

ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECT FILES 8672
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use. There you have to be very much concerned. Because the petrochemical industry not only has alternative feedstocks, it has alternative locations. The petrochemical industry itself is running out of gas as a plant fuel in the lower 48 states. In certain locations they are facing curtailment of natural gas as petrochemical processing feedstock. So that the availability per se may be a plus for Alaska, but you certainly would want to be concerned about what you do to the cost of it, if it is to be a feedstock for expansion of petrochemical facilities where you have to entice industry to make the denovo investment in the state. But again, there are ways that can be handled. Louisiana has been doing that for a long time in which in effect it has given an indirect and not a direct rebate of the Louisiana severance tax to industry using gas in Louisiana. That, I presume could be done too.

Insofar as the highest value in dollar terms, you may want greater utilization of gas in Alaska, even if it means lower value through its use in Alaska. But in terms of high value and dollars per MCF, the greatest value is in the lower 48 states and I would not think that anything you do within the range of the proposals that I have seen, whether a cents per MCF or percent of wellhead value is going to be a great disability.

RADER: What you are saying is that the largest value in the commodity sense would be in a domestic consumption through a pipeline in the United States the greatest value to Alaskans in a local sense would be quite contrary.

LIPTON: Yes, this is a matter of how Alaska sees the merits of getting the highest net back to the value of the gas relative to the utilization of its gas within the state even if it means lower cost gas to its own consumers or if it means the availability of raw material to entice industry here. This is something you must decide.

CROFT: How does the Louisiana rebate work?

LIPTON: Senator Croft, I don't have the details of it. We looked into it some time ago, but I think basically it is a subventure to industry to cover energy costs. I don't remember exactly how it operates. After subvention the gas costs industry less than if they were charged with the whole severance tax.

CROFT: I assume that the problem that you describe with regard to cents per barrel of the present tax is because it is tied to the consumer price index. One way with regard to Cook Inlet to solve that problem would be to have a cents per barrel to fluctuate according to old oil prices. Which might be more realistic with regard to Cook Inlet. I assume one of the disadvantages would be that some uncertainty as to what is going to happen with the whole pricing policy . . .

LIPTON: I don't see any real merit, Senator Croft, in the cents per barrel tax if you remember, along with me, what the Legislative history was. It started out in the first instance when the legislature was asked to make itself concerned with the fact that wellhead values were going to be so depressed by pipeline tariffs and the value of oil in California was going to be low and therefore the wellhead value would be low and the state of Alaska wouldn't be getting severance tax revenues adequate to budgetary projections for 1976-77, when the pipeline was presumed to go into effect. And so the cents per barrel floor was a way of putting a reference basis on for severance tax purposes. And then when it went through various legislative combinations and later on there was some concern that the way the companies were setting posted prices in Cook Inlet might not do justice in the future to the state's entitlement to a fair share of the true value, and therefore, if they don't raise their prices in Cook Inlet, well what the hell they'll be hit by the cents per barrel tax because it is based on an average of lower 48 crude prices. Of course, it worked just the opposite. It is not that they didn't raise their wellhead prices, they were not allowed by law to raise their wellhead prices, whereas U.S. average prices were going up, not because other old production was going up in price but because the new oil price was going up. And we don't know what moment in time the U.S. Bureau of Labor Statistics will wake up and put foreign oil in the wholesale price index. It belongs in there. It has always been excluded. So it is an unpredictable behavior on the whole there. I think the cents per barrel doesn't have a great deal of merit. It has worked in the wrong way in the past. I don't think it has a great deal of merit in the future. Although I can see why you would want to maintain a floor, under severance tax revenues which you have been used to collecting and the companies have been used to paying even though as I said they are already paying a percent of wellhead value higher than any of the proposed amendments would impose upon them as a percent of value.

CROFT: You are saying that we might want to retain it as a floor, you are talking about a fixed . . .

LIPTON: Fixed . . . yes. Whether it's the February rate or the January rate or the March rate, or some recent rate which is appropriate and would be a flat cents per barrel for different gravities of crude and for appropriate average well producibility and then thereafter the state's revenues will go up as the value of the oil at the wellhead goes up and according to whatever change you make in your rate of taxation. Severance taxation. Just roughly speaking if you were to adopt the rates of severance taxation in either of the amendments, the increases which bring the top rate up to 12 1/2 percent or 14 1/2 percent, depending upon the step schedule, and if the price of old oil at Cook Inlet goes up at about the rate which the Federal Energy Agency has projected.

Although I think their projection is too high. But about that rate. Then within about two years you would start collecting higher severance taxes from Cook Inlet. For about two years, or slightly less you would still be collecting the fixed flat cents per barrel. After that it would start going up. Because their prices have gone up and your rate of taxation, if you adopt either of these amendments will be somewhat higher.

BROWN: I wasn't in the legislature when the original bill was passed, but I would assume that one of the reasons for gearing the cents per barrel tax to the price index was to make sure that the actual affect in real dollars would take into account inflation. The tax would not just gradually decrease over a period of years.

LIPTON: No, because the cents per barrel escalated not with a wholesale price index. Only with a crude oil price component. And the worth was, that if, for example, all crude oil in the lower 48 states went up by ten percent then Cook Inlet crude oil would go up by ten percent too. And if the companies, being bastards as they are presumed to be, didn't raise their Cook Inlet prices, they would be taxed anyway because the index went up. Now, I don't think it was an attempt to maintain the real value of the state's income at all. I think it was an attempt to insure that the state got its fair share of the presumed value of Cook Inlet production.

BROWN: Even though my assumption is wrong, I still have that same concern. If we were to follow that recommendation that where we could keep a cents per barrel floor it would just be an absolute one not geared to something like that, in effect aren't we putting in a floor that will constantly decrease with inflation.

LIPTON: No, because if you assume also that crude oil prices are going to go up with inflation, which incidentally is built in to the Energy Act at the present time, then the base of your severance tax also goes up. And so, in a sense we will be collecting not a cents per barrel, you will be collecting a percent of the rising wellhead value. In other words, if your average rate of taxation at Cook Inlet works out to 8 percent of wellhead value and your inflation goes up at the rate of five percent a year the wellhead value will go up five percent a year, you will have eight percent of a rising wellhead value. So in a sense, the state is also protected against inflation.

