, I would underscore that. It is a hypothetical illustration of this modified apportionment formula applied to book income which is the feature of this new legislation, and we've done it for three major Prudhoe Bay producers. Now, I would call your attention to the note first of all because this is important. The note says the calculations shown on the table above are not intended to represent projections of income that actually would be of portion to Alaska in 1978 for the three companies

if this new approach were taken. It is not that. Rather their calculations are meant to provide a rough illustration of how this approach might work for three Prudhoe Bay producers that vary in size and scope of overall operations, and even though these are identified as SOHIO, ARCO, and EXXON, and we use some of their data, it really is not meant so much that it is these companies, it is companies of these characteristics, and these are quite diverse companies as you know. EXXON is a huge international company. SOHIO has been basically limited to domestic activities with very little production so far, and ARCO being somewhere in between, so they are not meant to be really the companies. We have used their data just to illustrate what will happen with companies of different size. Now, what we've done in this illustration is on the first line to take from the 1975 annual reports of these companies, these are the latest available to us, the pre-tax net book income of these companies outside Alaska. We've just taken a pre-tax net book income, and since basically in these companies virtually everything is outside Alaska in those years anyway, we take this as the income outside Alaska, and this is data for 1975, and all we've then attempted to do is to graph on to this sort of a Prudhoe Bay operation. Now, we cast around for data to use for Prudhoe Bay, we considered making our own estimates, but we finally settled for some data that had been submitted by SOHIO to the legislature at the request of the legislature, and we reluctantly

used this. It was readily available, reluctant because when SOHIO put this information into the record, they did it with a lot of reservations, and we have the same reservations about it, and anybody looking at these numbers, I think, certainly should take it in the context of all the reservations that SOHIO had about their own data, and we apologize to SOHIO in a way for using it without a complete list of all their reservations.

SENATOR CROFT - Could I ask just one question in that regard? That was the information that was furnished by SOHIO, at the request of the committee was furnished to you?

RICHARD KILGORE - This is SOHIO submission 1.

SENATOR CROFT - To Greg Erickson, analyzing the corporate tax? So it was for that purpose.

RICHARD KILGORE - Yes. It was for that purpose, and they labeled it as hypothetical and so on, which it is, and I want you to understand that that's all that it is, and we appreciate their reservations about it, but we had to have something to give us an idea, something that we could graph upon to present data, and we simply and arbitrarily gave 50% of that to SOHIO and 25% each to the other two companies,

simply because that seems to be roughly their equities in this thing, and if we add that, we end up with a figure for total pre-tax income. This is obviously hypothetical, it has '75 data, it has what someone hypothetically says might go on in Prudhoe Bay in '75 \_\_\_\_\_ purposes. Then, we attempted to apply the approach of Professor Zeifman to this. Looking at property factors where the numerator were the property factors used in the SOHIO thing. The denominator was property as we found it in the annual reports of the companies. Payroll, we just took an arbitrary 2%. It's arbitrary that makes relatively little difference to the analysis. The extraction factor, we took net production as assumed in SOHIO hypothetical illustration. We took as a denominator net production as it appeared in the annual reports of the companies without worrying about whether net production was quite what was meant in this bill, and we averaged the factors for the companies. We then applied it to pre-tax book income which included other activities of companies and this hypothetical illustration for Prudhoe Bay. Divide the average of the three, which is the way this approach would work, and that gave us the income that would be apportioned to Alaska under these circumstances, and that's the second to the last line down there, and then what we did on the final line was

to take this income apportion to Alaska out of the theoretical model, but applying this new approach to this hypothetical model, and looked at what percent that was of the income assumed to have been earned on Prudhoe Bay and Alyeska operations above.

I think that the most striking thing that came out of this was the difference in the way the approach worked for the three companies. Again, three companies of these different characters. In the case of the EXXON type company, the approach came very close to apportioning what is assumed in the beginning was the income there. 650 up on the top. 625 apportion. So it worked very effectively for the EXXON type company in this particular situation. It worked much less effectively in the case of an ARCO type company with these sort of data. It added up to less than half, the income apportion to Alaska, than it was assumed to be earned there in the first place. And of course, in this simple model, EXXON and ARCO are earning the same money in Alaska, but the amount of income apportioned to Alaska under this mechanism are quite strikingly different. In fact in the ARCO type case it's about half. The SOHIO type company comes somewhere in between, and in total the approach allocates about two thirds of the total income from three companies in Alaska. I certainly wouldn't put too much stock in the two thirds, but I think the more striking thing is the differences that

get thrown up amongst the three companies here. Now, these are very \_\_\_\_\_ calculations, and things could very well change. I might point one thing out to you. What is striking in the case of the EXXON type corporation is that, as I say, it appears to be very effective in this case. And the question is, why? If you go to an addendum on the third page, it basically explains why this works in this particular instance for this type of a company. If you will recall, I said a while ago that if ratios of income to the various kinds of factors you use are the same within and without Alaska, then the approach works in general quite well. To take that a step further, the ratios of income to the various factors such as property or extraction are higher outside Alaska than they are inside Alaska, then the apportionment formula tends to favor Alaska. That is, it brings in more income than it should. If the ratio is higher in Alaska than outside, then these kinds of ratios work to the disadvantage of Alaska. Let me put it this way, if we look at a property factor for example, and within the State of Alaska, one earns whatever 20% on property (on assets) that's the rate of return. If it's 10% on operations outside Alaska, a lower rate of return, and you simply take the total income of the corporation then use the ratios of property to allocate to Alaska, you will not get the income to the State of Alaska that you should.

If the rates of return are higher in Alaska than they are elsewhere, then if you simply had a one factor apportionment formula, simply property, and that says that, say, 15% of the property is in Alaska, and you apply that to the total income, but the problem is that that 15%, what is it going to bring in? It's going to bring in average profitability to Alaska. An average of everything, and if Alaska is higher you're not going to bring in as much income as you should in effect. That is because what you're bringing in is average profitability if you do that. If you simply go with the ratios of property bringing in average profitability into Alaska, when in fact it's higher. And the other way around. If profitability is higher outside Alaska, higher say relative to property, and again you only have a one factor formula, and then you use the proportion of property, you bring in average profitability into Alaska, and in fact it's higher outside, so that you apportion more than you properly should. Now what this is getting to is why does this particular formula for these set of circumstances seem to work for an EXXON type corporation? Well, the answer is basically shown on the addendum. These, what we've done, if you'll look at the top panel, we've got the ratio of income pre-tax net book income to property in this model outside Alaska inside Alaska. Now, if you'll look at EXXON, it has a very much higher ratio of income to property outside Alaska than inside Alaska, Pre-tax income.

And, therefore, application of this formula for the EXXON type corporation is beneficial in the State of Alaska. It pulls in more income than it otherwise would. This very high ratio of 42.4 here, has the effect of favoring Alaska, and that's basically why you get the results that you have here. That's why it works better for the EXXON type than it does for other models that we have. Now, I want to tie back to something that I said the other day. If you look at the question of why does pre-tax net book income to property look so high for EXXON. Is it because it has really such profitable operations outside the United States? This would suggest then that on a pre-tax basis they make 42% return on their property. The answer is that this number, this ratio, is inflated by all those foreign income tax payments that I talked about the other day. EXXON works big international operations. In the year 1975 it payed tremendous amounts of income tax to foreign governments, and that inflated its pre-tax net book income. After tax it would look quite different, but we're talking pre-tax here. This is the way this thing works. So, that has inflated this figure, you get a very high figure. It happens to work to the advantage of the State of Alaska under this model. Now, as I said the other day, this is a particular aspect of this thing, pre-tax net book income including foreign income taxes that may not be the case in the future. These may very well dwindle. Income tax payments

probably will be replaced by purchases of oil, so that this high factor that's built in here with our particular model that happens to throw up a reasonable amount of income for income corporations, may not in the future, may not be this way in the future, but the fact that this EXXON type corporation, international corporation in this particular illustration ends up with an apportionment formula working correctly may not hold in the future. It's uncertain for a lot of reasons, including this particular income tax feature. If we went through this illustration five years from now, the results might be quite different here. In total, and I think amongst companies, I think really there is no way of knowing. Now, again, this is merely illustrative, nothing more. We've taken these three companies because they're quite different companies, they're quite different companies of the type that will be operating in Alaska. Their own income will be quite different obviously, but if you just grafted on the Prudhoe Bay Alyeska thing to this on some rough assumptions as profitability and investments and so on, this is the way it would appear to work, and all I submit is that it does raise questions about this approach and about its ability really to identify income. Clearly, the apportionment by picking another factor that takes up a higher amount of income, but that in the process of merely increasing the income, it creates some inequity, and if what you want to do is simply

increase the take, you ought to increase the rate, instead of tinkering with one of the factors to simply produce additional income.

RICHARD KILGORE - Of course, if you increase the rate, you have to increase the rate for other corporations.

SENATOR CROFT - Sure, then what you're saying is that Alaska operations themselves are not paying enough once you've isolated it. Then your solution to that problem is to increase the rate if you think you have to have more, rather than trying to increase one of the factors that go into determining what portion of the income is allocated to the State.

RICHARD KILGORE - Well, this might be one approach. If you're not willing to change the factors, you would be left with changing the tax base which has also been suggested, or you would be left with changing the rate.

SENATOR HUBER - I wish that Dick would discuss the pre-tax net book income on extraction because I want to ask him a question about the sales factor that it replaces. It looks to me like the sales factor that it replaces would be on the same side of the book as how he explained the income

from property up above to where Alaska would get more than its share, because we have less than a reasonable share of the world-wide sales.

RICHARD KILGORE - Well, accept that to the extent that sales are really zero. This may drop out of your thing all together.

SENATOR HUBER - You mean that doesn't work out because we have a multiplying factor, or a dividing factor of zero? I don't like these mathematics that don't work both ways.

REPRESENTATIVE MEEKINS - I'm just trying to figure out how this works. Is it, I might have it backwards, is it the ratio of whatever the factor is to income to the factor if it's higher than outside then.....

RICHARD KILGORE - Then it's to your disadvantage because you're bringing it in at the average.

SENATOR CROFT - In that regard, our best guess as far as Prudhoe Bay is concerned is that with regard to about 75% of the operations at Prudhoe Bay is going to work to our disadvantage. We're talking about 50% SOHIO, and 25% ARCO.

RICHARD KILGORE - Or in total, but as I said, I would not put any precision on these at all. In this particular model, what happens in total, you throw up about two thirds when

the companies combine.

If you'll just look at the illustration itself, you will see that total income apportioned to Alaska, the sum of the three companies is seventeen sixty. When in fact by definition they are earning 2.6, it's about two thirds, but I would not take that as indicative of how much this approach will really do. I think that the more important thing here is how it seems to work for the different companies, and also in a sense says, at least suggests, that for this particular model it also doesn't throw up all of the income as well in total.

REPRESENTATIVE MEEKINS - But you could get a rough estimation of how that's going to work by seeking out different companies and going with their finding what their ratios are in terms of the profitability of their Alaskan activity versus their average, and you could see whether or not you are losing or gaining the respect of that individual company, couldn't you in that respect if you knew clearly that the profits rates in Alaska were much greater than for those factors than their average world-wide, then you wouldn't know exactly how much, but you would know that we're not getting what's appropriate, and we're taking the average instead of the higher rate.

RICHARD KILGORE - It is possible to gather enough information to look around and see how it would work with various companies, but that's not really what I suggest that you do. This is, as I said, intended purely as an illustrative to demonstrate how it works under these particular set of circumstances assumed here, and again I would look very carefully at the notes to this and also to the note which sets out some caveats about this.

Now, this illustrates, I think, some of the potential problems and I think, at least I hope, focuses on the workings of this thing, so you can think about the workings of this approach. This was described, I think, in testimony yesterday, as fictional and I guess it is illustrative based on some real data, but it certainly is not intended to be a projection of what will happen or anything of that sort. It was described as fictional as opposed to some actual data that were used, tax return data that were used to develop this approach, and I would like to make at least a couple comments on some of the inferences that were drawn from those tax return data. For one thing, they were used to illustrate net book income if you'll remember exceeded taxable income for the companies and it certainly demonstrated that, and no one was surprised at that result. Now, the second thing though, is that what turned up in those tax return data is that for

companies for which you had both apportioned income and separate accounting if you'll remember, the former, that is the apportionment is always higher, it was positive, described as always positive, and the latter, separate accounting always zero or negative, and this was taken as evidence that separate accounting doesn't work. Now, I'd like to address myself to that problem. The question is why did you get this result. Why did apportionment give you positive, and in this case which is oil companies operating in the State, 14 of them I believe back in '73, '74, and '75 that you got this kind of result. It was said that Mr. Lipton was wrong when he guessed that perhaps the reason was that you had zero sales and therefore when you went to separate accounting you had zero sales and you started subtracting and so on, but it wasn't indicated what it is that really gives you this kind of result, and I think that it would be of considerable interest to you to find out why you got this kind of result. The explanation really was not given, and when I say it was said that zero sales were not the reason, zero sales in the sense that producers that were producing and selling would declare their sales at zero. That was a hypothesis that we had, apparently that's not it. I can only speculate, I would guess that in the years covered what happened was that there were companies operating in Alaska and spending

money on payrolls, they have some office space, property, exploration, money, geophysical work maybe, bonuses, I think that bonuses were paid and the like, and there must have been such companies that had little or no revenue that were not gaining revenue out of production in Prudhoe Bay, and for these companies they would in fact be running losses. That is they would have no income. Not a question of your producing, but selling outside the State, simply that they don't have any income. Now, if they don't have any income, no revenues incurring these various expenses, they would run losses and separate accounting would certainly show them with losses, but I don't think if this is the explanation, and if it's not I think we'd like to know. If this is the explanation, I think one doesn't go from that to assume that separate accounting always ends up with no income or negative income, clearly if you apply accounting to the producers on Prudhoe Bay, they will not throw up no income. I would also point out the results which said separate accounting negative apportionment positive, why does that happen? Well that happens probably because these companies had payrolls in Alaska. People were here, and they were getting interested in the search here, and so forth, so you threw up some positive income by apportionment. You had some payroll, you had some property and so on. And you throw up positive income, but I think you have to ask the question of whether

this is really what you intend to do if we have companies operating in Alaska at losses because they haven't found any oil, haven't generated any income, do you really want to apportion income to them in Alaska and tax them on it? Should they pay income taxes when in fact they have no income in Alaska?

CHAIRMAN POLAND - Mr. Kilgore, I'm afraid we're going to have to break now. Our schedule this afternoon is 1:30 PM at the Supreme Court Room again, and we only have one individual scheduled to speak this afternoon, and that's the gentleman from British Petroleum, so possibly when he's through, we can resume the rest of this discussion with you. Thank you very much.

\*\*\*\*\*

TESTIMONY OF RICHARD KILGORE  
DIRECTOR OF RESEARCH FOR  
W.J. LEVY CONSULTANTS

RICHARD KILGORE - I am trying hard not to take it as a reflection of my testimony that every time I testify fewer people seem to show up, but this is a Saturday morning and its not quite like the middle of the week. My opening remarks, if you recall, were, try to present some overview of the various types of taxation on the issues and principals of oil and gas taxation. My second testimony before Senate Resources, and in the afternoon before the two committees, tried to elaborate and sharpen the pros and cons in approaches to income taxation, that is the apportionment verses seperate and direct accounting. Now today, I would like to provide you with our comments on the specifics on the bills before you, and also take the opportunity to address some of the issues raised by other testimony you have heard. And I would like to start again with the income tax. Before I get to the specifics there, I would like to discuss very briefly, some of the broad questions raised by industry spokesmen, in which they say that any deviation from the present three factor proportionate formula raises the potential for double or multiple taxation. I think this point was realised by every one of the oil company spokesmen. I want to make it clear that if all states used the three factor proportionate formula only, then the total income of the companies is apportioned to all the states and the sum of the tax basis in the individual states will add up to the corporations total income, and the deviations,

either by different factors such as the (Eathen, Ainsworth approach?) as substituting abstraction or going to book income or going to some sort of separate accounting approach does tend to work in the direction of raising the tax basis of states that do that and has the tendency of each of the states in their own approach to taxation identifying a tax base which when added up on total would be somewhat more than the total income of the corporation. I think there can be no denying this, taking either of these two approaches, does raise the potential for double taxation. This is clear, but against this Alaska has to be concerned with how the apportionment works for the State itself, and how, not simply how the system works in broad for the companies and equity for the companies, but how it works for the State of Alaska and what sort of income is thrown up for the State of Alaska, it can't ignore this either. The State, looking at its own situation, I think in many respects does have a unique situation to look at, in many respects Alaska is unique and the taxation of oil and gas in Alaska in itself is unique. As I don't really have to tell you, oil and gas is far in the way, the largest industry and will be the largest income producing industry in Alaska. Alaska also does not have other industry, much in the way of other industry other than oil and gas it does not have major, it does not have agriculture on any kind of major scale as do other states, so many other states with a broader economic base can afford to have apportionment formulas

which they work well for some industries, not so well though for others and so forth, they tend to more average out than certainly they would for the State of Alaska. Another unique feature of Alaska's situation is its oil and gas industry is largely extractive and transportation ends of the business, Alaska does not have major refineries as do other states such as California, Louisiana, and Texas. It does not have major marketing because it has limited markets on it because of its limited population, so it does not have major investments in marketing and alike as other states do. So without refining, without marketing, head offices are not located here and so on, it does not have many of these factors which in other states have helped the apportionment formula work for the states. That is where you have all of these other activities, one tends to have larger payrolls, there are larger numbers employed in these other functions tends to apportion income to those states. It does not have major sales within the state and so on. So this also makes Alaska's situation unique and as we have said many times, it tends to make the three factor apportionment formula not particularly effective for Alaska. So on the one hand, the industry's argument is certainly a legitimate one and they have every right to be concerned about potential for double taxation and I think, beyond that, the potential that if you adopt this sort of a system that other states may somehow follow you and if this happens to them they more and more run the risk that the sum of the tax basis in all the states exceed their own income and this is a very legitimate concern of theirs. On the other hand, you do have these unique features of the oil and gas industry in Alaska that I have just mentioned. This means that Alaska really has to weigh its own unique

circumstances against the violence done to the principal of uniformity and the potential for double taxation, if you alter your income tax, you must appreciate what you are doing and what you are doing to the companies, you have got to attempt to assess, at least broadly what it really does mean to the company it violates the principal clearly, but what does it mean in terms or dollars and cents of the potential for double taxation in those terms and I think in that respect, some of the questioning of Senator Croft yesterday was along those lines and I think you probably also should pursue this somewhat more. You have to admit what you are doing, it would work in this direction but you have to get some appreciation of exactly what that does to oil companies. And I think in that respect if you are looking at that, I think, it is relevant that the oil industry is not taxed in all states, there are some states that do not have a corporate income tax and I think it is, also relevant that the tax rate in other states is often lower than it is in Alaska. So if you are looking at the double taxation issue, I think this is relevant because it bears on how much are they really hurt by this kind of double taxation sort of thing which other approaches imply. And I think you have also been concerned, to some extent, that what you do would set a precedent for other states and, this is a legitimate concern of the industry, I don't know any other situation, at least I can't think of any other situations which what you are doing would immediately trigger something by some other state, but still the potential for that happening is there. So I think its very important for you to appreciate that what is being said is correct, you have your own interest, and if you are going to go this approach, that you appreciate what you are doing and try to get some feel for what it really means to the

companies. Now I would like to move on to some specifics on the bills before you, the income tax bills, and I would like to start with Senate Bill 236, and House Bill 322. This is the so-called corporate franchise tax and it is a modified apportionment formula. Now, here we really don't have comments on the bill itself and the way its drafted, it is, as far as we can see, a well drafted bill, does what it is intended to do, and I think in the respect of this bill the questions we have on the bill really have to do with the effectiveness of the approach and not really the specifics in the bill. It seems to do what it intends to do and the question in mind is, how effective is the approach this bill is attempting to use, so I really won't have any line-by-line comments on that, but I will on H.B. 105, excuse me, S.B. 105, H.B. 145, somehow I seem to have misplaced that one. Yes, Senate Bill 105. I would first like to call attention to, on page 1, line 18, to the intent of this bill, the intent of the bill seems to be, have to do with the determination for tax liability on production and pipeline activities, it addresses itself to these activities and in fact, uses the work "activities", it is not a tax on an entity, its tax on activities, now this approach would presumably differ from a net proceeds approach which taxes income from well or field or this kind of thing. This is presumably looking at these particular activities, that is oil and gas production activities and oil and gas transportation activities. And this is what the intent states, but when I am going to come to later sections and discuss those, I think it looks to us as when you go into the sections of the bill, which involve the calculation of the tax it doesn't really seem to be consistent with the intent to tax activities which is stated in the beginning, and I will ella-

borate on that when I come to it. I would also point out on page 1, line 28, that when it comes to taxing oil and gas transportation, like pipeline, this bill refers only to crude oil or natural gas by pipeline, the wording of the bill very specifically excludes products pipelines in the state and you have a products pipeline coming on soon I believe, I don't know whether this was the intent of the bill, I just want to point it out to you but this particular piece of legislation specifically excludes products pipelines and I question whether this was deliberate or not, I think you ought to consider that. Moving on to page 2, line 24, these are the costs that could be deducted under this bill. It has costs, including the cost of gathering, gathering is used there. Now, the point I want to make on the use of the words "cost of Gathering" is that these costs of gathering may very well be beyond the well head. This is a bill which takes well head value as the income and starts deducting cost, gathering cost may be beyond the well head in which they don't, in this case if they are beyond the well head they do not go to build up the well head value, but in fact, rather serve to reduce the well head value, so in effect if you take this treatment of using gathering costs as a deduction and these gathering costs are beyond the well head, in fact what you are doing seems to be allowing a double deduction, double deduction.

QUESTION- Thinking that the tax is placed at well head, and these are beyond the well head so its a bouble deduction.

KILGORE - It is a double deduction, right, it could be a double deduction, in fact I don't know how it is going to work on Prudhoe Bay, but the gathering could in many areas trump lines that also are the gatherers, it could be in this case that Alyeska pipeline would be the gatherer and you would be taxing them under this bill then you would also be allowing against oil and gas production a gathering

charge or a gathering cost so I think you ought to, this is something that needs to be cleared up, if it is gathering, maybe it should very specifically say, "gathering before the well head" or something of this sort. Your wording should establish some kind of consillience between the value in the producing function and the value of the activities in the transportation function beyond that. My next comments are on page 3, line 1, again we are talking about expences that can be deducted when it talks about lease acquisitions payments on the well head, lease acquisition payments, property taxes paid before the production on the lease holds, so what we are talking about are lease acpquisition payment on the lease holds, now we are going to underscore on the lease hold. Now its not clear to us with this kind of wording whether this is ment to be restrictive so that the deduction for these kinds of costs are restricted to producing lease holds, or is this generally an applicable feature of the law, that is when we use a word on the lease hold does that mean we are confining deduction of those costs specifically to income from that lease hold or is it more generally deductible. This sort of problem I think runs all the way through here and this particular section looks to us as if it might be intended to be restricted, that is restrict the income against which these acquisition costs could be written. Especially if you look at this in the content of section 7, a little further below it appears to us that this may be the intent. And that same problem comes up on the same page 3, on line 9, where we have associated with a lease hold, another case we have "field" in this particular wording here and, I t .ink in another section there's the use of the word "property". Now, if these different words are used in here, I think that it ought to be made clear that there

is a intended distinction amongst these various things, I am going to come later, to a more general approach to this, where one really wouldn't really need these kinds of words and this seems to imply to us that there is some distinction between these and therefore, there is some restriction against, restriction on what income various kinds of categories acrossed here can be written off. In general, the wording of this whole section here on deductions really seems to be closer to us to a net proceeds tax than it is what we would call a separate accounting approach. The wording here would seem to imply that to us if it doesn't mean that I think the wording ought to be changed, it ought to be very clear against which income you can deduct, your various expenses. For example, it is not clear to us in the wording of this bill how a producer who has income, say in Prudhoe Bay, has made another oil discovery and he is in the process of developing that discovery, putting in producing wells and the like, it is not clear under this bill, to us, how he could handle those development costs, would be able to, if he had to capitalize it, could he start writing them off immediately against his Prudhoe Bay income or his other income, or would he have to capitalize those and wait to deduct some sort of, that capitalized cost until he had production from this other new field that he has, so its not clear to us what is really intended in this bill, is it really a separate accounting approach or is it something closer to a net proceeds. This raises the question of what should be your basic approach. Now if what is intended here is really separate accounting, under an income tax and not a separate kind of tax as a net proceeds was, we would think a more appropriate way would be really, to consolidate all the exploration, development and production

revenues and costs anywhere in the State. That is one would take revenues where ever they were from oil production or production of oil and gas in the State, and then be allowed to deduct all expences having to do with the activity of exploring, development, producing oil and gas, and this ould mean allowing the expencing of dry wholes here agains income there or development costs, amortization of development costs as against your income elsewhere, and we think if this is really an income tax approach, this makes more since really than an attempt to narrowly link expenditures with producing income from specific fields, even if you then allow some sort of write-off for losses and so on. We think it makes more since to go a more consolidated approach and it does not appear to us that the working nearly does that. Moving on to page 3, down on line 24, this is where we get into the determination of pipeling transportation income, the first section of this has to do with pipelines that, operating solely in interstate commerce and in this case subject to ICC regulations. Now what the bill sets as taxable income under those situations is 8% comes from, ICC said that one can set tariffs no higher than that level which would result in a 8% return on valuation of the pipeline, thats where this comes from, and seems to be an attempt to get that income. Well, first of all there would appear to be a technical flaw if this is the intention of the bill, to tax from the basis of ICC income. If you may recall, the ICC 8% allowable return on pipeline valuation is 8% after tax, that is after income taxes, after the deduction of all income taxes, including federal income tax, therefore, if this tax were operative and you were taxing at 8% of the valuation of the pipeline, you would be taxing 8% of after tax income, not before tax, and I don't

think that was the intent of this bill. All your other sorts of taxes are always on before tax income, your present tax law starts with taxable income, federal taxable income, well, this is before the deduction of federal income taxes and this is after the deduction of federal income taxes, a very much smaller tax base, and I don't think your intent ever was to tax after the federal income tax was already deducted. So I think this was probably just a technical problem here I don't believe it was really an intent to tax after tax income rather than before tax, and if the intent is to really do this, that is tax assentually on a ICC basis this is what you would obviously have to do I think. is to take 8% after tax, add back the federal income tax, gross it up to a pretax concept. Again I think this is just a technical matter, I don't think this was the intent.

SEN. HUBER - I think, I wish Chancy were here, I think it was their intent to tax it after, if that was their intent, would you have any comments that would apply to it?

KILGORE - Well, I don't really know what the prupose of it would be, your general principal of taxation in most cases for corporations taxes in states is to tax on a taxable income basis before deduction of federal income taxes. And it seems to me, you are kind of restricting yourself to roughly half what kind of tax base you normally would try to reach.

SEN. HUBER - If the intent was to tax after, would this have the effect of not allowing it to be put into the base in such a manner that it would decrease the value of the oil? In other words, the value of Alaska's oil would decrease by the transportation charges and the profits on the transportation. They may have been aiming at that particular item.

KILGORE - Senator Huber, I don't see how it would work that way because no matter, what ever state taxes you impose on the pipeline I don't care whether they are on a before tax, after tax, or property or whatever basis, they are going to be a liable deduction under ICC rule making. Going to a lower base and taxing loss will not, it will still be a deduction obviously, it will be a lower deduction, but if thats purely your aim, you can not tax them at all if you want to get the well haired by that, if thats what you really have in mind. I think this is, you can talk to the people who wrote this but I think this is an oversite. This is a technical matter, I want to point it out because I suspect it was not the intent, but we also feel that this method of taxation has problems anyway it is clearly tax on deemed income, it does not look at the actual revenue of the pipeline, it does not look at the individual costs incurred by the pipeline, its deed, and it may very well not accord with the income actually earned by the pipeline. That is even if the pipeline, a Alyeska pipeline is setting tariffs in line with ICC rule making trying to get the maximum 8% there is no assurance in any one year that they will in fact earn 8% on valuation obviously, you don't know exactly what your costs are you don't know what the values are going to be and so forth, so what you do is set a tariff which would appear on a projected basis we will try to get your 8% valuation, there is no assurance from year to year that you may in fact earn income greater than 8% of valuation or less than 8% on valuation, there is just no knowg exactly what sort of results you will get, and so certainly the ICC itself does not intend that exactly 8% is earned every quarter every year and so on, its just an impossible thing, it just can't happen, infact if youlook at the ICC records,

you will see that's clearly the case, not every pipeline is earning exactly 8% from year to year. So we think the real problem with taxing on a deed basis an approach which looks at the actual revenue and expenditures of the pipeline, one of the other witnesses yesterday asked if this was in fact legal to do it on a deed basis, we don't know the answer to that but it may very well be legal questions with this, there are also questions with equity, taxing in a deed basis rather than an actual basis. Sen. Huber- is it possible then that they just intended to use the lower base so it would be effectively about 4% instead of 8%, is that possible

Kilgore- that's possible, that would be . . .

Sen. Huber - cause I can see what they are trying to get to, if you have to tax these oil pipelines in accordance with percentage of interest, mobile oil pipelines all over the country are all worked into the company and you get that scrambled egg that you can't unscramble, and I think they were probably willing to take a smaller percentage right off of the interstate Alaska line at a point where they would get it rather than unscrambling that egg., I think that's the attempt.

KILGOR\_- Senator Huber, it is my understanding that out of some underlegislation you passed in past session that the companies will be providing you with an accounting of Alaskan pipeline, unscrambled from the rest of their pipeline operations. That is my recollection, and the pipeline regulatory bill, this is one of the provision and one that was not taken out later that the companies will in fact provide you with revenues, costs for Alaskan pipeline

HUBER- again, this wasn't something that I helped draft, but I believe you to know information is to be provided the mechanisms

in our income tax law for unscrambling it and getting to the income of the pipeline just from Alaska are considered to be unyielding or don't exist. I think that's where the egg scramble is. I think that's what we've got here. It just may help in you telling us how to do it. I wish Chancy was here again, as I say. Is he coming back Madam Chairman?

CHAIRMAN POLAND - No.

SENATOR HUBER - He won't be back this morning. I had counted on him being here, he said he was going to.

CHAIRMAN POLAND - He's at a finance meeting.

SENATOR HUBER - The reason is because the bills that he's talking about now by the subcommittee, Chancy and Greg are the people that can really help us on them, and they should be here.

CHAIRMAN POLAND - Well, don't tell me Senator Huber, tell him.

SENATOR HUBER - Well, I can't tell another Senator what to do, but I'd really counted on him being here. It's too late now. We could have Greg and we'd be getting more information.

CHAIRMAN POLAND - I don't know why Greg isn't here. Let's go on anyway.

RICHARD KILGORE - Well, some of the intent of this section, I think, becomes clearer when you get to later sections about the Alaska Pipeline. I would like to point out though, that this taxing on this basis of inter-state pipeline at the 8% also really doesn't give them much of any incentive, no incentive really to lower their tariffs if they're really interested in doing it. What is being taxed at that full 8% and you go to a lower tariff, you don't even get any income tax benefit for doing that, so I'd like to point that out.

SENATOR HUBER - And even if you taxed it at half of that, it would be the same kind of incentive situation.

RICHARD KILGORE - Yeah, there just is no incentive to do that. You're going to pay on that regardless of what you do, unless you go to the other section of the bill that follows a little further on, which appears to be an attempt to strengthen the Alaska Pipeline Commission. That's a section just a little bit further on. Now, we basically wonder whether this is really necessary that one would try to force people through your income tax legislation to accept rules and regulations, and so on, of the Alaska Pipeline Commission through an income tax approach. I think we should also point out that under this

bill if a company, pipeline company, wishes to set tariffs, say, lower than what would give him 8% on valuation, in fact, he may very well want to set tariffs along the line established by the Alaska Pipeline Commission, but he may not want to go as far as the section here that says that he has to abide by all the rules and regulations of the Alaska Pipeline Commission. He may not want to go that far, but he may be willing to set tariffs along the lines that the Alaska Pipeline Commission feels are appropriate, and he'll still be taxed at the 8%. He has to go all the way in order to have his income calculated in another way along the lines of the Alaska Pipeline Commission, and we really question whether this is the proper vehicle for trying to strengthen the Commission. We think there's a question also on the bottom of Page 3, where there's no ICC valuation where companies engage at least partially in intra-state commerce, and then it talks about he can have his taxes assessed on the basis of the Alaska Pipeline Commission assessment of income, and it's not clear to us from the wording here whether, what this means. Does this mean the rules of the Alaska Pipeline Commission as applied to the total operations of this pipeline which is both an inter-state and intra-state commerce, or does it only mean that part of the business of the pipeline which is purely intra-state. I suspect the intent means all. The Alaska Pipeline Commission rules and assessments of income as applied to the total business of the pipeline, but it's not entirely clear to us that this section says that.

As I said before, when you come to Page 4, Line 14 where the election, there is an election, it may very well be that companies are willing to set tariffs more in line with what Alaskan's deem are appropriate, but still be reluctant to subject themselves to all regulations and so forth, provisions of the Commission. A minor technical problem on Page 4, Line 21, where we're talking about taxation of gas pipelines, this has to do with income along procedures established by the Federal Power Commission. I think it would work out very well to say Federal Power Commission or Assessor because as you may know there are, President Carter has proposed a reorganization of our energy, various energy agencies in the United States, including a Department of Energy which would include in it the Federal Power Commission, so it may very well be subsumed under something else, so I think it should say that. Now, our feeling is that if you're going to go the separate accounting route, I think you ought to consider carefully, rather than these sort of provisions that appear here, a more straightforward kind of separate accounting approach for oil pipelines. As I said before, it is our understanding that all the revenues and costs of the Alyeska Pipeline will be made available to the State, that is they will not be hidden in all the other pipeline operations of the companies in the lower '48, which would have been the case without your own provisions for them, but you will, it is our understanding, get the information, and it would seem to us a more straight-

forward approach to take these data and assess what the income is of the pipeline. One may want to take the information given and change depreciation rates or something of this sort. You may not want to use the same ones that the ICC does, as would be given to you by the companies, but you would have information to make a straight-forward accounting of the pipeline, if you desire to go the separate accounting route, and if you do, we would urge that you look carefully at that rather than these sorts of provisions here.

On Page 5 we have a section for the determination of income from other activities, that is from activities other than the oil and gas production and transportation, which you dealt with on the separate accounting basis, and what it amounts to is an apportionment formula for the rest of the income. Now, we think that the language here is really not clear either. There is talk about adjustment of factors to take out of the factors, say the payroll, etc., that are involved in the production and transportation section before which are separately accounted. One would take those out it says, but it doesn't really tell you whether they should be taken out of the numerator, or whether they would also be taken out of the denominator of the fractions used in the apportion system. We don't think it's clear. I think you could also raise a question as to what's intended here also, what you're going to do is exclude income that you tax otherwise in this bill before this on production and transportation,

but when you come to apportioning for other activities in Alaska, you appear to leave in the total income that gets apportioned, the total income of the company, you appear to leave in all their other production and transportation activities, so in attempting to get at, say, what refining income is here in the State, you're going to go through an apportionment formula which is also going to produce not only their refining activities elsewhere, but their production and transportation, and so on, and it's not entirely clear to us what exactly you really want to do under these circumstances. Presumably, if a company had no other activities in Alaska, that all their payrolls, properties, etc., were associated purely with the transportation and production functions, these fractions would be zero, and there would be no problem, but as long as there are other people involved in Alaska you would be apportioning, and I think you ought to consider carefully what it is that you want to, how you want to try to do that.

