

ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECTS 86 / 2

430 SCOMM11: INTERIM COMM. ON TAXATION & REVENUE 1975-76

Fur of the marsh-dwelling nutria (right)
provides a living for Cajun trappers;
below, nutria pelts dry on racks in
dappled shade

Opposite page, pelicans perch
within sight of rig on shell reef
off Louisiana shore



we were wrong . . . that the federal government had the exclusive claim outside the three-mile limit. Now the situation has turned full-cycle, and they are the unhappy legatees of their own ill-advised legal opinions and political positions taken a quarter of a century ago.

PETROLEUM TODAY: The charge is revived periodically that the oil companies contrived the energy crisis to promote profits. Do you believe this?

EDWARDS: I can best answer that by saying that there are 23 major or heavy independent oil companies in America. That's far greater than the number of steel companies, automobile companies or mail-order houses of national significance. If one looks at the amount of money that is consistently paid to the government in federal and state bidding for coastal tracts by these companies, it's obvious that there's no collusion among them. If they were colluding,

they certainly wouldn't leave millions of dollars on the table in bidding practices. They'd get together and rig the bids.

I simply say that there's fair enough competition in the oil and gas industry to more than allay the fears of anyone having that concern.

Also, you can look at the facts and figures. The reserves of oil and natural gas in place—whether we like it or not—declined by three to eight per cent a year because of many inhibiting factors and because of heavy usage. That's there . . . can be seen . . . can be calculated and projected. It flies totally in the face of the argument that the crisis has been contrived. It's just not so.

PETROLEUM TODAY: Proposed national legislation would establish a federal oil and gas corporation, national energy supply corporation, or other government operated company. Would you favor such a move?

EDWARDS: No. If there's one thing we have

proved in the past 200 years, it is that in no single instance can government operate as efficiently as private industry. Government should only engage itself in projects like TVA or Hoover Dam, where private industry does not have the capital or the powers of expropriation or what have you to accomplish a stated purpose. There are some areas where government must be involved.

But where private industry can handle it—and certainly the oil and gas companies can

pump and at the fuel station. It's really not doing the American taxpayer a favor.

I think the oil and gas companies should be treated like all other American businesses. Oil and gas were among more than a hundred minerals that were included under percentage depletion. All of a sudden, percentage depletion was removed for most oil and gas but not for the other minerals.

PETROLEUM TODAY: You have referred to federal regulation of natural gas prices at the

handle the exploration and production of oil and gas in this country—it should definitely be left to them.

Secondly, there is a limited number of off-shore rigs . . . a limited number of people in the business . . . a limited number of pieces of equipment and machinery. I don't think the government could acquire the equipment in any reasonable period of time, even if it had the men and technology to use it.

PETROLEUM TODAY: What was your reaction to Congressional action eliminating percentage depletion only for oil and gas?

EDWARDS: It was a step in the wrong direction. It will be counterproductive. I think it's going to hurt exploration at a time when we badly need to find additional reserves. And I think it's a beguiling of the American people. When you remove percentage depletion, the cost has to be passed on to the consumer at the gas

wellhead as "the first giant step backwards."

EDWARDS: Wellhead regulation began in 1954 as the result of an ill-advised Supreme Court decision interpreting the 1938 Natural Gas Act. Congress passed an act overriding the decision that wellhead prices should be under federal regulation. When it got to President Eisenhower's desk in February of 1956, he vetoed it because of a scandal involving a campaign contribution made by a lobbyist to a senator.

At the time of the veto, he recommended that it be reenacted. He predicted then—prophetically—that it would ultimately reduce supplies and heighten demand, and would not be in the long-run national interest.

He was right. What happened was that natural gas, being the only fuel regulated for 20 years, was sold at a price about one-third to one-half comparative Btu costs of other ener-

I would say 50 per cent of Louisiana's economy depends on petroleum and satellite industries

gies. Demand skyrocketed for this cheap, clean, and beautifully burning fuel. Enthusiasm of investors and producers for seeking additional reserves was dampened because the price was kept so low.

As a result of this paradox, reserves have declined from about a 22½ years' supply in relation to production to a seven years' supply.

PETROLEUM TODAY: Do you subscribe to the view of some that the oil industry rakes in "obscene" profits?

EDWARDS: No, I do not. When one considers the tremendous investment, that claim seems faulty. Anyway, it's a free country, and if things are that good, everybody can get into the oil and gas business. But for every one who's making a few dollars in the business, there are dozens who are losing money. If you can get into the business in a free and competitive market and make it, so be it. That's what this country is all about.

PETROLEUM TODAY: What measures have you successfully promoted at the state level to create greater incentive for exploration and production?

EDWARDS: Instead of decreasing the depletion allowance, we have increased it. We also have a fund to encourage independents to search for oil and gas by giving them certain benefits under state law. Then, of course, there's the effort to maximize state participation in produced oil and gas from state lands rather than to increase the cash bonuses required from oil companies.

PETROLEUM TODAY: How does Louisiana's economy compare with the national picture. What part has the petroleum industry played?

EDWARDS: Because our economy is largely based on oil and gas, agriculture and transportation—the three remaining growth areas—Louisiana has not fared as badly as many other states. The petroleum industry has been very, very helpful. I would say 50 per cent of our total economy is dependent directly or indirectly on petroleum and satellite industries.

PETROLEUM TODAY: What will the establishment of a superport mean to Louisiana?

EDWARDS: Something like 35,000 jobs and billions of dollars in industrial expansion.

PETROLEUM TODAY: Are you fearful of possible environmental damage from the operation of a superport?

EDWARDS: Not at all. I would say to those who have some fears that one thing is certain: the possibility of spills or environmental damage resulting from transporting oil in supertankers and discharging it in superports away from the traffic lanes and crowded ports is far, far, far less than transporting the same quantity in medium tankers to customary ports. That's already been established by the Council on Environmental Quality, which is a very conservative body.

PETROLEUM TODAY: If you were still a member of the national Congress, what measures would you support to promote energy self-sufficiency?

EDWARDS: First, I would do whatever has to be done to complete the Alaskan pipeline. Second, I would immediately lift all environmental restrictions on the mining, transportation and use of coal. Third, I would immediately open up all of the 10 million acres in the Pacific and Atlantic Oceans which appear to be productive of oil and gas, and get it explored and developed as soon as possible. Fourth, I would embark on a Manhattan-type project to develop alternate sources of energy. I would license immediately all applications for construction of nuclear generating plants.

I would proceed with operational pilot fast-breeder reactors, insist on use of coal in areas where it is in abundant supply, and initiate a crash program for research and development to gasify and liquefy shale.

Fifth, I would cut all the red tape and probably appoint one energy czar who would have complete authority to override all other agencies in granting permits for construction of refineries, thermonuclear generating plants and facilities used in either the production or generation of energy.

Finally, I would deregulate the price of natural gas and oil at every level. ●

February 27, 1976

Mr. Robert Paschall
Consulting Valuation Geologist & Engineer
460 Lovella Way
Sacramento, California 95810

Dear Bob:

Enclosed, for your information, is the most recent bill filed in the Legislature concerning oil taxation. It is known as the Cowper bill.

Sincerely,

John Huber

Enclosure

460 Lovella Way
Sacramento CA 95819
21 February 1976

Senator John Huber, Chairman
Special Committee on Taxation and Revenue
Pouch V
Juneau Alaska 99811

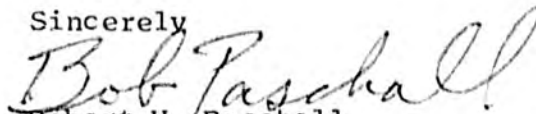
Dear John:

It seemed prudent appropriate at this time to render my statement to the Legislative Affairs Agency for work done in the months of January and February. I am sending two copies of both this letter and the statement in case you want a copy of the statement and the Agency needs a copy of the letter of transmittal.

Today I had a look at several Nevada Supreme Court cases and Attorney General's decisions dealing with the net proceeds tax, in order to anticipate any questions that might arise in the course of review or testimony. It was most interesting to find that all major issues were settled as far back as 1868, within four years of the time that the tax was enacted. How's that for longevity?

If you think that you have had trouble with the oil industry, you should see the language of the Supreme Court in dealing with the actions of certain mining companies more than one hundred years ago. The court said at one point "At the instance of the mine owners, and by their intrigues and threats..." The underlined words were in italics. Pretty strong, eh?

Sincerely



Robert H. Paschall
Consulting Geologist and
Valuation Engineer

440 Levee Way
Sacramento CA 95819
21 February 1976

Senator John Maber, Chairman
Special Committee on Taxation and Revenue
Pouch V
Juneau Alaska 99811

Dear John:

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Sincerely



Robert H. Paschall
Consulting Geologist and
Valuation Engineer

Robert H. Paschall
Consulting Valuation Geologist and Engineer
460 Levella Way
Sacramento CA 95819
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S T A T E M E N T

21 February 1976

Legislative Affairs Agency
Pouch Y, State Capitol
Juneau Alaska 99811

	<u>Hours</u>
January 5: discussion in Sacramento with Senator John Huber on oil and gas tax systems and proposals	4
February 1: Studied 14-page Mining License Tax proposal ~~and write~~	2
February 8: Studied 30page staff report on oil and gas taxation and wrote 7-page letter to Senator Huber	7
February 12: Studied 14-page report by Rush Moody on natural gas and wrote 4-page letter to Senator Huber	4
February 16: Analyzed three proposed Senate bills on oil taxation and wrote 6-page letter to Senator Huber	7
February 21: reviewed Nevada court cases and Attorney General's decisions on net proceeds tax	<u>1</u>
TOTAL HOURS	25
Amount due and payable, at \$30 per hour	\$750

February 18, 1976

Mr. Robert Paschall
Consulting Valuation Geologist & Engineer
460 Lovella Way
Sacramento, California 95819

Dear Bob:

Enclosed is the tax package that the Special Committee on Taxation and Revenue has prepared and filed with the Legislature. Because of your position as a consultant to the Committee I thought you would be interested in receiving these bills.

HB 699 and SB 620 are the companion bills on net proceeds; and HB 703 and SB 621 are the companion bills on excess value.

Sincerely yours,

John Huber

Enclosures

· PLEASE NOTE: THE PRECEDING PAGES WERE TREATED
· AS A UNIT IN THE ORIGINAL DOCUMENT.

STATE OF ALASKA THE LEGISLATURE

LEGISLATIVE AFFAIRS AGENCY

POUCH Y. STATE CAPITOL
JUNEAU, ALASKA 99811
465-3800

CONTRACT BETWEEN
STATE OF ALASKA
LEGISLATIVE AFFAIRS AGENCY
AND
ROBERT H. PASCHALL

The parties to this agreement are the LEGISLATIVE AFFAIRS AGENCY, hereinafter referred to as the "Agency", and ROBERT H. PASCHALL, of Sacramento, California, hereinafter referred to as the "Contractor".

THE PURPOSE OF THIS AGREEMENT is to provide professional review services and testimony on pending legislation relating to oil and gas revenues and taxation to the Alaska State Legislature through the Agency during the Second Session, Ninth Legislature.

IT IS, THEREFORE, MUTUALLY AGREED THAT:

CLAUSE I. - STATEMENT OF WORK

The Contractor shall do all things necessary for and incidental to the performance of the work as described in this agreement.

CLAUSE II. - PERIOD OF PERFORMANCE

(A) The Contractor shall be available at a mutually agreeable time during the Second Session of the Ninth Alaska Legislature to provide the services described in this agreement and under the terms and conditions contained herein.

(B) This agreement may be terminated

(1) by either party on 30 days' written notice to the other party, or

(2) by mutual consent of the parties to this agreement.

(C) This agreement expires on the last day of the legislative session aforementioned unless terminated earlier as provided in Clause II(B) of this agreement.

AGO 530323

(D) It is estimated that 60 hours will be spent by Contractor reviewing legislation in Sacramento, California, and seven days will be required for his travel and presence in Juneau, Alaska, to satisfy this contract. These time estimates may be extended upon approval of the Project Director.

CLAUSE III. - COMPENSATION AND METHOD OF PAYMENT

The Contractor shall be compensated as a contract employee at a rate of \$30.00 per hour while reviewing legislation in Sacramento, California, and \$325.00 per day and be reimbursed for expenses for travel to Juneau, Alaska, for testifying purposes. The Agency will make necessary arrangements for such compensation to be remitted to the Contractor on receipt of an itemized invoice from the Contractor. Total payments for the services of the Contractor under this agreement, excluding approved expenses, may not exceed \$4,075.00 unless extended in accordance with Clause II(D).

CLAUSE IV. - PROJECT DIRECTOR

Performance of the work specified in this agreement shall be under the general direction of Senator John Huber, Chairman, Senate Special Committee on Taxation and Revenue.

CLAUSE V. - REPORTS

The Contractor shall keep the Agency informed as to the progress of the work performed under this agreement and shall provide progress reports as specified by the Project Director.

CLAUSE VI. - RECORDS, DOCUMENTS, AUDIT

The Contractor shall maintain accurate records, including detailed time records, as may be required by the Agency. The records are subject to inspection by the Agency at all reasonable times. All documents, reports and writings are, upon delivery to the Agency or at termination of this agreement, the property of the Agency.

CLAUSE VII. - ALL WRITINGS CONTAINED HEREIN

This agreement contains all the terms and conditions agreed upon by the parties. No other understandings, oral or otherwise, regarding the subject matter of this agreement shall be deemed to exist or to bind either of the parties to this agreement.

IN WITNESS WHEREOF, the parties have executed this
agreement on this 8th day of February, 1976.

ROBERT H. PASCHALL

Robert H. Paschall
CONTRACTOR

LEGISLATIVE AFFAIRS AGENCY

John C. Doyle
ADMINISTRATOR

APPROVED AS TO FORM WHEN SIGNED
BY CONTRACTING PARTIES

Billy J. Bessie
AGENCY LEGAL COUNSEL

John H. Huter
PROJECT DIRECTOR

February 4, 1976

Mr. Robert Paschall
Consulting Valuation Geologist & Engineer
460 Lovella Way
Sacramento, California 95819

Dear Bob:

Please sign both copies and return them to me immediately so that I may have them signed by Jack Doyle and legal counsel. We will return your copy to you.

In the meantime, we are planning a short session and don't let the grass grow under your feet in getting to work on our material, as you have my word that you are covered.

Sincerely yours,

John Huber

Enclosures

460 Lovella Way
Sacramento CA 95819
1 February 1976

Senator John Huber, Chairman
Senate Taxation and Revenue Committee
Pouch V
Juneau Alaska 99811

Dear John:

I just studied Chapter 65, Mining License Tax, and was so shocked by its contents that I am impelled to let you know immediately of some serious problems, without dwelling on their solutions. Meanwhile, I am beginning to study the other data that you sent, and I eagerly await a letter from you acknowledging my role as a consultant to your committee.

Chapter 65 is absolutely, unequivocally not a "net proceeds" tax law, and bears only the faintest resemblance to the Nevada type of law that I have recommended to you. Instead, Chapter 65 is a corporate income tax, and can hardly be deemed to be in lieu of such a tax when it is one itself. Here are the chief difficulties with the chapter.

1. Depletion is allowed as a cost, yet depletion is the very essence of income to the mineral deposit. Depletion is a major element of after-tax cash flow, which is the "net proceeds to the mine" so far as a mine operator is concerned.