BROWN: I'll have to work that through my head about two or three more times. I may come back and ask a question later.

HUBER: What happens to us if the cost of pipeline construction and operation of the pipeline escalates at an even faster rate than other things including the discussed changes of the ICC that they may go as high as 10 1/2 percent or 12 percent allowable earnings.

LIPTON: Ten or twelve percent on what?

HUBER: Ten or twelve percent based on the profitability on the line. In other words. . . . wouldn't we need that floor to protect ourselves?

LIPTON: No, what you would desperately need under those circumstances is an aggressive Alaskan pipeline commission.

HUBER: Maybe a mean legislature too?

LIPTON: A mean legislature and an aggressive Alaskan pipeline commission.

The eight percent rate making rule of the ICC, as we have discussed so many times, may have been appropriate to circumstances in the times when it was enunciated, basically 1939. Now it is completely inappropriate. The ICC has been sleeping ever since and I would assume that you have regulatory legislation and ability to ride herd on the pipeline tariff. Now you can't protect yourself against rising costs of the pipeline construction. The costs are based upon investment, you can't protect yourself against those costs. Those costs will come out of company profits to the extent that the depressed wellhead prices will come out of the state's economic interest. Both royalty and severance and taxes. No question about that.

HUBER: I thought that that eight percent was based upon the investment in the line and did I detect in what you were saying that you say it was inappropriate now, do you mean that it should probably be higher now? What direction can we look?

LIPTON: I think what is inappropriate is the whole rule. The eight percent was on total investment. It's depreciated updated capital in the line. It was adopted at a time when virtually all the investment in pipeline was equity investment. In the 1930's who could build a pipeline on borrowed money? And the eight percent seemed to be a reasonable rate of return on total capital and total capital was basically equity. Of course, now there is no way in which a company wants to build on equity when it can borrow money and certainly now with the tremendous leverage that you have on Aleyska the real question is what is the appropriate rate of return on equity and on borrowed capital and the eight percent rate making a cash flow to the company, to recover their capital, pay all of their taxes and to yield eight percent in which the interest on the borrowed capital has already been charged off as an expense. So the rate of return on equity becomes fantastically high.

HUBER: What prompted the question was that I had heard that probably it would be going even higher, the eight percent allowable earnings and I was wondering if Milton had any word on that and also both Milton and ourselves recognize that there is approximately 15 percent equity interest on the pipeline and the rest borrowed money. At eight percent this translates to some 46 percent at the present projected earning on just the equity, after you have paid off all of the expenses of the borrowed money. So that's what I was trying to get at.

LIPTON: I would like to spend just a few minutes now talking about the state income tax, and the several bills that are before the legislature that provide alternative methods for computing taxable income generated by oil producing operations in the state which would be subject to comparable rates of taxation as other industries.

You have before you in the legislature SB620, net proceeds tax, and the second SS HB 803. Both of these are designed to identify, as I said income generated by oil producing operations in the state and make them susceptible to what is essentially the same rate of taxation as other corporate income. We have long urged direct accounting of production income in the state of Alaska because we felt that the apportionment formula works to the disadvantage of Alaska. That is to say, you have what is roughly a 9.4 corporate tax rate and 9.4 percent of what. The apportionment formula throws up a smaller estimate of the income earned in producing operations than would be the case through direct accounting. Your present income tax law does provide for direct accounting, the trouble is that the method of direct accounting in the state avoids almost any tax payments by the companies because so few of the companies have direct sales in the state. Most of the oil produced here is in a sense shipped out of the state and lacking direct sales they have no gross revenues. If you have no gross revenues, you don't have to worry about the allocation of costs, you have no net revenues, if you have no gross revenues. So we long urged an overhaul of it.

There is, as has been called to your attention, some legal questions as to whether the two approaches would in effect work from a judicial standpoint. That is to say, vis a vis, the state's commitment to the Multistate Compact, a possible question of double taxation. We have no real competence in this area, I presume that it has been looked into at various levels. I suspect that however deeply you look into it, you will not get a definitive answer as to whether direct accounting along the lines of SB 620 or HB 803 is consistent with the state's obligations under the Multiple state compact or whether it can be challenged in the courts as essentially an unconstitutional taxation on income that is earned out of the state because of the whole question of allocation. Whether or not you have good legal advice or whether you can get a definitive answer, I just don't know. I suspect that in the end the only way that you find out whether Alaska can do it is if you eventually enact one or another of these taxes.

From the standpoint of our review and with regard to the aspects of oil industry taxation that we are familiar with we feel that probably the treatment of costs in both bills are unnecessarily complicated. There are difficult definitions. I would assume that in any case you would want some input from the department of revenue as to the operational

questions that are involved. After all they're the ones who will have to administer the statute which you enact. If you are concerned about the specifics of these I have discussed SB 620 in March when I was here, we now have HB 803 in front of us and I am prepared to go through with the committee line by line of 803. I think from an administrative standpoint, in terms of what is reasonable economic treatment of costs we still find some difficulty with 803. I think a basic question before the legislature is how long it would take at this stage of the session to get a bill such as SB 620 or HB 803 into the kind of shape that we would want it to be in before you will be prepared to accept it as one approach to the direct accounting of oil producing income in the state of Alaska.

Let me just say I don't think either of these income measures will have very much net effect on the revenues on the state will get from Cook Inlet. I don't think that the margin is that great for Cook Inlet. It can be tremendously important by the time Prudhoe Bay comes on stream. I don't think that the immediate effect would be all that great in terms of revenue it generates. So you may want to defer this because of the time it takes to mark up the bills. I would strongly urge upon this legislature if it is deferred that the issue not be lost. The question is of vital and continuing importance to the state of Alaska, and it would be a shame if the legislature decided to defer action on this because of timing or because of difficulties in handling the bill for the principle to have been lost and because this aggressive legislature finally didn't come to grips with it that the next session of the Alaska legislature would somehow let it go. This is a basic piece of reform that is absolutely essential for your corporate taxation.