We have down in Section 15, some provisions that have to do with the Department of Revenue providing estimates of tax costs of various kinds of deductions, and I think our only question there is the way the wording is, it's a very raw statement about the tax costs of various deductions. It would seem to mean you would have to come up with a tax cost of all kinds of categories of costs. I think what is meant is the tax costs of various special kinds of tax accounting. I don't think it really means that they want the tax cost

of such things as just plain operating costs, wages and so forth. I don't think that's the intent of this that one would want the tax cost of deducting payrolls, I mean because noone questions the deduction of payrolls.

CHAIRMAN POLAND - I'm sorry, but we've had a slight emergency, and we're going to take a ten minute break. .

(MEETING RESUMED)

RICHARD KILGORE - I've been asked if I wouldn't state again what our problems were with the wording on the bottom of Page 5. This section calls for the Department of Revenue to provide a report, and in that report it asks for a report on itemized deductions by category, and the tax cost of these deductions. Now, I suspect what is not meant is all itemized deductions, that is, one would have the tax cost of allowing royalties as an expense, the tax cost of allowing payrolls as an expense. I don't think this is what they have in mind. Normally when you're talking about the tax costs of something, you're talking about what is the cost of treating various items in one way versus another way. That is in the case of intangible drilling costs, allowing them as a straight expense, or do you capitalize and advertise them over time, or if it's percentage depletion, what's the cost of this particular way of accounting, and normally one calculates tax cost for those things, not for

normal kinds of operating costs and so on that one has. I think that this should be defined a little bit more here, and the purpose of doing it too, also, I think should be defined, but I think what is meant is some special accounting procedures and so forth on tax cost of these, not all itemized deductions as is stated here.

Now, turning to Page 6, Line 3, talks about in this report for the Department of Revenue, a summary of each corporate tax return filed which shows income from the production of oil or natural gas, showing the total amount of oil and gas produced by or for each tax payer, the taxable income of the corporation from production as reported in accordance with and so on, and also the pipeline transportation. Now, we feel that this kind of a public report of income tax information could be especially threatening for the companies. We think it raises a lot of questions about laying out in the public record various kinds of information that would normally be considered confidential, and laying this out on the record, we think could have some impact on competitive situation of the industry. What it would do, it probably disclose the specifics of Prudhoe profitability. Everybody has an idea of what Prudhoe Bay profitability is, but this would probably lay it out on the line.

SENATOR HUBER - Is that bad, to have the profitability laid out on the line for all to see, so that we all know what we're

talking about?

RICHARD KILGORE - Well, I think from the standpoint of the companies, it is bad, and I think they have a legitimate complaint about this because once this information is out, it's not only available for you people to assess, but it also would effect competitive relationships. That is it would throw up information which say companies in the position of negotiating for the purchase of Prudhoe Bay Oil would know alot about what their competitors' costs and so forth were, and this is the kind of information which is normally not available in those kinds of buying and selling relationships, and I think for those who are in the selling position, this is.....

SENATOR HUBER - Did you say for oil or for lease \_\_\_\_\_ so that I can relate it.

RICHARD KILGORE - This calls for the whole corporation as such. This would presumably show for any individual company its total profitability on oil and gas production in Alaska, but it's basically EXXON's and Prudhoe Bay's position obviously.

SENATOR HUBER - Richard, I'm trying to be constructive, but I'm having trouble, I can see where more data base being out, if the companies we're talking about between themselves

selling their leases for their property, maybe somebody wants to sell somebody a pig in a poke or something, so the data being out would be detrimental, but I think you said that in selling oil, rather than oil properties, and I wonder about that being it's a completely controlled market, how there would be any legitimate interest there.

RICHARD KILGORE - Well, it may not very well be a completely controlled market, we don't know how FEA, what they're going to do on Prudhoe Bay pricing and so on, but what the FEA does is always set ceiling prices, and there's a question of whether one can realize the ceiling prices. There may very well be a situation where major refineries in California who are not Prudhoe Bay producers will be bargaining for North Slope Crude, and trying to strike a bargain with a North Slope producer, and this price is not fixed, there will be a bargain on some of these prices, and you do something when you introduce information in the public record that the buyer has access to. He knows then more about the economics of the seller.

SENATOR HUBER - The future danger it might cause than, rather than the present because they're so tightly sewed up now.

RICHARD KILGORE - In fact there's a general proposition putting this kind of thing on the record does put out confidential information which is normally not made available in public,

which is internal to companies, and I think it changes the bargaining kind of situation to some extent, it just has to.

SENATOR HUBER - I'm happy to hear, Madam Chairman, that somebody thinks that something may go more than the free market place, because from listening to the radio this morning, I was afraid that everything about energy was going to get further from the free market place until the President comes right into my house and tells me what I can do inside of my home.

RICHARD KILGORE - Anyway, we see problems with making this kind of information available by company. I think, if you want information it might very well be possible for the Department of Revenue to combine information in such a way that wouldn't disclose individual company positions. I don't know, aggregating data by producing areas or something of this sort. I don't know, but giving you information that would be helpful without raising these kinds of disclosure problems. That really concludes my specific comments on this piece of legislation. In sum, I guess, what we're really saying is if you feel you want to go the separate accounting route, that you might very well consider some alternative to this, or some alternative provisions, and in the oil and gas producing area really thinking seriously about consolidation, the consolidated kind of thing where you would consolidate all the revenues

and deduct all costs in the State of Alaska rather than the provisions here, which seem to be closer to a net proceeds, and on the pipeline that you consider again a more simple straight forward direct taxation on the basis of the information that will be coming to the State on the Alyeska Pipeline.

SENATOR HUBER - Madam Chairman, while Dick is still in this 015, this is the area where I questioned industry yesterday, if you remember. Dick on the secrecy of these reports, do you think that Line 28, Page 5, under the 015, one of the things I read into this is I thought that was all inclusive, and maybe it isn't.

RICHARD KILGORE - Would you repeat that again, Senator.

SENATOR HUBER - Page 5, Line 28, under 015. We're talking about public reporting, which you were just talking about a moment ago. I took it to mean itemized deduction by category, and that these returns by category must run all the way through this, so that you aren't disclosing actual returns, but only by category.

RICHARD KILGORE - Well, I did not read it that way Senator Huber. I read this particular part of the report has to do with itemized deductions by category and tax cost, and then

I read on the next page, Line 2 of the next page, also included in the report shall be the summary of each corporate tax return. I didn't read by categories as part of that. These seem to be two separate parts of this report to me.

SENATOR HUBER - Greg was that meant to be in there so that that is by category rather than divulging the summary of an actual individual tax report?

GREG ERICKSON - Mr. Haggert drafted that particular portion of it, and it is my understanding that, subject to correction by him, is that each individual tax report and the summary by category.

SENATOR HUBER - In other words, the way I'm reading category is what you determine it to be? But the category goes over to the next page too.

UNIDENTIFIED SPEAKER - No. There are two requirements. The intent when it was drafted, was that there be a general summary for all taxpayers under this piece of legislation by category. Then, in part B there would be for each taxpayer a summary of that taxpayer's tax due and paid, and so on, so that it would not be by category it would be by taxpayer in two parts of it.

RICHARD KILGORE - Okay, I would then like to turn to the severance tax. As I said in my general remarks, if you're interested in raising the severance tax, both of these bills that we're going to consider seem to in general follow our guidelines, and has to do with more the specifics of how each one of them works. We'll start with HB 144, SB 103. This bill does several things. One is it moves to lease averaging rather than wells in the calculation, and we think that makes an awful lot of sense from the administrative standpoint, and probably should be done even if you don't raise the severance tax, probably even amending your present severance tax would do that, and would make sense. Page 1, Line 11 of the bill moves the point of tax from the wellhead to a new point of production which is later defined.

SENATOR HUBER - How is this defined?

RICHARD KILGORE - It's defined back on Page 4, line 9, gross value at the point of production means for oil, the value of the oil at the point where it is metered or measured in a condition of pipeline quality on the premises of the lease or property from which it is recovered. So in some cases it would change the point of taxation from the wellhead to somewhere beyond up to a point where it was meter measured and made put in pipeline conditions, so it clearly, and this is pointed out by someone else, moves the point of taxation

and in a sense in certain situations it would tend to tax the transportation and upgrading of the crude oil. That's clearly the case.

SENATOR HUBER - I think it had another reason for being in there. I think it was on account of that Kenai deal to where if they transferred our royalty share portion that went into resale that they were subject to the APUC, and doing it this way, while they pushed their royalty share through our line, they were not subject to our APUC. There was quite a problem on that in Kenai, it happens to be in gas, but we're talking jointly here and I think this was done for the company's benefit.

RICHARD KILGORE - Well, I think also in Cook Inlet, as I understand it, there have been continuing disputes about questions of wellhead and where one taxes, and I think this is all intended to straighten this matter out by legislation. This is where it is, and we don't have to argue about backing out transportation or whatever, this is what they're talking about. This makes administration of it easier, clearly, I think that some of the testimony yesterday it was complained that there would be a cost to the companies in a sense that they wouldn't be taxed on transporting and upgrading. I think that if it's administratively easier and there is a cost, perhaps what you should do here is get a better idea of what you're really talking about in terms of cost and dollars and

cents. What is really the extra costs that companies would bear by doing this, or some idea. I think that's how you would have to assess that. Now lets look at the tax rates in this bill. I think you are all familiar with the fact that it adds higher well brackets and puts in these higher brackets at higher tax rates than exist in the present legislation, and it also lowers the tax rates, both the cents per barrel tax and the percentage tax for lower productivity wells. Now, just to give you a rough idea of what this does, and I'd like to just give you some numbers on how it would seem to us to effect, say, Prudhoe Bay, and then look at the Cook Inlet situation under this bill. All the numbers I'm going to use are ease of comperability for 27 gravity crude oil. Now, in Prudhoe Bay, and I'm assuming for purposes of this calculation that the wellhead value on Prudhoe Bay is say \$7.50 per barrel just as illustriative. Under the present tax for a 5,000 barrel a day well in Prudhoe Bay, and these figures are cents per barrel of gross production not of taxable production, but you still get an idea of the relative increase in the tax. The present tax for 5,000 barrel a day well at \$7.50 is 49 and 1/2 cents per barrel of gross production. This tax for the same well, a 5,000 barrel a day well would raise the tax to 68.9 cents. That's about a 37% increase in taxation of a 5,000 barrel a day well in Prudhoe Bay. If you went to a 10,000 barrel a day well, the percentage increase and the tax is greater. As against

about 51 cents at the present time, this tax would raise it to about 80 cents, so on a very productive 10,000 barrel a day well at Prudhoe Bay, the increase there would be about 58%, increased through this tax over what you have today. The effective rate on gross barrels produced would go from about 7.3% on a 10,000 barrel a day well to about 12.2% under the new tax, so this is what it does to Prudhoe Bay, very significant increases. And the percentage as I gave you were really the effective rate on taxable barrels going from 7.8 to 12.2. So you are ending up on the very productive well, you end up with an average effective rate on taxable barrels of just under 12 and 1/2 percent in Louisiana. I think that's what was intended. So that's the impact it has on Cook Inlet, I mean on Prudhoe Bay. Now, let's look at Cook Inlet, and particularly the old oil because we've always been worried about effective taxation of old oil. Now, this bill does retain the cents per barrel feature that exists in the present bill, and it retains the cents per barrel feature with basically the same floor price as you have today. It works out for 27 gravity crude to about \$6.10 today. So it retains that, but what it does at the same time is that it does lower the rates of taxation both percentage and the cents per barrel taxes in the lower well brackets, so despite the cents per barrel feature still being in there, it does lower taxes on low productivity wells below what they are today. I'll again give you some examples, and they'll

again be on the same basis as before. 27 gravity crude, and these are figures on a gross barrel basis. At the present time a 100 barrel a day well in Cook Inlet would be on the cents per barrel tax and it would pay 26.6 cents per barrel. This bill on a 100 barrel a day well would eliminate the tax. It would go to zero, and a very substantial gain for a 100 barrel per day well. For a 300 barrel a day well, would also pay under the present tax, 26.6 cents. Under this bill, under our calculations, it would drop that 26.6 to 14.2 cents per barrel. So you have about a 12 and 1/2 cent reduction for a 300 barrel a day well, and if you move up to a 500 barrel a day well, you still get a reduction. Under the present tax it would be 28.7 cents. Under SB 103 it would be 21.2. So even for a 500 barrel per day well, you're going down by about 7 and 1/2 cents per barrel, and in fact this new tax as compared with the present lowers the tax up to somewhere wells in the range of 1,000 to 2,000 barrels a day. Somewhere in that range, the new tax gets higher than the old tax, so it does provide very significant relief for low productivity wells.

SENATOR HUBER - Madam Chairman - the figures which we have in the committee they are open to him now, I think, I just wonder when he finishes there. If you have any dispute with those, I think that they confirmed his testimony.

RICHARD KILGORE - Yes Senator, we did do our own homework on this obviously, and we have had a chance to look at what legislative affairs has, and they coincide with what I'm testifying here.

SENATOR HUBER - I was wondering. It would help us a lot to know that they do or don't or if there are differences.

RICHARD KILGORE - No they don't they calculate the same way we do.

Now, so this bill does, I think, meet our objections really to the present taxation of old oil at Cook Inlet which has the high effective rates because of the cents per barrel feature. At least its present operation would reduce the tax substantially for low productivity wells, and we think that's a good feature of this bill. I should point out though, this bill does retain cents per barrel and it does retain escalation of that cents per barrel, so it is possible that under this bill we would again be back in the same problem that we have today. If the escalation manages to raise the cents per barrel tax high enough, we could be back in this problem again of taxing old oil in Cook Inlet at high prices, it's possible. The potential is still in this bill.

SENATOR HUBER - This evades it from present time, and we might have to look at it again in future years if we don't do something with cents per barrel.

RICHARD KILGORE - Yes, it may be back again.

SENATOR HUBER - Well, I'd sure look at it again, Madam Chairman, than I would to have Tom Fink for Governor.

RICHARD KILGORE - I think I was on record the first time I testified as saying that if you do retain a cents per barrel that perhaps what you do is at least consider no further escalation in cents per barrel, and perhaps that could be in this bill too. I don't know. I want to only point out that it could happen again. So that's basically what this tax does. It raises fairly significantly, the tax in Prudhoe Bay, but it does lower the tax considerably on low productivity old oil priced wells in Cook Inlet. It also has a severance tax for gas that is flaired, and a very substantial one, five times the rate. I think before you do this kind of thing and add such a tax, you ought to look very carefully at where gas is being flaired and why. There has been testimony yesterday about safety flairs and so on. I think you ought to look very carefully at what it is that you would be taxing and why the flairing is going on at the present time. Now, if what you're really trying to do is tell companies to find a use for this flaired

gas and find markets for it, I think that at the very least if there is gas being flaired now which you think you could find markets for, therefore you're going to try to compel people through this tax, somebody used the word incentive the other day, but you're compelling them through this tax that at least you ought to provide somebody with a grace period before they would pay this tax. That is, you wouldn't start right away. You would make it clear to them that they had certain time within which to find markets for this. You wouldn't penalize them in the meantime, but if you don't find gas for which it's logical to find markets, that you would say at some point in the future you're going to start paying a tax on this, so you had better get busy and look for markets. I don't think I.....

SENATOR HUBER - I think, Madam Chairman, that we should make sure in there. I think we should find out the required safety flair of no more than a certain amount except during an emergency blowout or something like that. The idea was, as long as it's economically unfeasible to take small amounts of gas and reinject them, the State loses its royalty share on it, and the nation loses the energy strictly because at a given space in time, using if you will excuse me, a cash discounting flow and everything else, that we determine its value and we say it's nothing, and what's nothing is moving down the pike another twenty or thirty years may be all we have, and Prudhoe Bay, in spite of an absolute no

flair restriction has been allowed to flair and everybody knows it. Somehow or other, it does have to be stopped, and if you make it so it isn't economically feasible to flair, then it becomes economically feasible to build a small compressor system for saving.

GEORGE SILIDES - Madam Chairman, I know that the flairing \_\_\_\_\_ as Huber pointed out, \_\_\_\_\_ that the flairing of course, and the word allowed is important, they get permission from the State, and we have to do something about the bill, that we don't have competition between the taxing department and the Department of Oil and Gas Conservation. They are the ones that give the permission, and you have to apply and you have to point out that it's being done with safety and so on. I don't think that the bill intended to penalize somebody for entering into a safety feature, and so am I correct Mr. Kilgore?

RICHARD KILGORE - I would assume that that's the intent. You'r not really interested in taxing gas.....

SENATOR HUBER - But that board still has the power and makes the exemptions and has been constantly making the exemptions, and it's a matter of record, both at Prudhoe Bay and elsewhere, they make the exemptions, they're legally made, but the product is gone, the resource is gone, it is flaired, and so at least putting in a fairly stiff recovery there, does at

least give us something off of our severance tax that went up in flair too.

GEORGE SILIDES - Madam Chairman, I might make another comment. I think that in view of the comments being made, we're going to have to look into the legality of being able to tax a safety feature.

SENATOR HUBER - No, we don't tax the safety feature. Let's not get crossways on that. We should put an exemption in here for the safety flair only, and somewhere we need to come up with a figure of what is the amount that may be flaired to date per well or per safety flair. We definitely shouldn't tax them on what is a safety requirement. But there isn't a provision. The gas that's being burned in significant, is not being burned in so called legal actual safety flairs. It's being flaired otherwise by legal permits by the board.

CHAIRMAN POLAND - I think we have to check with the Board as to why they are giving the tax.

SENATOR HUBER - That's why the Governor's bills has it in it. That's why committee's bills has had this for two years, and we should certainly, like Dick says, make sure that we don't tax the necessary safety flairs. I asked yesterday what

was, and they said a million cubic feet. That's a thousand MCF's a day. I'm not sure that that isn't considerably over what's needed to burn there in case, I need a good definition of a safety flair.

RICHARD KILGORE - I think also you might consider if you really feel the gas is being flaired that you don't want to be flaired other than as safety purposes or whatever, that's something you might consider as an alternative just tightening up your regulatory bill and your regulations rather than do it through a taxing approach.

SENATOR HUBER - We've done everything but tar and feather the board.

REPRESENTATIVE OSTERBACK - Madam Chairman, could anybody tell us how much gas they will be flairing at Prudhoe Bay? Anything that burns is energy. We're talking about we're running short of energy. Somebody talked about the railroad. If they took it in there, they could take out about a hundred tanks of gas a day, and they didn't think it would be enough to pack that out with flairing, and that would be an awful lot of energy, but most of us don't really know what this gas is with the flairing, but I know anything that burns is energy, and we're talking we're running out of energy. So I think there should be something done about it. Anything

that you can save as energy, you can sell. There's no problem in that.

RICHARD KILGORE - Well, I agree with you, if what we're really talking about is waste, then I think we should eliminate that. It is energy, and you're absolutely right, and I think you should look very carefully at what's going to happen at Prudhoe Bay, and how your regulatory people will handle it.

SENATOR HUBER - Might we, Madam Chairman, Al brought it up and it's very important. I think that it's understood that they have stopped flaring or are to stop flaring. It was only for that refinery that they flaired at Prudhoe Bay, and they didn't pump it back down the gas well even though they were drawing gas out to run the refinery because it would have cost more money than the gas was worth, so naturally the gas was worth nothing, so it wouldn't cost money to pump it back down into the ground. If it had a value of 20 cents an MCF, it would have been a lot cheaper to pump it back down into the ground, but just so that the record is straight, we aren't really looking for flaring at Prudhoe Bay, but if you will take a look at the Valdez terminal, you will find that we don't flair no more, but we've got three huge oxidizers there, and there's going to be a tremendous amount of energy unless the LPG's that are in that gas and the vapors that are in the gas at Valdez,

unless there's a plant built to recover those and use them which is not in the plan, it is going to effectively flair trillions of BTU's before Valdez is over with. That's because the plant and the tanks will not stand the pressure in the storage.

GEORGE SILIDES - Madam Chairman, I think the point is well made that something's got to be done about defining what is meant by safety gas, what is being wasted, and I think also that the bill had intended to address the bottom of the possible wasting of carbon dioxide. There was a considerable amount in this particular natural gas, and I suppose what we're getting to is that we have to do something about those things, either by definition or by amending the bill. I think this is a point that we're going to have to look into. I don't think we're going to get it solved right here.

SENATOR HUBER - I think they're willing, George, not to flair the carbon dioxide, but I'm not sure if they will get rid of it.

GEORGE SILIDES - It doesn't burn anyway, Senator.

CHAIRMAN POLAND - We'll be checking on this flaring part.

SENATOR HUBER - Well, it's important on both ends. I think that the bill needs to not penalize them, but by all means

should be retained in the bill, and we may of course have to put it in in some other places. I don't think this is going to effect it when it comes to the flairs in Valdez.

RICHARD KILGORE - I'd like to move on the the second severance tax bill, and that's HB 321, SB 238. Now, basically this tax changes the tax rate to 10%, but it also has a cents per barrel feature of 75 cents per barrel, so it has an effective floor price of \$7.50, and it also has what \_\_\_\_\_ for an economic limit factor built into it, and I think Mr. Wilson yesterday did quite a good job explaining how the mechanics of this worked, and he also provided an example for you that I think was probably quite useful. Basically what the bill does is give you the first hundred barrels a day as an allowance for operating costs is what it amounts to, and wells producing more than 100 barrels a day, they pay then an increasing fraction of the 10% for the 75 cent tax is the way it works, and it's a continually increasing thing as well productivity moves above average well productivity moves above 100 barrels a day. Very roughly, a 100 barrel a day well would pay no tax under this bill. A 200 barrel a day well would pay about 43% of the tax. It isn't 50% because as you might think by taking 100 to 200 because it's taxable barrels only that count. That is the 200 barrel a day doesn't produce 200 barrels that are entirely income to the company. Twelve and a half percent of those go to the State.

GEORGE SILIDES - Mr. Kilgore, it's 43%.

RICHARD KILGORE - It's 43%, 200 is 43% of either 10% of value or 75 cents a barrel depending on which it is.

GEORGE SILIDES - That's what I wanted you to say.

RICHARD KILGORE - For a 300 barrel a day well it would be 62% of these basic rates and on a 4,000 barrel a day well, it would be up to 89% of this. This is the way it works, and it amounts to a continuous function as against the step schedule that you have in your present legislation. As I said, it amounts to a continuous function and in principal we find it as kind of an appealing concept as against the step schedule. Now the other feature of it is that one can't apply for an economic limit factor greater than 100 barrels per day well average if you can prove it, and what you basically have to prove is that your operating costs that you require, out of pocket operating costs are greater than what you would get with 100 barrels of production per well. You would need more than this to recover your operating costs. Now, there appear to us to be a couple problems with how this actually works. First of all on Page 3 Line.....

SENATOR HUBER - Madam Chairman, I would note that we've got John Messenger here, too. This is the same problem that came

up yesterday in talking with the industries. We might want John to answer some of these.

RICHARD KILGORE - It has to do first of all with how costs are defined, and that starts on Page 3, Line 16, subsection C here, and as was pointed out in testimony yesterday, it is not clear that the cost category specifically allowed here really provide for all the kind of out of pocket expenses that a producer might have, and basically that's the concept that you're trying to get at, whatever is out of pocket expenses, and it's not clear to us that that is the case and some questions were raised yesterday and I think you ought to consider those too, but what I think is more important is that after calculating the costs here, you then have to determine how many barrels are necessary to recover, that is if more than the hundred that you are allowed anyway. Now the problem with it is that the way that the bill was written, you don't take your costs and divide through by the price of oil that you as a producer receive. That is your actual price, if you're an old oil producer and getting \$5.00 per barrel, you don't divide through by \$5.00 to see how many barrels you need to recover your costs, but you use another deemed price to do this, and the deemed price is acquisition, this is Page 3, Line 29, its acquisition costs CIF at westcoast refineries for imported oil of like quality and then you net this back to Alaska, so you're not doing it, on the price you actually

receive, you're doing it on a deemed price that you may not be receiving, and it seems to us this causes problems.

SENATOR HUBER - Could we at this point if it's convenient, I wonder, Sterling isn't here, but John is and this was the question yesterday, I understood from the testimony by the State that as of starting in December or sometime like that that these wells that were in economic trouble shall we say, that these figures that you have put in here talking about \_\_\_\_\_ price are actually what's happened. They are now being allowed, these higher prices on the producer's share, but not upon the State's royalty share. The argument yesterday, and I think we're right into it again today, is whether we're just talking about a possible deemed price working it back from San Francisco or whether we're truly talking about what they're going to get, and the industry said no this was unfair that wasn't what they were going to get, so we're right at the nitty gritty, and I think you can help us John.

RICHARD KILGORE - Perhaps, Senator, I'm going to give an example, maybe I ought to do this and then we can talk about it.

SENATOR HUBER - Okay, just so that John, he wasn't here yesterday, so he's alerted. My stand was or what I saw was that you fellows put this in here because that's actually

what the oil companies are getting, and so you were getting right to the nitty gritty, and they said no this is what they might give them, but I understood Sterling to say that this had actually started in December, and I don't think this was in testimony, I believe this was talking in the afterwards that it actually had started in December and the State had been denied that increase, but the producer's share had been allowed, so if that predicates it and as he goes on if you can straighten this out, it will help me a lot.

RICHARD KILGORE - I'd like to just give a little example of what we're talking about here. If we had an operating cost for a well or wells whatever the unit or something, and say \$2,800 a day, and these were direct operating expenses defined properly however, and if you didn't get these revenue enough to do this, you would shut down. Now, if one looked at the foreign price and then netted back to Alaska, let's say you came up with \$14 just to make the arithmetic easy, you came up with \$14. Now in calculating your economic limit factor here, you would divide through by that, and that would give you \$2,800 divided by \$14 is 200 barrels a day. You're economic limit you could then justify is 200, rather than the 100 which you had presumed. That means you're getting more, but let's say that the producer only gets \$5 a barrel for oil because he's receiving the old oil price in Cook Inlet. He doesn't get \$14, he gets \$5. Well for him to actually recover the

\$2,800 his total expenses at \$5 he's actually receiving for his oil, his real economic limit factor is \$2,800 divided by \$5 or 560 barrels, so that in fact, his limit factor, that is the number of barrels he needs before he's got to shut down, because he doesn't make it out of pocket cost of 560 under this bill it appears to me, he would only get 200. I don't think it really gives you the results that you intend. The result that you intend is to provide relief for marginal wells. It doesn't appear to really serve the intended purpose.

SENATOR HUBER - That's at \$5.61?

RICHARD KILGORE - That's at \$5.00 even.

SENATOR HUBER - But doesn't this other deal work to raise that?

RICHARD KILGORE - Well, the other thing we're talking about is price relief under FEA regulations. I think that's really something different here. I'm addressing.....

SENATOR HUBER - That's not five dollar oil. You know, if we're talking about his economical limit on the well then we assume it to be \$5.00 oil, but he is actually receiving \$10.95 for it because it's below a certain economic limit

already established, then we're dealing with something that doesn't exist, and that's what I'm trying to get into this, and I thought that that was why the State had drafted it.

RICHARD KILGORE - Because it assumes that the Federal government will always bail out people, is what you're saying, other than royalty owners.

SENATOR HUBER - My information was, it didn't only assume, it was based on what was happening. Can you clarify that John?

JOHN MESSENGER - Let me just make a couple comments. I guess it's true that one position that we've taken on this bill that our taxes should not be based on the artificial price set by the Federal government, and the Federal government set a price of \$5.00. Our position is that we shouldn't be content with the tax based on that artificial price, and that's why, one, we've set the cents per barrel floor, likewise when you're figuring the economic limit factor, again, we say the true economic limit is not how many barrel are produced at the artificial price, but the amount of barrels they would produce using the true value of that oil, pre-market oil. We should insure ourselves that so many cents to so many percent of that pre-market oil because that is our resource and we should get at least that percent out of it. Secondly, is that producers are

reaching their break even point which they will stop producing. There is a procedure by which they can make application to the FEA and get price relief and with that higher price they can produce longer, but the FEA has said that they will give price relief only to the producers, and not to royalty owners, so if a company is reaching its economic limit in Cook Inlet, and they go in for price relief, they are given that price relief. They will raise their price, but they will not raise that price in the terms of the amount of royalties which \_\_\_\_\_.

So, it's two things, one is the tax rate and the economic limit factor should be based upon the true value of the oil, and secondly that producers are protected through FEA regulations, but the State is not.

SENATOR HUBER - Then I guess what he's saying is that if someone's going to shut down the production there, by it being below economic limit on \$5.00 oil, the State is advocating that we put the monkey on the fed's back and say you did it, you set an artificial price, we're going to set our tax based on free market price, and if you want to save that resource, save that company, you can turn around and do likewise what's reasonable. I'd say it's what I call putting the monkey on the Fed's back. They caused the problem. I happen to be strongly in agreement with the State's stand on that, and compliment them for it because why should we throw away our royalty share and our

taxing ability because somebody forced an artificial price down our throat, and is forcing that same artificial price down the throat of the oil companies.

RICHARD KILGORE - Look, I'm going to address myself to the question of the artificial price, that's part of what I'm doing here, and I think the Commissioner took issue with earlier testimony I made when I said I thought this was a flaw in the thing, and it certainly was, I thought, a flaw in terms of its purpose of providing relief, and now I do understand why they do this which is another objective, than what appeared to be the intent of the bill, and I'm going to come back to the whole question of the artificial price. It's very clear they did this by design. I'd like to again, as you asked, talk about just very roughly what it does to Prudhoe Bay and then to Cook Inlet, and then discuss the consequences of that. Again, for Prudhoe Bay, looking at 5,000 and 10,000 barrel a day wells at Prudhoe Bay, this bill also raises taxes significantly on those wells as does the other bill, as does HB 321 that we looked at before, excuse me HB 144, that we looked at before, but it does not raise them as sharply as the other tax. If we take a 5,000 barrel a day well, I said that, and I'm not going to run through all the numbers here, I think, but that the other tax for a 5,000 barrel a day well raised the tax about 39% on a 5,000 barrel a day well. This tax would raise it about 29% it appears to us using the presumed hundred

barrel figure. The discrepancy between the two gets larger at very productive wells because of the steep rates near the end of the schedule in the other bill, and for a 10,000 barrel a day well, HB . . . it 5% this would raise it about 27% on the very . . . , so if it both increased taxes on Prudhoe Bay, clearly the one, HB 144 would increase them significantly.

SENATOR HUBER - That would be effective of what of 5 and 10.

RICHARD KILGORE - Okay, the effective rate would be very close to, on taxable barrels it would be very close to 10%. On 5,000, it would be 9.8% and 9.9% on the 10,000. It approaches 10%.

SENATOR HUBER - Just slightly under ten percent for a total maximum. Or fully 2 and 1/2 percent, a little over 2 and 1/2 percent below Louisiana. Using the Administration's bill.

RICHARD KILGORE - That's correct.

SENATOR HUBER - And it would be right at Louisiana with the other bill.

RICHARD KILGORE - Close to it. That's correct.

Now, let's look at what happens to the Cook Inlet old oil price here. This bill as the other one for a 100 barrel a day well eliminates the tax altogether. It does exactly the same thing, but what we find troublesome is that is you go to 300 barrel a day wells, these are the wells that we're concerned with because of their productivity and the old oil price they have to bare, they get the tax there doesn't go down, but it increases. It goes up from 26.6 cents on gross barrels to 40.6 cents. It goes up by 14 cents a barrel. This tax raises it that much. On a 500 barrel a day well, it raises it by about 13 and 1/2 cents, and on a 1,000 barrel a day well. I'm sorry 14 cents increase on a 300 barrel a day well, 22 cents on a five hundred barrel a day well, and 28 cents on a 1,000 barrel a day well. What I think are particularly disturbing are the increases on the lower productivity wells. A well as low as 300 barrels a day which we already have some concern for because of the effective rate on the old oil thing has actually a fairly substantial increase in its tax burden. As Commissioner Gallagher stated correctly, you get this result because of raising the floor price essentially. You are raising the floor price from \$6.10 to \$7.50 and you have higher tax rates at the same time, and it's deliberately designed to do this. Now, we really feel that this kind of goes against what we feel are good principals of severance taxation. What you're saying is the producer in Cook Inlet he received a relatively low old oil price established by

the Federal government. This in turn restricts his own profitability, but then the State adds to his burden by taxing him as if he received \$7.50, and it seems to us that rather than help his producing situation, this only makes the situation worse. One of the reasons given for doing this is that the Federal government is following an unwise, or I think it was described as a foolish price policy. Now, this may or may not be the case. I'm not willing to pass a judgement on that, but they're, you should know that the Federal government does have reasons for doing this. It's not capricious, they do have reasons. They have concern over the effect. What they're concerned with is this, we've had a fantastic increase in the oil prices outside the United States by the OPEC nations and if one frees the oil, the old oil price, it will go up very, very sharply. It will, perhaps in some cases, close to triple in price, and the people are concerned about the consequences of this. Rightly or wrongly, they are concerned about the inflationary impact on consumers. They're concerned about when \_\_\_\_\_ producers, because these are on old oil wells, wells production which is established at old costs and so on and therefore you have to question whether you want to give them huge increases in the price and windfalls. There is concern over that. So there are reasons, and you can argue one way or another, but there are reasons for this.

SENATOR HUBER - Would it be fair to say that those reasons are exactly on a par with the same reasons for having controlled gas prices as would be in inter-state commerce as well as setting a free-market price. It's the same principal in both cases.

RICHARD KILGORE - As deregulation of natural gas prices. Yes.

SENATOR HUBER - Deregulation of natural gas. Deregulation of petroleum would do the same thing, it would increase the price at the burner or the price at the gas tank as it comes in out of the nozzle, but all of the other factors of pro and con are the same.

RICHARD KILGORE - Yes, that's right, and the concern is that if you let it go up to, and I really object to the word free-market price because we're not talking about free-market price, what we're talking about is it goes to a price administered by OPEC. That's what we're talking about going from price administered by the Federal government to a price administered by OPEC. This is by no means a free-market price. It's a market price, but one set by OPEC, and set by political reasons as much as for economic reasons.

SENATOR HUBER - Some of us are referring to free-market price though as to this free-market price that exists that we talk

about what the price would be if OPEC were not controlling it. Some of us are talking about a true free-market price

---

RICHARD KILGORE - Senator, I don't know what the price would be if OPEC were not controlling it.

SENATOR HUBER - We don't know. We have projections just like we do on what Prudhoe Bay is going to cost.