2. Chapter 65 proposes a tax that is levied on the operator, not on the mine. The aggregation of income and expenses for two or more mines owned by a single operator vitiates the tax as a "mines net proceeds tax." Why should a profitable mine go tax-free simply because another mine owned by the same company is running in the red? The provision for aggregation obviously affords a much greater benefit to a large company than to a small one, because the small company is more apt to have a single and profitable property, with no tax shelter available from elsewhere.

3. Depreciation on plant and equipment is permitted as an expense "...not to exceed 10 per cent of the cost or market value of the asset, whichever is lower." There are two objections to this statement. First, if depreciation is allowed as an expense, the inclusion of market value as a prospective base will require annual appraisal of the plant and equipment. I assure you that such appraisal will be a difficult and controversial task, and will of course require hiring another body to do it. Going further: if depreciation is not allowed, the net proceeds will reflect the value of the plant and equipment and subject them to taxation, thereby making it unnecessary to tax them on an ad valorem property tax basis.

4. "Amortization of development costs" is strictly an income tax approach, and greatly complicates administration. A true net proceeds tax would treat annual development costs as an annual expense, regardless of their handling for Federal income tax purposes. In appraising large mines, for example, I simply expense development costs, rather than amortize them, because this is the way that the mining superintendent looks at them.

5. Allocation of expenses "...not directly attributable to mining properties or processes" is, again, strictly an income tax device, and one that is a real monster to handle. Only direct expenses should be deductible, and those are the ones for which the mining superintendent is typically responsible.

6. A minor item: the sentence dealing with "Taxes upon royalties" should presumably read "Taxes upon privately owned royalties," since it is doubtful that the State either can or would want to tax itself or another governmental entity.

In addition to the above, there are several areas in which the chapter is simply overwritten, especially where all sorts of minerals are named and where all sorts of processing methods are listed. Also, I have not even bothered to read the provisions for administration and penalties, so I have no comments to make there.

The first five numbered items above will demonstrate to you how concerned I am over the utter vitiation of the net proceeds concept, and the substitution of an income tax that will probably be just about as useful as your State's present income tax on oil and mining. At the same time, I fully understand the mining industry's concern over a severance tax, as outlined in Franklin Fleeks' memos to you. A severance tax is inevitably an inequitable one, and does indeed penalize the marginal operator. I can also appreciate that the industry may not read my comments with approbation, but they should not concern the industry nearly so much as a contemplated tax rate, and that I will leave to you and the fiscal and budgetary people.

Sincerely



Robert H. Paschall
Consulting Valuation Geologist
and Engineer

460 Lovella Way
Sacramento CA 95819
27 January 1976

Senator John Huber, Chairman
Special Committee on Taxation and Revenue
Pouch V
Juneau Alaska 99811

Dear John:

Today I received your mailing of January 22 (pretty good mail service for such a bundle!) and will very shortly begin to review it and put together my thoughts on its contents. However, before I launch into any substantial work, such as rendering you a report on the material, it is necessary for me to receive formal word from you that I am indeed being employed by your committee to engage in the work. Imagine my embarrassment if you decided all of a sudden to give up the vicissitudes of political life and return to business in Fairbanks! It may be useful to note that, prior to my working for either the State of Nevada or the North Slope Borough, I received standard contracts from the Attorney General and the Borough Counsel, respectively. I suggest that such a document, or something very near it, is rather comforting to both sides of a cooperative effort. In fact, both the State of Nevada and the Borough made progress payments so that it was not necessary for me to make substantial out-of-pocket outlays for the expensive business of long-distance travel. This is not necessary, it's just nice.

By the way, I have again received a mass of material from Sterling Gallagher, asking for my comments by February 16. It contains the Mining License Tax item that you sent and, as well, a 252-page transcript of a November public hearing on taxation of the mining industry. I find it rather embarrassing to have to repeat my letter of last October to Mr. Gallagher, pointing up the fact that I simply cannot engage in gratis critiques of the complex issue of minerals taxation for the State of Alaska. Of course, your situation and his are notably different. You and I have engaged in voluminous correspondence, I have worked before for your Committee, and you recently visited me to talk things over. Mr. Gallagher and I have never discussed any of the matters on which he has asked my opinion by mail.

Finally: I am sure you will be interested to read the enclosed report by H.C. Wainwright and Company of New York. Liebman of Wainwright called me many months ago and asked for a copy of the Prudhoe Bay appraisal that I made in 1973, and he promised to send me anything that he wrote about Alaska oil, whose economics he has been assigned to follow.

Sincerely



Robert H. Paschall
Consulting Valuation Geologist
and Engineer

AGO 530329

460 Lovella Way
Sacramento CA 95319
11 January 1976

Senator John Huber, Chairman
Special Committee on Taxation and Revenue
Pouch V
Juneau Alaska 99811

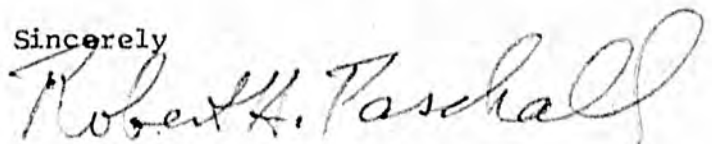
Dear John:

That was quite a four-hour chat that we had the other day, and I hope you enjoyed it as much as I did. As a matter of fact, it was the beginning of the darndest week for me. Before it was out, in addition to your visit I was either visited or called by people who want me to testify in four California county oil tax equalization cases. Since two of the callers were county counsels and two represented industry, I might stake a temporary claim to being nonpartisan. Also, something that I believe you will find interesting, I received a call from a professor at the University of West Virginia asking me to speak on mines taxation at next month's annual conference of the Council of Economics of the American Institute of Mining Engineers in Las Vegas. I accepted his invitation. Finally, on Friday I got a letter from the Executive Director of an outfit in British Columbia called the British Columbia Institute for Economic Policy Analysis. Somehow or other he had gotten a copy of my testimony in Juneau, and he began his letter by saying "I have just read with great delight..." He wanted me to fill in some details for him. I ask you: how was that for a week. Almost as good as money in the bank.

You asked that I provide you with a statement of my fees for working for your committee on bills analysis and testimony in Juneau. I am raising my fees this year by a modest amount: \$30 per hour for time spent here in Sacramento and \$325 per day (plus expenses) for a trip to Juneau. My past work for you and for the State of Nevada leads me to believe that bill analysis, et al., here at home will not take over 60 hours. A trip to Juneau seems inevitably to take a week. Put the two together and we are looking at a maximum of \$4,275 in fees plus about \$600 in expenses.

I am leaving tomorrow on an 11-day business trip, with four days in the Kern County Assessor's office followed by four days the following week at the Santa Barbara Assessor's office. I regret to say that I have not yet received anything from your office. I would like to have taken it along with me.

Sincerely



Robert H. Paschall
Consulting Valuation Geologist
and Engineer

AGO 530330

460 Lovella Way
Sacramento CA 95819
21 June 1975

The Honorable Sterling Gallagher
Commissioner of Revenue
Pouch SA
Juneau Alaska 99811

Dear Mr. Gallagher:

I recently had the opportunity to read the excellent master's thesis on oil taxation written by James Deagen of your Department of Economic Development. One statement, however, deeply concerned me, and I would like to comment on it. Mr. Deagen had this to say on page 51:

"If legislation is enacted on taxing oil reserves, however, it appears that the Alaska Department of Revenue will contract with a Texas consultant rather than California consultants. Both offer competent appraisal techniques. The Texas alternative, however, offers both the appraisal and legal expertise that will be required. It is 'easier' to obtain \$150-200 million in oil taxation revenues with the help of a veteran firm which has a good record in corporate-tax matters."

I disagree strongly with this viewpoint, both on behalf of the State of Alaska and on behalf of my personal interest in working for you. First, I propose that purely legal expertise relating to your State's oil property assessments falls in the domain of Alaska's office of the Attorney General. Should outside legal advice be required, which is doubtful, it should be sought on its own merits, and stipulated in a contract as something aside from valuation expertise. Please forgive me if this appears to be gratuitous advice, since I am sure that it is in accord with your current policies and practices.

More specifically, no valuation engineer can do a job for anyone unless he is thoroughly familiar with the laws applicable to the job. You are undoubtedly acquainted with my role in Alaska's recent legislation on oil property taxation. Senator John Huber provided me with every Senate and House bill draft, including the final statute, and I worked closely with him, Representative Steven Cowper, and John Messenger while I was in Juneau. Thus, I am as knowledgeable about Alaska oil property tax law as anyone in your state or elsewhere.

I am required to be equally knowledgeable about parallel California law. If that were not the case I could not do my work here, and the Alaska legislature would not have employed me to testify on its application. Moreover, I have testified on numerous occasions at equalization hearings on oil property assessments. I have been subpoenaed to appear three times in the past eighteen months, and have been notified by a major law firm that I will soon be subpoenaed in an oil equalization hearing involving several million tax dollars.

AGO 530331

Forgive me if I appear to be disturbed by the implications of Mr. Deagen's remarks, but of course I am. I would be highly chagrined to lose an account in which I am greatly interested because it is presumed that I am ignorant in an area where I am highly knowledgeable.

Sincerely

Robert H. Paschall
Consulting Valuation Geologist
and Engineer

cc Senator John Huber
Gerald D. Heier
Frederick P. Boetsch
John Messenger
James Deagen

John, I am very much concerned for your sake about another aspect of this matter that I really couldn't mention to Sterling Gallagher. It may not be the best of news to Chancy Croft, but Texas simply does not have the reputation in property taxation that California has. In fact, to be blunt about it, Texas has a poor reputation. If you believe I may be unduly prejudiced, you may want to check with the International Association of Assessing Officers in Chicago, or the Advisory Commission on Intergovernmental Relations in Washington, D.C.

The idea of hiring a Texas appraisal firm because it has a Texas lawyer as president just does not make good sense from Alaska's standpoint. There may be a good reason to hire such a firm, but that is not it.

Another thing: you may find that the present statute needs amendment next year. If so, the employment of a Texas firm would probably mean that you would have input only from Texas relative to legislation. I will suggest that Henry Wilkinson and Joe Witherspoon are adequate to the case, without bringing in a third Texan.



460 Lovella Way
Sacramento CA 95819
2 June 1975

Senator John Huber, Chairman
Special Committee on Taxation and Revenue
Pouch V
Juneau Alaska 99811

Dear John:

I am sure you will be pleased to know that a check from the Legislative Affairs Agency arrived today, in the same mail that brought your letter of concern on the subject. It may also relieve your mind to hear that, unfortunately, other states and governmental entities are similarly tardy in paying their bills, so Alaska has plenty of company. I'm not quite sure why this should be the case, and it appears to be a fit subject for a congressional investigation, at the very least.

How are things going in the field of oil tax legislation? I will be most grateful to hear as soon as a law may be enacted, for two reasons. One is that it is always gratifying to know of the successful conclusion of a campaign in which one has played a part, however small. The other, of course, is that I am still highly interested in serving as Alaska's valuation engineering consultant, should one be required. If I hear that ad valorem taxation has been enacted, I intend to write Commissioner Gallagher a follow-up letter. In fact, should I get the job, I intend to quit California state employment in order to do justice to Alaska's requirements.

Have you seen the article on Alaska in the most recent National Geographic? All told, it was pretty good coverage. And of course I was interested to encounter the names of three natives whom I have met: Eban Hopson, Willie Hensley, and Oliver Leggett.

I trust that you have had that fine boat in the water long before now, and have successfully pulled in your halibut skate.

Sincerely



Robert H. Paschall

May 29, 1975

Mr. Robert H. Paschall
460 Lovella Way
Sacramento, CA 95819

Dear Bob:

Thank you for sending me a carbon copy of your letter of May 26, 1975 to John Elliott.

I just wanted to let you know that I have been raising Hell to get you paid, which I believe is now very close if not already in the mail. I am truly sorry for this delay and sincerely apologize for my state and its administration.

Sincerely yours,

John Huber

JH:kb

AGO 530334

Mr. J. H. Pashall
Legislative Service Agency
P.O. Box 1
Juneau, Alaska 99801

Dear Senator Haber:

My present concern about not having received payment for my services to your State's legislature is two-fold. The most immediate, of course, is the fact that I have not been paid by a time that is now six and one-half months after I worked in Juneau, following my having submitted statements twice and having later sent you a telegram asking that you check on the matter with Senator John Haber.

My other concern is that I have heard absolutely nothing from you on the subject. I have begun to wonder whether your office has even received the three messages that I have sent. This puts me in a most difficult position. I can appreciate that a state may have administrative delays in paying unusual expenses like those of an individual consultant. At the same time, it also seems appropriate that the state might acknowledge correspondence on the subject, and give some idea of the time when the money will be sent.

It is most frustrating to be here 2,000 miles away, wondering what has happened to my communications on a subject that is highly important to me. By this time, of course, I have had to pay out of my own pocket the \$600 cost of my trip to Juneau, and the continued delay in the receipt of pay for my services is a concern that increases daily.

Will you please at least acknowledge receipt of this letter?

Sincerely

Robert H. Pashall

Robert H. Pashall
Consulting Valuation Geologist
and Engineer

cc Senator John Haber
Senator Chaney Croft

Dear Senator Haber and Senator Croft: I imagine that Nele Anderson would find some amusement in this delay, especially if he knew that the North Slope Borough always paid me within two weeks of billing. Is that where all the money has gone?

Bob P.

AGC 530336
30 April 1975

Executive Officer
Legislative Affairs Agency
Pouch Y
Juneau Alaska 99811

Dear sir:

The attached statement is a duplicate of one that I sent to your office on April 13. I hope that it will be possible for you to pay me in accordance with the statement at the time of your end-of-April accounting. Thank you for your attention to this matter.

Sincerely

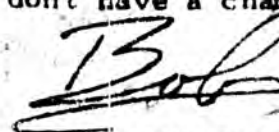


Robert H. Paschall

Dear John:

I hope that things are going well with you regarding your legislative goals. Yesterday I talked with Walter Mead. I concur with his idea of the usefulness of a Beaufort Lease sale of the waters immediately contiguous to Prddhoe Bay. Interestingly, these lands are labelled as "BP" and "ARCO-Humble" on BP-Alaska's Exhibit G for the 1971 Field Rules Hearing. But Walter said that Sterling Gallagher assured him they were not included in the 1969 or prior sales. At the same time, and without regard to the sale, an ad valorem statute might be useful as a reserve, should the sale not meet state needs. And the prospect of a sale might reduce the opposition to the ad valorem bill (might, I said).

Looking back, I greatly enjoyed my trip to Juneau, even if you did keep me so busy that I didn't get to explore the adjacent wilds. Of course, all of those signs saying "DANGER-- TRAIL CLOSED" were a problem, too. And the highlight of the trip was the ride that you took me on the day that I arrived. Incidentally, I talked to a forester since I got back about those trees that were broken off by the wind above your place on Douglas Island. He said this was not unusual when tougher trees on the perimeter of a forest are removed, as they were of course in building the road on Douglas Island. The trees inside the forest are as wind-resistant, so that when a hurricane hits them they don't have a chance. Interesting, eh?