COWPER: Assuming that we are able to get over such legal hurdles as we may have and we are able to solve some of these problems with the cost definitions, do you think that the basic approach which is attempted at least by second sponsor substitute for 803 is sound?

LIPTON: Yes. I have reservations about many aspects of it. But I think that the basic approach of identifying the income from an oil producing operation, whether or not you have to segregate it has been done. Which means in effect you treat the oil producing operations of a company here in Alaska separate and apart from other operations. Whether that is necessary, I don't know. There are some leading questions there. But to my mind the general approach that you have direct accounting, and the key to direct accounting is the determination of the gross value of production in Alaska. That is the key to it. Your present statute enables the department of revenue to select either apportionment or direct accounting. A lot of the companies had been on direct accounting and because they reported no sales in Alaska, the department of revenue goes back and kind of coerces them onto apportionment, at least they get something. You could have direct accounting under your present statutes. If, for example, in the absence of sales in Alaska you were able to impute a wellhead value for that which is produced and not sold in Alaska.

Now, the second sponsor substitute and also, I think, the net proceeds bill approach the value of the oil either at the point of first sale or at the refinery gate. Of course at the refinery gate if there is no sale you still have to impute value. If you can impute value at the refinery gate, if there has been no arms length transaction, why can't you impute value at the wellhead. You have to impute value at the wellhead for severance tax purposes and for royalty purposes. There are problems about how you handle the allocation of certain costs, there are questions of what kind of allowance you make for transportation but these are technical, I don't minimize them, they are difficult technical questions, but I do think that the approach to attempt to elicit from the industry a direct accounting which may give the state a higher revenue from the income tax on oil producing operations, or it may, in certain instances, give the state lower revenue, if the apportionment formula has worked to a disadvantage to some of the companies. This to my mind is less important than having the state in a position where they are able, in the near term when Prudhoe Bay comes on stream, and for the long run future when hopefully you will have more oil and gas producing operations to get a direct accounting. And if you don't have a direct accounting you will never have for any purposes, not for leasing purposes, not for other tax purposes, you will never know what the profitability of oil producing operations in Alaska are. You will always have, as you had in March, special studies made where somebody makes a whole set of assumptions as to what the value of the oil is going to be in the future, what the costs are going to be, and then there will be quarrels as to whether the assumptions were correct and you will always be faced with constant guess work as to what the profitability is. If you have direct accounting, it will, I know not only be helpful and equitable for both sides in terms of income taxation, but doubly helpful for the state to know what direction it can proceed from year to year in terms of leasing policies, in terms of tax policy. It is tremendously important.

What I have said in effect was that if it can be done within the time that remains we think the approach is on target. It's for you to decide how important it is. The other observation that we make is that we don't think in the short term it is going to have a great effect upon the state's income tax receipts from Cook Inlet operations. If it is not taken up in this session, we would hope that the principle is not lost and that it doesn't die.

RADER: You are addressing yourself as to the state's division of our statutes in order to get our oil producers to pay the customary corporate income tax as is paid by all other businesses in the state.

LIPTON: Right.

RADER: Do you intend to address yourself to extraordinary or different rates to be applied by one industry.

LIPTON: Yes, that's the third item on the agenda.

The third order of taxation with which you have been concerned is the surcharge on oil producing profits or the excess value surcharge. We are on record with your committees as to our difficulties and problems with the earlier bills. There is now before you SB 747 which approaches the excess value surtax via a surcharge on income after there is capital plus recovery. This approach to a surcharge on the profits of oil producing operations is something which we do not particularly recommend to the legislature but we said that if it was the decision of the legislature to identify an order of profitability of the oil industry which might expose them to a higher rate of taxation than the profits of other types of industrial operations in the state, then we said you might want to consider as the criterion which determines whether and if there is when, a company becomes exposed to this surcharge the principle of the recovery of the company's capital plus. What the plus represented was some multiple of the direct capital investment of the producing operation itself thereby the successful ventures in effect not only got their own capital back but because they were successful and were entitled to higher rates of return and recovering the capital lost in unsuccessful ventures by themselves or other producers who never became successful in the state. In other words, you had well established the future and continuing profitability of the venture before there would be any exposure to a higher order of taxation in the regular state corporate income tax.

Our feeling is that SB 747 is at least founded on a principle which has precedent in the oil industry which I think the oil industry will never be happy about because nothing which raises their taxes will make them happy and anything which singles them out for taxation other than the taxation that is common to all industries cannot be a happy result for the petroleum industry. There must always be concern on their part

about where is it going after the step has been taken. The first step is always the hardest to distinguish them. But once you distinguish them the second and third steps may be terribly onerous and I can understand the concern of the industry and in particular the common exposing of the industry that where they are subject to an especially high rate of taxation is precisely an area where they make their profit. You can only pay for the failures in one exploratory area by the success and the larger than average profits elsewhere. In other words you couldn't have ever explored futilely as long as one did in Alaska if there weren't profits elsewhere to invest in Alaska. In other words the successful ventures in the lower 48 and elsewhere paid for the original exploration in Alaska and the future of profitability in Alaska has to pay for more exploration in Alaska, and maybe for dry holes in Wyoming. And if you're always exposed where you are successful to specially high rates of taxation then in a sense all of the incentives fall apart. I understand all of these reservations. However, if it is the decision of the legislature that the circumstances of the industry are such where they may be exposed to separate taxation then we strongly urge that the criteria before which there is exposure and according to which the rate of their exposure is determined shall be the capital plus recovery.