RICHARD KILGORE - One the one hand, if OPEC did not exist one would certainly expect over time that the price would rise at some point in time to the level of alternative energy sources which are quite high in the \$20 - \$25 range. On the other hand, in the short run, you do have an overhang of surplus productive capacity in the world, and if there were no OPEC, and it were perfectly free market, there's no reason why the price couldn't drop to less than \$1.00 per barrel, because that's what costs are in their surplus capacity. If there were truly competitive free market, one would have \$1.00 a barrel oil or less because that's what the costs are in the middle east, less than that so but as time went on, and this surplus which overhangs the market now, and which would push it down, gets eaten up and it will, one would then have prices moving off in the other direction. I don't know what the price would be. But anyway, we're talking about not letting the price, the U.S.

government as a matter of policy, not letting it go to a price set outside its own borders by an organization of petroleum exporting companies, and that's what we're talking about. It's the intent apparently of the Congress not to do this because basically the idea is concerned with price impacts, concerned with windfalls, and also that there's no way of assuring that the price that would be set by OPEC is an appropriate price for our internal markets for our own costs and so forth. There's no way of knowing whether they will set a price appropriate to our cost circumstances in the United States or a price that may be very much higher than people think it is now or maybe even a price lower. Not good enough for development of our domestic resources. So this is a matter of national policy and people can quarrel.

SENATOR HUBER - Feable minded or otherwise.....

RICHARD KILGORE - Well, I don't want to characterize it. I'm trying to give you a few of the reasons for doing this, and this is a matter of federal policy. Now, but even if it is a foolish policy, or at least if Alaska views it as one, or the people who did this legislation think it is, I think that you have to ask, if that is the case, still, why do you want to then punish producers for this price policy basically. They already suffer enough from it in terms of the revenues they receive, why do you want to go an

added step and raise their taxes because of this. I don't think it's reasonable to assume that if you do this you will force national policy to change by what you do in the way of taxation here in Alaska. That seems to be reasonable.

GEORGE SILIDES - Madam Chairman, may I ask a question?

In addition to your comment of being unable to force national policy, would you think that this kind of tax is counter-productive?

RICHARD KILGORE - I suppose it's possible, I don't really know the answer to that, but I suppose there are reasons that might want to lead one to that result, and if the FEA has procedures for relief of these kinds of situations, then it sees the State of Alaska in fact imposing higher and higher taxes on such low productivity wells. I don't know. It's not inconceivable that it would enter into their thinking in this matter. Rather than providing relief, it seems that the State of Alaska goes in the other direction in this situation.

SENATOR HUBER - George brought something up here. Isn't this the fact that it effects these 300 barrel wells just because of the total tax maximum that we pay and then how we apply the mechanics of the formula. They could for instance, modify, and the mechanics of it I would have

to find out from somebody else how, so that that point would hit, maybe, more on a five or six hundred barrel a day well and maybe give as much as 10.3% or 10.4% out of Prudhoe Bay instead of an even 10%, and the formula diddled with enough to change that point to where it would be correct. Couldn't that be done?

RICHARD KILGORE - Yes it could be. If you like the basic approach of the continuous formula .....

SENATOR HUBER - Apparently you do, and I do too, and we might consider, and George's question pointed up that we might consider something from being John Messenger is here, that they might give us an alternative is that reasonable Madam Chairman?

CHAIRMAN POLAND - Well yes, except today we have Mr. Kilgore with us. He's leaving on a plane and we want to take advantage of this. We can bring this up.

SENATOR HUBER - I have considered this, Madam Chairman, to be a work session with him, and it's more valuable to me, the way we've been conducting it here today, than anything that we've had.

CHAIRMAN POLAND - Well fine. Let's give him a chance to get with it.

RICHARD KILGORE - Okay, we really are concerned with how this aspect works. There are two parts where Alaska is attempting to impose its own view of what the proper price policy should be, that is if they want the OPEC price. It comes on the floor, and it also comes as I said before in this calculation of the economic limit factor again. It enters in two places, and we have serious questions about this and what you really want to do. If the basic intent of the legislation is to provide relief that you don't go off in the other direction simply because you're unhappy with the prices because this throws all the burden on the producer, and then you're going exactly against what you really want to do, and you could have economic consequences to this.

I understand your concern with the prices that you get for your oil, and you'd rather get higher prices than lower prices, and that's fine, but the question is if the price is not set at a level that you think is appropriate then what do you do about it, and I guess, it's just bothersome to us that what you do about it is throw a burden back on a producer here. That's what you're doing about it, and that then goes against what we feel is an appropriate kind of severance tax because then you run into all the kind of economic problems with this gross tax and that's our concern, and we appreciate why you think in terms of floors and why you want to get an adequate value for your oil, and so forth,

and we understand why you do it, it's the consequences.

This tax also raises the tax on natural gas. If you'll recall our testimony before, we were always pointing out to you that if you did this you would have an impact on Alaskan consumers, that would flow through to Alaskan consumers. I noticed that there is another bill which is HB 329, SB 239 which is a residential fuel credit, and I presume that the intent of this is to mitigate to some extent the impact that raising the gas tax would have on Alaska. Consumers - we're not really in a position to know how adequately it does this because this has to do with what fuel bills really are in Anchorage and so on. We really don't have the information to calculate how adequately that does that, but obviously, you are concerned with that aspect to it, and the balance of the increase of course would be assessed against exports. I think that the other thing I should point out is that here you have in this not only an increase in the tax rate from 4% to 10%, but also introduce a floor price here, that is a minimum 6.4% per MCF, which is an effective floor price of 64 cents per MCF, and I think we have the same reservations here about this as you do on the oil side. If you have oil flowing, producers getting less than 64 cents, someone mentioned 42 cents the other day, but less than 64 cents, then you start to raise the effective rate of it, and I think we have the same problems with it here as we would anywhere else, and this

also has a gas flaired feature taxation, but it's only double, not five times, and all my comments on that go for this too.

SENATOR HUBER - That is in the equalization deal?

RICHARD KILGORE - No, it's in the severance tax, itself. There's a provision.

In the end, I'd like to talk a little bit about this whole question of the overall tax burden and how you assess it, the kind of questions that Senator Rader has been talking about, but I would first just like to make a few comments on the property tax bill, unless there are some other questions here on the severance tax.

CHAIRMAN POLAND - No. I was going to suggest that when you are finished on the bill, and before you kind of wrap up, that we take a five minute break.

RICHARD KILGORE - Okay, shall I just say a few things about the property tax. I have relatively limited comments here. HB 323, SB 237, now, this extends the property tax to some other areas as you know to refineries, gas plants, and also to marine transportation, and L & G liquifaction facilities, and so forth. So it extends the kinds of things that you would tax with your property tax. Now, the only real comments

that we have here are that for each of these areas that you're thinking of proposing a property tax on, you think carefully about where that tax will actually be borne. You're talking about taxing properties for crude oil production that largely obviously is borne by producers. They realize prices in the lower '48 that are set for them, and the tax you impose is a tax which they have to bare in terms of their own profitability, but that's not necessarily the case with each of these other areas that you are extending, and what I think you ought to think about what you are doing, because if you're looking at property taxes on refining in Alaska, we would expect that most of the refining capacity in Alaska for some time to come would be basically capacity oriented to supplying low markets so that the tax that you impose on those refineries presumably would over the long run be borne by Alaskan consumers. You're assessing a tax which goes to the treasury, but eventually that tax would have to be borne by consumers if the refineries are to operate properly. So you have to worry about the incidence of the tax. If you're looking at L & G facilities you have to worry again about the consequences of this and what will happen, and who will actually bare this. Will it be a cost that will simply be passed along because the facilities under an FPC jurisdiction will be passed along as probably may be the case. It's not clear that if it's L & G or export to foreign countries whether this would be the case. Who would bare it, it's not entirely clear.

GEORGE SILIDES - Would it not also have an effect on a decision as to whether to locate in Alaska.

RICHARD KILGORE - Yes, it could under certain circumstances. If it's a cost which basically the person thinking of putting in the facility has to bare himself because he hasn't got an automatic pass along or he can't pass along to Alaskan consumers, or he can't through his regulatory process, pass it along, then surely, it would be one of those tax entering into his decision as to whether to locate in Alaska. Noone can say whether this is the thing that would swing it in the balance, but obviously, it's part of the package of doing business, if it's a higher cost, it could have some effect, yes.

The last one is marine transportation, and there, well there's a question of legality, I guess, but we can't address ourselves to those, but it seems to me you might have some concern about this one too, because you already face a problem where you are concerned with the fact that your oil may have to move to quite distant markets, for example the U. S. gulf and the eastcoast, and you're very much rightly concerned about that long haul and those high transportation costs and what it may do to your wellhead value, and if you go this route of taxing marine transportation, you obviously add to the cost of transportation, I don't know how much would be thrown up by this tax, but you are in principal anyway

adding to the cost of transporting your oil which certainly works in the direction of lowering the value of your oil, so I think that you ought to consider this as well, as I say, in each case consider the consequences, but here you're putting an added cost on transportation and it may be small, but it certainly works in the direction of lowering your wellhead value. Basically that concludes my remarks on the specifics of the bill.

I would like to conclude with a few remarks about this old question of the total tax burden in Alaska. What fair share is, and at what point do you destroy incentives, undermine profitability and the like, and of course Senator Rader has been pressing a number of people for answers to this, but as he himself in asking the question admits, there obviously is no easy answer to this question. If there were, somebody would have given it, and I can't give you an easy answer. A number of things have been suggested, all of which make a certain amount of sense. What kind of activity is there in the State has been suggested. A number of people have suggested looking at the total tax burden in Alaska, relative to other states. I have a few comments on that aspect too. It clearly is important what the total tax burden is on the oil and gas industry, there's just no doubt about that and how it compares with other states. It certainly is not just the absolute amount of dollars being paid or dollars per

barrel of production being paid to the State. What really matters for the economics of the industry for their incentives to go in and so forth really are these aggregate dollars or dollars per barrel things put into context of the profitability of the operation in the various states. This is what really counts in the end, not just the amount that one pays. If one is paying a high tax, but in a situation where profitability is very large it's one thing, if they're paying perhaps even a lower level of taxation in a situation where profitability is low can be another thing. So, you really have to put it in the context of profitability. This doesn't make it any easier to answer obviously because profitability is elusive and difficult to measure, but certainly one has to put it in this context, not just in the dollars themselves. And the second thought about it is, I think that although some people have said this, that the mix in which you get your taxes out of this total burden to your state and other states is really not irrelevant. Someone suggested that a dollar is a dollar, but this isn't really quite so it seems to me if you're looking at the burden of those dollars on people. If you have taxes that are relatively based or geared closely to income, that is income taxes in kind of a true income tax in a sense that it is directly trying to measure income, it's one thing if you collect it that way as against certain just gross taxes or property taxes and the like, because if you have taxes based on income, they have a different economic impact than gross taxes.

If you have a severance tax, it's not a matter of indifference how it comes. If you're collecting high severance taxes in Alaska because you have wells that are extremely productive and that's the way your tax is structured that's one thing, if you're just doing it flat out on everything that's another. So, that it's not just the total dollars, these dollars have different effects, and that high taxes in one circumstance where they're thrown up out of a total tax package that's more closely geared to income and costs and so forth may be less of a burden than in another case where you have somewhat lower taxes, but their generated by things that have nothing to do with profitability, and you have a low profitability situation, so that I think it isn't strictly the total, it is the mix and the types of taxes that you have 'also, that also matters, and to the extent that the closer these are geared to income, the better you really are. The second thought I have on this whole question is the State, I'm thinking in terms of the burden of its taxation also has to remember that it has a role not only as a taxing authority, but you also in this State, and this is different from other states, most other states anyway, you have also a role as a land owner, you have lots of land and you will have leased that land and you will be leasing more, and you have to realize that the higher and higher you put your own taxes, this will have some effect on the kinds of terms that you're going to be able to get for your land. No matter how you lease it.

If you lease it on a bonus basis, the higher your taxes, the lower your bonus. If you go on a royalty bidding basis, the higher your taxes, you'll get lower royalty bids out of all that, or if you have a net carried interest or a net profit interest kind of leasing arrangement which you may turn to. Your profit people are willing to give you also \_\_\_\_\_ part of the taxes.

GEORGE SILIDES - This matter came up before in a different form, and the comment was made by the speaker was that not to be so terribly concerned because the competition in leasing would take care of that matter.

RICHARD KILDGOR - Well what I'm saying is that I think the competition in the leasing is going to reflect your taxation. That is, if you have higher taxes, I would expect in general you will get out of the competitive process when people are bidding for leases on whatever variable they're bidding, whether it be royalty or bonus or whatever, the amount of the tax that they will perceive you will take in the future will effect their bids, and they'll bid competitively and it will be reflected on how much money they're willing to offer you initially, or how much percentage of the thing they're willing to give you and so forth, so that your tax will effect the terms you're able to get on your own land.

REPRESENTATIVE OSTERBACK - I would like to ask a question. We listened to all this testimony, but we never came down yet with how much are we getting for our oil. And another question on leasing, it doesn't seem to make any difference, the bids I say that came out from the State or from outside the three mile limit seem to be about the same value they are bidding into the millions for off-shore leasing. What kind of a deal could you answer that on off-shore leasing? And the taxes, what kind of taxes are they paying? Are we going to get a benefit out of the off-shore leasing taxes?

RICHARD KILGORE - Well, on off-shore leases, where they're on Federal waters, you basically will not get the state severance tax from those barrels or MCF's of gas being produced out \_\_\_\_\_ there, and basically the tax that that oil in Federal waters will be subjected to is basically just the Federal income taxation, and you will not get severance or other kinds of tax revenues unless one's able to go through some franchise tax kind of thing. I just don't know whether that's legally possible for you to do that, but unless you can think of something ingenious of that sort, basically it will be just federal taxation on that, and the bids that would be received if you had comperable prospects on shore Alaska, lets say off shore but in Alaska waters similar prospects to something over the line in Federal waters, and you put these up for bonus bidding,

presumably what you would get since you have no severance tax on the offshore, you would presumably get higher bonus bids to the federal government, than you in Alaska would get for your exactly comperable prospects. I don't know if that answers the question or not.

REPRESENTATIVE OSTERBACK - One other thing, somebody brought up the other day that since we get 10%, or we pay 10% of the federal tax, I don't know, I know you know more about, . would we be getting a share of the federal tax in the amount of 10%?

RICHARD KILGORE - Yes, to the extent you share in federal revenues and so on, yes you do get some share that way. That is correct, but the other thing is that as you know, there is some move afoot in the Congress to provide some sort of sharing of royalties and other income from offshore productions with the coastal states, and I would think that the State of Alaska should push very hard for this kind of thing, and I would also think that in the past this was probably not the kind of thing that the Congress would pass because there were relatively few states which would benefit from that basically Texas, Louisiana and California that would benefit from that kind of thing, that is sharing the revenues, some portion of the royalties and bonuses in the federal waters off their shores, but the situation seems

to be quite different today because we now are talking about exploration along basically the whole eastcoast of the United States, so there are an awful lot more states which potentially could benefit from this and presumably would support such a measure in Congress. There seems to be a lot more support for that kind of thing than before, and perhaps you will get something like this. I think there's a lot of merit in doing this from a national standpoint too, because as you know on the eastcoast there are all kinds of environmental opposition to this drilling and everything and bringing this oil ashore and everybody is up in arms about the environmental problems, well, I would think that if the states including my own where I live, New Jersey, really thought they had the prospect of getting some direct share of the income from oil and gas in federal waters offshore New Jersey, I think they would view the environmental matters somewhat differently, or at least be willing to look much more realistically at them and have greater support for this activity, so I think that this is something that Alaska should be looking for, and maybe it's another way you would be able to benefit, and if you were able to get some benefit, in that way some share of royalties, bonus income and so on from federal waters offshore Alaska, I think the amounts of money, I don't know what the share would be, I think the amounts of money that you would be getting would be very very much larger than any kind of fooling with apportionment factors

in that franchise bill to try to pick up something. We're talking about much larger potential amounts of money I would think.

REPRESENTATIVE OSTERBACK - Talking about the environmental con- sion and everything, you're going to get a lot of static from fishermen, \_\_\_\_\_ coming out that the oil won't take Kachemak Bay for example. Now, Kachemak Bay, only produces about 6 million pounds of shrimp, but you come up towards the chain around Kodiak, what we do, that's just a drop in the bucket, and we're buying that back, so there's going to be a lot of static, say in the Bering Sea, is one of the richest crab, herring, shrimp, and out along the chain, so if there is no revenue for the : then we're going to kill off our fisheries and there ng to be a lot of static coming from that on the offshore drilling, because you can see what happened in Kachemak Bay, which is just a small little thing, and we're going to pay I don't know how many million dollars to buy that back to save that fishery. And what I'm trying to get across, if we're not going to get no sharing off the offshore, there's going to be a big fight to try to stop it.

RICHARD KILGORE - Absolutely, because then you say what do you need it for, to get nothing whatsoever out of it. I don't want anything I say to be construed that I'm against environmental concerns, they obviously are very real, but

I think what you're saying is correct and this goes for other parts of the country too, if what you're talking about is development of Federal waters, and off your shore with the potential environmental problems from which you will suffer, and you get absolutely no benefit, then what do you need it for. In those circumstances one would take a very extreme, I think, position on viewing the environmental damages. That is, one would say, I don't care if the chances are one in a million, I don't want it because I don't get anything out of it anyway. If there's any chance whatsoever, let's just don't do it, because I don't gain anything anyway, but if you have something to gain from it, I think perhaps people may very well take a more realistic view of what the potential hazards are, what might happen, and with the odds have been happening and so forth, but if people are in the position where they have absolutely nothing to gain, and any possibility of something happening to their environment, that's really going to be against them.

REPRESENTATIVE OSTERBACK - One more, if I may. Take say a barrel of oil is worth what \$12.00, \$11.00, what? A barrel of fish is worth about \$200.00. So what do we want?

RICHARD KILGORE - Sure, if you're going to destroy a valuable industry.....

GEORGE SILIDES - One of the things the administration has put forth through the federal government in my recollection is that, it is just that, and this is why they were hoping to hold off some of the offshore production was to submit a proposition to the Federal government on revenue sharing. I think you are familiar with that, and I think you touched on it. My recollection, and I ask this only for informational purposes as you know, it seems to me that we also suggested a two tier affair. I know you hate everything with two tiers in it, but in that all of the states were able to get a portion of the offshore revenues, so that you gain a broader base of support.

RICHARD KILGORE - Yes, and I think that's a sensible approach to this whole thing too. One can gain broader support where you have some approach as you're saying. Where you have everybody benefits to some extent, but those who are directly effected or so on, get some larger share.

I am saying that you do have this interrelation when you thir' about how high you put your taxes. There is this interrelation between what your taxing policy will be and how much you are raising taxes, and what you're going to get in terms of economic benefits when you lease lands, and that's very very clear, so to some extent you're taking one area through higher taxes and you give up in another through lower, whatever it is, bonuses and so on. So to some

extent they are offsetting, but of course at the same time you have to appreciate that while this is true on new leases for people under existing lease terms, obviously they can't change their contracts with you if you raise taxes, so if you raise taxes they are hurt. You also through your tax policy, obviously effect the value of lands or the value that one can get out of other landowners in the State, and of course the native corporations are obviously the ones who will be effected to the extent that you raise taxes and they make new arrangements on their lands, they will be effected, and they will get less in the way of.....

SENATOR HUBER - I wanted to just for a moment on that same subject to lead Dick back across the cannon ball range and the mud flats, and back to dry land for a minute on these leasing policies, and you were talking about bonus leasing when we got into this, and isn't it true that the price paid for a bonus lease whether it's offshore or onshore, mud flats or whatever, it is based upon what they're willing to pay for the price to gamble on what may be down there in a huge gamble and if we wanted to minimize what our tax would do on that, the minimum would be no tax, and other than that to have a tax that would have a minimum effect, would be a tax that was a percentage of a net profit, and if you had a percentage of net profit tax, that would be the kind of tax that would provide the minimum for losing money in your bonus, because they would all figure when they were bidding

that there would be no tax on anything that we don't get anything on and it will only be a maximum of this amount of exposure on the net when we do make, and if we don't make, we don't pay.

RICHARD KILGORE - That's correct, but that's assuming of course that the income tax that you have really is taxing what is real kind of income in Alaska. If you are on, as the gentleman from EXXON testified the other day, if you're on an apportionment formula, you may pay income tax anyway.

SENATOR HUBER - I didn't mean to lead you back into the net proceeds tax which you happened to design, but I'm thinking about any fair income tax that would.....

RICHARD KILGORE - The income tax works differently, that's right, in the sense when he factors it in and if it's true income tax, he only pays if he wins, so it does effect what he's willing to pay.

SENATOR HUBER - I just wanted to get it to where we actually, what kind of tax we've heard so much, so many times about how you discourage your front end money in bonus bidding, and in some cases, it's absolute milarkey, you don't do it at all, and there you hardly do any discouragement when you do it on a net profit basis. If you get a portion of that in there in a gross manner, you've got a problem.

RICHARD KILGORE - My only point here was to leave you with the idea that we do have an interrelation between the taxes and what you will get on your lands when you lease them, but you also will effect, of course, the value that other people get from their lands and \_\_\_\_\_ the native corporations.

Well in the end, this whole question of the relative tax burdens and the effects, and when do you have to \_\_\_\_\_ incentives, when do you discourage, obviously there are no easy answers as I said at the outset. There are many things you would obviously have to look at, and many of these have been suggested. One would obviously be an economic study of the industry, some of which have been done. Levels of activity would be another indicator of your total tax package, lease bids and so on, comparisons with other states and all these things are things that one would look to and try to assess how far you have gone in your taxation policy.

I think one of the really best safe courses, so one would really know where one is in this whole thing, even after you look at all these sort of measures, one of the best safeguards is probably to try to design taxes in your state that relate reasonably well to profitability. I think you run less of a risk if you do this. If you are able reasonably, or in some fashion to relate them to profitability, then you're not going to impose a very big tax burden if the industry isn't

very profitable, and if it is very profitable, you tend to throw up higher taxes and you run less of a risk really that you end up imposing on reasonable taxes on people, and this probably in the end is one of your best safeguards to kind of keep those principals in mind which means taxes related either directly related to income or taxes sort of semi-related to income as the step schedule that you have or the continuous schedule as is proposed where you really impose high taxes only in circumstances that seem to indicate high profitability, that is high well productivity which tends to be associated with high profitability, so I think the more that you keep to these kind of principals, the less of a problem you're likely to have in terms of really going too far in your tax burden on the industry.

GEORGE SILIDES - I have questions on two matters which concern most of us. One of them I know particularly concerns Senator Huber also, and if I may I would like to ask them now. One is do you have any comment on wipping out all the industrial incentive taxes in the State.

RICHARD KILGORE - We really don't have a comment on that.

GEORGE SILIDES - And the other one then is something which was discussed back in 1973 when we had a bill before us to own part of the TAAPS line. Now we have some bills in front of us which concern the possibility of again acquiring

an equity interest in gas lines or other lines, and I wonder if you could comment on that, whether your position has changed or what it might be now.

SENATOR HUBER - George, would you \_\_\_\_\_ bills particularly is for an industrial incentive, or for a state sponsor corporation which would operate on its own under the so called industrial incentive type bonding 100% if you could expand your question .....

GEORGE SILIDES - Senator, yes, I was going to make it into two parts, one is just to get a general statement on the State being an equity owner, and secondly of course we have SB 251 which is Senator Huber's bill actually.

RICHARD KILGORE - I haven't seen the bill itself.

SENATOR HUBER - It establishes an authority Dick, and with all of the powers, 100% of the authority to build the gas line.

RICHARD KILGORE - Well, frankly I would prefer, if you don't mind kind of deferring an answer to this question, and give it a little more thought. I know we have in the past, I guess, generally kind of questioned states being involved in things of this sort, and I don't want to give a general answer.

SENATOR HUBER - I don't want to force it either, but the reason that you might give it some consideration when you go back home is that the bill is not this one that is just an idea of whether we do it next year. This particular bill is an either now or never type of thing because it is designed, the whole purpose of it is to supply the North Slope gas to the lower '48 at an economically feasible price to make the project feasible, so it don't have to be subsidized either by users or the government, and if with the FEA setup and everything is set up with the President's approval and everything, it's an either pass it, so it's a method or else it will not be a factor. It's kind of a forced thing but it's now or never. It's timely.

RICHARD KILGORE - Senator, there are a lot of ramifications and a lot of things to think through on this particular kind of thing. I would prefer rather than just giving it off the top of my head, if we did especially take a look at the bill in itself, think it through carefully, and either come back to you with a written response or on the occasion of our next visit be prepared to respond.

MEETING ADJOURNED.

\*\*\*\*\*

ADDRESS TO HOUSE (SENATE) RESOURCES COMMITTEE

ON

PROPOSED NEW OIL AND GAS TAXATION  
(HB 638, 803 - SB 620, 621)

Mr. Chairman, members of the committee. My name is Oliver Leavitt. I am a resident of Barrow, Alaska and am appearing before you today as Treasurer and Director of the Arctic Slope Regional Corporation. I also serve as an officer and director of AFN, Inc.

As you are aware the native regional corporations and AFN, Inc. have gone on record unanimously in opposition to a package of proposed bills in both the house and senate. These bills, if enacted, will greatly increase taxes on oil produced in the state.

Uniquely, out of a commonality of purpose rather than by design or intent we find ourselves aligned with all present and potential future producers of oil. This includes any individual or corporate entity who holds or may ever hold an interest in oil produced in this state.

The cliché that "Politics makes strange bedfellows" is appropriate to emphasize that we are not here in collaboration with the oil industry. No conspiracy or plot by design or inference exists, but by coincidence we find ourselves on the same side of the playing field. Simply stated it is a case of the well worn expression "whose ox is getting gored."

While our self-interests or, better stated our economic survival is at stake we would also like to bring out in a few brief remarks why we believe the consequences of enactment of the proposed legislation at this time could have damaging effects on organized labor, the general business sector, and the individual consumer/taxpayer in Alaska.

Some of you may think that it is out of context for the native people of Alaska to argue for or against anything but preservation of our culture or historic life style including a subsistence living pattern. The Alaska Native Claims Settlement Act in recognition of the value of extinguishment of aboriginal rights and title, provided for compensation

in the form of land and its attendant resources as well as cash dollars. The primary vehicle for management of the assets that were granted are the regional corporations. Congress expressly mandated that the corporations be structured as profit making organizations who have an obligation and responsibility to improve the economic well being of their shareholders. So, like it or not, our task is similar to any other non-public corporation. Maybe because we are relatively new in this game we enthusiastically embraced the free enterprise concept. An individual through hard, honest work is entitled to make a buck and to be allowed to keep some of it.

That is what we have been led to believe. The intent of the Settlement Act was to provide a means to economically develop in a free society without the shackles of subservience or bondage of governmental domination. But, in truth, we are not there yet and we have a long way to go before our economic stability is assured.

Now, let us examine the whole spectrum of what is involved with this proposed legislation.

#### I. THE CONCEPT OF TAXATION:

Everyone in this nation let alone the State of Alaska understands why governmental authority from the largest to the smallest imposes taxes. Also we know what the taxes are supposed to do - provide services for the public. Taxes run the machinery of government which in turn provides the taxpayers with necessary services that they otherwise cannot effectively and efficiently do for themselves. Education, health, protection, transportation, economic stimulation, aid for those who need it, management of renewable and non-renewable resource belonging to the public - all these and more are the charge of government. Our system is to provide funds through taxes to support the level of need. The idea of taxing beyond the immediate and discernible need is not our system - it best fits those societies who think confiscation or expropriation are the way of life.

Some of you may believe that industry is such a greedy creature that no matter what tax is levied they will hang on. I won't belabor this point other than to cite a recent example that has been accurately statistically documented.

The action by the Western Canadian Provinces, especially British Columbia, in the past few years saw a sharp percentage drop until many people wised up and changed the make up of the government.

## II. THE POSSIBLE EFFECT OF USUROUS TAXATION

Both our U.S. Senators have recently commented publicly that Alaska may be on the verge of being considered a "bad little rich boy." We obtain more in federal support per capital annually than any other state - exceeded only by Washington D.C. But more than this Alaska receives 90 percent of the revenues from Federal Oil and Gas leases in the state and receives 25 percent of the stumpage from Federal Timber Sales. The latter is common to other forest product producing states but should be mentioned because the revenues flow directly to the local communities.

If the present proposed tax laws are enacted and the federal treasury loses from 25 to 38 percent over what it otherwise would receive from income of Alaska producers from sale of Alaska resources, why in the name of heaven would the preferential treatment continue? Lost distribution of federal receipts affect everyone - consumer, housewife, and individual taxpayer.

## III. THE IMPACT ON ASRC AND OTHER REGIONAL CORPORATION

I have attached to copies of this written testimony our interpretation of how the proposed taxes would effect our income from oil produced on ASRC lands, under both the House and Senate versions of the bills.

## LIPTON TESTIMONY

cents/barrel taxation upon the company, that is, you had anticipated that a \$6.50 wellhead value will obtain for most of the production on the North Slope, in which case the cents per barrel really is not onerous, because the companies were paying on a percent of wellhead value. So if your cents/barrel is geared to hurt a company only if the wellhead value falls below \$6.50, and you don't anticipate it falling below \$6.50. Oh, this was a kind of compromise, protection against what might go wrong. Well, a lot of things went wrong. Among the things that went wrong were things that were partly beyond control of the company. Namely the adverse economics of disposing of the Prudhoe Bay production beyond California. One of the other things that went wrong, not necessarily wrong but went counter to the expectations of the Legislature, was that the pipeline tariff posted by the companies and now applicable pending adjudication by the Department of Energy, the successor to the ICC, is a very high pipeline tariff. This tends to reduce the wellhead value. So partly the companies have in effect shifted wellhead value down, because of the profit of the pipeline, but partly it has to do with economic circumstances, the ability to market at a good market, the prices in California are not that different than in Gulf Coast, for competitive reasons, but that's a different story. Basically, the price that they have to compete against is not much different in California than in the Gulf of Mexico. The big difference is the difference in transportation costs and there is a difference of \$2.50 in transportation costs gross, and probably somewhere between 70 - 80¢ net after taxes out of pocket to the companies to go all the way to the US Gulf Coast.

Q: Sumner: I believe that I heard you say this morning that if we keep foremost in

mind the subject of future investment incentives in Alaska that we're going to have to weigh very carefully, even though we may want to restructure the tax structure here in Alaska, but as it relates to the aggregate of the total taxes that are being paid, I got an impression that you thought maybe we ought to think cautiously of how much we might increase in aggregate the taxes that are paid as it concerns the future investment incentives.

Lipton: I think that's right. I think that no industry can be indifferent and because the industry is important to Alaska, no legislature can be indifferent to the aggregate tax burden. I think that's quite a different thing from simply being overwhelmed by a statistic which says this industry is already paying, given our assumptions, somewhat, 5% more, five percentage points more than we would be paying in California. There's a shadow area between where tax burdens or expected tax burdens suddenly are going to affect industry investment incentives, particularly in the area of exploration. One thing you know, that the exploration dollar does not go automatically where the tax burden is least. The exploration dollar tends to go where the exploration prospects are best. You can surely shift it somewhere in this gray, shadowy area, where the tax burden get so overwhelming, or if there is somewhere the perception, and I think this is one of the things the Legislature surely will want to consider, that if the perception is that changes in the tax structure, as it is applied to the oil and gas industry, are regularly taken, largely with the view to budgetary needs or revenue deficiency, and hardly ever with the long view as to what is a reasonable tax regime for the state, then I think it creates impressions which may be even more important in discouraging investment than the fact of the tax burden per se. And this is why I think in all of our discussions with the legislature, we've

## LEPTON TESTIMONY

tried to emphasize that a balanced tax structure, in which each of the three elements, which are the income tax, the severance tax, and the ad valorem tax, have to be weighed somehow by a different criteria because they have different effects on the industry, but if it's balanced and if there's a concept of continuity over time, that under those circumstances we have not yet seen this legislature placing such extravagant burdens on the industry that if they had sufficient confidence in, you know, the trend over the future, that this would not discourage investment.

Q: Sumner: What is your guess to the likelihood of depressed oil prices in Alaska to resolve the oil activity throughout the rest of the world. Right now in terms of the efforts to increase or step-up production in many areas of the world and the West Coast surplus to some degree, do you see that as building on itself?

LIPTON: No. I don't think that there's anything in the nature of oil exploration world-wide. One has to have an incentive, and two, has to have a purpose. The incentive is the hoped-for profitability of the relatively high foreign oil prices. The purpose is to try to create the reserves, the expanded reserves that will meet world oil requirements in the future. If I may digress for just a moment, we're living in a strange circumstance. The productive capacity in the world today is considerably larger than world oil requirements. The reserves of the world today are really not very great compared to what future demand is going to be. We're facing a temporary surplus of collective capacity but a long run deficiency in the reserve base for oil, so the exploration is going to go on. I don't think there's any adverse effect on Alaska. I think the long run opportunities for marketing Alaskan oil in North America at prices that are attractive from the standpoint of the profitability

## LIPTON TESTIMONY

of exploration ventures, from the standpoint of the state's share of the economic value, the prospects down the line are terrific, and if the geologists of the company see the opportunities here, the exploration money will come.

Q: Sumner: I'm trying to determine what period of years might be involved in your projection there and weigh that against what is scheduled to be the peak production years, Prudhoe Bay for instances, which is right now of course one of the largest reserves in the state. You know, if it's ten years down the road, we won't be competitive, or we will have marketed the major part of this oil from that reserve. So does the long term picture look like three years, four years before improved or upturned pricing structure.

LIPTON: I don't think your prospects are all that adverse even at the present time. You're suffering a temporary disadvantage by virtue of several things, one, price control and two, the fact that your production is surplus to the ability or the willingness of California refiners to take that amount of your oil, and this will become aggravated next year when the production goes up substantially and the demand for all crude oil in California refineries is not going to be large, so that a larger portion of your oil is going to move beyond, but there will be in the interim, there'll be improvement in both world and US oil prices, world oil prices because of the level determined by OPEC and US oil prices under whatever compromise on energy policy evolves.

Q: SUMNER: On the near and the long term?

Q: HUBER: Milton, would you go further into the relationship between cents/barrel in relation to vertically intergrated companies allocation to expenses and profits, sales, processing, production, transportation, such as possibly what would be the difference in situations with BP/SOHIO for instance if they have decided to take not the maximum in the transportation but to take

## LIPTON TESTIMONY

a minimum from the pipeline transportation and maximize their production profits.