AGO 530336

WALTER H. PASTERNAK
Consulting Valuation Geologist and Engineer

460 Lavella Way
Sacramento Calif. 95810
.....

30 April 1975

Legislative Affairs Agency
Pouch F
Juneau Alaska 99811

S T A T E M E N T
for professional services

Analysis of legislative bills and testimony relating to ad valorem
taxation of oil and gas, plus report-writing and letter-writing:

23 hours at \$25 per hour (while in Sacramento) \$ 575.00

Trip to Juneau from April 5 to 12: testimony before legis-
lative committees, conferring with legislators, legislative
staff members, representative of the Attorney General, and
others on bill analysis and other matters:

6 full days and two one-half days at \$300 per day 2,100.00

Travel and other costs:

Air fare	\$237.68	
Hotel: 5 nights at Baranof in Juneau at \$33.28 and two nights at Sea-Tac in Seattle at \$25.27	216.94	
Meals, bus and taxi, telephone, laundry, et al.	<u>146.29</u>	
		<u>600.91</u>

TOTAL of all costs and professional charges \$3,275.91

bc Senator John Huber

460 Lovella Way
Sacramento CA 95819
30 April 1975

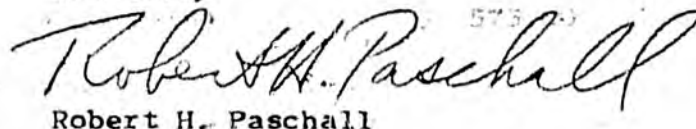
Executive Officer
Legislative Affairs Agency
Pouch Y
Juneau, Alaska 99811

Juneau Alaska 99811
Dear sir:

STATEMENT

The attached statement is a duplicate of one that I sent to your office on April 13. I hope that it will be possible for you to pay me in accordance with the statement at the time of your end-of-April accounting. Thank you for your attention to this matter.

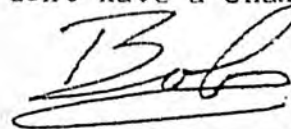
Sincerely


Robert H. Paschall

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AGO 530338

ROBERT H. PASCHALL
Consulting Valuation Geologist and Engineer

460 Lovella Way
Sacramento Calif. 95819

30 April 1975

Legislative Affairs Agency
Pouch Y
Juneau Alaska 99811

STATEMENT

Attached is a statement as a duplicate of one that I sent to your office on April 13, 1975, for professional services available for you to pay in accordance with the terms of the contract of your end-of-the-account. Thank you for your attention to this matter.

Analysis of legislative bills and testimony relating to ad valorem taxation of oil and gas, plus report-writing and letter-writing:

23 hours at \$25 per hour (while in Sacramento) \$ 575.00

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Meals, bus and taxi, telephone, laundry, et al. 146.29
TOTAL 600.91

TOTAL of all costs and professional charges \$3,275.91

bc Senator John Huber: I was on trip to Juneau, Alaska, to keep the record of the trip and to prepare the report. I was, of course, at the trip and the trip was the day that you told me on the day of the trip. I was on a forecast plane I got back to Juneau as that was the day off by the wind that your plane on the 1st of June. He said that was not unusual. He had fought trees on the coast and the forest was removed. He said that was of course a building and the forest was the day that you told me. He said that was a chance.

460 Lovella Way
Sacramento CA 95819
11 May 1975

Senator John Huber
Special Committee on Taxation and Revenue
Pouch V, Juneau
Alaska 99811

Dear John:

Several elements of HOUSE BILL 297, as offered 5/6/75, provide great cause for concern, and others can be improved for administrative reasons. Here they are, more or less in order of importance.

EXEMPTION OF "PRODUCING OIL AND GAS LEASES AND THE VALUE OF INTANGIBLE DRILLING AND EXPLORATION EXPENSES (Sec. 2, 43.55.010(b))

These exemptions are carried in the April 17 and later versions of HB 297. I strongly urge their deletion. I will play the devil's advocate and claim that they nullify all or part of Sec. 43.58.010, namely, the very proposal to levy an ad valorem tax on oil and gas reserves. Here is the case that I can make and that industry will make.

(2) Producing Oil and Gas Leases

A private party's lease with a government agency is the very instrument that creates its leasehold interest in the mineral rights. Unless the intent of 43.58.010 is to confine the ad valorem tax to non-producing properties, 43.55.010(b)(2) creates an unintentional exemption from ad valorem taxation for all fields that now produce. But the very fact that Section 43.58.030 provides for a production tax credit against the ad valorem tax indicates that producing leases are not to be exempted.

(5) Intangible Exploration and Drilling Costs

(5) Exploration and development are necessary to establish the existence of a valuable oil or gas reserve. More precisely, the completion of a new well capable of production enhances the value of the reserves, since the well is necessary to produce (part of) the reserves. One can maintain, then, that the cost of drilling is included in the value of the reserves developed by the drilling.

Now, what exactly are "intangible drilling costs" (IDCs)? They represent that portion of total drilling costs expended for wages, salaries, and services, and are identified separately from tangible drilling costs (for casing, wellhead equipment, etc.) only because the Internal Revenue Service permits expensing IDCs while it requires that tangibles be capitalized. IDCs have been under serious attack as an undue tax privilege; that is the case because the equivalent in real estate development would consist of expensing architect's fees and building contractors' salaries and wages.

DEFINITION OF "PROVEN RESERVES" (Sec. 43.58.190(7))

An excellent definition of this term was in the bill until the version of April 24 was written. That earlier version was almost exactly the one promulgated by the American Petroleum Institute and adopted throughout the industry. The definition in the latest version is awkward and ambiguous. The phrase "if it is economically feasible to market it" is not necessary, since the phrase "indicate to be recoverable" precedes it; no one will bother to recover it unless it is economically feasible. Also, the term "reasonably foreseeable conditions" is a monster, and lawyers would have a field day defining "reasonable" as it applies to a given oil field.

In fact, it looks as if the lawyers intruded themselves into an area that was hammered out years ago by engineers and economists to everyone's satisfaction. I recommend that the definition in the April 17 version be used.

THE AD VALOREM ASSESSMENT TIME TABLE

Here are key dates:

January 1: property assessed as of this date. This means that information as late as December 31 may be required by the valuation engineer.

February 1: all taxpayers returns shall be filed on or before this date. I can assure you that this will be essentially impossible in many cases, because of the lag in sending data from (1) the field to (2) a company's accounting department to (3) a company's tax department to (4) the state.

April 15: the department shall send a notice of the assessed value of each property to the operator or other person.

June 15: The department shall certify the assessment roll and send out the tax bills.

Here is the problem: typically, the valuation engineer will receive some critical data at least as late as February 15 (and he can't do much about it except complain). Also, he will have to furnish his values to the department by April 1 if the department is to send out notices by April 15. The result: the poor valuation engineer will have no more than sixty days in which to do his job.

A recommended solution: Change "April 15" in Section 43.58.060 to "May 15." This should give the department ample time for its job, and add a month's time for the beleaguered valuation engineer to do his job.

MANDATORY VALUATION BY THE DEPARTMENT

Sec. 43.58.100 (a), second sentence, says that "In either case, the department may make its own valuation of the taxable property." In my bailiwick, at least, that "may" would read "shall." It removes any doubt as to the department's right and obligation to value the property.

.....
I will now comment on the April 15 version of Senate Bill 374, beginning with the items in common with my remarks on House Bill 297.

EXEMPTION OF "PRODUCING OIL AND GAS LEASES" AND "INTANGIBLE DRILLING AND EXPLORATION EXPENSES" (43.55.010 (b) (2) and (5))

I cannot stress too strongly the need to remove these items from any bill on ad valorem taxation or other taxation of oil and gas. Putting it bluntly, everyone to whom I have described these items comes close to throwing up.

THE "PERIOD OF GRACE"

This element in SB 374 makes a great deal more sense than the language of HB 297. I suggest only that the word "other" be deleted from the first line of 43.58.020(3). I'm not quite sure what purpose it serves.

OPERATOR'S WITHHELDING OF PROPORTIONATE SHARE OF TAXES

The Senate bill carries no problem in this regard.

DEFINITION OF "PROVEN RESERVES"

The Senate bill carries the correct definition of this term.

THE AD VALOREM ASSESSMENT TIME TABLE

SB 374 poses a quite insuperable burden on the valuation engineer, since its Section 43.58.080 lops a precious month off of the short time provided in HB 297. See my comments above on that topic.

Here are some brief comments on other subjects.

I like SB 374's appeals procedures, including the omission of reference to a trial de novo. John Messenger indicated that one cannot stop a trial de novo, but that a plaintiff's right to it need not be stated in a statute.

I was startled to see the non sequitor "crude petroleum oil" in SB 374's Section 43.58.190(5). "Petroleum" means "rock oil," so "crude petroleum oil" means "rock oil oil," which is not only redundant but a term never, never used by anyone in the entire oil industry. I got Easy Gilbreath's concurrence on this, but I guess it was too small to be noticed. Would you please insert "crude petroleum" or "crude oil"? All petroleum geologists and petroleum engineers will be grateful.

Sincerely

Bob Paschall
Robert H. Paschall
Consulting Valuation Geologist
and Engineer

cc Walter Mead

AGO 530343

460 Lovella Way
Sacramento CA 95819
3 May 1975

Senator John Huber
Special Committee on Taxation and Revenue
Pouch V
Juneau
Alaska 99811

Dear John:

The oil industry and gas pipeline industry have just furnished us with an excellent example of the viability of reserves estimation and property valuation for a non-producing field. The April 21 Oil and Gas Journal carries an article which says in part:

"Northern Natural Gas Co. has asked the Federal Power Commission for an expedited hearing and decision on payments it plans to make to Exxon Co. U.S.A. for gas-purchase rights in the Prudhoe Bay area of Alaska... In one agreement with Exxon, Northern may acquire up to 2 trillion cu ft of gas from a 25% share of Exxon's interest in the Prudhoe field. In return, Northern may be required to pay Exxon as much as \$300 million."

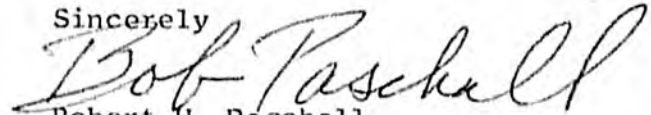
Here are some of the interesting things that may be inferred from the above statement.

1. Northern must have a great deal of faith that a ^{gas} pipeline will be built in the foreseeable future. This faith casts considerable doubt on the conclusion of the Governor's Task Force that Prudhoe Bay's gas is essentially worthless.

2. The proposed expenditure of \$300 million means that Northern has faith, as well, in Exxon's estimate of reserves and of the ultimate wellhead price of gas. The article later said that Northern will ask the F.P.C. for permission to incorporate the purchase price in its rate base. You can bet that the F.P.C. will require submittal of a detailed reserves estimate and cash flow stream. In short, the F.P.C. will require an appraisal.

3. Finally, the above items refute the contention of Milton Lipton and others that valuation for ad valorem property tax purposes is not feasible. If Exxon and Northern Natural Gas can do it, I can do it. In fact, I would accept the F.P.C.'s allowable addition to rate base as an excellent value indicator for gas in place at Prudhoe Bay.

Sincerely


Robert H. Paschall
Valuation Geologist and
Engineer

cc Walter Mead

AGO 530344

Dear Mr. Anderson:

It might be useful to you if I repeat or summarizing that the Oil and Gas Act is now in Senator Frank's office. It is very important, looking back on the work in Alaska, that under certain law have passed on the economic impact of oil release location. I readily grant your Legislator's right and obligation to make his own decision on the alternatives now before you. At the same time, I would regret seeing your right decision made for the wrong reasons. As a result, I would like to list the main elements that go into oil industry decision-making in regard to new leases. I contend that these elements are listed in the industry's order of priority.

1. Political Climate

The political climate is now very bad in the Mid East, North Africa, and Venezuela, only fair in Canada, and good in the United States, including Alaska.

2. Promising Geological Structures

No one will bid unless the geology is promising. If it is promising, it is hard to beat people off with a stick, as the money laid out for the 24th lease sale showed.

3. Availability of Money to Bid

Availability of money depends on the financial status of individual companies and on the money market, that is, on the amount of funds on hand for lending and the interest rate charged for those funds.

4. Availability of Skilled or of Timber Transportation

This problem is a familiar one to Alaskans, and needs no comment.

5. Availability of Drilling Rigs

The high costs of preparing rigs for Alaska operations and of shipping them makes rig availability especially important in your state.

6. Future Expenses

These expenses fall into three major categories: drilling and other development costs, oil and gas production costs, and royalty and taxes.

I hope that these comments are useful in putting the value of an unknown
variable into perspective.

Robert H. Puschall

Robert H. Puschall
Consulting Veterinarian, Zoologist,
and Engineer

cc Senator Clancy Craft
Senator John E. Hill
Representative Steven Cooper

460 Lovell Way
Sacramento CA 95819
14 April 1975

The Honorable Sterling Gallagher
Commissioner of Revenue
Department of Revenue
Pouch SA
Juneau Alaska 99811

Dear Mr. Gallagher:

As you know, legislation presently pending in Juneau contemplates an ad valorem property tax on oil and gas leasehold interests. Mr. Gerald Heier, Director of your Department's Property Tax Division, has testified that, in his opinion, Alaska should employ an outside consultant to appraise your state's oil and gas fields should a property tax be enacted. This letter constitutes my expression of interest in being that consultant.

I have had the opportunity to visit Alaska four times in the past year and a half, in all instances either to work on the appraisal of the Prudhoe Bay field or to testify before your legislature on oil and gas property taxation. My qualifications are stated on the attached professional resume.

Here is the job that I would do annually for your Department and the Property Tax Division for a fee of \$40,000 plus a maximum of \$5,000 in recorded travel and other expenses:

1. Employing standard evaluation practice, derive a total property value for each field.
2. Write a narrative appraisal report which contains the reasons for each consequential judgment that was made in valuing each field.
3. Allocate the total property value to each ownership, lease block, or other legal or geographic category required to be in accord with the task of oil and gas field equipment assessment that is presently done by your Property Tax Division.

I will remark in closing that I had the pleasure of conferring recently in Juneau with both Gerald Heier and with Frederick Boetsch, Deputy Commissioner of Revenue. They are in a position to confirm my stated ability to do the required job for your Department and to deal on your behalf with other governmental agencies and with industry.

Sincerely,



Robert H. Paschall
Consulting Valuation Geologist
and Engineer

cc Frederick P. Boetsch
Gerald D. Heier

bcc Senator John Huber
Representative Steven Cowper

AGO 530347

PROFESSIONAL RESUME OF

ROBERT H. PASCHALL

with special reference to the
valuation of oil and gas prop-
erties for tax purposes

EDUCATION AND EXPERIENCE

B.A. and graduate work in geology, UCLA and Oregon State University

Twenty years in onshore and offshore oil and gas reserves estimation and exploration in California; last position was Senior Geologist, Signal Oil and Gas Company.

Twelve and one-half years (to present) as Senior Petroleum and Mining Appraisal Engineer and Principal Property Appraiser, State Board of Equalization, Sacramento.

Editor and principal author, Assessors Handbook 566, Valuation of Oil and Gas Producing Properties (for ad valorem tax purposes), State Board of Equalization, Sacramento, 1966 (265 pages).

Have appraised oil and gas properties for tax purposes in 15 California counties plus the North Slope of Alaska, 1963-74.

Lecturer on "Valuation of an Oil Property" at three-day seminar in 1971 on "Valuation of Oil and Mineral Rights" in Phoenix, Arizona, sponsored by the International Association of Assessing Officers and Arizona State University.

Panelist in 1974 at two-day seminar on "Oil in California" sponsored by California State Assembly Science and Technology Council, speaking on estimation of oil reserves and taxation of oil properties.

Have served as technical advisor to legislatures of both Alaska and California on taxation and other matters relating to the oil industry.

Have been guest speaker on oil and gas properties taxation at meetings of county assessors, the Society of Petroleum Engineers, the Society of Petroleum Accountants, and other organizations.