On the basis of those principles we think that SB 747 is a not unreasonable approach. But it needs a tremendous amount of careful work yet. Not only are there problems of accounting built into it, which the sponsor of the bill himself has raised with me, so this is obviously not an attempt to be inflexible, so there is a lot to be discussed there as to what capital qualifies for recovery, what the rate of recovery shall be, what tax rates shall apply after the fact. For example, the higher capital recovery you allow, the longer the period during which the oil producing company is protected against the surcharge. On the other hand, it's the rate of the surcharge which will determine how much tax you're going to pay after this capital plus recovery takes place. These things have to be worked out. There are many complications here and particularly in a bill such as this I would say that before the legislature gives it serious consideration for ultimate passage this kind of taxation requires tremendously important input from the industry itself. I would not expect that the industry would come out and say if you just do these few things we will like this form of taxation. There is no way the industry will like any taxation and especially will ever graciously and willingly accept selective taxation upon themselves apart from other industries. But if it were to be done I think there is room for industry input on this. Because they must bring to bear their own experience in Alaska, their experience elsewhere, what are the circumstances in the past in Alaska, what are we looking forward, what should be the treatment of capital, and all of this.

In general, if you would ask me for my evaluation I would say that you have before you now an approach which is worth consideration. But it is going to take a tremendous amount of work and whether or not you can possibly do it this session, whether it is necessary to do it in this session in view of the fact that it is not going to pertain for a long time to come in any event because it wouldn't even apply to early stages of Prudhoe Bay production if you allow capital recovery. So that it seems to me that this session has already accomplished a great deal in focusing upon the question, what are the pros and cons and the perimeters of the problem should Alaska proceed, if so how. The answer as to whether Alaska should proceed with any kind of a surtax in the oil industry I think depends in large measure on how it's going to do it, but should Alaska do it and how it is going to do it interplay one against the other. And so you've got to have a pretty strong and firm feeling of how you propose to do it before you decide whether you propose to actually go ahead. And I would think that there is a certain merit in this stage and the bill that we would be prepared to work with you in greatest detail, namely 747, and reviewing this very critical question should Alaska establish a form of taxation on surcharge on the oil industry as distinct from all other industries. This is such a far reaching decision to be made. I would think that this merits consideration in light of all the other aspects of taxation that you have before you and the whole problem of leasing which is also up for review.

Now, in that respect, I might just add I saw today for the first time the Senate Concurrent Resolution and the idea as a joint concomitant review of the various forms of Alaska petroleum taxation and of leasing policy certainly commends itself to the legislature and to the administration. It's a shame that it hasn't been done in the past, and you come to it this late in the game. But certainly the idea of a review which takes together all forms of taxation and leasing I would think has a tremendous amount of merit.

I have three questions about the SCR. The first is, would the administration do this in any case, in other words, is this the responsibility of the administration to start looking at tax policy from a very broad gauge standpoint. The second, if it would do it anyway, would it do it any differently if there is a concurrent resolution. What is the legislature's position on this whole question of this review. And I would certainly think that if the legislature does not handle this by itself during the intersession period and if it is to be done by the administration I would certainly feel that it makes a tremendous amount of sense for there to be input from the legislature to whatever group within the administration works and I see a "be it resolved" clause in

which everybody is having input, the departments of revenue, commerce, economic development, natural resources, federation of natives, oil and gas industry, labor and investment counselors, economists, local governments, and interested persons, except the legislature. I would certainly hope that there ought to be some input from the legislature in any kind of a review that is taking place in the administration. So that if in fact, the purpose of this concurrent resolution is to get the recommendations of the study to the legislature within 14 days of the convening of the first session of the tenth session, that you would not like it to come as something strange to yourselves, that you would have some input into what comes through as a result of this study.

Let me conclude by recapping briefly and reversing the order. What I said about the oil industry income surcharge is that the question whether or not this is the intent and purpose of the legislature and if it should be done it is tied up with how it should be done and is a complicated thing which doesn't look to me to be far enough advanced, so that this is probably something which you will almost be inevitably obliged to carry over as part and parcel of a study of the whole system of taxation which interrelates severance taxation with ad valorem taxation with basic income taxation with a possibility of a surcharge.

What I said about the income tax is that this is of much more pressing concern and that I would think that it should be the purpose and intent of the legislature to come to grips with this whole question about how you establish taxable income for income tax purposes. On this you are far along. Whether or not you can handle the administrative things this session or not I don't know. But if it becomes part and parcel of a tax review I wouldn't want it to get lost in the interim and suddenly get lost because all of a sudden everything deals with the easy things like severance taxation, leasing policy and the whole income tax reform gets lost.

And finally on the severance tax, it is our opinion that it is perfectly appropriate for you to review the severance tax as a technical amendment which is worth consideration and that you may want to go in the direction of increases in certain brackets, reductions in other brackets, but in any case you should think very carefully about the the operation of the cents per barrel aspect of the tax as to how it would go in the future. But that again from the standpoint of revenue this is not of urgency to the state because with the kind of amendments to the severance tax that are before you in the present bills it is not going to make a heck of a difference on current production.

That is the jist of our reaction on current legislation as it now stands.

POLAND: Of course, we are not carrying over bills. This is the end of the legislature. And we don't know who will be sitting in the next legislature. And we take that into consideration, trying to decide what our priorities are in this legislature.

LIPTON: I appreciate that very much. Which is one of the reasons I said I hope it doesn't get lost. But I would assume that there is a certain continuity even in the Alaskan legislature.

RADER: You stated that there was precedent for this type of situation. Are you talking about foreign government precedent or what kind of precedent?

LIPTON: Not only foreign government precedent, but essentially all oil industry negotiations abroad. The petroleum revenue tax established by the United Kingdom for North Sea operations is a form of surtax on profits of oil production. It was first posed by the U.K. government. It was very carefully worked through by the government and the industry and tremendously modified in many respects before it was adopted by the U.K. government. But the industry itself in areas where it negotiates for example, of course there is no such thing as a concession anymore, but a contract or work agreement or production sharing contract or so on, where they constantly feel they are susceptible after they are successful to changes in contractual terms. The greatest interests of the industry and the greatest protection of the industry is the kind of arrangement which permits them relatively quick and early capital recovery. Because even if the margin per barrel of production is adversely affected by subsequent taxation legislation, having had capital recovery early in the process means that the effective rate of return after the investment has been recovered becomes ever so much higher than if they have to struggle through some kind of an averaging process over the whole life of a producing operation where the more successful they are early in the game the more they are subject to early changes in returns.