LIPTON: Well, Senator Huber, you pick a difficult example. British Petroleum has a direct participation in the pipeline, so whatever the after-tax profitability of the pipeline operations are, for its undivided share of tax it accrues 100% of the profitability. Now, whatever the effect will be upon the wellhead value at Prudhoe Bay, therefore on the tax liabilities of Prudhoe Bay producers, therefore on the after-tax profits of Prudhoe Bay producers, affect British Petroleum only through it's partial ownership of SOHIO. What the net effect would be, I would assume without doing a great deal of number work, British Petroleum looks at 100% interest on the one hand and less than 100% interest through SOHIO's participation in Prudhoe Bay, would in a sense place greater weight on it's 100% equity which is the pipeline participation than on it's indirect participation in Prudhoe Bay. But you see, neither this company nor any other company has complete flexibility in how they operate. The tariff that British Petroleum set TAPS can set on the same basis as all the other operating companies; that is to say they chose to calculate a tariff based upon the old ICC 8% rate-making modified by the 7% consent decree with Department of Justice, and so they all use the same principles, they've got approximately the same tariffs depending upon their debt proportions and so on. British Petroleum behaved exactly the same way, and obviously, if it did behave the same way as the other companies, it was thinking in terms of what seemed, from their assumptions, to be an appropriate policy. I really don't know that there's so much difference among the companies. The other part of your question is a meaningful one. If you have integrated operations, and if in fact the

## LIPTON TESTIMONY

tax exposure of profits earned in one place or one function is different, in other words, if you earn the profits here you pay more taxes, therefore you like to have the profit somewhere else. If you earn the profits in production, you pay higher taxes, therefore you like to have the profits in transportation. This is true of any company that has the possibility of shifting through transferring pricing the profitability from production to (IA). But the companies don't have freedom here in terms of the pipeline. . . The issue of the pipeline tariff really I think should be divorced from the taxing policy of the legislature, at least at this moment in time because it's now at issue. First of all in the courts and certain legal respect, and more importantly, it's at issue before the Economic Regulatory Administration, Department of Energy, which is looking into both things, both what the capital base is for the determination of tariffs, and two, what the proper rate of return ought to be. And this is now in adjudication. And your own Alaska Pipeline Commission is seized with the issue of the tariff between Prudhoe Bay and Fairbanks. It's going through it's own administrative process, and if it turns out that in fact, the administrative decision upheld in the courts is that the pipeline tariff is too high you will get higher wellhead values and (IA) the companies whatever their predilection will be low side of profitability and tax exposure, are going to have to follow suit.

Q: HUBER: I can recall the arguments when we put in the cents per barrel, and it was to protect the state, if I remember right, through revenues even if the oil would fall to zero wellhead value, and even if the allowed transportation should be extremely high. Coupled with that was the figures given to us many times that most oil pipelines were allowed to 8% maximum but the history of the ICC shows that they weren't, the prices were such that they weren't taking only 5%, 6%, 4.5%

## LIPTON TESTIMONY

of these figures and many others several times showed that most of ICC-controlled pipelines were not charging that maximum amount. Here we have the situation that you brought up, SOHIO is paying 12.25% effectively because of the floor

LIPTON: (INTERRUPTS) (16.5)

Q: (continues) you said 16.5% effective, and yet every one of them is change and it seems like they have decided that the Alaska pipeline that the old proportion will be used, they will go for the maximum they can and I'd hate to see what it would be if we didn't have the lid of 8%. It looks like you've got a whole new ball game here.

LIPTON: Senator Huber, I think I do recall your reference to the past.

We have been rather vocal on this subject of ICC tariff regulations and pointed out the history of two things, one, that the 8% rate making rule was a monstrous rate-making rule because it had been adopted in an economic environment which no longer existed and the ICC for unfathomable reasons has never gone back and reviewed the 8% and the rate-making rule, and because of that, we raised the whole question of the effect upon netback values, wellhead values, and we strongly supported the establishment of the Alaska Pipeline Commission, which gives you your own avenue of administrative regulation. But you know, an interesting thing happened. All of a sudden the ICC came alive, and the ICC said that that old 8% rate-making rule is no good. We're going to go to a 10% rule. But you know the 10% rule yields much lower tariffs than the old 8% rule. The 8% rule was 8% after tax and after recovery of interest on total valuation. The 10% rule, and there's nothing magic about it, and I suspect that in the course of time the review of the whole issue will modify that too, but the whole point of the 10% rate-making rule is not to give a higher rate of return. What is said in effect was the 10% shall be the total return to capital; that is to say your interest charges,

## LIPTON TESTIMONY

which are such a fantastically large thing have to be covered by that 10% return of your capital, and this led to ICC-proposed tariffs which were \$1.50 or so on the average below what the companies have posted. Now I suspect that the change in attitude of the ICC did not arise of a vacuum. It was a reflection of a long discussion on the implications of the rates that had taken place before your legislature over many years and argumentation over what the appropriate rates of return should be, what the appropriate rate base should be, and what the resulting tariff would be, and I think that at this stage of the game, from the standpoint of Alaska, not from the standpoint of the companies, there is reason to anticipate at least that there will be very very serious review of these pipeline rates. Now if it turns out that after all administrative review and after all judicial review, that the company tariffs stand, where are we left then? What's the judgement then? That everybody's wrong? The companies are wrong? The Department of Energy is wrong? The courts which uphold them are wrong? The Alaska Pipeline Commission hasn't been able to do anything. I doubt that that's the case. But if all of that does transpire, what then is the implication? Maybe the tariffs are not of our line. If it's done through all process, I don't think that's going to be the result. I think the strength of the Alaskan position is in everything which has transpired over the last few years, including the arguments about the rate base, the arguments about the rate of return, and everything else, I think this, I strongly believe that this is a judgment, a personal judgment, that you will have substantially lower tariffs on TAPS than were promulgated by the companies themselves.

## LIPTON TESTIMONY

Q: HUBER: Just one final follow-up. It is within our responsibility, purvue as legislators for the State of Alaska's people to determine at what point do you say this is what we would do in fairness, or do you say if it isn't economically feasible to produce this oil at this time because of transportation problems, federal rules that are in many cases arbitrary assumptions, maybe we shouldn't get rid of this depletable well at this time. The cents per barrel tends to do that, what I'm talking about, rather than removing it entirely, or move the cents/barrel down to where we could bring more fairness to the companies as you say, what do we do with ...

LIPTON: Senator Huber, if you're talking about revenue per se, it's a persuasive argument. If the function is to provide an underpinning to state revenues, the cents/barrel does it. Now, the other question is what are the implications when you choose to buttress or underpin state revenues by doing this? First of all, what you see is a kind of ad hoc taxing policy, increasingly year after year dedicated to our budgetary needs, revenue deficiencies, or whatever the case may be. There are circumstances which may militate in that direction, if it's necessary, if the state faces a crisis. But you must always ask yourself, is this to be the principle of taxation that you'll follow in every legislative session, or are you willing to say that the state has an economic interest which is represented by, first of all, it's royalty claim in the lease, secondly by principles of taxation which have been evolved over sessions, and only under extreme situations do you start intruding unique revenue problems as the basis for change in the tax liability in one year or the next year or the third year. I have no argument against the necessity of doing so from time to time, when abnormal circumstances intrude. I do think that it

## LIPTON TESTIMONY

causes, the question is asked of me so many times, including just this session, where do you start adversely affecting corporate investment decisions, and I said then and I still feel that you could with the burden of taxation do it, but more likely, the kind of changes in the burden of taxation really won't have that much effect, but if there is a perception that tax policy always is determined with a kind of a unique view toward the budgetary exigencies and the revenue deficiencies of the moment, and there seems to be no continually over time, that would have a very adverse effect.

Q: HUBER: By possibly reducing the floor, and I do hope that in some cases this might be a viable suggestion. I just can't get it with our responsibility that floor of 62.5 ¢ a barrel, for Alaskan oil now at least that's the floor on severance tax, and I can't see how that could be effective now when this same oil it's competing with throughout the world, other countries like Arabia, are taking \$10.00 a barrel, we're taking too much at 62.5¢. I just wonder if we're making our discussions in the right range. We shouldn't be making off somewhere halfway in between somewhere instead of down below the bottom one.

LIPTON: I'll give you a very quick answer to that. Saudi Arabia in effect takes more than \$10 a barrel for their oil. But let's assume that you'll be satisfied with a modest \$10/barrel taxation on your oil. You take \$10/barrel for your oil and the oil has to be sold in L.A in competition with Saudi Arabian oil, or \$13/barrel. Now you have left \$3/barrel to pay your transportation costs from L.A. to Valdez, never mind the profit on the pipeline, your pipeline costs from Valdez up to Prudhoe Bay, the costs of producing the oil. \$3 won't do that. That's why you can't get \$10 for your oil and Saudi Arabia can

MILTON LIPTON

get \$10 for it's oil. Furthermore, you are not a Saudi Arabia in Alaska. Let me be presumptuous for a moment in addressing the Alaska Legislature. You are not a United States in Alaska either. You're living as part of a nation which also has a tax regime. The United States has all forms of taxation upon oil and gas operations, including your oil and gas operations here in Alaska. The United States has a policy with respect to development of energy resources, the pricing of energy resources, they may be unattractive in Alaska. They are largely tax regimes attractive to the oil companies, the price and policies are attractive to the, but never the less, it is our national policy and it seems to me that the State of Alaska in its perception of how it treats the oil industry, must do so as part of the United States talking about an oil industry which is also part of the United States.

Q: HUBER: It just seems like we've got about a 20 to 1 difference there, and I hate to get working below the one figure in figuring where we should come out when I have a feeling it's somewhere between the 1 and the 20 instead of below the zero line, below the 1 line. And I just can't relate it.

LIPTON: A, Senator here, let me put it this way. There are companies operating here in Alaska who are operating in the Middle East, and earning in the range from .15¢ to .21¢ a barrel for their producing operations. And it's a bonanza to them. A fantastic bonanza, ever so much profitable than any operation in Alaska. If they earn as a margin of after tax profit in Alaska \$2 a barrel we couldn't come close to the profit ability of middle east operations. Look at the fantastic difference in investment that's involved. What's of interest is not just how many cents per barrel we take away after cost and taxes, but how much of an investment of that is necessary to do it. There's a tremendous difference. I'm not addressing myself again to the fact the industry could not

## LIPTON TESTIMONY

stand any increase in taxation here or it's too high now. This is a very difficult thing to arrive at and this is a thing the legislature always has to balance. But I don't think, this is my only point, I don't think that the criterion the legislature should use in deciding whether the taxes are too high, or whether in fact they should raise taxes on the oil industry here. That they should look at the government take or the taxation in foreign producing countries. It's completely irrelevant.

Q: HUBER: Could you tell us better and more direct how should Alaska get it's honest, true, fair share both as a property owner and as a taxing entity if we don't use comparative means. That I think is the level we set up.

LIPTON: You're comparing yourselves with other tax jurisdictions which are also state states in the United States. I mean this is one of the reasonable comparisons. And you look at one form of taxation which is a corporate income tax and try to get what is a, well, you've got a corporate income tax rate. The problem is that that rate is going to apply to too low an estimate income. You can correct that if you choose. You have a severance tax which has evolved over time, I think in a very healthy direction. You have increased the ceiling percent of well head value over time not to any onerous letters compared to other states. You reduced it at the other end. You tried to provide not only for the state's revenue under optimum circumstances, but for protection of larger industry operations under adverse circumstances. You loaded on ad valorem taxes at a very considerable extent, and you did that under the exigencies I think it's quite understandable that, in your judgement revenue needs which anticipated the flow of revenues. You chose an avenue which was to tax before profits were being generated. It happens a lot of times. But I think this is the basis upon which you judge. You look first at the total tax burden, then you look at the individual parts, and how are

they in terms of the revenue for the state and what are the economic implications for the companies that have to operate under those taxes. Certainly you've never subscribed here to the opinion that you're aggregate taxation, or that individual aspects of taxation were so onerous that in a sense they are discouraging operations here in Alaska. There's no evidence that operations here in Alaska are discouraged. If there's been a lag in exploratory drilling there certainly hasn't been because of the tax regime. It's because of the problems of leasing, land selection.

Q: REP. MILLER: Just real quick, and I'm curious, name a few states that use separate accounting.

LIPTON: Louisiana and Oklahoma

Q: REP. OSTERBACK: Talking about the oil. Have you done any figuring on the gas? That's the next thing that's going to face us in our Committee, the well-head price on gas. Have you done anything on that.

LIPTON: No. This is a wide open subject, and I have nothing but pity for those individuals who must now wrestle with the problem of not only what, what the well-head price of Prudhoe Bay gas can be. Second, Question, what the well-head price of gas ought to be. Can be, ought to be, and third, is how to get at those things. This is an awesome problem. Just let me say that I think this is one thing which is again to the thinking of the legislature. We always said that your oil is a price taker. That is to say, the price at which your oil can be disposed of in the refining centers of the lower 48 states can never be determined by Alaska, the state of Alaska or Alaskan producers. You're price takers you've got to move into the refineries in competition with other forms of oil. Which is why any increase in real costs that are incurred, for example, the ultimate cost of the pipeline, they come out of the ultimate profitability of Alaskan operations and they come out of the state revenue. There's no way of getting away from that. This

## LIPTON TESTIMONY

is not quite true in the case of gas. In the case of gas things which happen here in Alaska have influenced what the price of that gas will be when it's delivered to lower 48 markets. For example, severance taxes can be passed on. Increases in cost can be passed on. The reason is that the barrel of oil that reaches the California refinery has to be refined in competition with a barrel of oil from somewhere else. And MCF gas which reaches the Great Lakes area from Alaska doesn't have the market and competition with the MCF of gas which comes up from Texas, or off shore Louisiana, because you've got rolled in pricing which is involved at different stages of the game. Both in the transmission pricing and the distribution gas companies. Now how that's going to be resolved over future years, it has to be resolved before the new gas pipeline is finally going to be brought before us. But it is quite possible that the well-head price of gas on the North Slope will turn out to be higher on the BTU basis than the well-head value of the oil. It's quite possible. In which case the utilization of that gas in Alaska may not be so effective. If that's the way it works out. Although the utilization of the liquids may be very attractive, but that's a different story. I'm sorry but this is kind of a long winded answer, but the answer is basically I don't know what the price is going to be, but there's a difference between the way the price of gas can be determined and the way the price of oil can be determined.

Q: BUTROVICH: At what point in time and has the Prudhoe Bay oil been felt by the National Energy picture?

LIPTON: On sure. I mean there's no two ways about it. You've got 800,000 barrels a day of American oil being produced here which would increase our imports by 800,000 barrels a day if we didn't have.

## LIPTON TESTIMONY

If you ask how important is that 800,000 barrels a day or 1.2 million barrels a day which hopefully you'll reach next year, or 2 million barrels a day that you may reach by 1980. It's very difficult to judge how important that is from the standpoint of national balances. You would just hate like hell not to have it.

Q: BUIROVICH: I was going to ask you if that is good. The overall effect.

LIPTON: I don't think there's any argument on the part of the producing companies that have to pay your taxes and the part of the State of Alaska that have revenues, and the part of the United States as a whole, which has the benefit of that oil, no question about it.

Q: BUIROVICH: Suppose it hadn't gone on stream until July 1, 1979.

LIPTON: We're importing more oil now. The interim volumes of oil would be available in 1979 and thereafter. I don't think it would be the decisive factor in the national interest. I don't think it would have a very major impact upon the companies, and probably the state of Alaska. The companies' cash flow in the state of Alaska is revenue, you know.

Q: BUIROVICH: Would you elaborate a little about the companies cash flow, I'm not that concerned about the state's revenues.

LIPTON: There's no question that from the standpoint of operating companies the invested proceeds over time there is in the best of circumstances a very considerable lag between the time the investment starts and the time the investment is completed the first production, the first pipeline really begins and then build up your revenues thereafter. The companies have to pay out the money for a long period of years and incur interest costs over the whole interim. The duration between outlay and income, let us say the cash flow, is a very vital consideration, no question about it. Which is one of the reasons

## LIPTON TESTIMONY

that in almost all instances the companies would look for the most expeditious possible development of a resource the earliest possible production. The cash flow is, you said something interesting about the workers of other companies than the government because the government

Q: BUTROVICH: Pardon me. I didn't mean to say I was more concerned with the companies. I was more concerned with what effect it would have on the companies that's what I wanted to elaborate on. I'm more concerned about the state.

LIPTON: Yes. But your point, I was going to suggest that your comment really is a very meaningful comment in another context. For a profit making company the timing of it's outlays and it's income and it's cash flow, is extremely important to the continuity of it's operations because the dollar that's spent out can't be reemployed until it's returned in so for a company that would like to expand and continue to grandise it's profits. Cash flow is what provides the dynamics of it's operation. But for most governments the cost of waiting for income is really not as terrible as it is for companies. The cost of waiting if you have to put a discount factor or interest factor is bound to be lower for government, because for governments the governments are looking to a continuous lead for revenues over the future. Now nobody wants to defer revenue too long, but the dollar of revenue deferred which becomes a dollar of revenue earned is going to play it's role in the budgetary balance wherever it takes place. The viability of government is not dependent upon the timing of cash flow really so much as it is for a profit making organization. That's one of the reasons, again we're talking about taxes. If you built a foreign producing operations, one of the forms that has

LIPTON TESTIMONY

recently evolved is a production sharing contract. And you have a company that operates as a producer for a government oil entity and the nature of the production sharing contract is that the company will recover out of early production all of it's operating costs and what barrels of oil recover it's operating costs and relatively will quickly get enough barrels of oil to recover it's whole capital investment. Now after that shares go in increasing proportions say to government. For the company the amount that it's willing in negotiations to give to a foreign government will be the greater. The earlier the foreign government allows that company to get enough barrels of oil to recover it's costs. In other words, they will split more number of the government the earlier they can get back to themselves, because the cash flow is so important to them and the governments which recognize that are willing to do it, because they feel that the cash flow to the government is always going to be valuable in terms of their budgetary balances.

Q: RADAR: Mr. Lipton, the failure of Arthur Andersen to take into consideration the Cook Inlet production, is that considering amount of production. Does that significantly alter their conclusions here.

LIPTON: First of all I was not critical of Arthur Andersen for not doing this. They did what they were asked to do.

Q: RADAR: Yes, we are talking about a statewide policy here and ranking. What I'm saying is the failure of their application only to Prudhoe . . . What effect do you think it would have had, had they included Cook Inlet?

LIPTON: Senator, if all you did was to expand Cook Arthur Andersen model to include Cook Inlet as it is today, an extrapolation of the remaining reserves into a production profile for for Cook Inlet and apply the whole thing you'd have very little effect on the sum total. Because we're talking about close to 10 billion barrels of oil in Prudhoe Bay we're talking very

## LIPTON TESTIMONY

limited reserves, you know production now out of Cook Inlet is around 120,000 barrels a day which is projected with a (IA) overtime. Now I don't, the specific answer to your question is if the model had been designed to include all oil producing operations, all oil reserve discovered and available for development and production as they now exist in Alaska the effect upon the ranking would be very very small.

Q: RADAR: Would it be as much as 1%, maybe bringing 1 from 92 - 93 or something in that range?

LIPTON: I don't know. The answer is two-fold. The effect depends on two things. First of all upon the relative volumes. Now we know what that is. The relative volumes are overwhelmingly in the Prudhoe Bay direction. Plus the pipeline which is so much profitability and taxation involved in the pipeline. However, some of the greatest advantages the state gives under it's tax regime are given to Cook Inlet. I would not think it would make as much as 1 percentage point difference in the ranking producers.

Q: RADAR: In the future when we're in full production instead of limited production because of problems with the pipeline, full production Alaskan wells will move into higher bracket and Alaskan rating or ranking actually as compared to the next closest state would be further apart as the fields grow older and the fields produce less and less. Alaska's ranking would be closer to Louisiana's for example.

LIPTON: I'm not sure that I get the thrust of your question, and that is to say as you increase your production for example, if next year you average 7,000 barrels a day for a Prudhoe Bay well your cents per barrel goes up to 64.8¢. So your cents per barrel tax goes up. The chances are that your

## LIPTON TESTIMONY

average well-head value if the tariff remains the same will go down. The average well-head will go down, because a larger volume of the Prudhoe Bay production next year is going to have to move to the Gulf Coast and net back even lower. So if you're looking one year ahead then the incidence of taxation in Alaska will look worse than today. If the study were made just for one year, remember Arthur Andersen study is based upon a projection of 25 years. So if you are just doing it for next year as compared to this it will look less favorable. They've already done this for 25 years. That shouldn't have any effect upon their (IA) but let me just say something else. That if your tax regime remains as it is, abstract what may change, you have only to project reasonable increases in the well-head value because of what is happening to world oil prices and what's happening to government prices. Reasonable increases in well-head value and suddenly the tax burden becomes proportionately lower here in Alaska. Because increase in the value of the oil will go to a very considerable extent to the companies themselves. That is to say what's going to be the increase in the tax burden as the value of the oil goes up. Your ad valorem taxation really isn't going to increase very much. Your severance taxation will increase a little bit as you go through cents per barrel into percent of well-head value and by god, your state income tax revenue will hardly increase at all. Because you are under a formula an allocation formula. So as production increases in the future and as the value of Prudhoe oil goes up in the future the burden, the relative burden of Alaska taxation as things now stand becomes less.

Q: RADAR: I'm interested in your observation as to the statement we the federal government is going to expect Alaska to participate in the financing of an Alcan pipeline and the federal government in no circumstance is going to participate. I don't know that, and I understand that some federal people

## LIPTON TESTIMONY

will be up here in a couple of weeks to talk about that very thing. I'm a little bit uneasy as to what our posture is and what our maneuvering room is against what their maneuvering room is.

LIPTON: I recently returned from Alberta, Edmonton, where we are also consultants. The question of financing the gas line of course has been raised in Alberta as well as in the State of Alaska. I find it of double interest because while the pipelines were competing for authorization the promoters were very hush hush about requiring outside financing and everything. Once the competition was over and the realities begin to emerge and one begins to worry about who's going to do the financing and whether the province of Alberta should take an equity interest or whether the State of Alaska should lend money or whether the State of Alaska should in a sense guarantee the bonds so the rate of interest will be lower. I don't know how many different roles the state of Alaska can be cast. It's already been, with respect to the oil and gas industry, cast in the role of a sovereign power. It's already cast in a role of a land owner, and now it's going to be cast in the role of a money lender. I just don't know the answer. This comes down in the end to very pragmatic consideration. What are the realities of financing as they are presented to you? What is the state's interest in pursuing this? How far should the state go?

Q: RADAR: What do you think promoted the Federal government to take the position that it was reasonable for the state to finance or participate in the financing but unreasonable for the federal government to participate.

LIPTON: That's what they said to the city of New York.

Q: RADAR: New York was asking for something, we're not asking for anything.

LIPTON: No. They're saying that these are problems internal to Alaska and we should not take the responsibility for it. That is a bad analogy. But this a subject

## LIPTON TESTIMONY

one can address themselves to a lot better after one knows what the real circumstances are. I don't know that the Federal government in the end will not play in some kind of a role in the financing of the gas line. An awful lot depends on the extent in which the federal government wants (1) the gasline built by a certain date, (2) is convinced that private financing either is not available, which is unlikely, but is available at onerous interest rates. Therefore what role should the government, any government whether it federal, state or provincial. I think it is a little too early because so far I suspect that what we are hearing are the protestations of the party of the first part. That is to say the people who are involved in the financing.

Q: RADAR: When do you expect when the federal government will reach an agreement on the price, set a price, April - May?

LIPTON: This Spring or early this Summer I would suspect it has to be done. Even if the least optimistic time schedule or authorization, financing, construction, design and construction of the gas line has been met, the pricing policy is basic to almost any other decision that can be made.

Q: RADAR: Well if they expect the state to participate, again I'm thinking about our session and our opportunity to address this problem. Do you think we are likely to have before us the facts that it takes to intelligently address this problem if we were to adjourn in June, what's your best estimate on that?

LIPTON: I would doubt very much if you'll have all the facts, but I think you may have, the first thing I think you have to listen to more than anything else is just what the facts along this line are going to be, what are now the alternatives to the companies involved in the construction line.

How do they see their own alternatives. What is the Federal Government realistically thinking about. I don't think the Federal Government is

## LIPTON TESTIMONY

actually asking the state of Alaska to undertake any of the responsibility, I'm sure of that at all. The Federal Government may be simply saying to the people building this pipeline, "Look, you go ahead. These are the authorizations - these are the rules of the game. Now you go where can in terms of equity in terms of debt capital and in terms of the government entities that are involved. Really, which is basically the state of Alaska, the Province of Alberta, the Federal government of Canada to a certain extent, even the problems of British Columbia. I doubt if you'll have all the facts, but you'll probably have alot more."

(Answer to question asked by George Silides in Commissioner Gallagher's testimony)

Tom Williams Madame Chairman with your permission I would like to try to address that question and also try to speak a little bit to what Senator Radar was talking about earlier. For the record my name is Tom Williams I'm the Director of Petroleum and Revenue. We have two changes in the severance tax that we are suggesting. One is the economic limit factor and the other is the increase in cents per barrel floor. Right now we have a federal pricing decision to give oil, to Prudhoe Bay oil new oil treatment for both pricing purposes and for entitlements purposes. Entitlement is a transfer of money back and forth among the refiners to equalize their acquisition costs to the national average, that is the objective of the entitlement, and new oil in the lower forty eight comes in the refinery less than imported oil consequently there is a fraction of an entitlement that didn't flow, for the right to run as new oil. Our oil when it gets there, will not be below the cost for import oil it will be right at the cost for import oil. In fact the national policy has been for new oil like high risk North Slope production we got right from our Prudhoe Bay field. National policy is to give that, right now a \$10.95 average price, cause of the realities of market, we tried, if we insisted

or if the producers who own that insisted on getting a market price at the refinery that corresponded to a \$10.95 well-head price, someone is going to have to pay the transportation cost, and if you have say a total \$5.00 transportation cost you would be getting into the market place at \$15.95 the Saudi oil which is competitive with ours is selling for \$13.50 to \$13.75 so somebody would have to, I mean where's the incentive to buy, you'd have to compell people to buy our oil to get \$10.95 price or there would have to be a subsidy. This has not been a thing that we have been requesting the federal government to do. We recognize the fact that this is how the market is, we are far away from it in terms of cost. Consequently the well-head value is not that it's realized by a refinery price that's competitive with the Saudi Arabian oil. Our well-head value is going to be lower than the ceiling. The problem is that they are going to, if they treated this new oil, they are going to try to equalize something that is already equalized and it is going to result in a penalty over \$3.00 a barrel, this equalization. They will equalize all the rest of new oil for the lower forty eight, it won't hurt them too much, it will cause some problems though, because it will over equalize new oil producers in the lower forty eight. But for us it doesn't, it's completely inappropriate because our oil is already coming in at the level corresponding to imports. There is no need to equalize. Consequently if you make them buy at a fractional entitlement at a cost of \$3.00 or \$3.35 that means the refiner is going to pay that much less instead of paying \$13.50 he will pay \$10.50, and that means a Prudhoe Bay producer or the State of Alaska if it takes its royalty in kind and goes out and tries to sell it, when he gets it to the west coast is gonna see only \$10.50 coming to him. \$3.00 goes into the entitlement,

we never see that. So you start from \$10.50 down there in California and then you have that when you get to a \$4.00 welling price. Our contention is that if that happens the game is over. There will be no more exploration. There are no more Prudhoe Bays. It is highly unlikely, there is only one Prudhoe Bay in the United States and there may be a second one down in Mexico, in the Tabascoarea in the farmers fields, but a, there pretty darn few and far between to find a field that large and at \$4.00 . well-head value. If that's the prospect, four dollar well-head with

today's cost, even if you found it out of Prudhoe Bay the chances are nil that it would be developed. And so the game is over because we are not likely to find fields twice and three times the size of Prudhoe Bay. So given that the game would be over, we are not doing any more damage by saying that well, instead of \$6.00, \$7.10 is the floor and the post which is our present floor with the cents per barrel, we are simply saying, Why should the people of Alaska follow the resource? At the game, it then becomes a question of priorities and where our allegiance lies, with the people of Alaska or the share holders in the larger corporations? Now there is a balance, but given that \$7.50 is not a reasonable well head price for North Slope oil in the beginning of a cut, and as production continues and through what builds up, if it, the federal began, assuming the federal government doesn't screw things up and destroy the insantitudes, the increase thoroughfare will lower the pipeline tariff. This will allow the well head value to rise. OPEC countries can be expected to raise their price, that includes Arabia. So if the refinery price for our oil, our refineries will raise the charge for getting our oil from Prudhoe Bay to the refineries will be less. These two things will combine to raise our well head value and by the early 1980's we won't get by talking about the well head value of \$7.50, we will be talking about well head values greater than \$10.00. In fact extrapulating out by the end of this century, we will be seeing well head values of well, your world market values it sounds absurd today, but \$20.00 well values are certainly not inconceivable at that time, and thats \$20.00 in terms of today's dolars, you know, not inflation dolars of the year 2000, that twenty of today's dolars,

thats simply because we have increasing demand, our Latin American neighbors for instance, their energy consumption is growing at a rate ten times ours, their population keeps growing, and world energy demands are far outstripping our own nation's demand and as vast as the OPEC resources are, this is a world wide shortage developing in the next 10-15 years. This shortage is going to cause, ask developers, its going to cause the price to rise in real terms that is to say in addition to the effects of inflation, we will have an additional increase in the real rather than the illusion. Consequently when we turn back, to the point, if the federal government gives us new oil in Tilener's treatment, the question then becomes whether we are willing to sit by and say OK we will take 8% or 10% off for dolars and there it is, its not good, but thats all there is to it. Even though we are paying right now, importing almost 10 mission barrels a day to each, though I don't know what the latest figures are and we are paying our good, loyal allies, Arabs, Iranians, Abu Dhabians, and all those nice people and Indonesians, Nigerians and Algerians, 14-15 somewhere in that range, 14-15 dolars is the average per import acquisition cost.

QUESTION- Tom, I understand what you are saying, I really do, but how, I must have missed something, how does that help Cook Inlet today?

- OK, with Cook Inlet, we, Sterling and I have gone to the Federal Energy Administration last summer and in fact, the hearings that they had earlier, in April or May, it was in Anchorage regarding the price of new oil and how to compound the upper and lower tears should move through time, and also about this problem

of oil production that reaches its break-even point with the control oil price. Right now, I mean the federal government is not reluctant to price our oil severly below what its actually worth, in the inlet that oil is beginning from \$5.00 to \$5.15, and for oil of similar quality we are paying, almost, we are probably paying over \$15.00 a barrel to get it from Indonesia to the west coast or Pudget Sound. So we don't see a very friendly attitude on the behalf of the federal government toward Alaska production to begin with. We went there and pointed out that there are some properties in the oil that were at that time dangerously close to reaching this break-even point at \$5.00 a barrel, we said we know you have shis procedure to allow pricing on this basis, to allow the price to go up, so that they continue to have more revenue than expenditures. Then they, thats indeed true, then they said that of course we are not going to give it to the State of Alaska because thats fixed cost, you are going to be stuck there at \$5.00. Well that presents an interesting question about how they rewrite our lease, but they said that they would allow that much pressing relief and return the property to the level of profitability enjoyed in May of 1973 when price controls, that's the reference period they all relate back to, May of '73. But he said, we'll allow to have that same measure of profitability, which to my thinking would include among as profit, you have what's over for tax. So if you raised the severence tax, that's an increase cost, but an oil company can go into the FEA and present the case saying, here are my thoughts, now give me my May 1973 rate of return,

and in fact that should accelerate the movement to a more realistic price to the upper tier which is not still the market price, but at least its, \$10.95 is a good site better than \$5.00. And consequently, if the Federal Energy Administration is doing what they say they are going to do and if they can do it in a timely fashion, there should be no problem for the oil companies because this is simply an expence, severence taxes are recognised as such.

- that had not been explained before, thank you.

SENATE RESOURCES COMMITTEE

HOUSE RESOURCES COMMITTEE

Testimony of Lawrence L. Wilson

March 25, 1977

My name is Lawrence L. Wilson, Associate Tax Counsel, Union Oil Company of California. I shall be speaking today on a number of bills which cover income taxation, severance taxation and property taxation. Specifically, these will be SB 105 and its companion bill, HB 145 and HB 322, all of which deal with income taxation along with SB 202 which is the "net proceeds" tax. I will also cover SB 103 and HB 321 and its companion bill HB 144, which deal with severance taxation. Finally, there will be remarks covering HB 323 dealing with property taxation and HB 328 dealing with the Reserves Tax. Where appropriate, my remarks will also comment on testimony that has already preceded my testimony. The first bill I wish to comment on is SB 105. No reference is made to HB 145 since it is an identical bill.

SB 105

SB 105 is a bill which purports to determine income to Alaska through the "separate accounting" method. The prefatory language in Section 1 states that the present method of apportioning income under the three-factor formula embodied in the Multistate Tax Compact does not fairly represent the extent of

the business activities in Alaska for corporations engaged in the production and pipeline transportation of crude oil and natural gas. Section 1 goes on to state that the legislature, therefore, intends that section 18 of Article IV of the Compact, which allows separate accounting, shall be adopted for determining income derived from the production and pipeline transportation of oil and gas.

Richard Kilgore of Walter J. Levy and Associates and Professors Jerome Zeifman and Kenneth Ainsworth have commented on "separate accounting" as a method of determining income with Mr. Kilgore defending it and Messrs. Zeifman and Ainsworth attacking it. Even Mr. Kilgore acknowledged that the administrative problems of determining "value" for a product transferred out of the state and of allocating expenses to Alaska were troublesome. Messrs. Zeifman and Ainsworth painted a picture of corporate maneuvering by astute managers to deliberately operate Alaska affiliates at a low profit through such means as selling property to the affiliate at high prices to get high depreciation and by allocating excessive overhead.

However, none of these witnesses have provided this Joint Committee with the really significant reasons why separate accounting is an unsatisfactory method of determining income within a state. First, even if one could overcome the administrative problems of valuing production and allocating overhead, separate accounting simply cannot adequately and properly determine how much profit of a business is derived from within a

state where the overall business has parts which are dependent upon one another and which are located in more than one state. It was for this very reason that the "unitary business" concept was developed along with apportionment formulas to determine how much of the total income of the total multistate business should be apportioned to a state. This is precisely the procedure which Alaska uses today, as well as most taxing jurisdictions, i.e., the total income of the total business of a multistate company is determined and then apportioned.

The other reason why separate accounting should not be adopted is that it exposes the taxpayer to multiple taxation. Income which would be fully taxed in Alaska would also be apportioned to other states using the apportionment method, which looks to the total income of the taxpayer as a taxable apportionment base. Conversely, Alaska's or any other state's adoption of separate accounting could cause it to lose tax from an overall profitable multistate company -- specifically, where the in-state separate accounting calculations produce an in-state loss for such overall profitable company. As Mr. Bonney of EXXON will demonstrate <sup>LATER,</sup> this would have been his company's case had Alaska been on separate accounting during the development years of the North Slope. Instead, Alaska received income tax by using the current apportionment method, apportioning a part of that company's overall profit into Alaska.

Turning to the provisions of SB 105, it is clear that the bill is not even the form of separate accounting which any of the witnesses were debating. Rather, it is a hybrid form of

separate accounting. It seeks to determine income by simple reference to the wellhead value of oil and gas used for severance tax purposes and then allows only seven deductions while totally ignoring any other legitimate deductions which represent business expenses allowable under established principles of income taxation. Five of the seven allowed deductions relate to costs closely associated with production. Another category is for unsuccessful exploration costs incurred in Alaska. The only out-of-state cost allowed is for interest expense "not capitalized and capitalizable", but this expense would be severely limited for most companies through the use of a ratio of the book value of the fixed assets associated with the field to the total book assets held by the corporation and of its affiliates. All interest expense related to a company's operations within the state should be recognized as a current operating expense, without the limitation described in this bill.

It is clear that SB 105 would introduce new concepts of taxing an oil and gas producer which radically depart from concepts found under the existing Alaska corporate income tax structure. The traditional concepts established over decades of experience and which are contained in that corporate income tax structure would in large part not apply, yet the producer would be taxed at the same 9.4% corporate rate of tax.

One of the seven deductions is for "severance taxes actually paid." This provision may appear to be without problems until one analyzes it in connection with the reserves tax.