PROFESSIONAL LICENSES AND MEMBERSHIPS

Registered Geologist, State of California (Certif. No. 8)
Registered Petroleum Engineer, State of California (Certif. No. 537)
Member, Amer. Assoc. of Petroleum Geologists
Member, Amer. Inst. of Professional Geologists
Senior Member, American Society of Appraisers
Member, International Assoc. of Assessing Officers

460 Lovella Way
Sacramento CA 95819
30 March 1975

Senator John Huber
Special Committee on Taxation and Revenue
Pouch V
Juneau Alaska 99811

Dear Senator Huber:

This letter carries my comments on Milton Lipton's testimony before your committee on February 12. My aim is to highlight those topics on which I dissent from Mr. Lipton, and other topics whose treatment I find puzzling.

A. THREE SOURCES OF OIL INDUSTRY REVENUE (p. 2-3)

1. Bonuses and Royalty Payments

These two sources are combined, but I suggest that they should not be. Lease-sale bonuses are commonly viewed by industry as "hunting licenses," and have often been paid, as you know, where no production is ever established and no royalties are ever paid.

2. Severance and Ad Valorem Taxes

Both of these are called "...taxes on on-going operations divorced either from industry's expectations or their actual profitability." This definition does not apply to ad valorem taxation. "Ad valorem" means "according to value," and the value of an oil property reflects its anticipated future profitability. The more profit, the higher the value.

3. Tax Keyed to Actual Profitability

I have no dissent here to what I presume is an income tax, although that term is not used. It is interesting to note that Mr. Lipton says

"...for oil in particular this would have to be the major source of revenue which the State of Alaska or any state can expect to obtain..."

Actually, in California the local ad valorem tax on oil and gas exceeds the State income tax. That is the case because of the effects of depreciation and depletion in limiting income tax liability.

B. A PECULIAR STATEMENT ON BONUS BIDS (p. 3)

Referring to bids on leases, Mr. Lipton says:

"...(it) is a flow of revenue which the industry voluntarily undertakes to contribute..."

The phrase "voluntary contribution of the industry in its bidding" is later used on the same page.

I find this language rather unusual, and misleading as well. A lease bid is voluntary in the sense that most capital outlays are voluntary, but is hardly a "contribution." It has something of the risk of buying a speculative stock that is not presently yielding a dividend. Voluntary, yes, but not an act of charity.

C. COMMENTS ON INCOME TAXATION (p. 8-9)

I am fairly well-acquainted with oil and gas income taxation, but Mr. Lipton's statements are hard to follow. My feeling is that he has made it sound more complicated than it really is. Why not simply propose to parallel Federal law, as is done in California and I am sure in other states as well?

He indicates that a problem may exist in computing depreciation:

"You will have to think through the basic problems of how recovery of capital is handled."

I suggest that this is not a problem. Federal income tax guidelines exist for the allowable depreciation on oilfield machinery and equipment, and it must be established for each property. Why should Alaska have to work out its own system?

He does go on to say

"These problems...have been handled in other jurisdictions."

It might have been better to say this in the first place.

D. COMMENTS ON AD VALOREM TAXATION (p. 14)

Mr. Lipton engages here in some remarks that absolutely astound me, because they reveal such a very large gap in his knowledge of ad valorem taxation of oil and gas properties (and of other properties, for that matter). He says

"To estimate the value of oil or gas in place is an exercise in futility. No one really knows the value, even if you know how much oil and gas reserves there are..."

Of course, no one really knows the value of anything. We must settle for an estimate or an opinion of value, whether of an oil field or an oil refinery or a diamond ring. But estimates of value are not the province of just the tax assessor. The oil industry itself buys and sells oil and gas properties all over the United States. And the manager of a property acquisition department would be ill-advised to tell his boss that it is an exercise in futility to estimate the value of oil and gas reserves.

Mr. Lipton says that

"(In California the assessor ~~does~~ not really) determine what the value of the underlying reserves are, as it is a notional (nominal?) thing which brings in a certain amount of municipal revenue."

Wrong, completely wrong. The California constitutional goal is fair market value for all properties, and has been for 100 years. Granted, some lively debates occur here over oil property values, but no more so-- probably less so-- than over the values of industrial and commercial properties. That is the case, of course, because fair market value must be estimated for any type of property, and one can always argue over estimates. As to California's having only a "nominal" value (if that is indeed the right word near the bottom of page 14), the total value in 1974 of all oil and gas fields here was about \$4.7 billion. Hardly nominal.

E. SEVERANCE TAXATION (p. 15)

I am somewhat puzzled by Mr. Lipton's statement that, in the future,

"...the severance tax is going to be adjusted undoubtedly in the light of what seems to be the value of the reserves."
(underlining added)

This may have been only a slip of the tongue, although it is stated twice. I presume he is really referring to oil and gas prices and gross income, because a value determination is not necessary in administering a severance tax.

.....

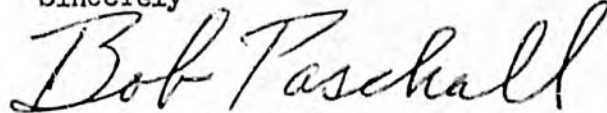
I would also like to comment on a statement of Mr. Lipton's made before the Senate Resources Committee on February 14 on the prospective sale of future royalties from natural gas. He rejected the idea of selling oil royalties for the good reason that the income would be discounted so heavily. However, he then stated that a public utility, which would be the logical purchaser of the gas royalties, would not engage in such heavy discounting because it could always incorporate the cost in either its rate base or its operating expenses.

I suggest that this is a dangerous assumption. The FPC and public utilities commissions are generally insistent that incurred costs are fair and reasonable. The FPC might take the stand that a utility paid too much, so that its customers are put in the position of subsidizing Alaska's tax deficit. And the excess cost might be disallowed.

The prospect is that a utility which might purchase Alaska gas royalties would consider this matter in advance, and even seek an FPC opinion. If the FPC proposed to disallow the purchase without adequate discounting, it ~~means~~ means that the sale of gas royalties would be no more favorable an action than the sale of oil royalties, from Alaska's standpoint.

You may wonder why I dare to comment on this issue. It happens that I have written a book on the valuation of utility water companies, and teach a course on that subject annually. Also, I once briefly held the position of Supervising Utilities Valuation Analyst, and now own stocks in a half-dozen public utilities. In the course of this activity I have become fairly familiar with rate base computation, at least as it is practiced in California.

Sincerely

A handwritten signature in cursive script that reads "Bob Paschall". The signature is written in dark ink and is positioned above the printed name and title.

Robert H. Paschall
Consulting Valuation Geologist
and Engineer

cc Dr. Walter Mead

460 Lovella Way
Sacramento CA 95819
27 March 1975

Senator John Huber
Senate Committee on Taxation and Revenue
Pouch V
Juneau Alaska 99811

Dear John:

The intent of this letter is to comment on the statements made by Jacob Adams and Thomas Kelly on behalf of the native corporations at the March 20 hearing of the Senate Resources Committee. My remarks are directed at areas of ambiguity or inaccuracy, especially in regard to oil property valuation and prospective methods of raising revenue. The Native Claims Settlement Act is a legal issue outside my province.

Mr. Adams commented at length on a gas discovery that has been made on an 18,000-acre lease. He stated that the U.S. Geological survey has estimated the proven reserves to be 213 billion cubic feet. He then said that a prospective wellhead gas price of 50 cents per MCF would produce a value of \$106 million, from which a 20-mill levy would extract an ad valorem tax of \$2.1 million.

Mr. Adams' conclusion betrays a serious lack of understanding of the relationship between gross income and value. His stated premise would yield an ultimate gross income of \$106 million, but this income falls far short of value for these reasons: (1) field development costs plus production costs over the life of the field must be subtracted to obtain net income, and (2) the net income will be spread out over many years' time, so its present value is far less than its total future amount. For example: no one in his right mind would pay \$1,000 now for the privilege of getting \$1,000 back ten years from now. If an investor wanted a mere 8 percent on his investment, he would pay only \$463 now for the privilege of receiving that \$1,000 a decade from now.

Here is a specific Alaska field example. I appraised Prudhoe Bay as of January 1973 at a value of \$4.8 billion, yet the anticipated future gross income from the field at that time was \$35 billion. My appraised value, then, was only 14 percent of future gross income.

If we apply that fraction to the gas discovery cited by Mr. Adams, a value of \$14.8 million is indicated, instead of \$106 million. Such an application is imprecise, but it serves to illustrate the degree to which he overestimated the prospective ad valorem tax. If the native corporation's net profits interest was taxable (which apparently no one intends), that interest would now be worth no more than about 30 percent of the total value, and the tax liability would be about \$89,000, not Mr. Adams' stated \$2.1 million.

AGO 530353

Mr. Adams next suggested six methods of raising revenue that he said might serve as alternatives to ad valorem taxation. It was difficult to follow all of his suggestions because, **although** they dealt with complex issues, the details for implementing them were in rather short supply. However, I **believe** that it is important to cite four of these methods for this reason: they all call for the state's selling future income to get present income, and discounting the future income in the process. Here are those methods as I understood Mr. Adams to state them.

ABC financing of oil royalties: the ABC technique was devised as a method of selling oil and gas properties with minimum income tax impact on the buyer. IRS regulations have changed its once-favorable status in that regard, but that is not important here. What is important is the fact that an ABC transaction depends on the sale of a producing property, and a sale requires the discounting of future income. The discount rate is set by the buyer and the lending institution (since a loan is implicit in the transaction), and it is typically substantial. In short, the state would now get many fewer dollars than it would get in future royalties if it did not engage in an ABC sale.

The other three methods proposed by Mr. Adams would have the same net effect on state revenues as the one just discussed. Those methods were: the advance collection of severance taxes, a purchase-option on state royalty oil to be sold to a public utility, and the advance sale of royalty income. Mr. Adams called the last "the least advisable at this time," but I find it hard to choose between the four, because they all carry the prospect of severe discounting of future state income that is presently assured without discounting.

I have no comments on the other two methods proposed for raising revenue. They were Arlon Tussing's proposal to issue revenue bonds and the proposal that a state lease sale be held.

Mr. Kelly then made two statements that I **believe** call for a response. Paraphrasing him as nearly as possible, he said that the discoverer of an oil field will not develop his discovery "if he doesn't have a market" for fear that he will be subjected to ad valorem taxation on the developed value (prior to production). I am rather startled at this statement because, as I recall, Mr. Kelly has considerable knowledge of the oil industry. What is the prospect that no market will exist for an oil discovery in Alaska? I will grant that it is not possible to find a case of zero risk in industrial economics, but we must be approaching it when we consider the risk of finding a market for crude oil from a new American oil field.

But that is not the most critical issue. Actually, the ad valorem taxation of oil properties has been criticized because it accelerated development and production. This is the case because no one wants to sit on an oil field of known value (however modest) and pay ad valorem taxes out of other income when he can start producing and pay taxes

out of income from the property. So, contrary to Mr. Kelly's conclusion, ad valorem taxation is apt to spur development rather than impede it.

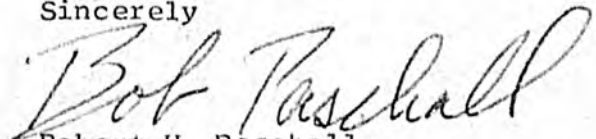
Mr. Kelly also stated that the imposition of an ad valorem tax would make Federal OCS lands more appealing because of their exemption from state taxation, and that oil operators would therefore place a higher priority on acquiring and developing Federal leases. I suggest that this conclusion is incorrect for several reasons. The overriding one is that the appeal of prospective oil lands, no matter what the ownership or taxation, is dictated primarily by the geological odds; if the geology is favorable, people will bid, and if it is not, they will not. Also, taxes are only part of the cost of doing business, and therefore only part of the decision-making process; in the case at hand, Federal lands will be so much more expensive to explore and develop that those costs will far outweigh tax considerations.

In addition, the proposed five-year period of grace following discovery eases the impact of state ad valorem taxes. And finally, of course, state lands would not be ignored in favor of Federal lands. Instead, the bonus bids for state lands would simply be tempered to take account of the prospective ad valorem tax prior to the commencement of production.

How much would industry temper its bonus bids because of prospective ad valorem taxes? I suggest that it will not be very much; if you would like me to do so, I will quantify it for a typical case. But the multiple aspects of the five-year grace period, the time-deferred cost of the tax, and the much greater burden of exploration and development costs suggest that it will not be as serious an issue as Mr. Kelly implied.

In my next letter I will comment on Milton Lipton's testimony.

Sincerely



Robert H. Paschall
Consulting Valuation Geologist
and Engineer

cc Dr. Walter Mead

460 Lovella Way
Sacramento CA 95819
23 March 1975

Senator John Huber
Special Committee on Taxation and Revenue
Pouch V
Juneau Alaska 99811

Dear John:

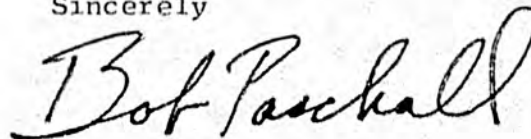
Three of the four bills that you have sent me say in the first paragraph:

"except as provided in Section 15 of this chapter."

The underlining is included, indicating it is a proposed addition to current law. My problem is this: Section 15 itself is not included in any of the bills. Would you be so good as to send me a copy of Section 15?

Another thing: I just came across a Pritchard and Abbott advertising folder that Jerry Heier once gave me. It confirms what I had in mind when I spoke to you about the firm on the telephone. P & A have a heading on their folder saying "Industrial Evaluations." The list a broad array of manufacturing plants that they have appraised. But they do not hold themselves out to be petroleum geologists or petroleum engineers. That is, at no point do they list "oil and gas fields" or "oil and gas reserves" as one of the property types in which they have appraisal experience and expertise.

Sincerely



Robert H. Paschall

460 Lovella Way
Sacramento CA 95819
23 March 1975

Senator John Huber
Special Committee on Taxation and Revenue
Pouch V
Juneau Alaska 99811

Dear John:

I have just been studying the unnumbered House Bill authored by Cowper that you sent to me on March 12. The bill contains many cases of wording whose clarity or precision can be greatly improved by using instead the language in the Governor's bill. But these things are minor compared to the serious problems posed by the combined effect of paragraphs (c), (d), and (e) of Section 43.56.015. I speak now as a tax administrator. It is not at all evident how this bill would provide for administration of oil and gas taxes in all cases. Let's look at the three paragraphs in terms of a fictitious oil property.

In the most recent year this property produced an average of 500 barrels a day of \$6.00 oil from one well. It is appraised for ad valorem tax purposes at \$2,000,000, and a 20-mill levy yields an ad valorem tax of \$40,000. However, its gross production tax (under the terms of AS Chapter 55) comes to \$41,610. How do we equate this situation with the terms of the proposed bill?

Paragraph (c) is common to your bill and to HB 102, and by itself is no problem. In the case at hand there would be no ad valorem tax liability, since the gross production tax is greater. Note, though, that it is necessary to value the property and to compute the ad valorem tax in order to determine whether paragraph (c) is applicable.

Paragraph (d) is, in part, the other side of the coin of paragraph (c). It says that the gross production tax "actually paid" shall serve as an offset to the ad valorem tax when the latter is greater. But it then adds "...after the subtraction of the credit allowable under (e) of this section."

It is paragraph (e) that is the problem. It begins by saying that

"Tax paid under (a) of this section may be used as a credit against gross production tax..."