RADER: What do you think of the argument that we should look for a precedent among purely capitalistic systems like the other states in the union, than perhaps a precedent in Norway?

LIPTON: I think there is a tremendous merit. I would assume that the state of Alaska will structure its system of taxation always within the context of what is legal precedent, competitive relationships, tax policy within the United States. As I said when I felt in juxtaposition

to the early bills with surcharge which we found objectionable because of the basis on which they identified when a company became subject to surcharge. Our objection there was that both of them we found, one of the in a sense which established a very arbitrary concept of long term supply price of oil and the other which was basically related to a rate of return above which they were subject to taxation. And I felt that since the whole subject was out that it would be well to introduce at least the concept for consideration by the legislature of early capital plus recovery. What I said at that time there are certain similarities to the petroleum revenue tax in the U.K. That was not why I was suggesting it. I was suggesting a matter of principle because in the bicentennial year I was not about to propose, 200 years after we fought for independence against the Stamp Act that we suddenly import from the United Kingdom a form of taxation. That's not the reason for doing it. That's not the precedent for doing it.

RADER: The charge has been made that the imposition of the excess value surcharge is one way of nationalizing a portion of the industry. Analyze that.

LIPTON: That doesn't have anything to do with nationalizing a portion of the industry. That is sophistry. What it is is an attempt to tax at a particular rate the income from producing operations. You could have a high rate of basic corporate taxation which would be unpleasant for the industry. I think that if you impose a high rate on the oil industry than on the other industries, it is onerous. It is terribly onerous from many points of view. I think that is a difference, too, between the oil industry in Alaska and the oil industry in other major producing states. And the difference has nothing to do with the presumed profitability per se. Hopefully, the oil industry is going to be more profitable in Alaska than any other state, and nobody hopes for that more than the oil industry.

But what I am saying now has nothing to do with profitability per se. When we discuss rate of return taxation and the Tanzer study, I'm dead set against any early judgments about what profitability is going to be as a basis for taxation. But the difference between the oil industry in Alaska and elsewhere is that if you take the other three major producing states, Louisiana, Texas, and California, all three states have very large and extensive agricultural industries. All three states have large, extensive industrial industry, manufacturing of all kinds. Alaska has basically the oil industry which will be a major generator of profitability in the state. And this to my mind means willy nilly that the State of Alaska is going to be looking at the oil industry in a different way from how California or Louisiana or Texas looks at the oil industry. I'm not making the argument now for higher

taxation. It may very well be under certain circumstances that you have to be more generous to the oil industry because it is a major industry and of great importance to you in the state. But states have different rates of taxation upon real estate all over the United States. They don't have the same rates of taxation. Corporate income taxes vary from state to state. There are different approaches to the relationship between property tax, income tax and excise taxes state by state.

The key, I think, by which you can judge whether or not you should, and if you do, how the industry is going to respond to the taxation, is what it does to their incentives. And what it does to their incentives depends upon what they think it does to their presumed profitability. If you're talking about a surcharge rate of 40, 50 percent then you are almost without exception, without regard to the attractiveness of exploration or anything else, you are posing a tremendous impediment upon any company making the judgment we ought to come into Alaska. But if you are talking about a surcharge rate of modest proportions which is geared to the superior profitability of operations in Alaska even after you take account of the fact that every successful venture in the United States has to be a superior profitability in order to keep exploration going. If that's how you key in on it and if the way in which you key in on it is through this capital plus recovery, then the industry will not like it. They shouldn't. But whether it has an adverse affect will depend entirely upon how you go about this taxation and what the rates of taxation are. You can just as well discourage the industry by an onerous rate of general corporate taxation. They feel secure against that because they don't feel you want to tax the fishermen, or other industries in Alaska at a higher rate. Don't misunderstand me. I am not urging this kind of a tax upon the legislature. I am responding to the fact that the issue has been laid before you and trying to be constructive. But I don't think one should interpret that any rate of taxation which is higher than other states do or higher than other industries do if you have due regard to the circumstances is partial nationalization.

HUBER: I was quite gratified by your explanation of 747 so far. I will admit that we designed this bill based on information that we gained from you and other sources, and primarily on the United Kingdom approach. Considering both the number of times capital rate recovery and the percentage that would be applied after capital recovery, would you compare this bill and its burden on the industry, would it be less burdensome on British petroleum, shall we say, than the burden Her Majesty has put on British petroleum.

LIPTON: I can't give you the answer to that. Because that would depend upon a host of assumptions of what the size of the field is on the North Sea, what costs are in the North Sea, what well producibility is in the North Sea. It is an entirely different set of economic circumstances for oil production on the North Sea. You don't have field economics in the North Sea, you have platform economics. You know the distinction. The economics of the North Sea operation are platform by platform not field by field. It is entirely different. We have made all kinds of assumptions ourselves about the incidents of taxation in the North Sea for other reasons. We have to be constantly in touch with it. But I would not even presume to hazard a guess as to . . . For example, the easiest way to answer your question, if I have the fact, which I don't have, would be to say that of the total profits over and above costs of a North Sea operation over the lifetime of the operation, Her Majesty's government takes this and this percentage of the total profits and Prudhoe Bay will take this and this percentage. That would be an answer to the question that in itself wouldn't be very constructive. Because there is nothing magical about taking the same percentage of the profitability. I would also say that if we are talking about what is the sum total of income taxation in Britain, whereas here you are talking about state income taxation and surcharge versus the federal government. Even then if they both came out to 60 percent or 70 percent or 80 percent, would that be right or wrong for Alaska. I don't know. You would be very much concerned what the rate of income taxation in Alaska take into account what previously had been paid as severance tax, and whatever ad valorem tax shall apply. Shall be such that no company when land is up for leasing here in Alaska would be deterred from going in and exploring the most marginal prospect. You want to keep exploration going at the margins. Not only Alaska, our country desperately needs that kind of exploration. So that the form of taxation must be that kind of taxation which says to the company if they see an exploration prospect which isn't all that great and they are not going to pay a big bonus for it, O.K. all exploration costs are pretty high in Alaska, but if they find a field with 50 million barrels in Alaska and they look at what they are going to have to pay as royalty and severance taxes and they look at the structure of income taxation that the candle is worth the burning because in that kind of a field they are not going to pay any inordinate income tax and essentially they wouldn't even be exposed to that kind of a surcharge. The structure of taxation has to be adapted to the circumstances of Alaska. Even if it is right for the North Sea it may not be right for Alaska. Which is why I say that I would want from the industry the strongest and most constructive kind of input when the legislature considers it and I would not feel that the legislature in a sense is giving up its independence in listening to the industry, any more than Her Majesty's government gave up their independence when they listened to the industry, and to a very considerable degree revised their terms.