Unless the statute is amended, the reserves tax will likely result in nearly \$240-250 million dollars paid to the state next June 30th. With the \$220 million paid on June 30, 1976, the aggregate of nearly \$500 million represents, in essence, prepaid severance taxes because the reserves tax may be used as a credit against future severance taxes payable. Hence, the word "actually" in the clause "severance taxes actually paid" takes on significance, and it appears that the authors' intent is to allow as a deduction only that amount of severance tax "actually" paid over after the credit with the result that some \$500 million would be denied as a deduction.

Depreciation is allowable but only on facilities closely associated with production, but the amount of depreciation is simply left to the Department of Revenue to handle by regulation. Depreciation is a vastly complex subject under income tax laws and can be handled in many ways to provide fair and equitable results to a taxpayer. The bill provides little or no guidance on a subject of such importance to a taxpayer.

As noted earlier, SB 105 does not fit within the category of the "separate accounting" method of determining income. What it really seeks to do is draw a ring around successful oil and gas operations and allow as expenses only those that are literally tied to the lease, plus expenses for unsuccessful exploration efforts and a severely limited amount of interest expense. The resulting amount is supposed to be net income, but in fact, would represent a level of income much higher than would occur under regular principles of income taxation.

In addition to the tax received by Alaska based on an inordinately high level of income, the authors of SB 105 would, under Section 43.20.014, still seek to reach, through apportionment, the taxpayer's out-of-state income, including its oil and gas and pipeline income as well as all other income. In short, SB 105 would allow Alaska to fully, or, rather, more than fully, tax directly all of the Alaska income from oil and gas and pipeline transportation and would also require the taxpayer to apportion to Alaska all of its other income except the income already taxed by SB 105. And, of course, the final effect to the taxpayer would be that other states where it does business would also apportion income to themselves under their tax laws and included in that apportionment to them would be the Alaska income already fully taxed by Alaska.

A state may constitutionally tax only that income of a taxpayer which is derived from within its borders. That fundamental rule applies irrespective of the method used to determine income. SB 105 seeks to reach all income from oil and gas and pipeline transportation in Alaska and at the same time, through apportionment, seeks to reach the taxpayer's other income including its non-Alaskan oil and gas and pipeline income, thereby raising the constitutional question of the taxation of extraterritorial value in violation of the Fourteenth Amendment of the U. S. Constitution.

With respect to income from pipeline transportation of oil, Sec. 43.20.013 simply provides that where such a pipeline is regulated by the Interstate Commerce Commission (ICC), the

annual taxable income "shall be eight percent of the valuation." There are no guidelines to determining income under any set of rules, and items of income and expense are not even considered. Obviously, this provision is aimed at the Trans Alaska Pipeline and, in effect, says that the tax shall be valuation times 8% to get around \$600 million of "annual income" which, when taxed at 9.4%, produces a tax of about \$60 million.

Attempting to tax a business in this manner would be similar to a law which says that an individual shall be deemed to have annual income equal to a certain percentage of the assets he owns. For example, suppose such a law say that a person's annual income is deemed to be 50% of his assets and the person owns an apartment house worth \$200,000 but has a \$150,000 mortgage against it. His annual income would be \$100,000 to be taxed irrespective of his costs. It would not matter that the person may, in fact, show very little profit.

A taxing scheme which deems "income" to be a percent of value of assets without regard to actual income and expenses is, in effect, nothing more than a property tax under the guise of an income tax and raises serious legal and constitutional problems.

The authors, however, have attempted to provide a form of "escape hatch" to the foregoing method of taxation by providing in Section 43.20.013(c) that the corporation operating such an ICC-regulated oil pipeline may elect to have taxable income from the pipeline determined under rules and regulations of the

Alaska Pipeline Commission. Thus, the idea seems to be that if the corporation does not like the percent-of-value method of determining annual income (which would deem annual income to be at a very high and fictitious level), then it can be economically forced to submit to the rules and regulations of the Alaska Pipeline Commission whose rules may or may not be parallel with the ICC rules. In fact, section 6 of the bill contains an amendment to Section 42.06.041 by adding new provisions which require the Alaska Pipeline Commission to give the Department of Revenue a certificate that the pipeline corporation so electing has complied with the Commission's rules and regulations. Subsection (c) of Section 041 provides that the Commission shall by regulations establish an accounting procedure to define net income to "coincide as nearly as possible with the net income definition used by the Commission in establishing rates and measuring rate of return."

What is happening under these provisions seems clear enough. The idea seems to be to put such an onerous tax burden on the ICC-regulated pipeline that it would be forced to elect to comply with all applicable regulations and orders of the Alaska Pipeline Commission concerning accounting methods and reports. In short, the Commission would set the rules for income determination notwithstanding that the pipeline company remains subject to the primary jurisdiction of the ICC. Thus, there would be four parties involved in determining income: the taxpayer, the ICC, the Alaska Pipeline Commission, and the Commissioner of Revenue who is interpreting the Alaska Commission's rules.

Use of the tax laws to achieve the apparent goal of regulation by the Alaska Pipeline Commission is an abuse of the taxing power. Further, the scheme raises obvious legal and constitutional questions and with so many parties that would be involved in the income determination process, the stage would be set for endless controversies.

The foregoing discussion relates to ICC-regulated oil pipelines. Where an oil pipeline does not yet have a value established by the ICC or where the oil pipeline is strictly an intrastate oil pipeline, the bill provides that such a corporation having one of these pipelines shall have its income determined under the rules and regulations of the Alaska Pipeline Commission. Here again, as would be the case of an ICC-regulated pipeline corporation which was forced to elect to have income determined by the Commission (discussed above), the income determination is left to another agency under rules and regulations as it chooses. In essence, the whole matter of determining income to tax under an income tax law is left to the vague guidelines of another governmental agency. This, in itself, raises questions whether there has been an unconstitutional delegation of legislative authority. But even if one gets over that hurdle, the fact remains that whatever rules would finally apply, those rules would not accord with general principles of income taxation which ought to apply to pipeline operations just as they apply to any other type of operation.

As to gas pipelines regulated by the Federal Power Commission (FPC), SB 105 provides in Section 43.20.013(d) that

taxable income shall be determined in accordance with reporting procedures established by the FPC. Here again, there is a departure from normal application of income tax principles because a gas pipeline, though regulated, is really no different from any other taxpayer insofar as having income tax principles applied to its operations. The regulation and rate-making process of the FPC fully takes into account a gas pipeline's handling of its operations where that pipeline utilizes the provisions of the Internal Revenue Code to achieve tax savings for the benefit of not only its customers but also its shareholders.

Finally, I would like to say a word about Section 43.20.015 which deals with "Public Reporting." Under that provision the Commissioner of Revenue is to compile and transmit to the legislature each year an annual report which shows the tax paid under SB 105 together with the itemized deductions that have been allowed and how much tax revenue was not collected because of the deductions. Further, the report is to provide a summary of the total amount of oil and gas produced by each taxpayer, the taxable income as calculated under Section 12 and 13 relating to oil and gas income and pipeline transportation in Alaska, and the out-of-state income of the taxpayer apportioned to Alaska.

In short, SB 105 would open up for general scrutiny without safeguards of confidentiality the whole operation of the oil and gas producers and pipeline operators in Alaska. I would hope that we haven't progressed to the point in this country where a

taxpayer's returns have become a matter of public record. I doubt if anyone would consent to having their tax return information bundled up by the tax collector to be laid bare for anyone to review. There are strict rules in all states and at the federal level covering disclosure of tax return information, and there are ways whereby certain limited groups of people having a legitimate interest can obtain that information on a strictly confidential basis with criminal sanctions imposed for violations. But under SB 105, the information could be made available to a large number of people where there are no guidelines whatsoever over disclosure. Such a provision is one that simply should not be tolerated no matter who the taxpayer may be.

#### HB 322

The next bill I wish to discuss is HB 322: This is the Department of Revenue's bill which adopts the recommendations of Professors Zeifman and Ainsworth. Essentially, this bill has the following features:

1. Impose a franchise tax on oil and gas producers operating in Alaska who have gross receipts of \$250 million or more.
2. The income base to be taxed would be the higher of (1) pre-tax book income as reported to stockholders before any reduction by reason of taxes on income, or (2) taxable income under the Internal Revenue Code.

3. Apportion the pre-tax book income under item 2 by means of a three-factor formula where the property and payroll factors are the same as now contained in the Multistate Compact but the sales factor in the Compact would be replaced by an extraction factor. Such extraction factor would be the ratio of oil and gas produced in Alaska (expressed in BTU's) to total production of the taxpayer everywhere.

Thus, there are two main themes to HB 322: tax base changes and apportionment factor changes. Such changes are the same changes discussed and recommended by Professors Zeifman and Ainsworth in their testimony earlier this week.

Professors Zeifman and Ainsworth would reject federal taxable income as a tax base because the Federal Internal Revenue Code contains many deductions, credits and exclusions which they allege have diluted revenue-raising potential through subsidization of of some activities while discouraging others.

In their report, though not mentioned except briefly in their testimony, the professors attempted to demonstrate how the revenue raising potential has been eroded and referred to the concept of "tax expenditures" which, in essence, is simply a listing of those items or categories constituting deductions, credits, or exemptions found in the Internal Revenue Code, together with the estimated effect they have on revenue collected. This listing is required to be published each year under the

Congressional Budget Act of 1974. However, instead of discussing and commenting on the more than 75 general categories of items in the published list as they apply to both individual and corporate taxpayers, the professors chose only to extract in their report but six categories, and only one of the six (expensing of exploration and development costs) applies specially to the petroleum and mining industry.

I have here the complete listing of "tax expenditures" for the Fiscal Year 1978 which also shows those "tax expenditures" for years 1976 and 1977. A copy of this listing is attached. There are two columns for each year, one for corporations and one for individuals. A review of both the number of categories listed as well as dollar amounts will reveal that individual taxpayers indeed have fared very well compared with corporate taxpayers. It will also be noted that there are only two items relating specially to the petroleum industry. One deals with the expensing of exploration and development costs, which, from the testimony of the professors as well as Mr. Kilgore, one would think was the major provision in the Internal Revenue Code but which in reality represents a rather small item compared to other items in the listing. In fact, that item has a revenue loss effect about equal to the loss from the credit allowed for buying new homes. The other category deals with the excess of percentage depletion over cost depletion. But this latter item applies to over 100 different minerals which involve percentage depletion--oil and gas being but one category. In any event, percentage depletion has

negligible application to major oil companies because of the severe restriction of percentage depletion for oil and gas resulting from the 1975 Tax Reform Act. The professors' attempt in their paper to show the petroleum industry as a highly favored industry that receives a major share of tax benefits is simply incorrect.

After leveling a finger at corporate taxpayers generally, the professors then recommended that one special group--namely oil companies--be singled out for tax "reform". However, the professors failed to discuss either in their paper or their testimony the inequity or possible legal problems of proposing a "book income" base for major oil companies which would be far different than would apply to any other class of taxpayers. They did not even mention in their report that no state in the country has a law utilizing "pre-tax book income" as a tax base though questioning by the Committee did bring out this information.

Even if one were to agree with the novel approach suggested by Professors Zeifman and Ainsworth and embodied in HB 322, a true advocate of their theory could not logically propose its use with one set of taxpayers and then ignore its applicability to the vast majority of other taxpayers. If such a radical change in tax approach is to be made, then it should apply to all taxpayers under all income tax laws at the same time, with corresponding adjustments of tax rates for all.

An approach which uses the higher of book income before taxes or taxable income can lead to distorted results. Mr. Bonney of EXXON will demonstrate through a simple example how the use of one versus the other could prevent a full recovery of a capital investment and yet tax phantom or non-existent income. Further distortion may result from the inclusion of earnings of non-controlled companies in pre-tax income, as required by generally accepted accounting principles. While the oil companies may be required to report the earnings of their investments in non-controlled companies, they do not determine if or when the earnings of these entities are distributed. Yet HB No. 322 provides for immediate taxation of this income because it would be included within the pre-tax book income reported to stockholders.

Professor Zeifman emphasized the fact that book income is invariably larger than taxable income, thereby showing that big corporations have tax benefits. However, of what real significance is it that a corporation's management chooses to adopt a conservative book accounting method as long as it is consistent in doing so year after year to avoid distortions? Differences between book and tax income due to different treatment has existed for decades under generally accepted accounting principles. For tax purposes the Internal Revenue Service, as well as a company's own auditors, will require a full reconciliation of the taxable income back to the book income and there are extensive schedules in tax returns which do this every year.

The only point Professor Zeifman is making is that under the Internal Revenue Code corporations are permitted certain deductions, or credits, or exclusions which, if taken advantage of, show a lesser "taxable" income than shown on the books if the management chooses to use a consistent method which treats the item differently. But the same thing can be said for all taxpayers, i.e., all taxpayers receive some form of tax treatment which causes their taxes to be less than if the tax law simply taxed the gross dollars received at a specified rate. This can be seen from the "tax expenditures" listing referred to earlier. Pointing the finger at one group of taxpayers as ones who should first go on the chopping block of reform while ignoring others who are not so treated is asking a lot of any legislative body whose duty it is to play fair with its citizens, whether they be corporate citizens or individuals.

Substitution of an "extraction" factor for the "sales" factor

The second main point of HB 322 deals with deleting the sales factor and substituting an extraction factor.

Before plunging into this subject, I believe it would be helpful to give the Committee some background about the traditional three-factor formula utilizing property, payroll and sales, where it came from and why it is used today by most states which tax corporate income. Another reason why this will be helpful is that Professors Zeifman and Ainsworth gave their testimony recommending a change strictly on the basis

that its use will apportion more income and, therefore provide more tax. However, the matter is not quite as simple as the professors have indicated.

When states began taxing corporate income over 50 years ago, there were various formulas used to divide the income. Because there were different formulas, it was not long before disputes arose between states and taxpayers, usually involving the question whether the state was reaching for too much of the taxpayer's income. It is very important to bear in mind all the way through the discussion of this subject that a state can constitutionally tax only that income of the taxpayer which is derived from within the state's borders. Thus, the search has always been to find a formula which gives both the taxpayer and the state fair treatment. But as to the taxpayer who operates in more than one state, the problem has also been to utilize a method of dividing income which does not subject the taxpayer to multiple taxation.

It is not difficult to see how multiple taxation can occur. Suppose X corporation operates in states A, B, and C, each of which has the same standard three-factor formula of property, payroll, and sales and each of which has an 8% income tax rate. It would be rare if X corporation had exactly the same mixture of property, payroll, and sales in each state. However, when each of the three states apply their tax laws and divide the income under their uniform formulas, X's total tax to all three states will be no more than 8% of its total income.

But let's vary the example just slightly and assume that in state A, X corporation has a heavy concentration of property and payroll but not many sales and that state A decides to delete its sales factor and have only a two-factor formula. In such a case state A will apportion to itself a greater amount of X's income but apportionment to States B and C will remain the same. The result will be that an amount greater than X's total income will be apportioned in the aggregate to all three states and X will have been subjected to multiple taxation because State A broke the uniformity.

The foregoing is a simplified example but nevertheless demonstrates how multiple taxation can result. As noted earlier, disputes over income taxation existed for decades and it was not until 1957 when the Commissioners on Uniform Laws in conjunction with the tax section of the American Bar Association and many other interested parties finally wrote a model law known as the "Uniform Division of Income for Tax Purposes Act" (UDITPA) in the hope that states would adopt it and thus put an end to the chaotic condition that existed. The apportionment formula settled upon utilized property, payroll and destination sales. Underlying this three-factor theory of apportionment is the concept that the employment of capital in the form of property, labor as reflected in payrolls and ultimate sales to generate the sustaining revenues for the business are all vital factors to be given equal weight in determining income. Thus, the theory recognizes that in a true economic sense some part of taxable income is earned at every stage of the business process.

To date, about one-half of the states (including Alaska) have adopted UDITPA and all but two states which impose an income tax use the three-factor formula of property payroll and sales.

The UDITPA model law only deals with apportionment of income and does not contain provisions setting forth rules or procedures whereby a state cooperates with other states to administer income taxation on a joint basis. In an effort to promote uniformity of tax rules and cooperation, a number of states formed what is now called the Multistate Tax Compact. However, a state which adopts the Compact also adopts the three-factor division of income formula based on the UDITPA model law. Alaska adopted the Compact in 1970 but followed the UDITPA formula before 1970. Hence, states which have adopted the Compact and states which simply follow the UDITPA rules have compatible laws.

With this brief background let me turn to the proposal to delete the sales factor and impose an extraction factor. The nub of the professors' argument is that the sales factor is low due to destination sales which causes lesser apportionment of income to Alaska and this can be cured by substituting an extraction factor. Thus, the sales factor is dismissed by the professors and the reader of their paper and the audience to their testimony is simply left with a conclusion void of any reasoning except maximizing revenue.

There was a sound reason for the UDITPA and Compact treatment of sales on a destination basis for purposes of the "sales" factor. A destination sale is one which occurs in a state if goods are

delivered in that state or services are performed in that state. Suppose a manufacturer has its plant in Illinois and has a large payroll at that plant. From this plant the manufacturer ships most all of his products to purchasers in other states. If this is the only plant, the property and the payroll factor to Illinois

will be high and if the sales are attributed to the Illinois plant as the origination point of the sale, then Illinois would apportion nearly all the income for taxation in Illinois. As can be seen from this simplified example, the major manufacturing states would receive an unreasonably high proportion of apportioned income to the detriment of non-manufacturing states. Hence, the "destination" sales concept is one which not only affords protection to less populated, non-manufacturing states, such as Alaska, but also gives legitimate recognition to sales activity in consumer states by deeming the sale to "occur" where the purchase takes delivery.

What the professors have proposed as a factor change is no different from what they might propose in any state based upon simple reasoning to get more revenue, the only difference being that in such other states it might be a different factor which provides the key. For example, they might shift their proposal to Illinois or Pennsylvania to point out that its sales factor also is destination-oriented and because most products are shipped out-of-state, the ratio of sales in either of those states will be lower. The professors could then recommend that the "destination" sales factor be changed to an "origin" sales factor or that the sales factor be deleted in favor of one based on manufactured units (e.g., television sets) in the state to total units manufactured everywhere. By such changes, those states could then command most of the apportioned revenue since, being manufacturing states, they already have the bulk of property and payroll and, through the sales factor change, they could prevent

dilution of the total factor to be used by the taxpayer.

But suppose it was some state which did not have heavy manufacturing (i.e., low property and payroll in the state)? Under the professors' reasoning this might call for use of only a sales factor -- i.e., destination sales and not origin sales because only the former would help the state (in contrast to what was said above as being in the "best interests" of Illinois or Pennsylvania). By so limiting the formula to a single factor, the non-manufacturing state maximizes apportionment of income to the state.\*

The foregoing are only two examples out of many one could establish to tailor apportionment formulas for various states if the only objective is simply maximizing revenue without concern for inequitable or unconstitutional consequences. However, the problems with the examples are parallel to the same problems that are contained in the professors' proposal for an extraction factor. In each instance there is a break in the uniformity of treatment by a state which inevitably results in the taxpayer being subjected to multiple taxation. The state breaking uniformity will tax a larger part of the income by use of its advan-

---

\* Recently the Iowa courts struck down as unconstitutional that state's use of a single factor of sales because it was not an adequate measure of the taxpayer's income derived from within Iowa. (Moorman Mfg. Co., Polk Cty. Dist. Ct. No. CE 3-1595 (12-17-76)). Similarly, in General Motors Corporation vs. Dist. of Columbia, 380 U.S. 512 (1965), the United States Supreme Court struck down use of a single sales factor by the District of Columbia.

tageous apportionment factors. Unfortunately, part of that same income will also be apportioned to and taxed by the other states having the uniform apportionment formula.

As noted, the professors have given no reason for use of the extraction factor except that it will raise revenue. Missing is the reasoning why the present factors are not a proper measure of a taxpayer's income within Alaska or, conversely, why use of the extraction factor will give a more accurate measure of that income. Merely saying that oil goes out of the state and does not count as a "sale" in Alaska to its detriment is not good enough because, as shown earlier, any state could analyze its economic position and make the same argument when it observes a resource material or manufactured item being shipped out of the state. If that happened, then clearly the states and taxpayers would be back to the same chaotic situation that existed before the uniform rules of UDITPA and the Multistate Tax Compact were formulated and adopted.

To satisfy constitutional requirements, an apportionment formula must fairly and reasonably measure a taxpayer's net income in the particular state since a state has jurisdiction to tax only that income derived within its borders. The professors and some Alaskan critics of the present three-factor formula have simply looked at the oil production aspects of the business of a multistate oil company operating in Alaska but apparently wish to ignore the other part of the business where that oil has to be transported, refined into products, distributed and sold.

In fact, the bulk of such a company's employees and a large portion of its investment lie in these phases of the business. Moreover, the revenue which pays for the expenses of company operations is generated mainly out of the sales of refined products.

The concept of income taxation is the taxation of the overall profits of an enterprise which may have many parts in many states but all of which contribute to the ultimate profit or loss. In devising a formula to measure income for apportionment, the drafters of the UDITPA model law were not being arbitrary when they settled upon use of property, payroll and "destination-oriented" sales. They were looking for a formula which not only contained elements reflecting as many aspects or segments of the business as possible but also for a formula which could be easily and uniformly administered and which provided equitable treatment to states as well as taxpayers. Using these guidelines, the drafters found that property, payroll and sales provided a balance of factors reaching and reflecting the essential elements of any manufacturing or mercantile business.

There can be no doubt that the author's solution fails to protect the taxpayer from multiple taxation but, rather, actually creates it. While this is reason enough to reject use of the extraction factor, it also is clear that use of this form of factor in place of a sales factor reduces the segments or sectors contained within a business whose operations are reflected in the formula. Sales from all phases of the integrated business are the sustaining element of the business without which the business fails, and such sales reflected in the sales factor

are drawn from the total business. Units of petroleum extracted are important to the business too but represent operations pertaining to only one segment or phase of an integrated petroleum company's total business.

While crude oil extracted may have a value at the point of production, that value exists only because of consumer demand for products produced within other equally important phases of the business consisting of refining, product transportation and marketing distribution. In this regard, oil production in the case of the oil industry is not unique and the same reasoning can be applied for iron ore in connection with steel making, for raw timber in connection with finished wood products, or even for grapes grown for winemaking since in each of these cases the raw product can be viewed as having been "extracted". In all these cases, as well as with the oil industry, the "extracted" material undergoes a complex transformation into products resulting in sales revenues only after having been acted upon by other necessary phases of the business containing most of the taxpayer's employees and containing facilities representing a substantial part of the taxpayer's invested capital, both of which are distinct from the "extraction" phase yet still a part of the overall operation of the enterprise.

By using an extraction factor in place of a sales factor the whole element of sales which sustain the business for its survival are disregarded. Units of oil and gas produced is simply not a proper measuring factor and, as will be pointed

out in an example by Mr. Bonney of EXXON, the substitution of an extraction factor can result in a distorted attribution of "downstream" income from transportation, refining, marketing, etc. to Alaska which can result in the taxpayer having income taxed twice.

From the foregoing it can be seen that substituting an "extraction" factor for the "sales" factor actually distorts rather than improves the measurement of net income of the total enterprise attributable to or derived from within a particular state. What it does is provide a change to "maximize" revenue which is not a goal of formula apportionment when done at the expense of sacrificing the other principles which lie behind the concept of apportionment

I would like to say a word about the provision in HB 322 which the professors recommend as being a basis for Alaska including OCS property, payroll and extracted oil and gas as its own factors when the OCS property is dependent upon on-shore Alaska operations. The professors were certainly correct in saying that there may be problems. However, they failed to point out that section 1333 of Title 43, which deals in part with state laws applicable to the OCS area, contains rather troublesome language for a state attempting to extend its tax laws to the OCS area. Section 1333(a)(2) contains the following sentence:

"State taxation laws shall not apply to the  
Outer Continental Shelf."

At least one state, California, has looked deeply into this matter of whether California, could consider the OCS developed area as providing property, payroll and sales factors for use by California, i.e., the same consideration being recommended by Professor Ainsworth. The California Franchise Tax Board in Legal Ruling No. 366 has held that California cannot claim property, payroll and sales in the OCS area for California's benefit, i.e., California cannot put these factors in the numerator for California. There is attached to my testimony copies of the pertinent federal statute referred to above, along with a copy of Legal Ruling No. 366 of the California Franchise Tax Board.

SB 202

SB 202 is basically the same bill which was considered in the 1976 session as SSSB 620. The main difference between the bills is that under SSSB 620 the net proceeds tax was a credit against regular corporation income tax insofar as that corporation income tax would represent tax on income from oil production taxed under SSSB 620; under SB 202, the taxpayer also remains subject to the Alaska corporation income tax but is deemed to be exempt only to the extent of income earned from production of oil in the state. In short, under SSSB 620 there was an actual credit against the Alaska corporation income tax but the net proceeds tax credit was only applicable against that part of the corporation income tax which was applicable to income from Alaska oil operations. Under SB 202 there is no credit as such but the taxpayer who apportions income to Alaska is simply not

taxed on income deemed to come from Alaska oil production.

As some of the members of this Committee know, I testified on SSSB 620 last year and pointed out what I believed to be the deficiencies in that bill. That testimony is no doubt still available in the Committee files and I do not propose to go into all the details of the bill again. Rather, I shall have some general comments on the bill and point out how this bill impacts on the taxpayer, as well as point out some of the legal problems with its operation.

The "net proceeds tax" contemplated by its proponents has features of an income tax in that it attempts to reach a level of "income" or "profitability" from successful oil and gas production operations with a tax rate applied which is equal to (or higher than) the regular Alaska corporation income tax rate (i.e., 9.4%). Essentially, the tax would be determined by subtracting from the wellhead value of oil and gas production certain limited costs and expenses directly associated with production and multiplying the difference by the corporation income tax rate of 9.4%.

Proponents of the "net proceeds" tax have chosen to label it as an "ad valorem" tax rather than an "income" tax. However, in substance and operation the tax is unquestionably a form of income tax and merely calling it by another name cannot change that fact.

Because the "net proceeds" tax approach is itself a form of separate accounting, taxpayers will be exposed to multiple

taxation under that approach for the same reasons as discussed in connection with SB 105. In fact, the economic effect to a taxpayer would be even more adverse since the goal of the "net proceeds" tax is simply to isolate successful Alaskan oil and gas producing operations, allow a very limited amount of deductions closely and directly associated with production, and tax the resulting "net proceeds" at the corporation income tax rate (9.4%) as though those "net proceeds" constituted net income of the taxpayers.

Proponents of the "net proceeds" tax in the past have admitted that the "net proceeds" to be taxed would represent a tax base which is higher than would occur under regular principles of income taxation applicable to other taxpayers. Hence, the economic effect is that Alaska would place a tax (at the 9.4% corporate income tax rate) on a level of income (but called "net proceeds" instead of "income") which is much higher than would result under regular income tax principles, and that same income (or at least a certain level of that income) would be included in the base subject to apportionment to other states and taxed by them because they use the standard three-factor apportionment formula.

But the adverse effect of the "net proceeds" tax approach would not stop there because under that approach the same taxpayer would still be subject to the regular Alaska corporation income tax. SB 202 would still require the taxpayer to apportion to Alaska under the three-factor formula all of the tax-

payer's income from outside Alaska, including its non-Alaska oil and gas income. Thus, SB 202 would provide Alaska with the best of all worlds: it would receive a tax at the 9.4% corporate income tax rate on Alaska "net proceeds" which would constitute a tax base much higher than under regular income tax principles and, through apportionment, it would also seek to reach all of the taxpayer's income from outside Alaska as well as any non-oil and gas income from within Alaska.

The concept of the "net proceeds" tax which would operate in substance like an income tax raises a legal question whether the method would permit the state to tax a greater amount of net income than reasonably could be attributed to Alaska.

Proponents of the "net proceeds" tax have claimed that a "precedent" exists for such form of tax and have cited the states of Nevada, Utah, Colorado, Idaho, Montana, and New Mexico as examples. However, a review of the statutes in those states reveals that the "net proceeds" tax has nothing whatsoever to do with a scheme to tax income such as that being advanced by the proponents of the "net proceeds" tax. Rather, the "net proceeds" involved in the states referred to are simply convenient and simplified means of arriving at a value on mining or oil properties for purposes of applying property tax rates by local county assessors in order to provide property tax revenue in the local counties. Such a method is essentially a substitution for the rather sophisticated and complex valuation procedure that would otherwise occur each year, such as the complex

valuation of the Prudhoe Bay field for purposes of applying the reserves tax in Alaska.

It is safe to say that no state in the country imposes a "net proceeds" tax of the type the proponents in Alaska have in mind.

I would now like to direct my comments to the Legislative Council's proposed production tax changes incorporated in the identical bills, SB 103 and HB 144.

#### DESCRIPTION OF THE BILL

As discussed yesterday, the proposal would:

- a. Change the point where the taxable value of oil is determined from the "well" to the point where "oil is first metered or measured in a condition of pipeline quality".
- b. Realign the stepped tax rates, lowering the tax on the first 1,000 bbls per well per day and substantially raise the tax on all production over the first 1,000 bbls with a high rate of 14% on all production exceeding 3,500 bbls per day.
- c. Use lease or property averaging in determining each well's daily production.
- d. Tax flared gas at 5 times the normal rate.
- e. Advance the monthly tax due date to the 20th day of the month following production.

#### COMMENTS

1. Adoption of lease or property averaging of daily bbl. per well production is a step in the right direction in properly ascertaining the stepped tax rates applicable to a field. The change, of course, will aid both the taxpayer and the state administratively.

2. The resultant increase in the overall industry tax burden (estimated by the Legislative Affairs Agency to be about \$180 million per year by 1980) is completely unwarranted, considering the question of need which others have already addressed and considering the fact that Alaska oil is already being taxed at virtually the highest level in the nation. The limited benefit given to the lower producing fields in Cook Inlet in no way should be considered as justification (or a basis of consistency) for placing such a harsh extra tax burden on high producing wells in the North Slope or any other location. This approach portrays the concept of taxing the taxpayer at a high level, not on the basis of state governmental need, which we believe to be grossly unfair.
3. Retention of the alternate cents-per-barrel rate floor with its wholesale price index adjustments more than counteracts any true benefit out of reduced rates given low Cook Inlet producing wells through percentage rate reduction. As Levy Associates has maintained, this minimum price-setting device has created an artificially high value on the old Cook Inlet oil for tax purposes, resulting in an effective tax rate well in excess of what we believe was intended by the legislature on such oil. The last time I reviewed the situation--which was about a year ago--the cents-per-barrel feature of the severance tax had caused Union and other companies for which it reports severance tax to pay about

\$5 million more than would have been paid under the percent-of-value method. We view this amount as simply an unintended windfall benefit to the State since January 1, 1974, the date the current cents-per-barrel tax took effect.

4. We do not see any justification for imposing a penalty rate (5 times normal rate) for flared gas, considering the fact that such flaring controls are best placed with regulatory agencies, not taxing agencies. If proper regulatory authority exists to flare gas, such as for safety purposes, there is no justification for adding tax at a confiscatory rate to a product that the producer loses through flaring where that flaring is done for reasons of safety.
5. Moving the point of measurement of production value downstream to the point of metering in a condition of pipeline quality could unjustly place a substantial tax on transportation costs on some fields which for a variety of reasons require movement of oil significant distances before measurement. Since the Alaska Production Tax is an occupation tax on the privilege of severing oil and gas, it would be more appropriate to continue measuring it by its value at the point of severance, i.e., the wellhead, instead of adding on to it incremental values of gathering, transportation and field treatment.
6. Advancing the delinquent date for payment from the first of the month following the month of production to the 20th day of the month following the month of production would place

an undue administrative strain on the reporting groups within the various producing companies. In most cases, the production data to calculate tax liability and prepare returns must be transmitted to offices outside Alaska. Advancing the delinquent date by 10 days will simply make worse an already short time open to comply with the law. By advancing the reporting time 10 days, the State, overall, only gains a total of 10 days for revenue collection which seems inconsequential compared with the added administrative burden on producers.

My next comments pertain to HB 321 and SB 238, identical bills, which contain the Administration's recommended changes to the oil and gas production tax.

Briefly, the bills would replace the present stair-stepped tax rates on oil production per well with a single rate of 10% on value or one alternative minimum cents-per-barrel rate of 75 cents (adjusted for gravity and for changes in the "Gross National Product Deflator").

Also, the 4% rate on gas would increase to 10% with a new alternative minimum tax of 6.4 cents per MCF. The new percentage rate and cents-per-unit rates would be adjusted by an "economic limit factor (ELF) discussed later.

The proposal also makes other changes, including changing the point of measurement from the wellhead to the point of measurement of pipeline quality. The proposal also imposes a double rate of tax on flared gas.

We strongly oppose perpetuation of cents-per-barrel floor prices and expansion of it to gas production, as well as increasing the minimum price to which it relates, that is, \$7.50 per barrel. As Milton Lipton has advised, the current floor as escalated by the National Wholesale Crude Price Index has worked in unintended ways on Cook Inlet Crude, creating an artificial taxing value well in excess of the value permitted by the FEA on old oil. Now the Administration not only recommends continuance of the minimum price concept but also proposes to increase the minimum price to \$7.50 per barrel.

The Administration supports this course with the argument that the FEA price is artificially low. But the oil companies producing such "old" oil nevertheless suffer the economic realities of federal pricing. Accordingly, we believe it is unfair that in addition to bearing such economic loss in price, the Cook Inlet producer must also bear an increase in production tax because of an arbitrary floor of \$7.50 per barrel used as the measure of tax. This, of course, would be equally true on the North Slope if the FEA placed a value below \$7.50 on that production. We fail to see any justification for the State to arbitrarily burden the production with such a heavy production tax through an artificially set value because of the possibility that FEA pricing decisions may not be favorable.

As mentioned above, HB 321 introduces the concept of an Economic Limit Factor (ELF) as an adjustment to the percentage rate of tax applied to both oil and gas. According to the Department of Revenue's February 1977 study, the Department believes that the present "stair step" rate schedule does not adequately take into account differences in the economic conditions existing from field to field, e.g., a well producing 1,000 bbl/day at one location may be marginal while such a producing rate at another location may be profitable. In short, the stair-step approach is deemed defective because it does not adequately protect against excessive taxation as a well approaches its economic limit.

To correct this, the Department proposes an ELF, the calculation of which begins by determining a fraction the numerator of

which is the "monthly production rate at the economic limit" and the denominator of which is the production during the month for which the tax is to be paid. Under HB 321, the numerator is by statute deemed to be 100 barrels times the number of well-days. Well-days are by definition the number of days a well is operating. Thus, if there were 10 wells on a lease operating for 28 days each, the numerator would be  $100 \times 10 \times 28 = 28,000$  bbls. If the total monthly production on the lease was 280,000 bbls, the ratio would be 10%, or expressed as a decimal, .10. The next step in determining the ELF is to reduce "unity", i.e., 1.00, by the ratio expressed as a decimal. Thus,  $1.00 \text{ less } .10 = .90 = \text{ELF}$ .