The underlining is added. Who determines whether it "may" be used as a credit? This is an awfully big "may," and leaves room for all sorts of later dissension. But a problem would exist even if the "may" was changed to "shall."

As noted, paragraph (e) turns things around and says that the ad valorem tax "may" be used as a credit against the gross production tax "...not to exceed 50 percent of the gross production tax due." That is, where paragraph (d) sets up the gross production tax as an offset to the ad valorem tax, paragraph (e) does the opposite. What would the effect of (e) be on the example that I proposed above?

Let's assume that someone decides to allow the ad valorem tax as a credit against the gross production tax "in subsequent years." What does "subsequent years" mean? Any year from now on, even beyond the year 1982 in which the proposed tax terminates? That is, could any ad valorem tax payment serve as an offset against any future gross production tax? The bill does not say.

Another thing: paragraph (e) refers to "(the ad valorem) tax paid under (a) of this section..." But (c) provides that no ad valorem tax is paid if the gross production tax exceeds the computed ad valorem tax. As a result, the phrases "gross production tax due" and "ad valorem tax paid" are completely at odds with one another here, because of the earlier terms of paragraphs (c) and (d).

I find it impossible to make a tax computation for my above example based on paragraph (e). Why did the author not write a paragraph (c) that said simply

"Producing oil or gas leases or ownership interests in
proven oil and gas reserves shall pay either a tax based
on value or the gross production tax, whichever is greater.."

and forget about paragraphs (d) and (e)?

I hope that you will find these comments useful.

Sincerely

Bob Paschall
Robert H. Paschall

SCOMM

#11:15

Roosevelt Hotel

539 H Street
Anchorage, Alaska 99501

277-5541

To: Senator John Huber
Chm of Senate Special Comm on Taxes + Revenue

Dear Mr. Martin:

City Center — Free Parking

120 Rooms — Direct Dial Phones
Bruce Kendall, Owner-Manager

May 29, 1975

I don't believe it is legal for the oil companies to loan money to the state treasury and use the future royalties as collateral. My reasoning is based on facts as well as theory:

1. Nevada, New Mexico, Wyoming and California hold that future oil royalties in the ground are "realty", just like land. The owners can sell the oil "once", just as land owners can sell but "once". Furthermore, these states have some court tests on this subject.
2. Cook Inlet production royalties are legal since that oil has already been produced, severed and taxed. The present new oil revenue law is a mortgage because that resource is in place, not severed (will not be for some years to come), nor have the taxes been paid as per lease agreement. Our Constitution has been interpreted that, by law, the lease holder or producer, whichever, doesn't have to pay severance, income tax, or business license tax until it is being produced for use. To carry this theory further, it is surely no different than placing a first mortgage on state lands or buildings. How it is possible to construe that the oil in place is different than realty, capital improvements, or a fixed asset of the state's residents?
3. The administration, through the elected governor and empowered state agency, can legally lease oil lands for the single purpose of finding and producing the oil from said leased lands and collect annual rents. Therefore, upon discovery and production the tax laws apply. That chain of events makes the bonus and lease money rental income for the general treasury for the elected legislature to appropriate for the general public's good and benefit. To rent property or a fixed asset is one thing; . . . to pawn it is another. That places this legislature in the position of obligating a future legislature to return the debt in reduced earned income to the treasury of the state. It certainly must follow that the future legislature must allow credit to the debt since the future legislature would be powerless to renege if the present bill becomes law, and is not successfully challenged in court prior to any collection of monies. The state constitution clearly states that each year the operating budget must at least balance with that year's earned revenues. At present, that isn't exactly fact. The state constitution also states very clearly that any debt of more than one year's duration must be approved by the qualified voters of our state. It is very definitely separated in our constitution that annual operational appropriations and long-term debts are different subjects.

Roosevelt Hotel

539 H Street
Anchorage, Alaska 99501
277-5541

City Center — Free Parking

120 Rooms — Direct Dial Phones
Bruce Kendall, Owner-Manager

May 29, 1975

-2-

4. The state constitution also states that no long-term debt can be used for operationsl budget deficit financing. It can only be used for specific capital improvements that are approved by the qualified electorate. Therefore, we must address ourselves to the question of what is the "operating budget" that is appropriated by each annual legislature and disbursed by each legal agency and what is a "long-term" or "fixed debt"?
 - (a) An operational annual budget is composed of day-to-day expenses to operate the agencies, expend aids and benefits to the general public as prescribed by law and to pay the debt service charges on long-term debts, i.e., capital return and interest to the long-term lender is also an operational budget item.
 - (b) Long-term debts are approved by the voters of the state, then the proceeds are appropriated for a specific voter-approved improvement and is specifically not a general fund item to be allocated at the legislature's whim of the moment. And even worse, "How can a private corporation transfer funds in this manner without showing earned interest on balances?" I am sure that the IRS will have something to say on this.
5. In conclusion, how can this legislature or our elected administrator borrow money on a fixed asset of the state without the consent of the qualified voters when it is an obvious fact that long-term reimbursement of those funds to the lender are spelled out so specifically in the law? In addition, the oil companies intend to use this advance payment on royalties as collateral in their own private financing. How could the above points be more clearly identified as a promissory note of the State of Alaska backed by oil royalties as realty?

Respectfully yours,

Bruce Kendall
Speaker of Alaska State House
1963-64

BK:mmm

AGO 530360 +

Roosevelt Hotel

539 H Street
Anchorage, Alaska 99501
277-5541

To: Senator John Heiber
Chm of Special Senate Committee
on Taxes and Revenues

City Center — Free Parking

120 Rooms — Direct Dial Phones
Bruce Kendall, Owner-Manager

May 29, 1975

~~The Honorable Guy Martin—
Commissioner of Natural Resources
Beaufort Sea Hearings
Anchorage, AK—~~

My Dear Mr. Martin:

The Legislature has been struggling for 125-30 days now with a budget problem of serious shortages. This administration and the Legislature have raised consumer taxes. Not enough money was raised to even dent the deficit proposed. Also, both have been toying with "gimmickery" such as the "Ad Valorem Tax" on reserves plus an advance pay scheme on "royalties" which as I previously presented. It appears to me when our State government has such a serious short fall in cash flow. . . and it appears to almost everyone that I know, that the only thing to do is dispose of something of value that has a market for cash. That, gentlemen, is the "Beaufort Sea lease sale". It's really the only value that can be converted to cash quickly.

This commission surely can't recommend leasing the lower Cook Inlet which is before the Federal Supreme Court. On this score you might have to repay all or part of the last Cook Inlet sale because that's before the State Supreme Court. The Gulf of Alaska is under considerable doubts as to any lease sales in that area for sometime to come. Our Governor will, in my opinion, never lease any lands in the major river deltas even if they were ready to lease.

The Governor's task force turned in a report on the Beaufort Sea which in essence said it is within the tolerable ecology and technology limits to go ahead and produce oil if found. The task forces only negative comment was, "It would bring more people to Alaska."

Therefore, I think that your hearing is timely and is really the only transferable value that is available in the time frame that exists for budget balancing. I sincerely hope your findings are positive and I am absolutely sure that the Legislature will be very receptive to a positive recommendation. Thank you for your time.

Very truly yours,

Bruce Kendall

Bruce Kendall
Speaker of the State House
1963-64

BK:mm

AGO 530361

HABER
May 27, 1975

The Honorable Helen Fischer
Representative
Alaska State Legislature
Pouch V
Juneau, Alaska 99801

Dear Representative Fischer:

I don't believe it's legal for the oil companies to loan money to the State treasury and use the future royalties as collateral. My reasoning is based on facts as well as theory.

No. 1 - Nevada, New Mexico, Wyoming and California hold that future oil royalties in the ground are realty "just like land." The owners can sell the oil "once", just as land owners can sell but "once." Furthermore, these states have some court tests on this subject.

No. 2 - Cook Inlet production royalties are legal since that oil has already been produced, severed and taxed. The present new oil revenue law is a mortgage because that resource is in place, not severed (will not be for some years to come) nor have the taxes been paid, as per lease agreement. Our constitution has been interpreted that by law the lease holder or producer, whichever, doesn't have to pay severance, income tax or business license tax until it's being produced for use. To carry this theory further, it is surely no different than placing a first mortgage on state land or buildings. How is it possible to construe that the oil in place is different than realty, capital improvements or a fixed asset of the states' residents?

No. 3 - The administration, through the elected governor and empowered state agencies, can legally lease oil lands for the single purpose of finding and producing the oil from said leased lands, and collect annual rent. Therefore, upon discovery and production the tax laws apply. That chain of events makes the bonus and lease money rental income for the general treasury for the elected legislature to appropriate for the general public's good and benefit. To rent property or a fixed asset is one thing -- to pawn it is another. That places this legislature in the position of obligating a future legislature to return that debt in

reduced earned income to the treasury of the State. It certainly must follow that the future legislature must allow credit to the debt since the future legislature would be powerless to renege if the present bill becomes law, and is not successfully challenged in court prior to any collection of monies. The State Constitution clearly says that each year the operating budget must at least balance with that year's earned revenues. At present, that isn't exactly fact. The State Constitution also states very clearly that any debt or more than one years duration must be approved by the qualified voters of our State. It is very definitely separated in our constitution that annual operation appropriations and long term debts are different subjects.

No. 4 - The state constitution also states that no long term debt can be used for operational budget deficit financing. It can only be used for specific capital improvements that are approved by the qualified electorate. Therefore, we must address ourselves to the question of what is the "operating budget" that is appropriated by each annual legislature and disbursed by each legal agency, and what is "long term" or "fixed" debt.

- A. An operational annual budget is composed of day to day expenses to operate the agency, expend aids and benefits to the general public as prescribed by law, and to pay the debt service charges on long term debts, i.e., capital rent and interest to the long term lender is also an operational budget item.
- B. Long term debts are approved by the voters of the state, then the proceeds are appropriated for a specific voter-approved improvement, and is specifically not a general fund item to be allocated at the legislature's whim of the moment.

No. 5 - In conclusion, how can this legislature, or our elected administrator, borrow money on a fixed asset of the state without the consent of the qualified voters when it is an obvious fact that the long term reimbursement of those funds to the lender are spelled out so specifically in the law? In addition, the oil companies

intend to use this advance payment on royalties as collateral in their own private financing. How could the above points be more clearly identified as a promisory note of the State of Alaska backed by oil royalties as realty? And worse, how could a private corporation show such a transfer of funds without an interest yield? I am sure that the IRS will have something to say about that.

Respectfully yours,

Bruce Kendall
Speaker of the Alaska State
House 1963-64

SCOMM

#11:16

PLEASE NOTE: THE FOLLOWING PAGES WERE TREATED
AS A UNIT IN THE ORIGINAL DOCUMENT.

SENATE RESOURCES COMMITTEE

TESTIMONY OF MILTON LIPTON

LEGISLATIVE CONSULTANT ON OIL & GAS

March 24, 1976

Members in attendance were Senator Kay Poland, Chairman, Senator Pete Meland, Senator John Butrovich, Senator Chancy Croft, Senator Joseph Orsini and Senator Pat Rodey.

SENATOR KAY POLAND: The Senate Resources Committee meeting will come to order. Our purpose of meeting today is to hear from Mr. Milton Lipton, the Legislature's consultant on oil and gas. What we would like today, Mr. Lipton, is to have your opinions, I know you gave some of them yesterday at the Joint Meeting but most of our members were not able to attend that. We are not going to discuss any bill in particular unless you feel that necessity.

MILTON LIPTON:

Thank you Senator Poland. I don't intend to repeat the testimony that I gave before the Joint Resources Committee yesterday for fear of boring those who have heard it all. What I would like to do is to pick up from the discussion of Tuesday morning and simply try to touch upon the highlights of what we feel are the most important considerations that the Legislature must bear in mind in framing a tax policy, therefore, in judging the kinds of tax bills that are before it.

First point. I said on Tuesday and I find myself being quoted now by representatives of various oil companies, that I said quite forcefully that in our opinion DCF calculations, rate of return calculations on a discount of cash flow basis for Prudhoe Bay, are absolutely inappropriate as a basis for a state tax system. I did not say and I did not intend to imply that the State of Alaska or its Legislature in designing tax amendments or in judging tax proposals, must close its eyes completely to the potential profitability of a Prudhoe Bay, or any other oil field that may in the future be discovered in Alaska. There is a difference between saying that on the basis of our calculation about the potential profitability of Prudhoe Bay, it will have a DCF rate of return 48% or 24% or the industry will argue perhaps 17%, and try to design a tax system around it. The DCF calculations are inappropriate, irrelevant really, to tax policy. First of all, they do not tell you what it's going to be. The future remains in the future. Secondly, there are many different ways of calculating profitability. DCF rate of return is one basis of calculation. At the end of the

day, it's the average rate of return on the net assets of the stockholders, it can be an internal rate of return, it can be the marginal efficiency. These are technical things about which economists will argue endlessly. The point is that it is the prospective profitability which the State may want to look at but the tax system should be such that it is not triggered in any case until the potential profitability is realized. One doesn't tax on the basis of projections of profitability.

Therefore, if you are looking at the taxation system of Alaska, which encompasses already a severance tax, a normal corporate income tax, which we find faulty for reasons I will not discuss again but which I think should be fixed up in any case, and the proposals for some form of supplementary tax. How high the supplementary tax should be, how you determine what income is subject to supplementary tax -- we will discuss all of these things a little later. But, if you took at the entire tax system of Alaska and possible amendments to it, I'd say there are several things you must keep in mind which are absolutely basic if the tax system is to serve the interests of Alaska. First of all, it should not discourage exploration. There should be nothing in your tax system which discourages continuing exploration. You, yourself, will determine what kind of exploration and how it should be done by your leasing policy itself, but you should not use a tax system to discourage exploration and you wouldn't want anything in your tax system which does discourage exploration. That is to say, don't push back the margin of exploration. If there are prospects that industry would be well to explore, the tax system should encourage them, not discourage them from the exploration. Secondly, that the tax system should not impinge unduly on the prospects for profits and profitability of successful fields. On the prospects for profit and profitability of successful fields! Don't confront the industry in advance with a full knowledge that the tax system works in that way. Third, and this follows from what I said before, that the tax system, particularly if there is to be some form of surtax, or surcharge, that it should not be based on the assumption of superior profits, but it may well come into effect and apply when the fact, the evidence and the knowledge, the reality of superior profitability becomes evident. This is what I mean by not misinterpreting my remarks about DCF calculations, about Prudhoe Bay. I don't think the State has to close its eyes to the potential profitability of Prudhoe Bay, but if the potential profitability is established and a fact, then I think it is perfectly reasonable within certain guidelines, for the State to say that this is a proper avenue for taxation amongst all of the other decisions by the Legislature as to what the spending and disbursement policy of the State is, what the total revenue policy of the State is, but, certainly one cannot say _____ that one can ignore this as a potential avenue for revenue.

So the critical question then becomes, "Should there be, in Alaska, such a thing as a surtax." In other words, if in addition to your normal income tax, which is paid by every corporation based upon its taxable income within the State of Alaska, should there be for

the oil industry, first of all and I'd like to get this in as often as I could, a restructuring of your income tax of the oil industry at least pays the same nine plus percent tax on its producing profits as it would if it were any other type of industry in the state. But beyond that, should there be a surtax? This absolutely must fall within the discretion of the Legislature. No one can say, from the standpoint of economic policy, from the standpoint of the pros and cons of the industry's position, you must do it, or you dare not do it. It depends upon the whole structure of the Legislature's own thinking about the needs for revenue, about the alternative sources of revenue and is this something which ranks as a high priority rank in the minds of the Legislators as a source of revenue. Let me assume for a moment, for purposes of our discussion, that the answer is yes, that the Legislature is inclined to look upon the income from oil producing operations in the State of Alaska, separate and apart from the income of other economic activity in Alaska. It may chose not to do so, but if you do, what are the guidelines to the kind of tax that might then appropriately be levied?