It is not the U.K. North Sea approach that I have been suggesting as an alternative to Alaska. It was the principle of capital plus recovery which may take an entirely new form from the North Sea.

HUBER: That brings me to my second question, and you practically ask it for me Milton, and that is how can we get, other than just negative, testimony from the oil company on this type of bill. You've seen during this session so far and during other sessions of the legislature, whether it was to raise the severance tax one percent or whatever it is, the oil industry from our recent testimony has taken a stand just no, no, no on taxes. Here we have a principle on taxation that we're going to need to work with them on and how would you suggest we get them to sit down and work with us on it.

LIPTON: I don't think that your problem is to get the cooperation of the oil industry. I think your problem is to get the cooperation of some oil companies, and you don't need an oil industry presentation. What you need are knowledgeable companies who are going to address themselves to a concept of taxation which you are considering to the technical problems that are involved, and particularly to the applicable to the circumstances of Alaska where they have had experience. You have had companies here who have had a great deal of experience, not only in Cook Inlet and Prudhoe Bay, but a lot of them have been exposed to other parts of the state. And many of them are working now with the regional corporations all over the state. They know something about the circumstances. So you don't have to ask them whether they are approving and going along with the principle of a surtax, but if it were to be done what are the features of it which are peculiar and representative of operations in Alaska and if there is to be a capital plus recovery what is the definition of capital. What is the plus that has to be done.

The plus is a different thing. If you know what the relationships are between the types of capital cost that are being incurred here typically, these are the sort of things that you could hope that there will be at least some knowledgeable company who will be responsive whether they like the principle of taxation or not, and if not, then I suppose it's on their heads that they have not been responsive.

HUBER: You sat through some of the other testimony, you did note that the testimony was broadly leveled like a shotgun from the industry, from all of the members of the industry in Alaska we can see sitting here today, and they were here then also, they just generally said no, we can't stand more taxation. And their public reaction to it has been it will discourage everything in Alaska, and that is their present stand on it. So I am looking for a method how to get them to talk about it.

LIPTON: You're leading me into an area of response which perhaps I should have not enter into. But it seems to me that a great deal of discussion before your committees in March was less upon specific bills and more upon the kind of studies that have been presented in the legislature in justification of it. The presumptive profitability of Pruchoe Bay, the presumptive profitability of Cook Inlet, and as I said, if you adopt the principle of taxation within the whole structure of Alaskan taxation which can stand on its own two feet, it will stand on its feet without your prejudging what profitability is. For example the surcharge. The surcharge is never going to be, a corporate liability unless they are exposed to it. Now when are they exposed to it. Under what circumstances.

HUBER: When they make money.

LIPTON: Well, no it is not just making money. It is making money under certain circumstances in a certain order of magnitude. And it may very well be that if in fact Prudhoe Bay turns out to be as marginal a producing operation as has been suggested in some of the testimony, then they may not be subjected to any more than a modest state income tax. The legislature is well advised to think this one through in terms of studies that begin to tell the legislature what the profitability of Cook Inlet is, the profitability of Prudhoe Bay is, and what the profitability of hopefully 10 or 15 more oil producing areas in Alaska that haven't even been explored yet. What you are looking for is something which is consistent with what is within the area which is also relevant to the incentives for continuing operations.

RADER: Your proposition that we should have a tax structure that does not discourage development on marginal properties but which will after the capital recovery that there will be a recapture at that time. Let me ask you this, if you have two investment opportunities, state A and state B. State A if you were successful with a marginal well, and you also have a bonanza, and you get the bonanza, whereas in state B, if you get the marginal well, you get the marginal well, but if you get the bonanza you have your capital plus tax. Isn't that by very definition going to inhibit the bidding on the marginal well. Because as a total investment opportunity, in the first state is better than the second state and you can't really distinguish in this bidding situation whether or not we are inhibiting this exploratory expectations, we don't want to destroy.

LIPTON: Of course, a marginal well in Alaska is a different thing from a marginal field in Texas to begin with. There is nothing, I believe, in the Alaskan tax statutes today, even what is being considered here at

the present time which is adverse to the incentives to go after what the industry feels is a marginal field prospect in Alaska. You don't have an onerous level of severance taxation, you don't have an onerous level of state income taxation and there is anything in the picture that I find is going to keep the industry out of Alaska. You know the industry responds very much to prospects. If they view the prospects highly attractive it is difficult to keep them out. What I'm trying to say is that if you have, I presume your directing your attention to the surcharge, I don't want to be in a position of defending the surcharge, that's not my position before the legislature, you asked me to be the devil's advocate I will, if you have a modest surcharge . . .

REMAINDER OF TAPE UNTRANSCRIBABLE

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TEL. 212-586-5263-4
CABLE "WALTLEVY"

January 20, 1976

The Hon. John Huber
Alaska State Legislature
Pouch V
Juneau, Alaska 99811

Dear John:

Needless to say we have heard and been intrigued by the proposals that have originated within your committee with respect to petroleum taxation. I do wish we could have gotten this first hand, and that is the point of my writing to you.

Would you send on to us copies of whatever bills are going into the legislative hopper? From our standpoint and also that of the legislative committees before which we may have to testify during the session, it would be most helpful to see them in good time.

All that is pro forma. More important, I would very much like to hear from you directly as to any questions and observations that may be relevant to your thinking and that of your committee about what we all agree is the very basic problem of Alaska's taxation: to what extent and by what means the State can appropriately identify its legitimate entitlement to the prospective earnings of the industry in Alaska.