The best way to explain how the HB 321 mechanism works is through a simplified example, a copy of which is attached. The example uses Cook Inlet production of 35° oil at a \$4.85 per barrel controlled price. Under the bill, one of the adjustments is a half-cent for each degree above 27°, so 4 cents is added to the 75 cents. The GNP Deflator adjustment is ignored. The statutory presumption of 100 barrels is the numerator and 1,600 barrels is the denominator which gives a decimal of .0625, and when subtracted from 1.00 gives an ELF of .9375. Both the cents per barrel of 79 cents and the 10% rate are multiplied by .9375 to find the adjusted cents-per-barrel and percent-of-value rates. Next, the royalty of 200 barrels is subtracted to find 1,400 non-royalty barrels. Finally, the 1,400 barrels are multiplied by the value of \$4.85 and then by 9.375% to find the tax under the percent-of-value method, and are multiplied by \$.7406 to find the tax under

the cents-per-barrel method. Since the tax of \$1,036.84 is the higher (i.e., under the cents-per-barrel), that tax is the one that would be payable.

At the bottom of the example the tax under HB 321 is compared with the tax produced on the same production if it occurred this month (March 1977) under current law. As shown, the increase is about 60%. Also at the bottom of the example it is shown that the effective rate of the production tax under current law would be 9.5% but 15.3% under HB 321. While not if the production rate had been 800 bbls/day instead of 1,600, the increase in tax over the current tax would have been around 75% instead of 60%.

As mentioned earlier and used in the example, the monthly production rate at the economic limit is, by statute, presumed to be 100 barrels times well-days unless the producer in a formal hearing proves by "clear and convincing evidence" that it is otherwise. However, in proving this, HB 321 contains some rather curious and questionable ground rules which do not track with reality. These provisions are found in subsections (b), (c), and (d) of Section 43,55,013. In essence, the "average monthly direct operating cost" (based on at least 4 consecutive months) is divided by the value at the point of production of oil which is produced from the lease, but this "value" is not the value the producer actually gets but, rather, that value which is deemed to be the value of comparable crude at West Coast refineries for imported oil which is then "backed out" to the wellhead.

Translated, the "value" used to divide into the monthly operating costs is, for Cook Inlet, Indonesian Crude laid into Los Angeles at about \$14.50 per barrel. When the \$14.50 is "backed out" to the wellhead, the value at the wellhead is about \$13.50. Thus, it is not the \$4.85 real price used to calculate "monthly production rate at the economic limit" but, rather, \$13.50.

While that is bad enough, with regard to the "direct operating expenses allowed", the bill only allows four: drilling supplies, fuel, routine maintenance and wages and benefits of employees working on production operations. Specifically excluded are capital expenditures, tangible or intangible drilling expenses, costs of well workovers, costs for repairs or replacements (other than routine maintenance), depreciation or amortization, taxes, insurance, overhead, or monies paid or set aside to cover the cost of terminating operations, i.e., abandonment costs.

Allowing only four listed costs is not realistic because there are cash operating costs not allowed but which are tied to operations versus no operations. Any cash cost which would be affected by a decision to operate or not operate is the realistic approach and more in line with the way it would actually be approached by a producer in a true situation. HB 321 would even deny severance taxes on the production itself and property taxes on the equipment. In short, "economic limit" is that point at which actual revenue and actual costs are equal.

I requested Union Oil's oil and gas division engineers to run some calculations using real data as a test. Doing it in the

normal way, our people used the realistic value of about \$4.95/bbl for value and the real operating costs to get an ELF of about .67. But by using \$13.50 per barrel as a value and limiting the costs to the four categories the ELF was around .92. We also made a rough comparison of the taxes under HB 321 compared with taxes paid in 1976 and found that the tax on oil production would have been increased by about 50% if HB 321 had been in effect in 1976.

HB 321 also contains an ELF for gas production though it is not totally clear under the bill language how this is computed. In any event, the principle is the same and the same four direct operating costs are used but the value used for gas is the highest price in the field or within 100 miles.

With respect to gas production, the minimum of 6.4 cents per MCF is especially onerous, since gas is customarily sold under long term contracts and those contracts may not permit the seller to receive a value which happens to be the highest price on the lease on "within 100 miles". The 6.4 cents minimum tax is equal to 64 cents gas at a 10% rate, but there are contracts of sale for gas where the price is much less than 64 cents. Hence, the effective rate of tax on gas is much higher. For example, if gas were sold at 42 cents, the tax would nevertheless be the minimum of 6.4 cents (assuming no ELF applied) which would equate to an effective rate of tax of 15.2%.

With respect to the proposed gas rate increase--while admittedly the gas tax rate might warrant some degree of increase, the severity of this proposal is overreaching. We would suggest that any value tax on gas be based on actual sales price at the

sales meter. We would discourage taxation governed by an artificial floor price or by what some other producer may be receiving for his gas in some other field.

For flared gas, the rate is doubled, i.e., 12.8 cents. Even gas used for safety flaring necessary to safe operations would be taxed, which cannot be justified by any standard. We oppose this double tax for the same reasons as stated in the discussion under SB 103.

In summary, while there is merit to the concept of an economic limit factor, the manner in which it is determined under this bill is unrealistic and virtually meaningless. It seems to me a lot more thought has got to go into it before it can be a worthwhile mechanism. The way it is set up now--with questionable use of phantom values and restricted costs--an ELF so determined could have other consequences beyond just severance tax because the concept of economic life of a field is one used in valuation for property tax too. If economic lives of oil or gas properties as used for property valuations are to be determined using the methods for the ELF for severance tax purposes, then the stage is further set for endless arguments and disputes over property values as well as in connection with the ELF itself.

I would next like to comment on the Administration Sponsored Bill, HB 323.

This bill proposes several amendments to the so-called "20-Mill Hardware Tax", and certain provisions of Title 29, governing municipal taxing limitations.

Section 1 would add to the statute a highly controversial amendment to regulation 15 AAC 05.840 which was issued by the Department of Revenue in June 1976. This provides that any municipal tax levy, say for bonded debt, which is in excess of the \$1,500 per capita limitation is not creditable against the 20-mill tax.

We take direct exception to this provision in that AS 43.010(a) quite clearly provides for a maximum tax of 20 mills on our state-assessed properties. This issue is presently being litigated in a case involving the 1976 tax levy of the North Slope Borough. It would seem appropriate to let the court rule on this important issue rather than to amend the statute at this time.

Heretofore, the state 20-mill tax has applied to exploration, production, and pipeline transportation properties. HB 323 would extend this tax to refineries, liquefaction or processing plants, plants manufacturing oil or gas products and also to tankers and other marine equipment used in the transportation of oil and gas.

We believe it inadvisable to enact any further extension of this special state property tax imposed upon oil and gas producers.

The taxable basis on the marine equipment is specified as replacement cost less depreciation based on useful life multiplied by a fraction of days in Alaska ports over days in port both within and without the state. This proposal raises serious questions in

that it is believed that only the home port, under long standing case law and practice, has taxing jurisdiction over ocean-going vessels.

Aside from the "home port" doctrine, and assuming that Alaska could legally assess these properties, we would suggest a more equitable formula. One possibility would be use of days in Alaska ports versus days in the year.

Due to the controversial nature of this issue, however, we would respectfully urge that this section of the bill be stricken, irrespective of what action is taken on the remainder.

HB 323 additionally would delete the existing provision for using straight line depreciation of historical cost on pipeline assessable values in those instances where the physical life of the pipeline materially exceeds the economic life of reserves committed thereto. As a consequence, pipelines would be assessed with regard to "economic" value based on the economic life of committed reserves.

This issue is being litigated in the Cook Inlet Pipeline Co. case and it would seem appropriate to let the court rule on the issue rather than amending the statute. It is further believed that the existing law and Regulation 15 AAC 05.890 pertaining thereto are sufficiently workable to develop assessments for operating pipelines which will be fair and reasonable, both for the state and the taxpayer.

Section 8 of the bill provides that the municipal taxing limitation of \$1,500 per capita shall be adjusted each year in accordance with changes in the Consumer Price Index for Anchorage.

Assuming that the \$1,500 per capita levy is reasonable, it would likewise be reasonable to key it to an inflation index.

Section 12 makes the provisions of HB 323 retroactive to January 1, 1977, except for tanker assessments which begin January 1, 1978. This retroactive provision seems peculiarly unreasonable in view of the fact that the 1977 tax returns have been filed and assessment notices have been issued by the Department.

I will now turn to House Bill Number 328, the Administration's proposal on the Oil and Gas Reserves Tax.

The Reserves Tax was enacted for a two year period, 1976 and 1977, for the purpose of meeting anticipated revenue shortfalls for Fiscal Years 1976 and 1977. The statutory tax rate for 1976 was 20 mills (2%) and the 1977 tax rate was set by the 1976 legislature at the same rate -- 20 mills. Reserves Taxes paid in 1976 were \$223 Million and in 1977 are expected to total approximately \$270 Million.

In Fiscal Year 1976, because of the Reserves Tax revenues and increases in other revenue sources, unrestricted general fund revenues exceeded expenditures by approximately \$125 Million, leaving a surplus of \$505 Million, of which \$338 Million was available for appropriation at 6/30/76. Revenues in FY 1977 are also expected to exceed expenditures, thereby increasing the surplus.

HB No. 328 proposes to reduce the 1977 tax rate from 20 mills to 12 mills, reducing the revenue from this tax from \$270 Million to about \$170 Million, but subject to the following:

- (1) If on October 1, 1977, TAPS thru-put is less than 600,000 bbls/day, an additional 8 mills would be levied, payable November 30, 1977.
- (2) If on December 15, 1977, TAPS thru-put is less than 1.2 Million bbls/day, the Reserves Tax would be extended another year.

While the prospect of a reduced tax rate is always welcomed, we question the propriety of the limitations mentioned, which limitations are so specific and restrictive.

Present indications are that the Prudhoe Bay Field will start delivering oil to TAPS reasonably close to schedule at mid-1977. It seems unreasonable that some minor variance from the restrictive provisions of this bill could cause the tax rate to be increased and possibly for the Reserves Tax to be extended another year.

Accordingly, we believe that the Reserves Tax should expire, as scheduled in the existing statute, at the end of 1977. However, we certainly agree that the 1977 tax rate can be reduced to 12 mills, since the 1978 budget can be met with no difficulty and the 1979 budget as well unless there were some serious, prolonged delay in TAPS startup. This reduction would certainly be consistent with the original intent of the reserves tax which was to help the state over a potential period of deficit in the General Fund.

ATTACHMENTS TO TESTIMONY

OF

LAWRENCE L. WILSON



**SPECIAL  
ANALYSES  
BUDGET OF THE  
UNITED STATES  
GOVERNMENT**

**FISCAL YEAR**

**1978**

repeal of all itemized deductions resulting in tax expenditures. This hypothetical revenue gain would be \$21.2 billion in 1978, whereas the simple sum of the tax expenditures for each separate item is \$31.3 billion. The estimate for the combined effect of all such deductions was derived from a model of the tax system that accounts for the interaction between tax expenditure provisions and the provisions of the normal structure. In particular the model provides that individuals would take the standard deduction if itemized deductions were repealed. No comparable estimate can reasonably be made for the combined effect of a hypothetical repeal of all exclusion provisions.

A few aggregations of related tax expenditure items are presented and discussed in the next section. These aggregates have been specially estimated so as to account for the interactions referred to above but do not consider the effect of changes in behavior. Where tax expenditures for both individuals and corporations result from the same tax code provision, such as the investment tax credit, the two estimates may appropriately be added together.

#### TAX EXPENDITURES BY FUNCTION

Estimates of tax expenditures are grouped together by functional category and presented in table F-1. The estimates are shown separately for individuals and corporations. Wherever possible, particular tax expenditures have been classified according to the functional categories used for budget outlays. Many tax expenditures do not, however, fit into these categories and for this reason three special functional categories have been added: business investment; personal investment; and other tax expenditures.

A brief description of each of the special tax provisions for which a tax expenditure estimate is shown in table F-1 follows.

*National defense.*—The supplements to salaries of military personnel, including provision of quarters and meals on military bases and quarters allowances for military families, and virtually all salary payments and reenlistment bonuses to military personnel serving in combat zones, are excluded from tax. Disability-related military pensions received by current retirees are largely excluded from taxable income. The Tax Reform Act of 1976 terminated the exclusion of noncombat related disability pensions for those who entered the armed services after September 24, 1975.

*International affairs.*—Prior to 1976, a U.S. citizen was generally able to exclude up to \$30,000 a year of foreign earnings if the taxpayer were a bona fide resident of a foreign country. After 3 years of foreign residence a taxpayer could exclude up to \$25,000 a tax year of foreign earnings. The Tax Reform Act of 1976 modified these provisions, limiting the exclusion to \$20,000 only for employees of U.S. charitable organizations and reducing it to \$15,000 for all others, denying tax credits for foreign taxes paid on excluded income, and taxing income beyond the amount eligible for exclusion at the higher bracket rates which would apply if the excluded income were also subject to tax. The estimates also reflect the tax-exempt status of certain allowances received by Federal employees working abroad.

Table F-1. TAX EXPENDITURE ESTIMATES BY FUNCTION<sup>1</sup>

(In millions of dollars)

Description	Corporations			Individuals		
	1976	1977	1978	1976	1977	1978
<b>National defense:</b>						
Exclusion of benefits and allowances to Armed Forces personnel.....	-----	-----	-----	1,020	1,025	1,260
Exclusion of military disability pensions.....	-----	-----	-----	90	105	115
<b>International affairs:</b>						
Exclusion of gross-up on dividends of LDC corporations.....	40	-----	-----	-----	-----	-----
Exclusion of income earned abroad by U.S. citizens.....	-----	-----	-----	145	120	135
Deferral of income of domestic international sales corporations (DISC).....	1,220	1,030	1,190	-----	-----	-----
Special rate for Western Hemisphere trade corporations.....	50	35	25	-----	-----	-----
<b>Agriculture:</b>						
Expensing of certain capital outlays.....	85	80	70	455	370	440
Capital gain treatment of certain income.....	10	10	15	315	330	350
<b>Natural resources, environment, and energy:</b>						
Exclusion of interest on State and local government pollution control bonds.....	110	170	270	50	75	100
Exclusion of payments in aid of construction: Water and sewage utilities.....	-----	15	10	-----	-----	-----
Expensing of exploration and development costs.....	640	610	600	160	105	150
Excess of percentage over cost depletion.....	1,010	1,035	1,060	285	275	300
Pollution control: 5-year amortization.....	10	-80	-130	-----	-----	-----
Capital gain treatment of royalties on coal and iron ore.....	15	20	20	40	45	50
Capital gain treatment of certain timber income.....	290	300	325	95	95	100
<b>Commerce and transportation:</b>						
Exemption of credit unions.....	145	155	185	-----	-----	-----
Exclusion of certain income of cooperatives.....	410	455	490	-155	-165	-170
Corporate status exemption.....	4,170	4,630	4,250	-----	-----	-----
Deferral of tax on shipping companies.....	110	50	70	-----	-----	-----
Railroad rolling stock: 5-year amortization.....	-25	-35	-40	-----	-----	-----
Financial institutions: Excess bad debt reserves.....	485	560	645	-----	-----	-----
Deductibility of nonbusiness State gasoline taxes.....	-----	-----	-----	710	795	880
<b>Community and regional development:</b>						
Housing rehabilitation: 5-year amortization.....	15	10	5	25	20	10
<b>Education, training, employment, and social services:</b>						
Exclusion of scholarships and fellowships.....	-----	-----	-----	195	250	285
Parental personal exemptions for students, ages 19 and over.....	-----	-----	-----	720	750	770
Deductibility of contributions to educational institutions.....	190	215	240	510	540	565
Deductibility of and credit for child and dependent care expenses.....	-----	-----	-----	270	840	870
Credit for employing AFDC and public assistance recipients.....	10	15	15	-----	-----	-----
<b>Health:</b>						
Exclusion of employer contributions to medical insurance premiums and medical care.....	-----	-----	-----	4,400	5,195	5,840
Expensing of removal of architectural barriers to the handicapped.....	-----	5	10	2,315	2,585	2,870
Deductibility of medical expenses.....	-----	-----	-----	-----	-----	-----
<b>Income security:</b>						
Exclusion of social security benefits: Disability insurance benefits.....	-----	-----	-----	330	380	450
OASDI benefits for aged.....	-----	-----	-----	2,725	3,125	3,360
Benefits for dependents and survivors.....	-----	-----	-----	615	750	795

See footnotes at end of table.

Table F-1. TAX INPS

Description

Income security—Continued
Exclusion of railroad retirement
Exclusion of sick pay.....
Exclusion of unemployment
Exclusion of workmen's compensation
Exclusion of public assistance
Exclusion of special benefits for miners.....
Net exclusion of pension plans:
Employer plans.....
Plans for self-employed
Exclusion of other employer plans.....
Premiums on group-term life insurance.....
Premiums of accident and health insurance.....
Income of trusts to fund annuities.....
Employment benefits.....
Meals and lodging (other than for employees).....
Employer contributions to pension plans.....
Employee stock ownership plans through investment.....
Exclusion of capital gain.....
Excess of percentage over cost depletion.....
Income allowance.....
Additional exemption for married couples.....
Retirement income credit.....
Earned income credit.....
Veterans benefits and services.....
Exclusion of veterans' benefits.....
Exclusion of GI Bill benefits.....
General government: Capital contributions.....
Revenue sharing and grants-in-aid:
Exclusion of interest on local debt.....
Credit for corporations.....
Deductibility of nonbusiness expenses (other than on own line).....
Interest: Deferral of interest.....
Business investment:
Exclusion of interest on development bonds.....
Excess first-year depreciation.....
Depreciation on buildings.....
Rental housing.....
Other.....
Expensing of research and development.....
Expensing of construction.....
Capital gain: Corporations (timber).....
Investment credit.....

See footnotes at end of table.

Table F-1. TAX EXPENDITURE ESTIMATES BY FUNCTION—Continued  
(In millions of dollars)

Description	Corporations			Individuals		
	1976	1977	1978	1976	1977	1978
<b>Income security—Continued</b>						
Exclusion of railroad retirement system benefits.....				190	200	205
Exclusion of sick pay.....				195	50	55
Exclusion of unemployment benefits.....				3,335	2,745	2,445
Exclusion of workmen's compensation benefits.....				590	705	810
Exclusion of public assistance benefits.....				95	100	105
Exclusion of special benefits for disabled coal miners.....				50	50	50
Net exclusion of pension contributions and earnings:						
Employer plans.....				7,290	8,715	9,940
Plans for self-employed and others.....				1,060	1,305	1,535
Exclusion of other employee benefits:						
Premiums on group-term life insurance.....				765	800	835
Premiums of accident and accidental death insurance.....				65	70	75
Income of trusts to finance supplementary unemployment benefits.....				10	10	10
Meals and lodging (other than military).....				310	330	350
Employer contributions to prepaid legal expense plans.....					5	10
Employee stock ownership plans (ESOP) funded through investment tax credits.....	25	245	255			
Exclusion of capital gain on home sales if over 65.....				40	40	70
Excess of percentage standard deduction over low-income allowance.....				1,140	1,285	1,410
Additional exemption for the blind.....				20	20	20
Additional exemption for over 65.....				1,145	1,220	1,250
Retirement income credit and credits for the elderly.....				110	495	440
Earned income credit.....				220	215	205
<b>Veterans benefits and services:</b>						
Exclusion of veterans disability compensation.....				595	655	650
Exclusion of veterans pensions.....				30	30	35
Exclusion of GI bill benefits.....				305	255	200
<b>General government: Credits and deductions for political contributions.....</b>						
				35	40	35
<b>Revenue sharing and general purpose fiscal assistance:</b>						
Exclusion of interest on general purpose State and local debt.....	2,845	3,105	3,470	1,520	1,600	1,880
Credit for corporations in U.S. possessions.....	240	265	310			
Deductibility of nonbusiness State and local taxes (other than on owner-occupied homes and gasoline).....				7,255	8,075	8,950
Interest: Deferral of interest on savings bonds.....				550	565	625
<b>Business investments:</b>						
Exclusion of interest on State and local industrial development bonds.....	150	195	235	75	90	110
Excess first-year depreciation.....	40	45	45	140	135	145
Depreciation on buildings in excess of straight line:						
Rental housing.....	100	100	100	405	405	475
Other.....	225	210	200	200	180	175
Expensing of research and development expenditures.....	1,375	1,395	1,450	25	30	30
Expensing of construction period interest and taxes.....	415	475	500	215	150	140
Capital exp. Corporate (other than farming and timber).....	545	555	550			
Investment credit.....	7,655	8,640	9,670	1,810	1,970	2,205

See footnotes at end of table.

Table F-1 TAX EXPENDITURE ESTIMATES BY FUNCTION—Continued  
(In millions of dollars)

Description	Corporations			Individuals		
	1976	1977	1978	1976	1977	1978
<b>Personal investments:</b>						
Dividend exclusion.....				430	455	480
Capital gain: Individual (other than farming and timber).....				7,320	7,050	7,360
Exclusion of interest on life insurance savings.....				1,655	1,815	1,995
Deferral of capital gain on home sales.....				845	850	935
Deductibility of mortgage interest on owner-occupied homes.....				4,870	5,435	6,050
Deductibility of property taxes on owner-occupied homes.....				4,030	4,500	4,995
Deductibility of casualty losses.....				310	345	380
Credit for purchase of new home.....				650	100	.....
<b>Other tax expenditures:</b>						
Deductibility of charitable contributions (other than education).....	350	400	445	4,360	4,950	5,475
Deductibility of interest on consumer credit.....				2,105	2,310	2,565
Maximum tax on earned income.....				605	730	855

## MEMORANDUM

Combined effect of provisions disaggregated:						
Capital gains.....	865	885	935	7,770	7,550	7,860
Exclusion of interest on State and local debt.....	3,110	3,475	3,925	1,645	1,850	2,090
Deductibility of State and local nonbusiness.....				10,855	12,125	13,480
Deductibility of charitable contributions.....	540	620	655	4,870	5,440	6,040

1 All estimates are based on the tax code as of Dec. 31, 1976.

The 1976 Act repealed a special provision for U.S. firms operating in a less developed country (LDC). When a foreign subsidiary of a U.S. corporation operating in a LDC repatriated dividends to its parent corporation, that income could, under prior law, be reported net of foreign income taxes paid. U.S. tax liability was then calculated on that net amount and the foreign tax taken as a credit. For non-LDC corporations, foreign source income must now be "grossed up" by adding back in an amount equal to foreign taxes paid. Under prior law the failure to "gross up" dividends by the amount of the foreign taxes paid to LDCs resulted in a tax expenditure.

The profits of a domestic international sales corporation (DISC) are not taxed to the DISC but instead are taxed to the shareholders when distributed to them. This deferral was available for 50% of the export income of a DISC prior to 1976. The Tax Reform Act of 1976 permits DISC benefits to the extent that current export gross receipts exceed 67% of the DISC's average for a 4-year moving base period (initially 1972-75) which will move forward year-by-year after 1979. DISCs with less than \$150,000 of taxable income are exempt from the incremental rule. The Tax Reduction Act of 1975 denied DISC benefits to exporters of energy products and the 1976 Act terminated DISC benefits for 50% of military sales.

The 1976 Act phases out the 14-percentage-point tax rate reduction provided under prior law for domestic corporations qualifying as Western Hemisphere trade corporations.

*Agriculture.*  
ing corporati  
certain costs  
for inventorie  
ments. The T  
forms of tax t  
accrual acco  
agricultural z  
costs.

Capital gai  
orchards, via

*Natural res*  
State and lo  
control facilit  
The volume  
growing rapid  
The Tax R  
by customers  
of aiding the  
to capital ratk

Certain cap  
production m  
over the usef  
intangible dri  
the cost of d  
for mine shaft  
amounts ded  
wells to be re  
property by t  
that they exce  
expenses were  
the well. The  
drilling costs  
capitalized an  
cost depletion

Extractive  
and percentag  
extent not im  
tive life of the  
for the depre  
businesses in  
percentage of  
to 5% for cer  
65% of net in  
not limited t  
basis for "co  
recovered the  
intangible di  
centage depl  
expenditure  
depletion and  
would be sig

§ 1333. Laws and regulations governing lands—Constitution and United States laws; laws of adjacent States; publication of projected States lines; restriction on State taxation and jurisdiction

(a) (1) The Constitution and laws and civil and political jurisdiction of the United States are extended to the subsoil and seabed of the outer Continental Shelf and to all artificial islands and fixed structures which may be erected thereon for the purpose of exploring for, developing, removing, and transporting resources therefrom, to the same extent as if the outer Continental Shelf were an area of exclusive Federal jurisdiction located within a State: Provided, however, That mineral leases on the outer Continental Shelf shall be maintained or issued only under the provisions of this subchapter.

(2) To the extent that they are applicable and not inconsistent with this subchapter or with other Federal laws and regulations of the Secretary now in effect or hereafter adopted, the civil and criminal laws of each adjacent State as of August 7, 1953 are declared to be the law of the United States for that portion of the subsoil and seabed of the outer Continental Shelf, and artificial islands and fixed structures erected thereon, which would be within the area of the State if its boundaries were extended seaward to the outer margin of the outer Continental Shelf, and the President shall determine and publish in the Federal Register such projected lines extending seaward and designate each such area. All of such applicable laws shall be administered and enforced by the appropriate officers and courts of the United States. State taxation laws shall not apply to the outer Continental Shelf.

(3) The provisions of this section for adoption of State law as the law of the United States shall never be interpreted as a basis for claiming any interest in or jurisdiction on behalf of any State for any purpose over the seabed and subsoil of the outer Continental Shelf, or the property and natural resources thereof or the revenues therefrom.

total taxation invalid in the regulation itself is canceled. Accordingly, until such time, treatment benefits payable to disabled San Francisco policemen and firemen, after such personnel has applied

for service retirement under the new Charter provisions, are not excludable from gross income under the salary formula contained in Revenue and Taxation Code Section 171.9(b)(1)

[§ 205-026] Legal Ruling No. 366.

Franchise Tax Board, December 11, 1973.

**Franchise—Corporation Income—Allocation and Apportionment—Taxation of Income Generated by Offshore Oil Operations.**—The activities of a unitary enterprise conducting offshore oil operations under federal jurisdiction by reason of the Outer Continental Shelf Lands Act can only be reflected in the denominators of the three-factor apportionment formula. Under the Act, California lacks jurisdiction to tax the revenues derived from the Outer Continental Shelf since it is under exclusive federal jurisdiction. By including the Continental Shelf factors only in the denominators of the formula, no income is apportioned to California.

However, the operation of a drilling barge within California's jurisdiction must be reflected in the California numerators of the apportionment formula denominator.

See § 12-414.

**Facts:**

Advice has been requested as to the treatment to be accorded to the income earned by unitary businesses, taxable in California, from oil operations beyond the three mile continental limit. The operations considered are:

1. The actual operations of an offshore oil well, beyond the three mile continental limit, conducted from a fixed drilling platform; and
2. The exploring and drilling operations beyond the three mile continental limit conducted from floating drilling barges.

**Questions:**

For California franchise tax purposes, what is to be included in the numerator and denominator of the apportionment formula with respect to:

1. Activities conducted from fixed drilling platforms which are under federal jurisdiction by reason of the the Outer Continental Shelf Lands Act?
2. Activities conducted from fixed drilling platforms which are within the jurisdiction of a foreign country?
3. Activities conducted from floating drilling barges?

**Decision:**

See discussion.

**Discussion:**

1. In 1973 the United States Congress passed the Outer Continental Shelf Lands Act (67 Stat. 462, 43 U.S.C. §§ 1,331 et seq.) which extended the Constitution and laws of the United States to the Outer Continental Shelf, i.e., that property located beyond the three mile limit of state jurisdiction which was established by the Submerged Lands Act (41 U.S.C. §§ 1,301 et seq.). The outer limit of the continental shelf is not established with precision, but rather is marked only by a steep drop of the continental mass toward the ocean deeps. (1953 U.S.

Cole Congressional and Administrative News, p. 2,178). In some cases this may occur several hundred miles from shore.

Section 1333(a)(1) of the Outer Continental Shelf Lands Act extends federal jurisdiction to all artificial islands and fixed structures erected on the Outer Continental Shelf:

... to the same extent as if the Outer Continental Shelf were an area of exclusive Federal jurisdiction located within a State. . . .

It is a matter of settled law that no state has jurisdiction to tax in an area of exclusive federal jurisdiction located within a state. *Surplus Trading Co. v. Cook*, 281 U.S. 617; *Standard Oil Co. v. California*, 291 U.S. 242; *James v. Dravo*, 302 U.S. 131. Since Congress extended federal jurisdiction to the Outer Continental Shelf "to the same extent" as if it were an area of exclusive federal jurisdiction within a state, this body of settled law applies with equal force to the Outer Continental Shelf and effectively prohibits the imposition of any state tax on revenues derived therefrom.

The lack of jurisdiction in a state to tax in areas of exclusive federal jurisdiction applies not only to direct taxes but to indirect taxes as well. In *James v. Dravo*, *supra*, the United States Supreme Court was faced with the question of whether "annual privilege taxes" measured by profits from "business and other activities" could be imposed by West Virginia on a contractor working on government-owned land. The Supreme Court stated that this depended upon, "... whether the United States has acquired exclusive jurisdiction over the respective sites. Wherever the United States has such jurisdiction [the Court added] the state would have no authority to lay the tax."

In the Buck Act, 4 U.S.C.A. §§ 104-110, Congress did provide the states with jurisdiction to levy certain specified taxes within federal enclaves. The

Buck Act cannot be construed, however, to apply to the Outer Continental Shelf. Section 1333 provides:

State taxation laws shall not apply to the Outer Continental Shelf. . . .

The provisions of this section for adoption of State law as the law of the United States shall never be interpreted as a basis for claiming any interest in or jurisdiction on behalf of any State for any purpose over the seabed and subsoil of the Outer Continental Shelf, or the property and natural resources thereof or the revenues therefrom. . . . (Emphasis added.)

In view of the well settled law establishing the absence of state jurisdiction to tax in federal enclaves, the provisions of Section 1333(a)(1) extending federal jurisdiction to the Outer Continental Shelf by reference to such enclaves, the provisions of Section 1333 negating any possible application of the Buck Act to the area in question, it is clear that California tax laws cannot reach revenues derived from the Outer Continental Shelf.

Before considering the formula it should be mentioned that the income to be apportioned is the total business income including that derived from the Outer Continental Shelf. When a corporation doing business solely within California commences operations on the Outer Continental Shelf, outside California, it becomes subject to Section 25101 and its business income will be apportioned in a like manner with other unitary businesses as follows.

**Property Factor:** All real and tangible personal property owned by the taxpayer everywhere must be included in the denominator. But the numerator can include only those properties with sufficient California connections. In this situation, any such contacts appear to be minimal.

Although some suggestions have been made to exclude the property from both the numerator and the denominator, if such is done, there will be an indirect apportionment of additional income to California contrary to federal law.

However, it may be noted that, under the rule set forth in *Montgomery Ward & Co., Inc. v. Franchise Tax Board*, 6 Cal. App. 3d 149 (1970), that oil in transit to a California location would be considered California property includible in the numerator of the property factor.

**Payroll Factor:** Regulation 25132 provides that the payroll factor shall include the total amount paid by the taxpayer in the regular course of its trade or business for compensation during the tax period. Subdivision (b) further provides that the denominator of the payroll factor is the total compensation paid everywhere during the income year. Accordingly, compensation paid to employees whose services are performed entirely in a state where the taxpayer is exempt from taxation, for example by Public Law 96-272, is included in the denominator of the payroll factor. In other words, there is no drawback of the payroll to the California numera-

tor even though the taxpayer is exempt from taxation in the state in which the services are performed. Where the services are performed partially within California and without California, the tests set forth under Regulations 25132(c) and 25133 apply. Payroll shall be included in the California numerator in accordance with the provisions of Section 25133 and the regulations thereunder.

**Sales Factor:** In view of the express federal ban against any state taxation of revenues derived from the Outer Continental Shelf, none of the sales, if any, which take place in the Outer Continental Shelf area will be includible in the sales factor numerator. Furthermore, in order that there be no indirect taxation of income from such sales, the sales factor denominator must include these sales. And, of course, if the natural resource is placed on the driller's own ships, no sale has occurred. On the other hand, if the natural resource is piped or brought into California, then the sale can be included in the numerator thereafter (assuming that it is subsequently sold in California).

It should be recognized that there are two fundamental considerations involved in this question. There is first the mandate that, under California law, the income of a unitary business must be apportioned by formula. *Edison California Stores v. McColgan*, 30 Cal. 2d 472 (1947). *John Deere Plow Co. v. Franchise Tax Board*, 38 Cal. 2d 214 (1951). Secondly, there is the federal prohibition against state taxation of revenue derived from the Outer Continental Shelf.

It is established that while formula apportionment is inherently incapable of attaining exactitude, so long as the formula employed produces a reasonable result its use will be sustained. *El Dorado Oil Works v. McColgan*, 34 Cal. 2d 731 (1950). It is submitted that the formula factors set forth above take into account both fundamental considerations. They provide formula apportionment to California of the income reasonably attributable to California sources, and by including the Continental Shelf factors only in the denominator, they do not apportion income to California, thereby giving effect to the federal law.

2 Section 25120(1) of the California Revenue and Taxation Code provides that the definition of "state" includes a foreign country. A basic purpose of the Uniform Division of Income for Tax Purposes Act (UDITPA), which is codified in Sections 25120-25132, is to insure that 100 percent of income, no more or no less, would be subject to tax. See Pierce, *The Uniform Division of Income for Tax Purposes Act*, 35 *Taxes* 747.

It therefore seems clear that where another state has jurisdiction to tax and the taxable activity has no connection whatever to California, the factors associated with the activity may not be reflected in

the California numerator. These factors, however, are income producing and must be included in the denominator. *McDonnell Douglas Corporation v. Franchise Tax Board* (9 Cal. 2d 501 (1968)).

3. The Outer Continental Shelf Lands Act extends federal jurisdiction (and prohibits state taxation) "To the subsoil and seabed of the Outer Continental Shelf and to all artificial islands and fixed structures which may be erected thereon. ..." 43 U.S.C. §§ 1333.

It has been established by a number of decisions that a drilling barge or rig is neither an artificial island nor a fixed structure within the contemplation of the Act, but rather is properly classified as a vessel.

*Offshore Company v. Robison*, 266 Fed. 2d 769 (1959); *Producers Drilling Co. v. Gray*, 361 Fed. 2d 432 (1966); *Marine Drilling Company v. Aulia*, 363 Fed. 2d 579 (1966). Although the cited cases arose in the context of wrongful death or injury under the Jones Act (46 U.S.C. § 688), rather than a tax context, they hold squarely that drilling barges or rigs

are vessels and not within the ambit of the Outer Continental Shelf Lands Act. It therefore follows that the Act likewise does not exempt the activities of such barges or rigs from state taxation and California can apply its usual rules to tax the income earned from the operations of the barges.

Under the Submerged Lands Act (43 U.S.C. §§ 1301 et seq.) California's jurisdiction to tax extends offshore for three miles. There can therefore be no question that, to the extent that the drilling barges are within the three mile limit their presence and activities must be reflected in the California numerators of the apportionment formula. Similarly, the activities of drilling barges not present within California's jurisdiction will only be reflected in the denominator of the factors of the apportionment formula.

When, during a taxable year, the drilling barge is both within and without California waters, its operations and presence shall be reflected in the California numerator in accordance with the rules set forth in Cal. Adm. Code, tit. 18, Regs: 25123 to 25136, inclusive.