First, I think the most important thing, such a surtax should not be effected before the company that is producing in Alaska and the income of that company from oil producing operations in Alaska is clearly beyond the average profitability. That is to say, the profitability is not estimated, is not imputed, is not guessed at, but it has been clearly established. Secondly, that the surtax should, under no circumstances, become effective for anything which is close to marginal exploration. That is to say, anyone who is looking at an exploration prospect here, and says, in the State of Alaska there is a surtax on certain types of oil producing income, must know that if what he finds is a marginal field, if it is barely worth developing, or if it is going to give him modest profit as well, that he is not discouraged either from looking at the prospect in advance and taking a lease, or having taken a lease because he thinks its going to be a real good prospect and finding out that it is very very marginal -- is the candle worth the burning -- should we develop that field or shouldn't we -- there should be nothing in the tax structure that discourages that.

This means, in effect, that the price which the United States Government is holding out to the State of Alaska and which determines the value of oil produced in Alaska, this price that the U.S. government is setting, the upper tier price, the price for new oil, which is designed as an incentive thrust to encourage people to go in and explore farther, explore harder, that there is nothing in the Alaska tax system which cuts away any of the incentives under that price. The full price is basically available as the incentive to exploration in Alaska as much as it is to exploration in any other state in the union, as much as it is to exploration in the Outer Continental Shelf or on federal lands.

It seems to me that the criticism which we may have of the bills that are now before the Legislature, which in one form or another involves surtax, the excess value surtax which is House Bill 703 and Senate Bill 621 and the oil production income tax which is House Bill 803, at least in the version that we have seen, and I am not sure we have seen all of the sponsor's amendments to them, but at least in the version that we have them, our criticism of these bills would be that to expose profits on production to a surtax before this superior profitability has really been established. In other words, they are anticipating that. One can object to them in principle also, there should or shouldn't be a surtax. I think I have covered that -- I suppose I should repeat it every once in a while because it gets lost. On the assumption that there is willingness on the part of the Legislature to consider at least the principle of the surtax. Our basic criticism of these bills is that they trigger the exposure of producing profitability to a surtax at a time when we feel is previous, unnecessary and possibly introduces all kinds of disincentives towards the exploration operation.

I suggested in my testimony yesterday morning, that there might be an alternative. I'm sure there are many alternatives. But there is one that we threw out and we put it out on the floor of the Joint Committee -- I will mention it here also because I think it is worth something as a basis for discussion by staffs and by legislators too. And this was the idea that if there is to be a surtax that what determines the breaking point between the time when a producing company pays no more than the regular state corporate income tax on his profits and when he is exposed to some surtax or some surcharge on his continuing profits from the producing operation in Alaska, should be the principle of capital recovery. That is to say, for purposes of the state income tax he continues as is normal under your state law and under your revenue department's regulations, he takes depreciation as it is allowed, expenses as it is allowed and so on. But for purposes for determining whether or not there is any producing income liable to surtax and if so, how much income there is liable to surtax, he shall be able to charge against his producing income as fast as he has revenues to do so, all of his capital costs necessary to achieve that production. Which means the lease acquisition costs, exploration costs, development costs and so on, and capital costs plus. That is to say, some markup of those capital costs, charged against his producing revenue. This means that for some length of time, even the most prolific field will probably not be susceptible or liable to any surtax. How long depends upon how much production is coming out of the field and what the costs were. But for a while there is no exposure to the surtax. For marginal fields, where it may take the life of the entire operation to recover all of the capital costs, there would never be any surtax so that it has no effect upon the marginal whatsoever. For the fields of modest profitability, not by guesswork, I am talking about at the end of the day, at the end of the life, there may or may not be exposure to surtax, depending upon what the capital cost ratios are. Now, capital recovery plus how much? I don't want to offer

a number at the present time. I might suggest for example that where there is such a tax system in practice, which is in the U.K. North Sea, they allow 1.75 times the capital recovery. I am not proposing the State of Alaska consider the U.K. tax regime, far from it. In our Bicentennial Year, I am not going to suggest that the United States look at a British tax system 200 years after they fought against the Stamp Act and got our independence. But there are some features which are similar and I think this is worthy of discussion because it meets one very important criterion, and that criterion is that it does not or should not have any affect upon the incentive for exploration and it really doesn't become effective until superior profitability is established.

Whether or not this would yield any revenues from Prudhoe Bay depends upon many circumstances. Nevermind the DCF calculations about Prudhoe Bay. What is the margin of profit? That is to say, the cents per barrel that would be made. This depends upon an awful lot of factors. None of us really know what the price is going to be and so on. But it all falls into place so that over time there is very substantial profitability in Prudhoe Bay, I would say, yes, it probably will be _____. If things go wrong in Prudhoe Bay, incidentally, -- if things so right it works well. Suppose things go wrong. What can go wrong? The _____ for example -- in the timing of the start of the production -- or the ability to move from 600,000 barrels per day to 1.2 million barrels per day -- experience in the first few years of producing operations. Nothing else should go wrong in Prudhoe Bay, enough has gone wrong already. But there has been no real experience with the affect of producing operations upon reservoir pressures but the industry has tremendous confidence and so on. But the economics of Prudhoe Bay, probably at this stage of the game, depend more than anything else upon well producability and the ability of wells with an average producability of four or five, six thousand barrels a day, but this has to carry forward. If it turns out that it is going to take a tremendous amount of additional drilling of producing wells after several years of operation in order to sustain the producability of Prudhoe Bay, then something else has gone wrong and that begins very seriously to interfere with the flow of the barrel profits and the ultimate profitability. So you see, what this principle of capital recovery costs does is it says to the oil company, "Up to the day you produce the first barrel, you've taken all of the risks. You took risks when you first took a lease from us and paid bonuses." They weren't so large in '64, '65 and '66, but they were pretty big in '69. "You took exploration expenses and they could have been dry holes. You started to develop" -- and development costs in Alaska typically must run tremendously high -- "You've taken all of the risks and now the first barrel is being produced. We the State, will pick up some of the risk now. That is to say, if there is to be a surtax, that surtax is not going to touch you for some period of time. You are now going to recover your capital which you have invested and for taking all these risks. After that period, your risks have become very little. You have recovered your capital. The State feels that if a superior profitability" -- now that doesn't mean that the industry shouldn't be compensated several times over for the

risks that they took. This has to do with the rates of return and what you expect if you are taking all these risks. The State says at least, "We are not going to even touch you with any kind of a surtax until -- we are taking the risk here and if things go wrong in a producing field so that you incur greater expenses, okay, then we are going to allow you the recovery of that also before a surtax comes into effect." In the producing operation which may be very profitable for a while but in order to sustain production it is going to require reworking of wells, a secondary recovery, these become capital outlays and the State says, "Fine. If you do this to sustain production, our surtax becomes abated until you recover that as well." But it does say that "If at some point in time you have very superior successes in Alaska, the State will not ignore that this is something vital, this industry is vital to Alaska, we do everything to sustain it but at that point in time we do not close our eyes to the fact that there can be superior profitability and this is the way in which we propose to tax."

Secondly. If the State is considering a surtax -- I think this is tremendously important -- what is the rate of the surtax? If you move from the state income tax at a little over 9% which you must strengthen so you make sure you get that 9.3% severance tax. But if you move to a surtax, the surtax rates cannot be oppressive. If the surtax rate is oppressive I think it does violence to three tremendously important features of a state tax policy.

First of all, an oppressive surtax cuts into, it cuts too deeply into the superior profit which the most successful are expected to earn and have to earn if they are going to pay for the marginal fields and for all of the losses. In other words, the tax system should not imply that suddenly all of this added profitability is surplus profits, windfall profit, or in the language of the economist, all economic rent, and therefore you can tax all of it away. That is to say, do not leave one unnecessary dollar with an oil company. I don't think this should be the policy of state taxation. You can't have excess profitability until you recognize that there are sufficient losses. You can't have windfall profits until you recognize that there are windfall losses. And there is no such thing as an economic rent on an oil field. There is only an economic rent in an entire oil producing product. You simply cannot measure economic rent on an individual oil field. You have to have a margin of superior profitability. This is what brings people into the exploration game. Nobody really looks to find a marginal oil field. Nobody really looks to drill dry holes -- of course not. Nobody looks to discover a marginal oil field -- the real incentive to exploration is the attraction of the bonanza, of the great discovery. And a certain amount of that must always be the expectation, and it must always be the realization. So the rate of surtax has to attune itself to the fact that there is going to be superior profitability which remains with the most successful company.

Secondly, I think you must be very, very concerned, careful, as to how deeply the State's rate of taxation cuts into the federal tax _____. I would hate to suggest to the Alaskans that they take their taxes after the federal government. You obviously have first claim. I don't think it is in the interest of Alaska completely to ignore the fact that when they are taxing with a surtax, the profits of companies, they are also taxing the income of the federal government. The federal government picks up a part. You take that into account when you reckon what the net cost is to an oil producing company to pay taxes to Alaska. I don't think you can really ignore how much you are taxing the federal government, when you establish a tax system in Alaska. You may weigh this how you will but the fact is that Alaskan oil producing operations are very much a part of the U. S. oil producing area. They are in many different ways. The most particular one and of relevance to you is that under our present energy act, the value of oil in Alaska is determined by the federal government. The producers at Prudhoe Bay suffered as many of the _____ and misfortunes as any successful explore could have been confronted with. Between the time of the discovery well and their first barrel of production there have been delays, there have been run up of costs, there has been misadventure after misadventure. All the risks that a private company should take, and have taken all of those risks, the profitability of Prudhoe Bay may have been driven down to an infinitesimal figure if they hadn't been bailed out. What happened in the interim was the tremendous run up of world oil prices by OPEC. This did not bail out the producers of Prudhoe Bay because the world congress which authorized the construction of the Alyeska system forbid, without special approval, the export of a single barrel of North Slope oil. You may be able to get \$15 a barrel in world markets but you are not allowed to do it. What has bailed out Prudhoe Bay has been the policy of the federal government, which has said, even under conditions of price control that we are establishing price incentives for new exploration ventures. Whereas before, at the time of the discovery well, the average price of crude oil to the United States was about \$3.40 a barrel, under normal circumstances it might have gone up five percent a year -- seven percent a year. \$5.00 oil in the lower 48 states would have left Prudhoe Bay a poor venture indeed. But the federal government said that, "despite the fact that we maintain price control, we are allowing an upper tier price for new oil." Prices today as high \$11.28 and they are going to go higher. But this is all pursuant to federal policy. And the purpose of this federal policy is to _____ exploration. And I don't think the state of Alaska would want to do anything which says in effect that the pricing policy of the federal government was designed to achieve certain purposes, shall not be fully appreciated here in Alaska, and we will ignore this by an undue level of taxation.

I have been quoted to the effect that, "If Alaska isn't careful, the FEA, the Federal Energy Administration, is going to lower the price of North Slope oil." I never said that. I think that is nonsense. I don't think the difficulty that may emerge between Alaska and the Federal government if you go to an exaggerated tax

system is going to depress the price of your oil. I think that is silly. That would be cutting their nose to spite their face. There is uncertainty as to what the price of North Slope oil is going to be for a lot of different reasons. But the problem has to do less with whether there is going to be specific retaliation, but more in the nature of how does Alaska as a state fit into the whole concept of our federal system and where does one draw the line between what the state takes first and what is left thereafter.

Third, it has to do with the implications of your surtax rate for the export of capital. Let me explain what I mean by that And if you don't allow the expensing of dry holes in Texas, you should allow the export of capital as well. That is to say, Alaska has benefited from the willingness of companies to come in and explore in Alaska on the basis of the superior earnings of their exploration efforts elsewhere. When you look at your rate of surcharge, what that tax rate is, you must be perfectly willing to allow that there are superior profits. You've given them an incentive to invest superior profits in Alaska. But they should not be denied superior profits even if they want to export the capital out of the State. In other words, you admit that you are part of the United States and you are not trying to tax away every dollar of superior profitability unless it stays in the State of Alaska. The principle then that I am addressing myself to is that if there is to be any such thing as a surtax, called by whatever name it is, if there is to be, (1) It should hold marginal and modest exploration efforts harmless against any surtax; (2) it should not come into effect in any case until superior profitability has been well established - one to one criterion is the recovery plus of capital; and (3) when it is applied, the tax rate shall not become onerous, it shall be a tax rate which is reasonable in terms of the presumed profitability so it does not attempt to simply siphon off all of that profitability, but it remains cognizant, aware of, and sensitive to the fact that a superior exploration effort must continue to earn superior profitability, even though it becomes subject to and liable for some surtax in Alaska.

SENATOR JOE ORSINI: If we had a regular corporation profit tax of 9 percent, which would actually tax them, as you pointed out numerous times in past years, that you are actually taxing at nine percent. Would we then also have the severance tax or should we drop the severance tax if we had sufficient regular corporation tax?

MILTON LIPTON: I think that a corporate income tax at the level that you have it, coupled with a severance tax is absolutely appropriate. I see no reason why the State of Alaska, if it subjects the oil industry to nothing more than normal corporate income, should give up principles of taxation which have been adopted in every other state -- either a combination

is direct accounting under your present law would require them to show gross proceeds from sales in Alaska, allocation of costs, proper allocation of depreciation according to the nature of the property and so on. All of that would have to be done. The reason it really isn't done is because the companies don't fill out more than the first line - gross revenue from sales in Alaska - None. Nothing else is necessary and you can't touch oil producing profits in the State of Alaska. You could go to the allocation _____, we think that is sufficient. Now, whether you go the net proceeds bill -- I think your Revenue Department will comment on that net proceeds bill -- if you want us to we can also. Or the Revenue Department may come up with its own way of doing direct accounting. But if once you have that kind of accounting for purposes of the regular corporate income tax, there is not a lot more of accounting which is going to be necessary to determine whether a company is liable to surtax or if so to what extent it is liable to surtax. But I don't think this involves a bureaucratic nightmare.

SENATOR JOE ORSINI: You haven't then, looked at the net proceeds tax proposal? As I understood, you weren't prepared to comment on the specifics.

MILTON LIPTON: Yes, I have looked at the net proceeds tax. Yes, we would be glad to comment on the specifics if you like us to. I don't know if you are at that point.

(QUESTION INDISCERNIBLE)

MILTON LIPTON: Our major objection to the net proceeds bill as it is written, is that it makes the determination of gross value, which is the starting point of everything else, we think unduly cumbersome. It says, "FOB price at the Alaska border or other convenient point or as determined by the Department" and so on. The idea here is to separate out a company's income tax liability on account of profits from oil operations from all other forms of income because the feeling is that this is the one thing that gets most badly hidden in your present tax regime. If that were the case, it seems to us the most convenient and the most representative place to calculate the value before everything else is computed is at the wellhead. It has to be calculated at the wellhead in any case for reasons of severance tax and for reasons of royalty payments. And there would be as much or as little dispute about wellhead value for these purposes as it would be for income purposes. Indeed, if you could, under your present tax laws,

of severance tax, gross production tax, advalorem taxes and so on. I think that your attention of the severance tax is absolutely appropriate. It is not unreasonable for you to consider possible increases or restructuring of your severance tax rates in light of what has happened. I wouldn't want you to go ahead and decide on a whole new set of severance tax rates before you've made a decision on so many of the other tax bills that are before the legislature.