With best personal regards and looking forward to seeing you in the course of the session, I am

Cordially,


Milton Lipton

ML:iw

AGO 513721

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STATEMENT ON AD VALOREM TAXATION OF
OIL AND GAS PRODUCING PROPERTIES

Robert H. Paschall

April, 1975

I. DEFINITIONS

- A. "Ad valorem" means "according to value" of the property. In regard to oil and gas properties, "ad valorem" does not mean or imply a given gross income or a given proven reserve of oil or gas. It means the best estimate of the price that might prevail in a sales transaction between two willing and knowledgeable parties. That and nothing more.
- B. An ad valorem tax on oil and gas properties is not a "tax on reserves" or a "tax on oil (or gas) in place." It is, instead, a tax on the value of the leasehold or other mineral interests which properly implies a tax on the value of the right to produce the oil and gas.

II. SOME HISTORY AND COMPARISONS

- A. Oilfields in California have been subject to ad valorem taxation for 60 years. Assessment and tax collection is done locally. In addition, the state levies an income tax that is 50-60 percent as large as the property (ad valorem) tax. The state does not levy a gross production tax.
- B. Oil and gas field values are reviewed and revised annually by professional staffs. The market value of all fields in California in 1974 was about \$4.7 billion, and ad valorem taxes were about \$115 million.

- C. Oil and gas field valuation (which is the assessor's main task relative to these properties) is actually less troublesome than the appraisal of heavy manufacturing plants, e.g., cement plants, steel mills, oil refineries. Put another way, the valuation of any complex property is a challenge, but not at all impossible. In fact--and this is a most important consideration--industry itself regularly makes appraisals. Every major oil company has a properties acquisition department and that department commonly must appraise oil and gas fields in all stages of development.

III. ELEMENTS OF AN INCOME-TYPE VALUATION

A. Definitions

1. The goal sought by the valuation engineer is the present worth of anticipated future net income.
2. Net income is gross income less the out-of-pocket expenses incurred in producing the gross income, that is, in producing the oil and gas.
3. "Present worth" is derived by discounting the future net income at an interest (discount) rate that reflects investors' goal of return on investment.

B. Elements Required by the Appraiser

1. Estimate of oil and gas reserves
2. Future rate of production
3. Prices of oil and gas
4. Operating expenses
5. Discount rate

IV. OBSERVATIONS ON VALUE AND ON AD VALOREM TAXATION

- A. Value is only a fraction of ultimate gross income (which in turn equals the barrels of oil or the MCF of gas multiplied

by their respective prices). My 1973 Prudhoe Bay value estimate was only 14% of ultimate gross income.

- B. Ad valorem taxes are directly tied to the profitability of a producing oil field. Since "profit" and "net income" are essentially synonymous, the higher the future net income, the higher the present value.
- C. The net effect of "B," above, is that a well administered ad valorem tax has the same effect on a producing oil field as a perfectly graduated severance tax. That is, when the field is new and has its highest value, the ad valorem tax might be 10 percent or more of gross income, and would then decline over the life of the field to zero when the field reaches its economic limit.
- D. Ad valorem taxation tends to stimulate development of any type of property, oil or other, not retard it. For example, it is notorious in South America that potentially productive farm land lies idle because it is subject to little or no property taxation.

Actually, economic analysts have criticized an ad valorem tax on oil as an undue stimulus to development and production. So statements that an ad valorem tax might hinder development of an oil discovery are incorrect.

- E. Distant income has little present value. If the discount rate is 15 percent, \$1.00 to be received in 1995 has a present worth of less than 7¢. This means that oil reserves estimates need not be precise if the reserve is to be produced over a relatively long period. For example, I cut off my Prudhoe Bay appraisal at the 20-year mark, although 600 million barrels of oil and 15 trillion cubic feet still remained. But the value shortfall that resulted amounted to

only a fraction of one percent. (A declining rate of production was also influential in this case, as well as the matter of diminishing present worth.)

F. Some Misconceptions on the Part of Senate Witnesses

1. One witness stated his belief that two fields with reserves of 150 million barrels each would both be appraised at the same value, even though one is difficult to produce and will last 30 years, and the other is easy to produce and will last just 15 years. Not so. The net effects of (a) different rates of production, (b) different operating expenses, and different discounting to present worth make it evident that the shorter-life field would have a greater value than the longer-life field--in fact, the value of the one would be about three times that of the value of the other.
2. Another witness was under the impression that gross income and value were the same, so his "estimate of value"--if it can be called that--was 8 to 23 times higher than reality, depending on whether one considered the tax on the total property interest or on only a native corporation's net profits interest in the property.

- G. Many precedents exist for the assessment and levying of ad valorem tax on shut-in oil and gas properties. Specifically, a shut-in gas field awaiting pipeline connection is now going into its third year of assessment in California. No one protested its taxability or the \$15 million that went on the assessment roll.

- H. A guide exists for the appraisal of oil and gas properties for ad valorem tax purposes. It is the California State

Board of Equalization's 266-page Assessors' Handbook 566, Valuation of Oil and Gas Producing Properties. That volume was subjected to lengthy and critical review by the oil industry ten years ago, and has since been used as an appraisal manual by all state and county valuation engineers.

V. ECONOMICS OF ADMINISTRATION IN CALIFORNIA

1974 Fair Market Value of Oil and Gas Fields	\$4.7 Billion
1974 Taxes	\$115.0 Million

Estimated Cost of Administration

Appraisal Staffs	\$345,000
Enrollment	68,000
Tax Collection	<u>135,000</u>

TOTAL	\$548,000
-------	-----------

Costs as Percent of Taxes	.48 of 1%
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Or Conversely, Net Tax Collection	99.52%
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SCOMM

#11:17

PROPERTY TAX ON OIL RESERVES, ALASKA

A
GOVERNMENT PROJECT REPORT

Presented to the
University of Alaska in partial fulfillment
of their requirements
for the degree of
MASTER OF PUBLIC ADMINISTRATION

By
James R. Deagen
Juneau, Alaska

May 1975

AGO 530365 +

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Graduate Program in
Public Administration

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UNIVERSITY OF ALASKA

May 9, 1975

Mr. James R. Deagen
RR 4, Box 4071
Juneau, AK 99803

Dear Mr. Deagen:

I am very pleased to congratulate you on your recent completion of your study, Property Tax on Oil Reserves, Alaska. It is easily one of the best studies which a student in this program has turned in to meet the requirements for a graduate degree in public administration.