[§ 205-027] Legal Ruling No. 367.

Franchise Tax Board, December 14, 1973.

**Franchise—Corporation Income—Sales Factor of the Apportionment Formula—Advertising Receipts.**—Receipts from sales of advertising space in magazines and periodicals are included in the numerator of the sales factor of the apportionment formula in the same ratio as the sales of magazines and periodicals in California bears to total sales.

See § 12-442.

Advice has been requested regarding the inclusion of advertising revenue in the sales factor of the apportionment formula under the Uniform Division of Income for Tax Purposes Act (UDITPA) for publishers of magazines and periodicals.

Receipts from the sales of magazines and periodicals and advertising space in such magazines and periodicals by publishers, gives [give] rise to income from transactions and activity in the regular course of the taxpayer's trade or business constituting "business income" under Section 2512(a), Bank and Corporation Tax Law. Gross receipts from those transactions constitute "sales" as defined in Section 2512(c) which are required to be included in the sales factor (Section 2513) of the apportionment formula under UDITPA.

Tangible property is that which is visible and corporeal, having substance and body. *Roth Drug, Inc. v. Johnson*, 13 Cal. App. 2d 720, 734 (1936). It is evident that a magazine or periodical has

substance and body. Consequently, the sale of magazines and periodicals by the publisher to subscribers and newsstands are sales of tangible personal property. (cf. *Time, Inc. v. Huhner*, 201 N.T. 2d 374, 377, 31 Ill. 2d 344.) Receipts from such sales are to be included in the sales factor in accordance with Section 2513 governing sales of tangible personal property.

The sale of advertising space in such magazines and periodicals is closely connected with the sale of the publication. The primary purpose of the advertiser is to reach the market provided by the publisher. The publisher in turn guarantees a particular circulation volume, or in other words, a market. Since advertising included in magazines and periodicals is inextricably connected with the sale of those publications, it is concluded that advertising receipts are to be included in the numerator of the sales factor based upon the ratio which sales of magazines and periodicals in this state bears to the total sales of magazines and periodicals everywhere.

[§ 205-028] Legal Ruling No. 368.

Franchise Tax Board, December 14, 1973.

California Tax Reports

§ 205-028

Tax Calculation

Under Current Law  
=====

(a) % Of Value Method:

300 bbl X \$4.85 X .5% = \$72.75  
 700 bbl X 4.85 X 6% = 203.70  
 600 bbl X 4.85 X 8% = 232.80  
509.25

Less 1/8 Royalty Portion 63.66

Tax = \$445.59  
=====

(b) Cents Per Bbl Method:

300 bbl X \$.3519 = \$105.57  
 700 bbl X .4224 = 295.68  
 600 bbl X .5632 = 337.92  
739.17

Less 1/8 Royalty Portion 92.40

Tax = \$646.77  
=====

Tax Payable (higher of

(a) or (b) = \$646.77  
=====

Tax Calculation Under HB 321

Tax rate = 10% of value or \$.75 per bbl plus adjustments for gravity (up 1/2 cent for each degree above 27°) and for Gross National Product Deflator-- (1st Qtr. 1977 = base period).

Cents per bbl = \$.75 X .04 = \$.79

Percent of value rate and cents per bbl rate multiplied by Economic Limit Factor (ELF):

$$ELF = \frac{100 \text{ bbl}}{1600 \text{ bbl}} = .0625$$

$$1.000 - .0625 = .9375 = ELF$$

Cents per bbl adjustment:

$$$.79 X .9375 = $.7406$$

% of value adjustment:

$$10\% X .9375 = 9.375\%$$

Tax Calculation

1600 less royalty (200) = 1400 bbls

% of value method:

$$1400 X $4.85 = $6,790$$

$$$6,790 X 9.375\% = $636.56 \text{ (Tax)}$$

Cents per bbl method:

$$1400 X $.7406 = $1,036.84$$

Tax Payable: \$1,036.84  
=====

Difference in tax between HB 321 and Current Law:

HB 321 = \$1,036.84  
 Current Law 646.77  
\$390.07 = 60.3% increase in tax  
 =====

Production tax burden as a % of producer's net share of \$6,790 (1400 bbls X \$4.85);

Under current law = 9.5%  
 Under HB 321 = 15.3%

QUESTIONS AND ANSWERS  
PROFESSORS ZEIFMAN AND AINSWORTH  
March 21, 1977

SENATOR HUBER - I'd like to get into that change in apportionment formula. I believe you said substituting a production factor for sales.

PROFESSOR ZEIFMAN - We called it an extraction factor.

SENATOR HUBER - Alright an extraction factor. Was that in addition to sales or was that separate from sales?

PROFESSOR ZEIFMAN - In our proposal, we recommended the use of an extraction factor instead of the sales factor. So that there would only be property, payroll, and extraction.

SENATOR HUBER - Okay, now you can by defending yourself, why instead of an extraction factor, in answering this question, you'll get what I want, instead of an extraction factor why didn't you, so that Alaska would get the best possible deal, why didn't you put in a factor that said the average number of degree days below zero degrees celceus? Now, I'm serious about that. If you can answer why you did something like that instead of that....

PROFESSOR ZEIFMAN - If I were a resident of Alaska, I think I'd prefer rainy days in Juneau.

SENATOR HUBER - \_\_\_\_\_ but why is it we can't use something like that instead of adding an extraction factor. What stops us?

PROFESSOR ZEIFMAN - Well, I think the nature of the Supreme Court decisions in this area if you'll look at the Northwestern Portland Cement Company case, is that an apportionment factor has to or should in some ways reflect the business activities of the company in the State and be reasonably related to the economic impact that those activities have on the State. If we were using rainy days in Juneau to total rainy days, that would make no sense unless the companies themselves were producing the rain.

SENATOR HUBER - Excuse me Madam Chairman. Do we have to have the concurrence of any of the other members of the multi-state compact in order for the change in factor or can we change it unilaterally for Alaska?

PROFESSOR ZEIFMAN - I think that you can change it unilaterally for Alaska both pursuant to Section 18 of the compact, but also this is a sovereign state and you can enact this whatever laws you wish. There is no penalty provided for in the compact for states that depart in this line. I think that you can change it unilaterally.

SENATOR HUBER - If we went ahead with the extraction factor which would take care of things in oil, wouldn't we then have lost the sales factor that takes care of such things as us getting a fair return from the J. C. Penny Company, and from other outfits that sell in Alaska? In other words, you've got enough of it, I think.

PROFESSOR ZEIFMAN - Yeah. Well, I don't think in fact that that follows. I think you could continue to use the sales factor for other types of industries. As a matter of fact I would draw a distinction between the petroleum industry and other types of industry because of the fact that the petroleum industry is removing from the State a non-renewable resource, and I think that's a perfectly legitimate basis for drawing distinction between the use of an extraction factor and sales factor. I think that the sales factor is far more appropriate to a merchantile type of operation that is not engaged in production and certainly not engaged in the removal or the extraction of non-renewable resources.

SENATOR HUBER - Well, I can see Professor, and I won't pursue this much longer, Madam Chairman. I can see that our extraction factor could very well be New Jersey's sales factor, and they could for instance have an extraction factor maybe on wood' products or something else. That would then become a sales

factor here. It's like a doubled ended thing, it could work from both ends.

PROFESSOR ZEIFMAN - Well, My immediate reaction is that I don't think you have to worry about that too much. West Virginia for example has a two factor formula based only on property and payroll, and Florida has a different type of a sales tax there than Alaska does. The fact that other states have departed from the Uniform Act in one form or another or had not adopted the Uniform Act, I don't think is a matter that ought to persuade you one way or another.

SENATOR HUBER - It is obvious, Madam Chairman, that some of us don't understand about the multi-state compact and how some of the factors are brought into it. They might appreciate an answer of just if you wanted to change to the two factor system or substitute extraction factors for sales on petroleum, or sales on other things, who in this State has to act in what manner. What has to be done to bring this about?

PROFESSOR ZEIFMAN - I think it simply requires an act of the State Legislature.

SENATOR HUBER - I can't find any multi-state compact act in our books now. It looks like the thing is done somewhere else, except we're members is all I know. I can't find it in the statutes.

PROFESSOR ZEIFMAN - There is a statute, I don't have the statutes in front of me, but the citation is referred to.

SENATOR HUBER - It makes us a member of the multi-state compact but it doesn't spell these out.

PROFESSOR ZEIFMAN - You have also adopted the formula and also the formula has a provision in it that the Uniform Division of Income for Tax Purposes Act has a section 18 which permits modification.

SENATOR CROFT - I had two particular sets of questions. One, in the Bill itself on the bottom of Page 3, the definition of net income, Section 41.1030 defines net income as the net income determined and certified by an independent certified public accountant for the purpose of a report to shareholders covering its earnings, and the like, and I noticed in today's Wall Street Journal on Page 6 there's a summary of a considerable amount of recent activities with regard to the drawing suspicion that independent auditor's opinions are simply unreliable. In the first place, the commission on auditor's responsibilities of the American Institute of Certified Public Accountants as long as two and one half years ago put out a report critical of auditors opinions, and now there's a Senate subcommittee headed by Lee Metcalf of Montana holding hearings on the role of auditors and financial reporting,

and this article says a highly critical report by the subcommittee staff accused auditors of being too close to their corporate clients and recommended a major expansion of the government's role in setting accounting and auditors standards, and I'm curious why with the increasing suspicions that corporate management can manipulate the auditors reports. You're suggesting that the study should base its tax on something of that nature.

PROFESSOR ZEIFMAN - Well, Senator, I think that any changes in the procedure in this area as our society becomes more and more consumer oriented, if that's the right way to describe it, any changes will reflect a tightening up of the procedures rather than a liberalization of them in terms of tax avoidance, so that the concern of Senator Metcalf, which I would agree is a legitimate one, about the use of the independent \_\_\_\_\_ I think is relevant, but I think that the significant thing is that given all of the flexibility that does exist in the law, the company has an incentive under the present system to face it fully and realistically, to put it in a colloquial way, I think our proposal catches the company between the bark and the tree, or the auditor between the bark and the tree. The accountants have an interest in maximizing earnings and profits in terms of the report to the share holders, and they have an interest in minimizing taxable income for tax accounting purposes. So we're suggesting that the State would do better by adopting a tax base which is measured by an amount where the

company itself has an incentive to maximize the amount rather than minimize it. I cannot see company accountants for purposes of reporting earnings and profits collectively, espousing as your suggesting, espousing an accounting method that's going to decrease their earnings and profits. So, to whatever extent there is flexibility, by and large, the companies own accountants will want to maximize the book income, now if we were talking about this as a 60% tax, we might have a different kind of a situation, but in view of the fact, once again, that the accountants have a desire to maximize earnings and profits, I would think that it would be a desirable thing for the state to simply say, listen what you report to your shareholders, we regard as more a reflection of your real profitability, and then as a way of protection, I don't think this is needed, but as the Administration bill does, if you simply say look, we'll take federal taxable income or book income whichever is the higher, you have plugged the loopholes if that's what you want to call them more effectively than has the federal government, and I would suggest you have plugged the loopholes more effectively than has any other state in the United States.

SENATOR CROFT - Madam Chairman, I don't care to belabor the point, I do understand what you're saying if you're basic assumption is correct that the companies for reporting purposes will maximize their income in terms of book value which may or may not be correct, then what you say may be appropriate,

but the notion that the independent auditor is not subject to manipulation by the corporation, it seems to me that all of the information the past couple years indicates they are, but if you are correct about book value, it seems to me that what you're saying is that our Department of Revenue, if you're correct with regard to your figures about oil corporations in Alaska today, our Department of Revenue has simply not been doing an adequate job of enforcing the existing law, be it you're saying that they can take book value now and have increased the income taxes to be paid to the State of Alaska because they have the authority to do that even under the multi-state compact do they not?

PROFESSOR ZEIFMAN - No. Respectfully, I think you misunderstand the law. The law talks about giving the administrator the power to modify the apportionment formula, but not the unapportioned tax base.

SENATOR CROFT - Let me ask you then, what is the interpretation of 43.19.010, Section 18, which says that the allocation and apportionment provisions of this article do not fairly represent the extent of the taxpayers business activity in this state. The taxpayer may petition for or the tax administrator may require in respect to any or all of the taxpayers business activity if reasonable A. separate accounting. And then they go ahead and list three other factors.

PROFESSOR ZEIFMAN - Senator, I believe that's not relevant to this discussion. That is the means of dividing a pie. The pie is the tax base prior to apportionment. The size of the allocation and apportionment method is a method of determining what percentage of the pie is going to be taxed by Alaska, but the subject of how large is the pie which is going to be subject to the apportionment and allocation is the subject of the undivided tax base. For defining the undivided tax base prior to apportionment, the State has adopted the federal definition of taxable income so that our findings in no way indicate any remission on the part of the Department of Revenue, though the Department of Revenue does not have the power to eliminate the deductions for intangible drilling expenses in defining the tax base, so I think that the talk about the tax base prior to apportionment is a separate subject than the subject of modifying the apportionment formula. I hope that's clear.

SENATOR CROFT - Then I'm curious why you propose, Madam Chairman, that we change the formula if the present formula adequately addresses Alaska's interests. Why is one of your major provisions a change in the formula as well as increasing the size of the pie?

PROFESSOR ZEIFMAN - Well, if I were hungry so to speak, and I was concerned about getting more to eat, I would try to

persuade my mother to both make larger pies and to give me a larger percentage.

SENATOR CROFT - And would you argue the percentage of the existing pie if you had the authority to do it?

PROFESSOR ZEIFMAN - Yes.

SENATOR CROFT - And we have that authority?

PROFESSOR ZEIFMAN - No. Only under extraordinary circumstances is the case I would argue that in terms of both the case law and the statutes that only under those circumstances in which the company is involved in something called a nonunitary type of business and that would not be relevant with respect to the vertically integrated petroleum companies.

SENATOR CROFT - I thought you had said a minute ago that the section of the statute that I read gave the State only the authority to change the allocation as it related to other states and not to increase the size of the pie itself.

PROFESSOR ZEIFMAN - Right.

SENATOR CROFT - Then my question is, how has the State attempted to increase the amount of the multi-state income that's allocated

to the State under its existing statute? You said that that was one of the two things that you would do.

PROFESSOR ZEIFMAN - Well, when you say the State do you mean the Department of Revenue or the legislature?

SENATOR CROFT - No. the Department of Revenue.

PROFESSOR ZEIFMAN - Well, the Department of Revenue, as I understand it, has been trying to administer the present formula in its present statutory form. The legislature in its wisdom has enacted a statutory method including the use of a sales factor and said, so to speak, to the Department of Revenue, this is the general method of doing it, and this is the method that you should use. In very extraordinary cases, we are giving you authority to exercise some discretion. Generally, that kind of administrative discretion that is provided for in the statute has not been construed as far as I understand it by the tax administrator of this State or by the tax administrators of other states as a kind of license to exercise an \_\_\_\_\_ discretion and say look, we don't like the size of the pie that the statutory formula gives us, so therefore I'm going to come up with my own method of doing this. I would be opposed frankly as an interested citizen if you will, to that type of approach to the whole text deals anyway with where the Administrator would take the position of "We didn't get enough money from

your company this year, therefore, we're going to change the rules some. I think that's the worst kind of tax administration.

SENATOR CROFT - One final question. Doesn't your bill allow that though? Doesn't it say that in the event the Commissioner of Revenue decides that the method of reporting that the company uses on book value isn't adequate, that the Commissioner can change the rules of the game and require a different reporting method?

PROFESSOR ZEIFMAN - Now, that's a different kind of a situation, Senator Croft, that's prescribing a normal amount of administrative discretion with respect to prescribing rules which most tax administrators have that would be consistent with the statutory scheme. I would not construe every grant of discretion to be a total departure, I think as you are suggesting, from the prescribed statutory methods.

SENATOR RADER - Is there an easier way or a more clearer way to get the tax that the State should have from the petroleum activities and what we \_\_\_\_\_ do you have any other suggestions? Are there any other avenues that would be easier or more fair?

PROFESSOR ZEIFMAN - Well, easier, yes. I think that, first of all my philosophical point of view, if you wish, the nature of a corporate income tax, a tax measured by profitability

is such that it invariably runs into the kinds of problems we're discussing, allocation and apportionment. I personally feel that the most effective and the easiest way to tax petroleum production is at the wellhead in terms of the severance tax. I think that an effective severance tax is perhaps the most, certainly the easiest if it's valued properly. I want to add, however, though there's a subject that I'm particularly interested in. The income tax does offer you the advantage perhaps, and I don't hold out any guarantee of this, but at least it gives you a crack at outer-continental shelf development through the apportionment device. Under the present law, you are just not going to get, I would say you have no chance of winning a supreme litigation, trying to impose a severance tax with respect to outer-continental shelf activity, so in that regard, that would be the exception. I think an apportioned income tax has a better chance of withstanding constitutional attack with respect to the outer-continental shelf production, but generally in the arsenal of state tax weapons, if that's an appropriate way to put it, I would regard the severance tax as the main battery, and income tax as kind of a secondary battery.

SENATOR RADER - Are there other states using the method that you are suggesting here that we adopt.

PROFESSOR ZEIFMAN - There are no other states as far as I know that have adopted the method of using book income. It's rather interesting. Some years ago, the State of Tennessee had that kind of a provision that taxable income is the income determined by a normal \_\_\_\_\_ two standard accounting procedures. When we were investigating the tax structures of all the states, I was particularly fascinated by that and talked to the tax administrator, and to my surprise, he said "oh well, we don't bother with that, we'll accept whatever income they report for federal tax purposes. That part of it is novel of our proposal in that respect. The idea of an apportionment formula based on production as one of the factors is not novel, it's used in one form or another by different types of states. A few states, I don't have our report with me, but some states have used apportionment factors, special apportionment factors based on cost of production. As I mentioned West Virginia eliminates the sales factor entirely, so that the use of a specially fashioned apportionment factor designed to reflect the peculiar economic situation of the State I think is very conventional.

PROFESSOR AINSWORTH - Senator, if I might add just a comment to Professor Zeifman here that the book value is not used as such by any state that we know of. On the other hand, a number of states do start with taxable income and then tend to restore

toward book value to some degree. I think with the Supreme Court case in mind that Professor Zeifman just mentioned in his earlier testimony and with the general desirability as many states see it of restoring taxable to a degree that this would be a forward looking step and you might find yourself cut off from the restoration thing and you would have to go all the way to its value if you wished to use it.

SENATOR RADER - Of course you have a great volume of law and experience and regulation as to what is \_\_\_\_\_ taxable income. Do we have any such law, body and experience as to what should be book value income, so that when you have this acute, I know that you mentioned that the bad apple is the bad apple, the bad apple accessor or the bad apple tax payer in this direct accounting approach left too much to discretion. Do we have a body of law that can resolve disputes? Part of our problem with our corporate citizens or other citizens is to resolve as easy as possible, put grease on those places where we have pressure and have a difference of interests so that it will work without too much scraping and burning and chewing. What kind of discription do we have of book income that when we get into a dispute with someone as to.....

PROFESSOR ZEIFMAN - Well, I think that we have the experience of the Securities Exchange Commission and the experience of

stockholders in general. I appreciate the observation, and I think Senator, that it's a very profound one. I think that the great body of law however, is a two edge sword. The great body of law has also created an army of lawyers, accountants and tax planners that have given an enormous incentive to diminish the taxable base through various types of devices. I think that the beauty of the book income proposal is that the company as I mentioned to Senator Croft, if the company wants to diminish its income for Alaska tax purposes, it's got to persuade its shareholders that it is not being operated very profitably.

SENATOR RADER - Well, let me ask you this. Let's take EXXON because they're so large and let's assume that only 5% of their operation is in this state. From their point of view to their stockholders, they're going to be interested in a consolidated sheet that shows their whole operations. Do you say it's their incentive to keep them honest and to sell their stock and to keep the FCC, and if they meet all of the FCC requirements, but still won't they have the same incentive and the same opportunity to shift the responsibility of their costs in the book method as they would have in any other method? And if we are only 5%, let the Alaska portion show as being unprofitable and pick it up someplace where they don't go on book method.

PROFESSOR ZEIFMAN - Again, Senator, I think that your observation gets right to the heart of the question, and I agree with your

observation, however, that would occur only if you have a separate accounting system. I think your question illustrates the disadvantages and the dangers of separate accounting.

SENATOR RADER - Can you create a system to do that? I mean you've only had one system and the federal government doesn't care, they're not going to care as to how we do it at least between the states, excuse me, go ahead.

PROFESSOR ZEIFMAN - You see the advantages, rather than talk about individual companies like EXXON, we have not identified the individual companies. In no case, let's assume that the book income, I think you can reasonably assume that the book income is going to be at least twice, at least double the amount of federal taxable income.

SENATOR RADER - This is as defined by them.

PROFESSOR ZEIFMAN - Yes, worldwide.

SENATOR RADER - Without any body of law to define how they define that.

PROFESSOR ZEIFMAN - Other than the regulatory procedures of the FCC.

SENATOR RADER - Which are only calculated to prevent them from overstating their \_\_\_\_\_, not understating them, I assume.

PROFESSOR ZEIFMAN - Well, it cuts both ways, and although we are talking about book income as though it were different from federal taxable income. Let me also point out this, Senator, I think this is a key feature that frankly I think that Mr. Kilgore glossed over. Many of the basic book accounting mechanisms are in fact policed by the Internal Revenue Service. For example, Mr. Kilgore mentioned inventory accounting and talked about the fluctuation of inventory. Well, the Internal Revenue code requires that the company use the same tax accounting technique in terms of evaluation of its inventory, the exact same for federal tax purposes as it does for reporting its book income, and so in a sense the advantages of book income as I see it is you have the feds. in a sense policing a big hunk of the accounting aspects of the company. The company cannot play hanky panky with its inventory accounting, with its gross receipts, with the major blocks of its item. The IRS is policing that, and the internal revenue code requires that it police that, so that in using book income, you're not departing from.....(end of tape) ..... provision that would go like this would say no depreciation deductions would be allowed in excess of the depreciation actually taken of the companies books. In that way small companies would

continue to have the advantages of accelerated depreciation here and there, but the large companies would not be able to use quick write-offs to a very large extent to substantially reduce their taxable income. So, I think that although we have been talking about the difference between book income and federal taxable income as though they were two different things, the major sediments that comprise blocks of income and expenses that comprise book income are in fact audited by the Federal government.

SENATOR RADER - Well, then you're saying we're not making a significant change. It is a significant change, but you're saying that the major portions are already audited so \_\_\_\_\_ right now.

PROFESSOR ZEIFMAN - Right.

SENATOR RADER - And so we're talking about this insignificant change which is going to be tempered by their own statement to their own stockholders in which they have a goal of maximizing profits instead of minimizing, but then I get down to this, and we don't have a body of law. That's really largely management discretion, I assume. The security exchange regulation which I don't know now, that's what I'm asking you, isn't it largely a management discretion then to, you're not breaking the federal tax laws when you report your income differently to your stockholders on different accounting

basis, and as Senator Croft observed independent auditors will I think, generally submit to management discretion if there is no breach to the law, and the most that they would do would be to footnote it with an asterik and say this is within management discretion, and can be done three different ways. This is an acceptable way. How do we eliminate without a body of knowledge and law, and with the same opportunity to shift income for book purposes between one state and another or between one opportunity and another, so long as the bottom line is the same.

PROFESSOR ZEIFMAN - Well, the last part of your sentence, Senator, is the part that I have the most trouble with, and somehow Senator Croft's question indicated for example a misunderstanding. We are combining the notion of use of book income with the idea of the combined report. We are saying to EXXON if you will, look, we don't care. If you want to play games for any purposes. If you want to keep your Alaska subsidiary at a low level of profitability for your books, you go ahead and do it. We are aware of that fact that you might want to do that. The advantages of the apportionment formula and the combination approach, and as a result the \_\_\_\_\_ disadvantages of separate accounting is we are saying look, we are going to look at the whole pie, and we want the book income of the whole pie, and so long as we're dealing with the book income of the whole pie, it makes no difference whether the company in its internal bookkeeping among its affiliates divides it up.

SENATOR RADER - I see what you're saying. I understand that, but now let me ask you one other thing. You say no other states have adopted this. Now, to be the devil's advocate, why not? Is this something of your own creation that hasn't been tried yet?

PROFESSOR ZEIFMAN - Let me make this observation of why not, and I say this I hope that based on 20 years of experience working for the United States Congress, I would say lack of political muscle, in the sense especially with respect to the petroleum industry and because of the United States Congress. The Congress does not have political muscle in part to remove the tax subsidies from the internal revenue code, on the one hand that are related to the petroleum industry. Another part of it is perhaps a question of policy. When Congress decided that it was going to, if ever there was a radical departure from the use of normal accounting procedures, it was percentage deflation. Congress decided it was going to subsidize the petroleum industry, and so it provided for a percentage depletion. In a sense, the use of book income as we conceive it, and in terms of a general policy, we are saying look what we are interested in the earnings and profits with no subsidies. If we are going to subsidize the petroleum industry, we might do it in other ways, but we're talking about a tax base that is based on purely accounting procedures, as distinct from a tax base that's eroded through policies that reflect a desire to reduce the tax.

SENATOR RADER - Let me ask you again, and I think you've answered it, and it's only my own inability to receive your intelligence as fast as you can state it. I'm unaccustomed and haven't got quite the receiver you have transmitter either, but when you get back to it, is there a body of law through the FCC or otherwise to which we could go to if we were in a dispute with any one of our corporate citizens, and say, we think that when we say book value that the questions have been answered to the extent that there's a reasonable body of law that people with the opposite interests of the taxpayer and the tax collector can look at that and their attorneys can look at that and handle that problem without rubbing each other wrong and fighting their way through courts interminably.

PROFESSOR ZEIFMAN - I think Senator, that there's probably as much of a body of law on that subject as there is..... I think it's a less complicated body of law in terms of the federal taxable income, and its lack of complexity, I think, is an advantage. As a lawyer, let me make this observation. This is an everyday kind of dispute. If I'm a minority stockholder for a closely held corporation, and we get involved in litigation as to its profitability, or if there's going to be a dispute among partners for the evaluation of the states. The extent to which the accountants have overstated or understated various items I think is a subject that the courts and most lawyers have had a great deal of experience with. I suppose I'm doing my own profession a disservice, but I'm suggesting that the use of book

income takes the body of law, the normal body of law, and applies that as distinct from the highly specialized priesthood of the internal revenue code.

SENATOR RADER - One more question, if I might. Now, Mr. Kilgore, I think, suggested this morning that he made some actual projections using this extraction factor and it did not appear to him to protect the State as well as he had thought it might. I might have misunderstood him in that, but have you done any such estimates as to how it will actually work.

PROFESSOR ZEIFMAN - Yes, we have on the basis, and I'm glad you mentioned that Senator, because I had a meeting with Mr. Kilgore and Mr. Lipton in New York, and at the outset before I agreed to accept the contract as a consultant to Alaska, I made it clear that I did not want to be a consultant or make any recommendations unless I was able to make the recommendations as I put it on the basis of actual data and not addressing myself to paper solutions to paper problems. I think that the data that Mr. Kilgore has relied on has been data which has been admittedly been fictitious, a sample that was provided to a large extent by Standard Oil of Ohio. Our predictions and our data are based on a study of the actual tax returns.

SENATOR RADER - If my previous question about is there an easier or better way, and you said well, the easiest and the simplest way is at the wellhead. Count the barrels and put a tax on it, and a gross income tax instead of a net income tax so you don't have to worry about all the rest or the other half of that problem. What is the customary way of doing that? Do I understand you to say that the main reason that you're proposing the book income tax is the ability or the possibility to capture the outer-continental shelf production which can not be done with a severance tax.

PROFESSOR ZEIFMAN - No. The use of the book income, you could adopt our proposal in part using the extraction factor and the outer-continental shelf feature without adopting the book income part. Do you follow? That's an apportionment part. The book income is the means of defining the pie.

SENATOR RADER - Now wait a minute, say that to me again, I don't understand it.

PROFESSOR ZEIFMAN - You could continue to use federal taxable income and still have a formula that has an extraction factor in it, and also include in the numerator of the extraction factor as is done in the administration's bill, the amounts related to the outer-continental shelf production. It's not the book income feature of our proposal which relates to the

outer-continental shelf, it's the extraction factor.

SENATOR RADER - I see. Thank you, Madam Chairman.

SENATOR HUBER - I wonder if I could get just a line, a short quicky on the bottom of Senator Rader's before the thought is lost? I was following along very well when you answered Senator Rader about going it alone. This is the reason for going with the compact instead of going it alone. If a corporation or any corporation taking in a profit, is doing so from a state such as Delaware or Washington, that does not have an income tax, and then they have an Alaska subsidiary here, and they don't give a darn about the Alaska subsidiary taking a blood bath every year in the annual report book because their stockholders are in the main corporation and they think the more Alaska takes a blood bath in the Alaska corporations the higher the value of the coupons that I clip. Now, aren't we still leaving that loophole? I think it's a yes or a no.

PROFESSOR ZEIFMAN - Under our proposal, No.

SENATOR HUBER - That loophole is plugged?

PROFESSOR ZEIFMAN - Yes, because of the fact that we're saying to the company, that's the advantage, and you see this is the disadvantage to separate accounting. We're saying to the

company, look, we're saying to the whole group, the whole multi-corporate enterprise. We're saying look, we want to see the whole pie, and then we will apportion a piece of the whole pie to us, and so if the company, for example, and I appreciate your question, Senator because it really illustrates what we're getting at. Suppose you had under the present system to make it simple. Lets say New Hampshire does not have a corporate income tax, and I were going to drill in Alaska, here's what I would do. I would create a New Hampshire parent. I'd get a Delaware corporation, has its principal place of business, its so called domicil with Deleware, have its office in New Hampshire, and have it own an Alaska subsidiary. I would operate the Alaska subsidiary at a low level of profitability and the New Hampshire parent at a high level of profitability. Since New Hampshire has no corporate income tax, I'd be off the hook entirely, and if Alaska insists on separate accounting, Alaska has no remedy. Under our proposal, we're saying look, we are going to take the Deleware corporation. We don't care about all these arrangements, we want to know the size of the pie, the total income, the total profitability of the whole family, then we will make an apportion to Alaska. That is the modern progressive method of corporate income taxation that has been adopted by those other states that have progressive modern forms of taxing corporate income including California, Minnesota, and many other states.

SENATOR HUBER - They can't get out of that by only operating in the states that isn't a member of the inter-state compact?

PROFESSOR ZEIFMAN - That's right. They cannot get out of it. That's the advantage of the combined report approach, and you see, this is exactly what has been going on in Alaska for years. Alaska affiliates of large petroleum companies have been reporting to Alaska that they have a low level of profitability. They have said separate accounting. The tax administrator recently, consistent with the practices of a multi-state tax compact have been saying in so many words, listen, we are not going to buy that. We want to know whether or not, we want to know about the relationship between you and the parent. In a sense this is what I'm getting at with the treaty. The treaty which Great Britian has persuaded the Treasury Department to adopt, and which the Senators from Alaska were opposed as well as I understand the Governor and the tax administrator would say to Alaska, you must only look at the Alaska subsidiary, and if the Alaska subsidiary is operated a low level of profitability, there is no way, according to this treaty, that you can look at the parent if the parent is located in Great Britain, and that's exactly the disadvantage of separate accounting. It's been \_\_\_\_\_, I suppose I'm making a speech, but it's been \_\_\_\_\_ by the proponents of separate accounting some wierd notion, they say we ought to draw a ring around Alaska as though it's kind of a bath tub, and only look at the local subsidiary. Well, I am suggesting to

you that if you really want to know about the profitability of the petroleum companies operations in Alaska, that I would urge you not to simply look at the books of Alaska's subsidiary, but to go for the whole pie.

SENATOR HUBER - Thank you Madam Chairman. It did straighten me out, but I'm going to have to do some more background yet on why, I guess that's the word. There's a piece missing there.

REPRESENTATIVE GRUENING - Professor Zeifman, you mentioned the treaty. Does that treaty in any way prevent us from getting the advantage of the franchise tax?

PROFESSOR ZEIFMAN - It sure would. Of course, the treaty has not yet been approved. Fortunately, it has to be ratified by the United States Senate, and due to the opposition of some Senators it came close to being ratified by the way. I would like to urge this body to adopt a resolution urging the President to withdraw the treaty, and the present Secretary of the Treasury to get the United States out of that treaty. But at any rate the treaty would, as I indicated, prevent you from looking at the whole pie. It also would prevent you from. I'm sorry, the treaty would. The separate accounting proposal would accomplish the same thing as the treaty, and that's what I find is rather extraordinary, the proposal that Alaska would inflict upon itself. The same limitations on its

own taxing power by compelling its own tax administrator to look only at the Alaska subsidiary in its books, destroy the most powerful weapon that it's had, when the petroleum industry is urging especially those parts of it that are related to the United Kingdom is urging the Congress to impress this limitation on Alaska as well.

REPRESENTATIVE GRUENING - Aren't we doing about the same thing though on the franchise tax in terms of apportionment in theory as done under the multi-state compact by saying, okay, we're going to take a different look at what the basis is, but we're still going to use an apportionment theory to attribute the sum of that income back to Alaska.

PROFESSOR ZEIFMAN - Right, exactly.

REPRESENTATIVE GRUENING - But is there a constitutional problem then with through treaty with the federal government telling us that we can't use this as a describing basis. I mean isn't this an interference under the constitution with State rights?

PROFESSOR ZEIFMAN - One of the unfortunate conditions under which you labor is the supremacy clause of the constitution which makes the federal statutes and treaties and treaties are given equal status under the supreme law of the land, so that if for example the United States were to enter into a treaty with France protecting french citizens against

inheritance taxes in Alaska, I think you would be stuck.

REPRESENTATIVE GRUENING - I have one other question. Mr. Kilgore, this morning outlined some disadvantages of the franchise tax, and I think maybe Senator Rader's questions about the body of law might have answered them, but as I recall, you were here this morning listening to his presentation. Three things allows a different treatment on accounting methods, greater write-off flexibility and companies can revise their accounting procedures. Now, maybe Mr. Kilgore ought to elaborate on that, but as I understand the criticism there, it's not so definite, you're relying on the incentive factor to keep them from changing, as I understand his criticism, I may be unfairly stating it.

PROFESSOR ZEIFMAN - I very much appreciate the fact that Senator Rader brought this up in questioning because it frankly compelled me to address myself to it. That is, you know, I want to make it clear that the use of book income is not an either, or, we're not saying we're not going to use the federal tax system because anyone who has filed a corporate income tax report can tell you. You just don't go changing your inventory method in terms of the book income and your accounting method for the purposes of the companies books without the IRS policing them, and so any system, for example, and I was rather amazed by Mr. Kilgore's observation about inventory. There is a very strict requirement, and as a matter

of fact there is probably no subject which is more carefully audited by the Internal Revenue Service. You just can't go playing around for federal tax purposes by using a different inventory method of accounting on your books that you are using for federal tax purposes. The inventory accounting that you use for federal tax purposes is required by law to be the same as you are using for your book income. So that fluctuation, I think, is very unrealistic.

REPRESENTATIVE GRUENING - What is meant by greater write-off flexibility under the franchise. Maybe I should ask \_\_\_\_\_  
I mean that was listed as a disadvantage, greater write-off flexibility.