SENATOR JOE ORSINI: Then you recommend against then, to have the advalorem tax?

MILTON LIPTON: You are quite right. I should have said yes and dropped it. But I want to draw an analogy. Our criticism of the advalorem reserve tax was in effect, that it was a tax on profits before the first profit was being had. What we are trying to suggest to you is that if you go the surtax route, that again, you don't assume that there are superior profits until the evidence of superior profits is in hand. Of course the evidence is in hand after there has been this degree of capital recovery. And after the risks have been largely removed and you are saying to the company, "You have taken all the risks up to now, we will take the risk now." The criticism of the advalorem tax was that you tax normal profits before they began. If you are going to have a surtax, I don't think you would want to tax superior profits until the fact of superior profitability is clearly evidenced and not because somebody has computed, no matter how correctly, a DCF rate of return.

SENATOR JOE ORSINI: If we are going to change our regular corporation tax structure to adequately get the oil company, do we have the mechanisms now to allow the various costs involved to be amortized over a period of time?

MILTON LIPTON: I think that if you go ahead with a revision of the corporate income tax. For example, the net proceeds tax proposal is essentially, as I understand it, an attempt to transform the companies' options under the tax law, to a new method of calculating what the profit is on oil production per se, and subject them to the same rate of taxation as they would have if the present income tax could reach out and identify producing profits, which we don't think it can. The net proceeds tax would involve a certain form of revenue accounting to your Revenue Department. But so would it today if the companies filed on the basis of income -- that

SENATOR CHANCY CROFT: Do you know of an easier way of doing it?

MILTON LIPTON: The easier way depends upon legality. My feeling is that if you could simply have all companies report either gross value of sales in Alaska or in the case of any product -- I hate to get involved in things which may involve other industries -- but if you're willing to say that in the case of oil producing operations, if you can simply either the value of sales in Alaska or the value at the wellhead. The value at the wellhead presumably represents a net _____ from the value of the sale wherever it took place. If you can do that legally, I think that is the easiest and simplest way. If not, then you have to go the round about way and if it involves this kind of segregation, which means that you are separating out the profits in oil production from the profits elsewhere, you are separating out the losses in oil production from losses elsewhere, then you've done that kind of artificial division. I don't think there is anything terribly wrong about that.

SENATOR CHANCY CROFT: Just so that I understand it, its one thing to say there's nothing terribly wrong about it, but its another to say that....

MILTON LIPTON: I will be much more positive. I think that if this is the way that you can insure that Alaska collects its normal rate of corporate taxation of oil producing profits, then I think it is a good piece of legislation. I cannot say that there may not be a simpler way. But, per se, I think it is certainly an appropriate way of going about this.

SENATOR CHANCY CROFT: I know that you _____ money, but I think that you have had a chance to see, to at least talk to, some of the people on the staff and it seems to me that it was their opinion that the reason for taking this approach was that legally you had substantial problems with any other method. I think it was because of the legal concerns that you discussed that this method was proposed.

What about the question of severance tax? Do you think we should consider changes in the severance tax rate at this time?

MILTON LIPTON: Yes, but I don't think that you should do it independently of your decision as to how to dispose of the other tax legislation. I think it is perfectly appropriate to consider revisions in your severance tax from a lot of different standpoints. You may want to consider what the effect of higher rates

say, "Line 1 of direct accounting for income in Alaska." If you could legally say, "Gross revenues from sales in Alaska or in the case of oil producing operations, wellhead value of oil produced in Alaska", then you could go with your present tax law, you wouldn't have any problems. I think that for that purpose, it would make an awful lot of sense to start with a wellhead value since the purpose is to separate the income from oil producing operations from everything else so that it becomes identified and susceptible to the normal income tax rate.

There are some problems about the deduction of drilling costs and capital expenditures. It is not clear what this definition of property is, whether these allowances are by lease or what provision is made for dry hole expenditures. I think there are technical things in here that one has to look at very carefully. There may be easier ways to go about it but this is the sort of thing that the Revenue Department can probably speak to quite quickly.

SENATOR CHANCY CROFT: With the changes that you've suggested with regard to the net proceeds tax, do you think it is a reasonable approach?

MILTON LIPTON: The net proceeds tax? Yes. If we understand the intent and purpose of the net proceeds tax -- is to say that there shall be in effect a direct accounting of income from oil producing operations in Alaska. We are going to _____ at it this way, it's by indirection, but we are going to get it out this way and we are going to subject it to the same rate of taxation as if it fell under the purview of the regular corporate income tax law. This is not literally true. The minute you segregate out one piece of income from another piece of income, the two taxes don't work exactly the same. I have no real criticism of this approach. If this is the way in which you insure that oil producing profits in Alaska are subject to the normal state income tax rate, all well and good. Certain things happen. For example, you cannot reduce your liability for corporate income tax on the profits of Prudhoe Bay by money you lose in a gasoline station. On the other hand you can't reduce your tax liability for profits you make on gasoline by a dry hole somewhere else. You are separating it out. I don't think that is an abomination. I think the most important thing is that the oil producing income is reasonably subject to a corporate income tax. This is whether or not you have a surtax. If there is an easier way of doing it, I would like to to be done an easier way.

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MILTON LIPTON: The expectation is that by the time it is produced it might be on the order of \$5.00 a barrel.

SENATOR CHANCY CROFT: And now we are talking about over \$10.00 a barrel.

MILTON LIPTON: The net effect of everything that has happened in the interim upon Prudhoe Bay, per se, is certain or uncertain depending upon how you measure the net effect. If you measure it in terms of the rate of return on their investment -- it depends upon what calculation you use. By our basis of calculation, and we are not prepared to utilize the industry's arguments that all capital investments including the pipeline and tankers will all have to be paid out of the profits of Prudhoe Bay. But by our calculations, it would appear that -- and again, say that the assumptions about the future, and you are right about those assumptions, that the rate of return on Prudhoe is probably lower today than what? This is the important thing. That might have been estimated in 1970 on the basis of what then were reasonable assumptions about the future. And people made different kinds of estimates then. We think that the rate of return may well be lower. Especially if you use the DCF calculation. But the aggregate profitability is going to be ever so much higher. The dollars per barrel that will be earned on production should be much greater today than one might have assumed before, dollars per barrel. Which means that if your profitability on one -- if your rate of return on one Prudhoe Bay has gone down, if you now have a lower rate of return on several Prudhoe Bays, because the rate of return is now being calculated on a multiplied capital investment. In a sense, the rate of return on Prudhoe Bay has gone down but because of the acceleration in prices and so on -- it is not as though the rate of return on Prudhoe Bay has gone down, but it is as though the companies have now found oil field A, oil field B, and oil field C, all of which have somewhat _____ rates in tax. I don't know what you make of this as a principle of taxation. I don't think it is really relevant for formulating what kind of tax policy the state should follow.

If you take into account what has happened to costs and to prices, then in general it would seem, that because of the tremendous inflation would -- When the costs that were inflated are capital costs, it takes a hell of a lot of earning to maintain a rate of return. But you may still have a very, very large increase margin of profit per barrel. This

may be, you may want to change the steps schedule, you may want to continue or abandon the cents per barrel feature which I think has worked in a rather uncertain way, sometimes to the detriment of the industry sometimes to the detriment of the state. I well remember the reason for it having been put in. The merits of the reasons at that time are no longer merits today. I think an awful lot has happened since those severance tax rates were established. You will remember that when this aspect of severance taxation was introduced and was being discussed, we talked about them excessively for keeping severance taxation in Alaska reasonably in line with severance taxation elsewhere taking into account also, where there is or is not advalorem property tax. Alaska has found a range of advalorem property taxes in the interim which they have added to it. When we say, reasonably in line, it doesn't necessarily mean that a barrel of oil produced in Alaska shall pay no more in severance tax and advalorem tax than a barrel of oil produced somewhere else. What it means is that if a severance tax in Alaska were adopted by all 48 states, would it make sense or would it it. Now the feature of the severance tax which we feel is most progressive is the step schedule, which says in effect that the State of Alaska is prepared to tax, as a percent of the gross value of oil at the wellhead, certain producing operations, less than virtually any other state in the union. It is prepared to tax as a percent of wellhead value for certain operations more than many states in the union but not more than some. To consider, at this stage of the game, with a vast change in the circumstances of costs, prices, values and everything else, to reconsider these severance taxes -- I think it is appropriate. My only suggestion at this moment for the committee is that the decision on the severance tax not be the first decision taken but it be taken in the context of how the other tax legislation is disposed of.

SENATOR CHANCY CROFT: Just so that we might have it in perspective. You mentioned that the problems and the risks that the owners of the Prudhoe Bay fields have taken, and it is true that from their original estimate of some 900 million dollars to build the pipeline, they are now talking close to 10 billion dollars at this point -- a tenfold increase in that item of cost alone. But shouldn't we also keep in prospective the increase in the value of Prudhoe Bay. At the time they were talking about \$900 million, they were talking about \$3.00 a barrel oil?

is the net effect of what has happened in between. I would guess that the oil industry could probably demonstrate to you that the rate of return has gone down to very much lower than what has been assumed. And they argue that the margin per barrel has not increased as much. This is a matter of judgement. The profitability rate of return is probably lower, the total profit per barrel, and multiplied by all the barrels at Prudhoe Bay are very considerably larger.

QUESTION:

Larger? Is it fair to say that the rate of return on Prudhoe Bay has gone down and other fields have gone up, since 1974 of world

MILTON LIPTON:

Yes: The rate of return on most existing oil producing operations will have been improved because the capital base remains unchanged. Operating costs have gone up somewhat owing to inflation but it is relatively unimportant. But if the price under which the oil is sold is very much higher, and this is true even for a large number of established oil fields that are operating under the old price ceiling, these can be very, very profitable. When the price which you get goes from \$3.40 to \$5.25, and even taking into account the loss of the depletion allowance in the interim, it looks as though, on the average, the profitability of oil fields has improved.

I'm not sure the net effect would have been in the Cook Inlet because while their capital base has remained the same, it's an old established thing, and the prices have gone up somewhat, the State of Alaska has really subjected them to a high rate of severance taxation. Quite independent of the increase in their own wellhead price. In Cook Inlet they are paying on the basis of cents per barrel and the cents per barrel has gone up under your severance tax escalation clause not only because the price of old oil has gone up but it's based upon the wholesale price index of crude oil and that raised the combination of new oil prices and old oil prices. And when the new oil price started going up, as it did last month up to about \$13.00 a barrel, that pulled the wholesale price index up. The wholesale price index escalated your cents per barrel severance tax and for over a year their own wellhead price is under old oil price control. This stuff stayed here; the cents per barrel tax came up and you were collecting windfall profits which the state had never anticipated. The state thought the cents per barrel would go up as the posting at Cook Inlet would go up. "Don't let the oil companies fool around too much with their posting, we are going to make sure they're honest. To get back to your question, I would guess that for -- Your question really needs two

different answers. What the effect of a relationship between higher prices and higher costs will be on an exploration venture in Alaska today. I would guess that it is favorable for the exploration venture and for profitability. Although costs have multiplied several fold, there has really been quite a rapid run-up in the new oil price, the upper tier price, and it is still going higher. I think it should be very favorable for exploration incentives and for the profitability of successful ventures. The second part of my answer deals with something I discussed on Tuesday morning and I think it is very well worth bearing in mind. In any aspect of your consideration of taxation, if in fact there has been a favorable impact on the profitability of exploration ventures, this is absolutely essential. It is essential because this higher price which gives you the higher profitability on successful exploration ventures was intended to bring the industry in to more exploration than they otherwise would have done. And more exploration means taking leases where they otherwise would not have. Taking leases on inferior prospects. Drilling more dry holes. Abandoning more leases. Doing seismic work and then saying, "No we are not going to drill." It means that the high price is an inducement to the industry to lose more money. "We give you this high price with the complete expectation that you will lose more money in unsuccessful ventures." If the industry doesn't, then the whole U.S. policy falls apart. But how do you induce industries to lose more money? Because the high price says that when you are successful you will make more profit than you would have if you were successful with a five dollar price or a four dollar price. In other words, although the new price cost relationship should be favorable for profitability, they very well better be, if the industry is going to do the kind of exploration and suffer the kind of risks which the high price is designed to encourage. So there are two balanced aspects of it. I think this is part and parcel of the intention of our oil policy and the idea of giving out a higher price will support the objectives of policy only in so far as it works that way. Only in so far as the industry is prepared to take on greater risks than they otherwise would have before, when they are successful to earn somewhat higher prices to pay for the greater number of losses. This is one of the things I said that the State should take into account when they say, "Well, where is the measure of superior profitability. What rate would we, if we do at all impose a surtax on them."

SENATOR CHANCY CROFT: I am also curious with regard to the question of the profitability of Prudhoe Bay and that analysis. There is some indication that the oil industry is again moving the point at which it plans to maximize its profit from its integrated operations. It has moved it historically through several different stages of the process and there is an indication again, with the loss of the depletion allowance that industry is moving their profits from the production stage to the refining and marketing stage. I wonder if you might care to comment on that?

MILTON LIPTON: It is pretty difficult to generalize about what the industry is doing when each company strikes its own _____ and it does it only within the limits of what it is permitted to do by tax laws. The profitability of the producing venture is supported by prices. Prices have gone up even though your depletion allowance has been eliminated. Profitability, historically had been very low in refined marketing. One of the reasons of course is that the competition is very intense. Competition is intense because of the structure of operation. Not only the structure of the industry, there are more firms in refining marketing, but it is the structure of the operation too. The fact that if you have capital invested in a refinery and the refinery operates at 80% of capacity, you've got 20% of refining capacity, you utilize it. Then the marginal processing is very much lower than the _____. When you can measure capacity in the refinery -- you can't measure capacity. You certainly can't measure unutilized capacity in distribution plants and gasoline stations. Historically, you've got so much unutilized capacity in that feature of the industry -- you put investment in gasoline stations, you want to get volume, turnover, and so the oil company operates a gasoline station, like a department store, you want to get as many people walking through, you want to sell as many units of your product as you can. And historically the companies could survive if there was intense competition at that end, provided they had some form of superior profitability in the producing end. Whether it was because of the depletion allowance on U. S. operations, or high unit profitability on foreign operations. That is pretty much out of the window now. Now the industry is faced with the need to obtain competitive profitability in virtually every function of their operation. There really isn't one thing that is going to support the other. A great deal of the profitability in foreign operations has been very much reduced. So that you find a tendency, a trend towards the strengthening of product prices out of the sheer necessity to make them profitable

so that you can support them, insofar as competition permits it. It is not happening in Europe yet, that is for sure. In the United States, of course, there has been a reduction in product prices but this is part of the . I would say over the next few years, I would expect that refining and marketing profits will improve here. I don't think it is a matter of shifting so much. I think in Alaska we have always been very much concerned about the of integrated profitability as between the producing function and the transportation function. Because the profits on the pipeline is virtually assured so long as operations continue and they are protected against the rate of taxation in that, so in effect, if the profit goes into the pipeline, which reduces the wellhead value, they are protected against any higher rate of taxation on a dollar of producing profit than it would have on a dollar of transportation profit. This is one of the things that the state would presume to maintain surveillance over, is Alaska Pipe Company.

SENATOR CHANCY CROFT: You were very critical yesterday of the discounted cash flow method of analysis that has been utilized in attempting to analyze profitability. Several of us in the legislature have been told that is the method by which the industry itself often evaluates a venture before they commit themselves to it, is the discounted cash flow. It also seems to me that you're suggestion with regard to a capital recovery mechanism in the surtax proposal is somewhat similar to a discounted cash flow method of analysis, that what you are ensuring is that there is a rate of return based on a level of expenditures.

MILTON LIPTON: I am not critical of DCF calculation. I am critical of some of the ways in which DCF calculations have been used or interpreted in connection with analyses of Prudhoe Bay. How can you criticize a DCF calculation? It is a piece of arithmetic, that's all it is. Does the industry use DCF calculations? The industry must speak for itself, company by company must speak for itself. Let me tell you what our experience has been with oil companies, insofar as we are consultants with oil companies. The DCF calculation is used typically, to array alternative investments. If you have a DCF rate of return of 35 that goes here, if it is 30 it goes here, if it is 15 it goes down here. It permits you to array. Secondly, when you say that this is higher in the array and this is lower in the array, you've got to look at what your nature of the investment is. DCF calculations become reasonably comparable and are useful for purposes of array if two things hold true. If the intensity of capital

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investment is approximately the same and if the lifetime of the investment is approximately the same I don't think any oil company would ever array a 31 percent DCF rate of return on an exploration venture, side by side with a 31 percent DCF rate of return on a refining venture. It wouldn't go into the arrays even. These DCF rates of return are not comparable. Now, if you talk about exploration ventures, I would suggest that most oil companies in an exploration utilize DCF calculations. This is one way of pulling together all of the facts which are necessary to make a judgement. To my knowledge, an oil company would not, having made a DCF calculation, determine what its bonus bid is going to be on a lease. They might use it as one of the pieces of evidence, but they would not say that under this DCF calculation ... I am being more specific than I ought to be, but if a DCF calculation on a particular exploratory prospect comes out 50% and the company has as a rough criterion for yes, no, do we take a crack at the lease or don't we take a crack at the lease. and then say okay, if I take the difference between 50% and X percent and I can translate that into a bonus payment and that is what I'm going to bid. And I wouldn't bid a penny more because if I do that I ruin the rate of return and I wouldn't bid a penny less because I have to be competitive. The DCF rate of return is one tool that serves a purpose. But you see, I would have been equally critical about the utilization of a rate of return calculation on Prudhoe Bay for tax purposes whether a DCF rate of return or were it an average return on net assets over the lifetime of the field, whether it was the marginal efficiency of capital or anything else. My real quarrel with the rates of return is that presumptive rates of return ought not to be the basis for taxation. These are presumptive rates of return. Even if it were the end of the day, I think it would be very difficult to look back and say, "Yes, there is superior profitability, but the superior profitability, because it yielded a return of 48% is exactly this much because it should have yielded only 24%." You may be able to calculate the 48% at the end of the day, but you really don't know what it ought to have been. The economic rent is over the whole area of the oil exploration operation.

MILTON LIPTON: I would like to suggest that perhaps you would like on Friday, to at least devote a little time to the question of leasing policy. This has been an old issue and I know that the native corporations have raised the whole subject of leasing policy as something which is vital to how the state reviews both tax policy and leasing policy. There is a bill that is before the legislature on leasing policy and I think it might be worth spending at least a few minutes if it is of interest to you now.

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Continuation of presentation by Mr. Lipton, Consultant on Oil and Gas
(Tape of this meeting is available through the Legislative
Affairs Office)

MINUTES
SENATE RESOURCES MEETING
FEBRUARY 14, 1975

Senator Poland began by stating that Mr. Lipton had had the opportunity of being with us for a couple of days now, and had an idea of some of the bills and ideas coming before the Legislature. He had asked for a short time for a presentation before we started questions and answers.

Mr. Lipton began by stating: There is always an interest on the part of the Legislature in things in general and external and so therefore when I meet with the first committee upon coming to Juneau, I am sort of beholden to talk at length on this. One never knows quite how relevant it is. I've seldom had direct exposure either to the Bills before the Legislature or the thinking of the Legislators so it is difficult. It is a pleasure that I'm back with the first Committee again, and perhaps we can solve this problem with time. I would like to focus upon those matters of legislation or Alaskan administrative policy which come directly to bear with the primary interest at the moment, which is a prospective budgetary deficit and how it can be met--the presumption being that bridging this deficit; dependent upon contributions for a taxation upon the oil and gas industry. I pass no judgment on this presumption. If you look at the alternatives that I have been asked to address myself to over the last three days, they are 1) the possibility that the industry will contribute by virtue of a lease sale, 2) the State itself will exact funds from the industry by virtue of a taxation where the avenue of taxation is a new tax, an ad-valorem tax on oil and gas-in-place or the reserve tax, and 3) the industry will contribute by virtue of the various ways in which the State can sell either royalty oil and gas or options for the industry

to purchase oil and gas sometime in the future.

Of the three alternatives I would rank highest the lease sale. Not in terms of a decision on the part of the State, because it is in the budgetary deficit to go out and sell oil and gas leases. If that were the case, suddenly the State would turn the oil and gas division loose and study the maps and State lands to scrounge up acreage which could be thrown upon a lease sale market. I don't mean this. But since there is identifiable acreage available to the State that already falls within the near term leasing intention of the State. - that this acreage in Beaufort is of considerable interest to the industry. And because this acreage is also on the North Slope where from the standpoint of both the industry in finding reserves and the standpoint of the State in assuring optimum utilization of the pipeline, it will be a positive contribution to make certain that the reserves are available so that at least 2 million barrels a day are available for throughput to the pipeline. Footnotes to this general observation: First, there is reasonably within hand, the 1.2 million barrels of crude oil production which the operators of Alyeska pipeline expect to be the early throughput to the pipeline. The Prudhoe Bay Field as it is being utilized would probably support something like 1.5 to 1.6 million barrels. Additional oil would be necessary to rise to 2 million barrels a day. There is no question that in due course it will be there. I think it is to the interest both to the industry and the State that the pipeline is operated at optimum capacity as quickly as possible.

Rule of thumb and for your information, the difference between what the costs of transportation might be at 1.2 million barrels a day and what it might be at 2 million barrels a day, is probably in the order of magnitude, \$1.25 a barrel. All things being equal, this is what happens to the costs of transportation. Of course from your standpoint, the costs of transportation to the pipeline is tremendously important to the value of the oil at the wellhead and therefore, the revenues of the State. So if there is a difference of \$1.25 a barrel in the cost of transportation with the State having a one-fifth interest in that, it makes a tremendous difference to what the State's severance tax and royalty revenue receipts will be in the early years of pipeline operation.

Secondly, the area is highly attractive. There are all kinds of complications and uncertainties and I will go into that later. There should be a reasonable flow of competitive bidding if this area is put up for lease. So for both of these reasons, from the standpoint of what the revenue prospects are and from the standpoint of what early development of the Beaufort Sea might mean to the economic utilization of the pipeline. I would rank this kind of a lease sale relatively high. Not because the State conjurs up and improvises a lease sale, but because it is already in the offing, and if it can be done within the time frame that matters to the State, I would rank it highest among the alternatives.

The third alternative would be the Sale in Advance of State and royalty gas, or the sale of options on State and royalty gas. I would

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rank this lowest on the array of alternatives available to the State for many reasons. 1) The value you could get from selling royalty oil today or the option to buy it today, is a very uncertain thing. It is uncertain because the companies who might be inclined to bid for the purchase of royalty oil or to negotiate for the purchase of an option to buy it in the future, are themselves faced with tremendous uncertainties. They don't know what the price or the value of that oil is going to be in 1978, or 1980. They are not really in the position to say that well whatever negotiation or contract they enter into with the State will be at the then market price. But they are not in the position to say what that market price means to them in terms of competitive position. Market price is a dubious sort of thing. The recovery of the price that you pay for the oil on the North Slope depends on the price at which you can sell gasoline in Los Angeles. This is a tenuous uncertain relationship. For all of these reasons, I feel strongly that if the State enters into either bidding for the sale of royalty oil or even negotiating the option to buy and sell royalty oil in the future - all of these uncertainties work to the disadvantage of the State. No oil company is really in the position to commit themselves to the purchase of your oil or option without assessing a relatively high interest rate against the funds that they advance to you compared to the time that the oil is forthcoming. The interest rate that an oil company has to look at is considerably higher than what the cost of capital is to the State of Alaska.

Finally there is the presumed importance of the State's continuing

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access to royalty oil - for possible self-consumption within the State, support of a Fairbanks refinery, possibility of refining capacity and most importantly, the fact that the movement of the oil through the pipeline and intrastate commerce is to underpin the regulatory authority of your Alaskan Pipeline Commission.

The middle alternative would be the tax on oil and gas-in-place or the reserve tax. It is our judgment that this tax as a tax measure is a bad tax, in the sense that in all the ways in which the State obtains revenue from the Industry beginning on Day with the bonuses of the lease sale ending on the day they get the income tax from the profitability of the industry. And inbetween the severance tax, and royalties ad-volorem tax on real property, the tax on oil and gas-in-place is a bad tax for two reasons - because there is no criteria available to the Legislature or to the person being taxed as to what really the incidence of the taxation is. If you talk about an income tax you have the tax base which is identifiable - that is to say, the profit is being taxed. If you talk about the tax rate you have a comparison - what are other tax rates elsewhere. So the industry being taxed has a basis of judgment on what it is being taxed. If it is bonuses, this is what industry enters into of its own volition; the ad-volorem tax on oil and gas-in-place is an estimate; it is unknown. The whole history of oil industry tells us that these estimates vary over time. If you know what is in place, how much is recoverable? What is recoverable is not a technical estimate, but an economic estimate. Over what span of time

will it be produced - this depends on the circumstances of the reserve and good conservation practices.

To assess the value of oil and gas-in-place is a different kind of animal than trying to assess other real property in the State.

Secondly, insofar as it may involve the respective assessment of a company's oil or gas, or oil and gas-in-place, one is confronted with the problem of equitable assessment, so long as it's just Prudhoe. If this is the only thing it is focused upon, it becomes the taxation of one person. The assessment and the mil rate don't matter all that much except in terms of how much money the State gets and how much money the individual pays. But if the tax were to be applied elsewhere in the State it becomes a matter of equity; a matter of legal responsibility that the value of one person's oil and gas-in-place shall be assessed by the same criteria as the value of the other problem or assessment because of the value of oil and gas-in-place which is so different from every other aspect of ad-volorem taxation. From that standpoint it is a bad tax.

There are times when the State is driven to legislation which is not, necessarily the best available. In effect, if it has to be done for reasons of sheer budgetary necessity then one should make the best of a bad thing, if that is possible. One thing, the tax should not remain on your books as a continuing tax which is one of many affecting the oil and gas industry. It ought to self-destruct as quickly as possible.

Secondly, if the purpose is for the State to get the optimum revenue from the oil and gas industry that should be done through bonuses, royalties, severance tax, income tax, and so on. I'm not arguing that the State should not get more revenue from the industry. We do want to look at it from the application of your severance tax, both on the oil and gas side, and the effectiveness of your corporate income tax. If the purpose is over the time span of oil and gas industry operations to get more revenue, it should be done differently. But if the purpose is to stand a budgetary deficit, what you are really saying is: Let's try to move the revenues from tomorrow toay. Not to get more revenues, but just try to advance those revenues which could be done by the sale of revenue bonds. Two features of this tax would be tremendously important: 1) that this tax has a limited duration, and 2) if the purpose is not to add total revenues, then provide a carryforward credit so that the very few taxpayers who are identified and hit by that at least will know that what they pay today becomes a credit against their severance tax liability tomorrow. If they have to pay today what they don't have to pay tomorrow, there is a very considerable interest cost - and for every 100 million dollars at 8% interest, if it takes about 5 years before they have tax abatement, we are talking about almost 50% - quite a carrying cost to the companies. Nonetheless at least it represents a recognition by the Legislature that they are trying to make the best of a bad thing.

The question is, does it have to be done? Number one which was the lease sale is the questionable item in terms of how much revenue it

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would raise. You have a timing problem in your Legislature. Let me go back now to the sale of the State's royalty oil and gas. The royalty oil has many reasons why I believe it would be a mistake for the State to enter into a fire sale. There is a slightly different perspective on the sale of the State's royalty gas. First of all, oil is sold in barrels per day per a contract period. Gas is normally sold in terms of reserves. That is to say, the State would sell or give an option to somebody to buy all or some fraction of its royalty gas. The big difference in my opinion is between circumstances of oil and gas sale and the oil sale I tried to make clear that there are so many uncertainties. In effect, the State would be faced with a relatively low value today, for what it will be selling tomorrow. This need not be the case in gas. For one thing, an oil company has to worry about what the value of the oil is going to be because he buys it and he has to refine it in the competitive sense - and he has to recover it in gasoline. But a gas transmission company knows out of the circumstances of our regulation in the United States, but mostly out of the circumstances of our very acute gas shortage, that a gas company can always get back at the other end of the transmission pipeline the price he pays for gas. So there is no uncertainty for a gas transmission company as to whether buying gas at the market price he really recovers that price. This is clear...so that the uncertainty doesn't work against the State.

The second thing is that a gas transmission company that makes advances

for the purchase of an option or advances against the contract sale of gas, is operating under regulation whereby all of these advances in a sense enter into the company's rate place; e.g., if the company invested 500 million dollars in pumps and pipeline, it would be entitled under FPC regulations not only to recover that, but to make a profit upon it. In a sense, the money that they advance can enter into their rate place. So they can not only recover the price of what they will ultimately pay for the gas, but they can recover the value of the money they invest. In other words, for them to give you an interest free loan in terms of the purchase of an option to buy gas later on, doesn't really cost them anything out of their pockets, so that the State isn't really discounting the future value of their gas in the same sense that they might be forced to discount the future value of their oil.

This is not to say that the State should be cavalier in the selling freely of gas reserves, but if faced with a budgetary crisis, you have on the one hand the option for a lease sale with an uncertain bonus income, but with good expectations that will be there, and on the other hand the possibility of selling an option or even a contract to a portion of the reserves of gas which represent your share of the royalty gas that this may make a sufficient contribution to the near term flow of State revenue. It is a different set of circumstances than if nothing else were there and all you are looking at is the budgetary deficit and how soon and to what extent do you have to go to an oil place tax which we feel is bad taxation that should only be entered into under the pressure of extreme circumstances.

Perhaps the circumstances may be less extreme if you follow the alternatives. Perhaps the timing may be less immediate if you follow those circumstances. I can't judge that. What I've tried to present to you is how we balance these alternatives.

QUESTIONS:

Senator Rodey: In balancing these alternatives, I assume you don't take into consideration other physical factors that may be present in the State of Alaska? Mr. Lipton answered: Not at all. The last thing I would dare do is to start addressing things to things that you know so much better than I. This is a situation; if it's the oil and gas industry you are looking to, of how do we assess the implications in relationship to the State and the industry.

Senator Rodey: For example - turning to the lease sale which you mentioned as the best choice insofar as raising revenues are concerned, I suspect it is desirable if we consider it in a physical vacuum. However if we consider it in the light of the State of Alaska to channel our oil development in the direction you think proper, then perhaps a lease sale loses some of its glamor. Mr. Lipton stated: I tried to say at the outset, that I would not urge upon the State an aggressive fire sale of State lands. That is the last thing I would ever suggest to the State. I think, for a combination of reasons, this particular lease sale, which has already in a sense been on the docket before the budgetary problem at least came to my attention. It is an area of intense interest. There are some technical problems to it that I