PROFESSOR ZEIFMAN - I would agree that there would be greater write-off flexibility with the use of book income, and some write-offs would be permissible.

REPRESENTATIVE GRUENING - That are not permissible under .....

PROFESSOR ZEIFMAN - Yes, but again the observation is the company, if it does that, it's going to diminish its earnings and profits for shareowners. I'll give you the example, I think, the most dramatic example of that. The petroleum industry as you know, is able right now to expense intangible drilling costs. Take a current deduction, and use intangible drilling costs to minimize their federal taxable income as a result. Well, many

of the large petroleum companies do not expense their intangible drilling costs because if they did they would diminish their earnings and profits for purpose of distribution to the shareholders, so they capitalize their earnings and profits, in a sense it is true, I would agree with Mr. Kilgore's observation that there may be some ways in which the companies could have a lower book income this year, that they would have some flexibility, but at the same time that flexibility as I put it sort of gets them between the bark and the tree because in order to reduce the Alaska tax base, they would have to tell their stockholders they were earning less money, and that's a different kind of position than they are now in.

REPRESENTATIVE MEEKINS - Is there a provision in the bill that, I think I heard you say, that you take the federal taxable income or the book value, whichever is greater, so in relation to what Senator Rader was asking, you're saying that there's a motivation that's strong enough to keep them from playing around with these possibilities, flexibilities they have, with the motivation being that they have to report to their stockholders the profitabilities because that's what we're looking at. They can't erode our Alaska tax base without going against that other need that they have.

PROFESSOR ZEIFMAN - Yes, they could not go below which is the advantage of the alternative base here. No matter how much flexibility there is.....

REPRESENTATIVE MEEKINS - They'll never go below the taxes, so in that respect we're not any worse off even if they did.

PROFESSOR ZEIFMAN - It is inconceivable to me that the use of book income will cause, the way it's written in this bill, it's inconceivable to me that the use of book income would result in a lower tax base for Alaska with the alternative written into it.

REPRESENTATIVE MEEKINS - You see, that brings up the question, I mean the point of going to book income is that there's not really that much faith in the federal taxable income because of the subsidy as you call it written into it. So I'm wondering wouldn't it also make sense to, couldn't we have the alternative be federal taxable income plus putting back into that some of these allowances that are taken out? Couldn't we do that also and then.....

PROFESSOR ZEIFMAN - Yes, we mentioned that in our report as an alternative. You could take federal taxable income \_\_\_\_\_ add back all capital losses. California has done that. Federal taxable income plus, we will prohibit carryovers. Federal taxable except that intangible drilling expenses are to be deducted.

REPRESENTATIVE MEEKINS - Well the, what I'm getting at is then you would really have them because you could also then say that either, or whichever is higher, book value or that value, but that valu

is even higher, so the difference, if there was any possibility of arranging that as some people are fearing, you'd have even still a higher base for the federal taxable income in which to make or take your percentage.

PROFESSOR ZEIFMAN - I agree that that's an alternative. The advantage of book income is that you're doing it all in one fell swoop and the easiest way that we know how. The item by item thing, frankly again if I can be political, would compel you to have to fight it out on each front. You're going to add back, you're going to have a vote and add back, disallow the carryover, the capital gains item by item. The book income does have the advantage of simplicity, I think.

REPRESENTATIVE MEEKINS - I have one more question on separate accounting. I'm not quite sure. When you do separate accounting, does that mean you just look at the Alaska subsidiaries, the numbers that they have on their books, but you don't consider anything else at all. There's no apportionment whatsoever, there's just totally separate accounting?

PROFESSOR ZEIFMAN - Essentially, yes.

REPRESENTATIVE MEEKINS - Essentially you are using the numbers that the companies give you, in that case, wouldn't that be correct?

PROFESSOR ZEIFMAN - Essentially, yes.

REPRESENTATIVE MEEKINS - Can you put back into that your own extraction factors and things like that?

PROFESSOR ZEIFMAN - No, the extraction only works when you are talking about a pie to a portion.

REPRESENTATIVE MEEKINS - Yes, so if you put in an extraction factor, you're not.....

PROFESSOR ZEIFMAN - Let me give you a simple example of separate accounting that the Supreme Court repudiated. There is a case, Wallgreen Drugs. Now you know everybody's got a drug store, that ought to be simple, it's just like a candy store. Wallgreen Drugs tried to argue that it ought to be able to use separate accounting because it could show through separate accounting that its Minnesota drug stores were being operated at a lower level of profitability than its non-Minnesota drug stores. The Minnesota tax administrator said, "hey listen, we can't unscramble that egg. All we know is that Wallgreen is in the drug retailing business. In effect it's a kind of a view that goes like this, it doesn't have any geographic source. It has an economic source. They said in effect, "look the ice cream manufacturing plant that you've got outside of Minnesota, that contributes to the profitability of the Minnesota store, so we're going to require you now to make an apportionment, add the

whole thing together. How much income did all of your drug stores earn all over the United States, and then we will make an apportionment based on the ratio of Minnesota to total property payroll and sales. The taxpayer argued separate accounting. We ought to be able to use separate accounting, I can keep my own books, I can show you the Minnesota sales of the Minnesota drug store", but the court repudiated that, so on its surface separate accounting is deceptively simple, but with any degree of sophistication at all, especially when you're dealing with multi-national companies, it is no difficult problem at all for a non-United States company for example, or a New York based company to operate its Alaska subsidiary at a low level of profitability, and especially in getting it back, Senator, to your observations about the federal government, here's the rock now. The federal government doesn't care. In other words if you have a New Hampshire company operating at a high level of profitability, and the Alaska subsidiary at a loss, the federal government doesn't care because it's getting the tax from the New Hampshire company, and it's not concerned about the policing of it. The federal audit in the apportionment area is not really going to be helpful. So, I hope that my observations are, I hope that I have been helpful to you, and again, I want to reiterate that no state of the United States, currently and as far as I know in the last 30 or 40 years has adopted separate accounting method of taxation under these

kinds of circumstances as a general method of imposing a tax. The controversy has always been as to whether or not any form of separate accounting was going to be permitted, even in extraordinary circumstances, and generally the court has been said to look with disfavor on the separate accounting notion. I might add, for example, in California, you don't have much Alaska case law. I mean, you have no Alaska case law on this subject, but in California, let me give you an example. This perhaps will confuse you because it goes the other way. The Wildcat Oil Company, drilling a dry hole in one state and operating, if you want, not striking oil. It then goes to drill another hole in another state and still doesn't strike oil, and it goes on through six or seven states that way, and still doesn't strike oil, but most of California, and in California it strikes oil, and all of the oil is sold at the wellhead, right then and there. This is an unusual type of operation. The California tax administrator said in so many words, "this is one of those extraordinary cases in which we might try separate accounting, because after all if we only talk about the California operation, it's a desirable state of affairs. The taxpayers said, "listen I'm a unitary business, I've been operating all around, you've got to treat me as a single entity. The California courts invalidated the use of separate accounting under those circumstances. So, again, I would urge you to examine the notion of separate accounting very carefully because, not because of the disadvantages that Mr. Kilgore points out, about the hypothetical pricing and

the administrative overhead. That's not the disadvantage of separate accounting, the disadvantage of separate accounting is that you don't get to look at the whole pie, and he didn't mention that.

SENATOR RADER - Then, it's like you say, if the piece of the pie was very profitable and the rest of their operation non-profitable, we might want to separate out and have accounting only as California attempted to do. You're saying that our court, if they followed the California court would not permit separate accounting if the Alaska operation was a bonanza and the Texas operation was no longer profitable.

PROFESSOR ZEIFMAN - That's right if they followed the California Supreme Court. And perhaps Professor Ainsworth ought to address himself to this because in the longrun the advantages of the combination approach, as I see it, is in the longrun you're dependent upon the fact that on the overall profitability of the whole multi-corporate family, and I would argue that that provides you with a much more stable type of a tax base. It's almost like a diversified investment. We could, for example, in the Wallgreen Drug case, you could have this kind of a situation which would make good business sense. Wallgreen goes into Minnesota, intentionally operates its drug stores at a low level of profitability, sells its products low and at a cheap price in order to compete in the local market, but it really is as a result the profitability of the whole. The whole company is

enhanced because of the additional sales and the large quantity, so for the State to deny itself, and to take away from the tax administrator, if I could leave you with this thought, whether you buy that proposal or adopt a proposal of that book income, or the extraction factor, perhaps there's a separate question, and maybe these are not alternatives. Whether you adopt the proposal of book income or the extraction factor is perhaps a separate question, but I would urge you to not voluntarily, by your own act, deprive your Department of Revenue and your State of the most effective tax weapon that you have in the corporate income tax area, and that's the ability to look at the whole picture and the whole pie.

SENATOR RADER - Well, I have a little different line of inquiry, if I could? We're in Juneau with the Prudhoe Bay situation where we're in pricing hearings right now, or we start Wednesday. Are you at all familiar with what our problem is there? They have not set a price for Prudhoe Bay as one tier or another tier, new oil or old oil. They haven't said, they might leave it uncontrolled like they suggested for Pet 4, which is not producing doesn't make any difference then. There's some suggestion that's come to our attention that the Federal government in their Prudhoe Bay pricing will take into consideration the tax structure that the corporations operating there and elsewhere in Alaska are facing in so far as it affects their incentive to explore and develop further. It seems to me

like sort of a delima problem. If we were going to increase the tax burden on a petroleum industry, our state administration is going in and asking for the highest possible price, I believe that's there position, the highest possible allowable federal price, it would be new oil or uncontrolled oil, and so it would be with the foreign oil, and their argument is that we need this as an incentive because of the extraordinary cost in Alaska. True we've had a bonanza in Prudhoe Bay, but then that's statistically and otherwise not expected to be counted upon and that we really need a very, very high price here to insure that lesser sands, sands that we know to be less profitable in existance, that you will preclude us from pumping or developing those, or even exploring further unless you give us a high price, and the State if urging the same thing because we are a royalty owner on one side. We've got one hat as an \_\_\_\_\_ and on the other side, we have the hat of the tax collector, and on the side of the \_\_\_\_\_, we want the highest price we can get, and we also want it for our oil company citizens. We're all citizens and we are all \_\_\_\_\_ 7/8 and 1/8 all have the same interests, but when you get to the point of doing the taxes, should the State if we're going to pull taxes, impose it now before they set a price on that oil, or should we wait until after they set a price on that oil. The argument being that if we try to set it before we set a price on the oil, that it destroys our credibility that we need a high price for purposes of encouraging development, and the other argument being that if

we don't assess it now, that it will not be taken in as a cost, and therefore that if we try to assess it later on, we would genuinely create a disincentive that would be so severe to the companies that they couldn't produce under the pricing, and I'm not sure I understand the problem, so I'm certainly sure I can't explain it. Does any of this ring a bell to you?

PROFESSOR AINSWORTH - I think that in a situation like that, I don't know how the State tax or the enactment of a state tax right now would effect the price that the federal authorities might permit you or might not permit you. I would suggest, of course, that any business entity including oil companies would welcome a higher price, and part of the justification in that in the case of oil is always the exploration and coming up with new and better resources, and I think so far as the oil supply situation in general was concerned, that I would leave that pretty much to national policy. Now, as to your own tax, I would say yes, a state tax will indeed reduce in some measure, if you look narrowly at it, the profitability of the oil company. I don't think there's any question about that. On the other hand, what I think taxpayers as well as tax collectors and the State generally would also see is that this tax comes at a time and in a situation where you have no history of taxing oil companies really. I think that this is a whole new thing as far as the State of Alaska goes with substantial oil being produced and generating income and therefore being subject to tax. So that you're coming in more or less at ground zero

as far as major production is concerned and what you ought to be concerned about is not whether you go from say the experiences of '73, '74 where so many separately accounted zero income to your state and so on and so forth, but you ought to look at that and say well now, how will our tax compare with other taxes around about in other states because ultimately it's the differential between your state's tax and other oil producing states tax. If that differential is not substantial after you take account of the very high quality deposit you have here, why then I'd see no great disadvantage to the State going with a 9.4% tax that was effectively applied to oil profit. Every State taxes it in some measure.

SENATOR RADER - Now let's follow that up a little bit. I saw an analysis put together by one of our operators here which had indicated that our total combined tax load if you consider our Ad Valorem taxes, the taxes on the pipeline, the taxes on the whole works, of their properties and their operation that we were 114% above California, or Texas, or something like that. We were 99% of Louisiana. In other words there might be one state in the Union that has imposed a heavier tax load on its petroleum extraction industry than Alaska. Is that, how do you respond to that kind of a statement? And if that is the case should we be talking about imposing any more tax?

PROFESSOR AINSWORTH - Well, I'm not familiar with that particular oil company's own report on its tax problems, but I would suggest

that this is one company, and it apparently comes up after it analyzes its own tax situation for its own information presumably. With this finding, that difference might possibly apply to one company, but not apply to all companies. Certainly a differential of tax as between and among states would however, have to look at what I understand to be the relatively good deposit that you have here, differentially good deposits relative to some other area, and if I were looking at this, I think, strictly from a state point of view, I would certainly take account of that quality differential before I assessed any ninety nine hundred and fourteen study that a particular oil company made.

SENATOR RADER - Let's assume that we determined that our present tax level was all taxes combined, was at the very top, very close to the top in the nation. Do you think as a policy matter, can we go much beyond that or not? What kind of constraints do we have there?

PROFESSOR AINSWORTH - All taxes combined, I think I've seen some of these general statements also, and yet I don't have a detailed picture of them before me, but frequently the general statements I've seen, when they say all taxes combined, the oil companies had sometimes included what they paid the farmer for the oil in North Dakota as a part of the payment to the State.

SENATOR RADER - They broke out the royalty payments as being different than the tax payments.

PROFESSOR AINSWORTH - So you certainly ought to wipe that out first.

SENATOR RADER - I think that's broken out clearly. What they did was they took the operation, they took the wells in operation, and they took the pipeline, the gathering lines of the rest of it and they applied it, and said you can pick this whole thing up and move it to Louisiana and use Louisiana's rates, in some places they're higher than ours, in some places they're lower than ours, and in some places there's no Ad Valorem taxes, \_\_\_\_\_ that we were at 99% Louisiana, and Louisiana was the highest in the nation, and we were 114 - 125% of other states to which they made the comparison. Now let's assume, I don't know if it's right or not either, but let's assume for purposes of discussion that that presentation was fairly made.

PROFESSOR AINSWORTH - If that were fairly made, then I would only caution that the only thing that they can't pick up from the State of Alaska and put it in Louisiana, even hypothetically, is the oil itself in the ground, and that's differentially good in Alaska, so you may have a margin there to work on.

SENATOR RADER - And how would you determine that the historical experience of the petroleum industry in all fields of Alaska as compared with historical experience of the industry in all fields in Texas, or something? How would you determine that?

PROFESSOR AINSWORTH - Well, I think I would make a current comparison of productivity, potential productivities as we look from here ahead.

SENATOR RADER - Well, if you do that, because of our extraordinary Prudhoe Bay situation, then I would assume that you might say we could afford a tax at a much higher rate than 125% of the next highest state in the nation, and still not provide disincentive to the petroleum industry. If you look at only where we are so far rather than statistically trying to estimate the likelihood of a repeat. I don't know how to judge it, I'm completely at sea on it myself, so I'm not asking you a question on which I have any opinion. I just know that the oil companies make the argument that I'm making to you, and that is "look, we're at the very highest right now, we admit that Prudhoe Bay is a heck of a find, but can we afford to continue hoping to hit that one long shot if your taxes are out of line with what is customary in other producing states". How do we analyze that?

PROFESSOR AINSWORTH - I would say the first thing to analyze would be to do your own study of differential taxation. Included in that study, I would certainly look at all of the work that

the companies have done and take full account of what they've done, say for their Texas, their Louisiana, whatever other place, how they came out of it there as getting all the information you can about statements regards taxability, levels of taxation in various states, and come to your own conclusions, then as to how far you could go on a differentially high side would depend largely, I think, on the relative of quality which is perhaps not quite the right word here of your own deposits visa vis others, actual and potential, and I would be concerned that the State of Alaska should, especially with this a non-renewable type resource, take its own long distance welfare into account in deciding whether or not the tax differentially high, and how far you might reasonably go in that direction.

SENATOR RADER - Well, I think in taking a look at our own welfare, we'd like to say that, we certainly would not want this to be the last exploration done by the petroleum industry in this state because of the fact that we have established an unreasonable taxing method based upon a bonanza, instead of based upon what could be expected to be an average productivity profitability for an industry, and I have no idea how to judge that, nor do I think again, I think you're right, you have to look at and compare our own state with other states, and I don't say you rely on any one else's analysis for that, but I'm just saying let's assume that we've made that analysis. and we've found that our taxes were among the highest and we have transportation

costs. If you did get too high, how would you know it?

PROFESSOR AINSWORTH - You would know it by whether or not the companies continued to operate at profitable levels and whether they continue to explore, how far they went. I would think you could consider that as kind of a current evaluation of what they do in the circumstances that they present.

SENATOR RADER - If we were to take something that's current here on how to explore, what would we have to do, ask them ask EXXON, I keep picking on EXXON just because we started in. It's nothing personal or impersonal about it, but they are a corporate citizen. Would we ask them how much of their exploration budget is coming to us as against other states and other areas of the United States to determine whether or not we think that we have already based a tax level which has created disincentive considering the costs of production and the transportation problems when we get through with the rest of it. How would we go about putting our finger on what is a reasonable level? Everybody talks about fair share. You want to tax your fair share? Sure. I want to pay my fair share. Sure. They're miles apart. Nobody knows what that is.

PROFESSOR AINSWORTH - I think you have very little problem there because as is so vividly reported at the federal level and regards the shortages of fuel just this past winter.

Nobody seems to have data that they agree about regards reserves and what was and what wasn't done with that. We seem to get different stories on that. I would think that the best thing and it probably doesn't apply explicitly or exclusively to Alaska, but would be that if one could come up with your own independent testaments of what your resources are, and the potential yields and profitabilities of them.

SENATOR RADER - Well, we could do that to some extent, but finally the proof is what is their ability to spend the money to poke the hole, and there's been some suggestion that the state should start going out and wildcatting. That way they would know alright, but I imagine they would blow a lot of money too.

PROFESSOR AINSWORTH - That might be a kind of a check that the State would want to make.

SENATOR RADER - Can you think of any way we could get a handle on that problem as to whether or not we've become unreasonable in our tax policy, and in effect driving our petroleum industry out of the state, or diminishing to an unreasonable point their incentive to explore further for new finds and new development.

PROFESSOR AINSWORTH - I think the only way to work at that is to do what seems to be a reasonable job of getting your tax in order for the first time on this kind of industry and activity

really. By that I mean bringing it up surely to the level of other states which with the sales destination and so on, I would judge under the separate accounting would not be the case. Get it up to that level then assess the differential quality as best you can. The information is imperfect. The companies and the energy people in the federal government seem to agree on that at least, and you just have to continue to evaluate.

SENATOR RADER - Well is there any argument in anybody's mind that we are taxing among the highest rate on our severance taxes and on our other taxes than any other states? You see that I thought we were nudging the very top for a long, long time and exceeded almost everybody.

PROFESSOR AINSWORTH - Of course, we're buying an awful lot of oil just now from foreign sources which I think would have a total tax and price situation that would make Alaska's quite minutive perhaps.

SENATOR HUBER - In the studies that you've been doing, do you have any doubt but what singling out Prudhoe Bay. It seems to be what we're basically talking about there anyway. Is there any doubt but what it could stand exceptionally high taxation rates in comparison with other places in the country? Have you discovered that it couldn't, that it would have to be held down to an average of what other states are, or could Prudhoe Bay as being a bonanza, something that you don't find

everyday, could it bear a high rate of taxation in relation to other places?

PROFESSOR AINSWORTH - Of course we're out of the area of the income tax.

SENATOR HUBER - No, we're really not out of the area of the income tax. We're talking about a total rate. Madam Chairman, if you'll give me a little latitude here, Senator Rader was tying us down to the approximate maximum of what other states were doing, and we've had other studies and testimonies since the Tanzer report indicating that Prudhoe Bay is capable of supporting from 50-85% total taxation rate, and many other studies that show maybe as much as 50%. We know that countries in the middle east, some of them with about the same production that we have here are sustaining from 10-11 dollars a barrel tax out of a total price of \$14, so that's what I want to get some comments about. I thought it was all going on one side that maybe the oil companies were going to leave before we left this room.

PROFESSOR AINSWORTH - I would not expect that, but more specifically to that point, I think first of all, your suggestion, Senator, that one looks to the other states, but also of course to other places in the world, the petroleum market and its exploration and so on is indeed a worldwide kind of thing, so before concluding as to what could be done by way of taxation

of petroleum companies in Alaska, I would certainly take a very broad look at it. Secondly, it seems to me that we're really not quite at the point of being differentially high in Alaska. We're really sort of starting from the beginning as far as oil operations are concerned, and the ineffectiveness historically, ineffectiveness of the sales destination package historically has set a low base here as a starting point and unless something is done, I think that it would continue perhaps unfortunately low to the disadvantage of the State. Then a final observation I would make is this that in terms of the kind of taxes that are most inconveniently kind, as it were, for all taxpayers, but certainly including corporate taxpayers, it seems to me the net income tax applies only when there is in fact net income, and what we're proposing primarily is a system for determining what that net income is and assigning its fair share to Alaska, and then taxing it. If it comes out zero as it conceivable could, though I think unlikely in the foreseeable future, why then it would go away, unlike a tax, say well the tax that Professor Zeifman mentions as the first string on the bow, if you wish, the severance tax, that does not vary with the profitability of the oil companies, so in a sense an income tax is a more conveniently kind tax which gets less if profitability diminishes. So its differential effect between and among the states would be somewhat moderated as compared with say the severance tax and those other taxes which are not geared to net profitability, so I think you have a way

to go before you come up to for all practical purposes this line if you look nationwide and indeed OPECwide, and also the income tax would be of less concern, I should think, than almost any other tax because it is a net thing. It's only after their profitable that in fact taxes are applied.

SENATOR HUBER - Madam Chairman, would you care to comment upon the different make up of the type of oil companies that we have on the slope in Alaska, mainly comment maybe on there being more of the vertically integrated multi-national in regards to the small independents there in many states like Texas and other places. I know it's an entirely different problem of handling them and dealing with the two different kinds of companies. In fact it's entirely different to be fair with them even. Would you care to comment on that?

PROFESSOR AINSWORTH - I would comment to this extent on that, and then perhaps Professor Zeifman can add something. It seems to me that if you look at the House proposal before you 322, the destination versus the Senate proposal 105, the separate accounting one, that for the company which is entirely and exclusively in Alaska, any one of these three is likely to come to about the same end result, because you are indeed all there. Now, if you look at it however, from the other perspective. If you keep the destination factor or if you use the separate accounting device as a way to determine Alaska taxable income, then you will be providing an opportunity

for the large integrated company to reduce its tax liability differentially low, relative to the small highly local company because the effective rate of 9.4% will indeed be applied to that local company which is 100% Alaska no matter how you look at it. The whole pie is here obviously and simply. The destination factor and the separate accounting factor provides an opportunity for some shipping of income out of Alaska which might by the House 322 be apportioned to Alaska, and in that sense, the small local company will be treated equally. They will pay their 9.4% on income just as the large company will pay 9.4% on its income more reasonably now apportioned to Alaska, so the small company gains not in the sense that its taxes go down all that much, but in the sense the other competitors, larger competitors will be paying at the same effective rate or more nearly so, now there is also a size provision that applies in some measure here and perhaps Professor Zeifman.....

PROFESSOR ZEIFMAN - Our proposal of course applies really for all practical purposes only to multi-national corporations, and I think we've already discussed the tax avoidance possibilities of them with respect to the use of separate accounting. I would sort of like to address myself to both of your observations, and that is that I wouldn't necessarily be persuaded by one way or the other by the fact that whether Alaska has the highest effective rate of taxation of the petroleum industry of any state in the United States of course has some relevance, but

I don't think that that ought to be necessarily the measure. At the same time, you could say that one of the chief industries of Alaska, perhaps more than other states, that the heaviest industry in Alaska is the petroleum industry, and therefore it follows that it would come out that way. I interestingly enough, and this is purely coincidental, most of my experience or ten years of my experience with the Congress, especially with the subcommittee on the outer-continental shelf was working with a chairman from Louisiana who used to be in his earlier days, was the majority leader of the Louisiana assembly, and he used to talk to me in great lengths about the problem of taxation in Louisiana where the State had a similar kind of situation before the oil companies came, and that was the timber industry. It came into Louisiana, stripped the timber bare, and left, and left the state with practically no tax base, and then when the petroleum industry came, I suppose Huey Long who often became criticized for other things began a program to try to develop an effective tax program with respect to the petroleum industry, but as the petroleum industry becomes more and more multi-national, again I want to reiterate that for the State to look at a multi-national petroleum company, only in terms of the profitability as determined by the company, in terms of its own books, in terms of the Alaska subsidiary, I think prevents you from getting the kind of data and the kind of perspective that you would need in order to make this kind of a decision. As I mentioned to you before, if I were working for a multi-national petroleum

company, what I would do would be to try to demonstrate again, and again, and again the low level of profitability of Alaska petroleum developemnt, and the way I would do it would be to establish affiliates, have them operate in Alaska, and control them from parent corporations that exist elsewhere and argue that their profitability was low. So again, I think in order to get the kind of perspective that you're talking about, that both of you are talking about, you have to look at the whole picture of the petroleum companies operations. Also, again I think that we run into this problem all over, in the sense that the New York stock exchange threatened to move out of New York. There are some industries that can't move. The California wine industry is not going to move from California. I don't think the citrus industry is going to move from California, and the petroleum industry is not going to move from Alaska, but you have, I think, an especially important problem here, and that is the non-renewable nature of the resource, and so I think that in addition to asking yourself the question about what happens if, are we going to discourage the petroleum companies to move out. You ought to also ask the question of the extent to which you are extracting revenues from them that are commensurate with the burden and with the long-range economic environmental burden that they are imposing on the State. The more the petroleum industry comes into Alaska, the more it imposes burdens, so I would suggest to you that an important measure of the tax begins where I first started, the preficatory

language of the bill that the measure of the tax to a large extent ought to be related to the economic burden and demand for services that the petroleum industry creates for the State. Admittedly, to translate that into a tax rate is I guess fortunately for us lawyers, that's the kind of thing that economists are dealing with.

SENATOR HUBER - Madam Chairman, it's interesting to note about this language at the beginning of the bill. I think maybe Professor Zeifman mentions that it seems to be important. If I remember right, I don't have to remember back very far. Four years ago our drafting attorneys used to tell me that we couldn't put it in. Three years ago they started putting it in if I jumped up and down hard enough, and now every bill I get has it drafted in, and they all tell me it don't mean anything, it has nothing to do with the legality, so I'm not sure that it does, but there's one observation that you made about the 9.4% tax that Alaska corporation would have to pay doing the same thing, and where the multi-national or vertically individual company gets away from it, and this is where we got started, where we are now is trying to plug up that loophole, that Alaska corporation would have to pay, and the other ones wouldn't have to pay. We look back at history like you mentioned in Louisiana, and we found that our fur traders were here and all they did was left us with a bunch of mad indians, and then they came along and dug the gold up and left us with tailing piles, then the salmon were gone and

all we're left is fighting with the Japanese over whats left of the little piddlin bit of salmon that's left, so now it's oil. It seems like Alaska has had one after another.

PROFESSOR ZEIFMAN - It sort of ends the history of successful people in mankind doesn't it?

SENATOR HUBER - Something on that order, but we end up with in each case Alaska's ending up with the impact, but look at salmon, and those pilings that we pick up all over aren't worth a damned, as Senator Poland will tell you. It's another thing that makes it a paying thing, and somehow or another I suppose we're trying to do the same thing with the petroleum industry which we know is depletable.

CHAIRMAN Poland - Senator Huber, did you have another question? I think that our consultant for the Committee, Mr. Silides might have some.

GEORGE SILIDES - Madam Chairman, both Mr. Erickson and I have several, but I think we'll have to defer, except for one which I think is going to need answering on Rader's plan of \_\_\_\_\_  
If we might be able to mail them or telephone them in.

PROFESSOR AINSWORTH - Or if you wish we could remain with you, whichever.

GEORGE SILIDES - I'm concerned about how effectively your approach would be in apportioning income to Alaska from Prudhoe Bay and the Alyeska operations. You know, Alyeska in particular is wholly an inter-state corporation. That was the question. How effective are you or would your scheme be in apportioning income to Alaska from the Prudhoe Bay and the Alyeska operation?

PROFESSOR AINSWORTH - Well, I would argue that it is the more effective way by far in the sense that first of all, I think there's a little bit of a mystery as to how the pipeline company is going to operate totally, but I would argue that, let me put it this way in order to be very specific. Again, I'm not talking about the book income part of it, and I'm talking in part about the extraction factor, but the part again that I want to emphasize, because frankly, respectfully, I feel that Mr. Erickson has totally misunderstood the nature of this problem, but anyway I want to make that clear that the idea of looking at the whole picture of the out of state owners and their profitability of the whole picture of their profitability is important, extremely important because the truth of the matter is that in a true economic sense, the pipeline companies are not operating solely in Alaska. They are part of a worldwide conglomerate type of operation, and although they have set up subsidiaries that operate in Alaska, in a true economic sense, those pipeline companies are truly and part of a unitary kind of business, and it has been suggested

to me for example by Mr. Erickson, that the state ought to draw a ring around Alaska, and therefore make sure that it is effectively taxing all those companies. That ring that Mr. Erickson would draw around Alaska is a ring that would prevent the State from having any effective remedy if the control of the pipeline companies, let's face it, the pipeline companies are not controlled by Alaska. They are not controlled by the legislature. They are controlled by corporations who have their corporate headquarters, and the major portion of their resources outside of Alaska. If they operate those in a manner to minimize their profitability which they easily can do, and the Department of Revenue is straddled with what I call this bow and arrow, obsolete, outmoded, mioptic form of taxation based on separate accounting. I think you are opening the flood base for widespread tax avoidance on the part of pipeline operators.

GEORGE SILIDES - Madam Chairman, Professor, that was not Mr. Erickson's question, but at any rate, one last thing. What is to prevent, now let me ask you this, you have said that no other state has adopted this particular procedure.

PROFESSOR AINSWORTH - Now, let me be very specific about this, and I'm very appreciative to Senator Rader for having brought this up. When I said that no other state has adopted this procedure, I am talking about the use of book income as a taxpayer, not the subject of the so called worldwide combination

or combined report which most of the progressive states have adopted.

GEORGE SILIDES - I understand all that, but now supposing that all the other 49 states have adopted this book income, wouldn't Alaska or Prudhoe Bay with it's high profitability, wouldn't Alaska income be voted by other states as jumping on to a possible venture?

PROFESSOR AINSWORTH - If all of the states adopted the book income approach, all the states would agree on the total size of the worldwide pie that's all. That is not related. If I could rephrase your question, I think what you're getting at is if all states are adopting the kind of apportionment formula that we are talking about.

GEORGE SILIDES - No.

PROFESSOR AINSWORTH - Well, I understand it to be addressed to book income, and I would say that the effect of all states adopting book income as the state taxable income would be to enlarge the corporate tax revenue for every state, a little bit as we suggested it be enlarged in Alaska. It would not shift income from one state to another, but every state would be more effective in raising revenue by that device.

GEORGE SILIDES - From the company?

PROFESSOR AINSWORTH - Yes, but not at the expense of Alaska.

GEORGE SILIDES - That answers my question.

PROFESSOR AINSWORTH - If I may Madam Chairman, in further comment so far as the pipeline property is concerned, in  
ing my estimates of revenue, I have assumed that property would indeed be incorporated into the numerator and the denominators of the appropriate oil company, so in that sense it would also be incorporated into this proposal that we have. We did not exclude that as part of the property factor.

GEORGE SILIDES - Professor we understand that we have a unique situation here, the pipeline companies are actually small.

PROFESSOR AINSWORTH.- Also, let me make an additional observation about the pipeline company which is a form of justification for departing from the uniform act. The uniform act itself and the draftsman of the uniform act expressly, intentionally they were cognizant of the fact that transportation companies present special problems, and so they did not include, they excluded transportation companies from the coverage of the uniform act, which is a further justification for the use of an extraction factor with respect to the apportionment of income in Alaska.

CHAIRMAN POLAND - Are there no further questions? Thank you very much Professor Ainsworth and Professor Zeifman, and ladies and gentlemen for your patience. We will resume our joint resources meeting here tomorrow at 1:30 in the afternoon.

STATEMENT

OF

BRISTOL BAY NATIVE CORPORATION

February 9, 1978

Madam Chairman, my name is Donald F. Nielsen, a shareholder and Vice President of Bristol Bay Native Corporation.

We are opposed to S.B. 236 or any other proposal to establish an oil and gas corporate franchise tax. Under the terms of our agreement with a major oil company, if oil or gas is produced on our lands, we will share in the production and would become a producing oil company. The market for our production would be outside of Alaska. The figure in excess of \$250,000,000 gross receipts may be of some protection in the immediate future; however, there is no assurance that if such a proposed bill becomes law that this figure could not be adjusted downward to fit any given corporation, nor does it take into account any future price increases.

As an Alaskan corporation, we do not feel we should be required to keep separate accounts and pay any different tax than any other normal Alaska corporation. Also, we feel the proposed franchise tax, if passed, could later be applied to other industries such as mining, all of which tends to discourage major investments and financing of any type of investments in Alaska. The same reasoning applies to any burdensome tax policies that that effect Alaska's investment climate. Thank you.



CITIES SERVICE MINERALS CORPORATION

A SUBSIDIARY OF CITIES SERVICE COMPANY

1016 WEST SIXTH AVENUE

ANCHORAGE, ALASKA 99501

DON STEVENS, PH.D.  
DISTRICT GEOLOGIST

(807) 272-9441

March 17, 1977

Mr. Bill Bishop  
Bristol Bay Native Corp.  
445 East 5th Avenue  
Anchorage, AK 99501.

Dear Bill:

Mr. Ranspot and I want to thank you and the Bristol Bay Native Corporation staff for the courtesies extended during our meeting last week. We found our review of the Bear Creek Mining Data to be most interesting and, in fact, these data exceeded our expectations. Bear Creek Mining has done an excellent job in its investigation of porphyry type targets.

As I mentioned on the phone, we have had to decline entering into an exploration agreement with Bristol Bay Native Corporation for a number of reasons in spite of the excellent mineral potential indicated by the data reviewed.

Certainly one important reason for being very hesitant to engage in new minerals exploration programs has been the Hammond administration's attitude toward mining taxes. Not only are attempts being made to adversely change the present mining license tax but several comments by the administration have indicated that an additional severance tax bill is going to be introduced in the next session of the legislature. One needs only to look at what has happened to taxes on oil and gas production in the last ten years to believe that the same thing will happen to the mining industry. With the high capital costs and the high infrastructure costs in mine development in Alaska a high tax burden will simply eliminate any chance for development of a mining industry.

The attractiveness of possible mining operations on native corporation land is being outweighed by the ever more burdensome tax policies generated in Juneau.

Sincerely,

Donald L. Stevens

DLS:hh

*John Ranspot*