Very shortly I will be contacting the President of the Southeast Alaska Chapter of the American Society for Public Administration to discuss the prospects of publishing and distributing your study with him and the association's Executive Board. For purposes of publication further editing may be necessary and, given the time-frame in which we would be operating, I would estimate that it would be four to six weeks before we could distribute the paper to interested readers.

In the meantime let me assure you that, under the formal terms of the research grant which the University of Alaska extended to you, the paper is your property to dispose of as you so wish. Under the terms of the grant you have met your obligations to the University of Alaska and to the Alaska Department of Revenue by providing copies of your paper to both agencies.

Sincerely,

A handwritten signature in dark ink, appearing to read "R. E. Newton".

Robert E. Newton
Associate Professor and
Program Coordinator

REN:sh
cc: President, S.E. AK Chap., ASPA
Commissioner, Revenue
Provost, University of Alaska, S.E.
Director, Student Services

AGO 530366

TO

Gallagher
(Eppenbach)

Martin
(Fackler)

Motley
(Hubbard)

Edenso

Poland
Huber ✓
Orsini
Rader
Butrovich
Meland
Rodey

Anderson
Cowper
Brown

Bradner
Miller

PREFACE

Taxation of oil in place evolved as a subject of interest to me because it was an obvious revenue producing option for the people of the North Slope as well as the State. Only after embarking on the study did I discover the ad valorem property tax to be a volatile subject of considerable contemporary interest. This interest was growing within the legislative and executive branches of Alaska State Government.

Thomas K. Williams of the Alaska Department of Law provided help far beyond the call of duty. John R. Messenger also of the Law Department was very helpful and attempted to keep me advised of impending testimony and the legal issues involved. Two of the nation's foremost experts on the subject of ad valorem oil property taxation, Robert H. Paschall of California and Edward S. Pritchard Jr. of Texas were very interested and helpful. Extensive useful information was supplied by E. Lee Bryant of Marathon Oil Company.

To these and more than thirty additional people who are listed in the bibliography, I wish to extend my sincere appreciation for the help and advice.

In acknowledging the assistance of these people, it should be made clear that they provided much valuable information and many insights, but I take full responsibility for the synthesis of observations and conclusions.

Finally, I would like to express appreciation to Dr. Robert E. Newton of the University of Alaska and Dr. Charles L. Schroth of the Alaska Depart-

ment of Revenue. Their guidance was invaluable. To Jeri who deciphered my nearly unintelligible scribbling - a very special thank you.

TAXING OIL IN PLACE

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INTRODUCTION

Taxing oil in place in the United States historically has provided a local government source of revenue. In oil producing regions, the local taxing entities have reaped the bounty, and in the localities with no oil, naturally no revenues have accrued from this source.

This paper examines the oil taxing procedures of the 16 states with the highest current production, (see Table 1 & 2). All of these were contacted for information on oil taxation. Thirteen replied. The remaining states with minor production would not be able to provide additional significant information. Companies with extensive oil exploration and producing equipment in Alaska were queried concerning their view of this type of tax. In particular, their analysis of ad valorem tax equity in comparison with the various forms of severance taxes was sought. Possibly this was not a realistic query, since the impact of the tax on each company has significantly more importance than the eventual spread of the taxes paid by that company. Taxes paid to all forms of government by the oil companies is included in this analysis. The paper then examines the general field of property taxation showing Alaska as relying on this form of taxation less than any other state. Finally, the paper concludes with a review of some of the expert testimony presented to the Resources Committee of the Alaska State Legislature concerning oil property taxes, and a look at the alternative methods of obtaining revenue to cover the "shortfall" in State of Alaska revenue for the 1976-78 period.

TABLE 1
OIL PRODUCTION LEVELS OF THE 16 HIGHEST OIL PRODUCING STATES

OIL PRODUCING RANK	STATE	OIL PRODUCTION (1,000 b/d)				Per Cent Change From:	
		Feb. 75	Aug. 74	Feb. 74	Feb. 73	Feb. 74	Feb. 73
1	Texas	3,339	3,596	3,654	3,538	- 9%	- 6%
2	Louisiana	1,943	1,970	2,132	2,388	- 9%	-19%
3	California	877	886	914	943	- 4%	- 7%
4	Oklahoma	490	490	498	535	- 2%	- 9%
5	Wyoming	374	418	420	353	-11%	+ 6%
6	New Mexico	267	272	268	295	--	-10%
7	ALASKA	201	202	189	194	+ 6%	+ 4%
8	Kansas	176	181	176	193	--	- 9%
9	Mississippi	135	143	151	163	-11%	-17%
10	Utah	108	109	98	73	+10%	+48%
11	Colorado	105	107	102	110	+ 3%	- 5%
12	Florida	99	104	90	77	+10%	+29%
13	Montana	91	97	97	93	- 6%	- 2%
14	Illinois	78	79	81	94	- 4%	-17%
15	North Dakota	54	54	55	56	- 2%	- 4%
16	Michigan	53	47	42	37	+26%	+43%

Source: Oil & Gas Journal: February 25, 1974, August 19, 1974 and February 17, 1975

TABLE 2
OIL PRODUCTION, VALUE AND RESERVES BY STATE

Rank As Oil Producer	State	Value of Crude Oil Produced in 1972 (Millions of \$)	Crude Oil Produced Barrels Per Day Average Per Well in 1972	Average Drilling Cost Per Well in 1971 (Thousands of \$)	Proven Reserves December 1972 (Millions of bbls.)	State Rank In Proven Oil Reserves (End of 1972)
1	Texas	\$4,536.1	20.7	\$ 85.4	15,036	1
2	Louisiana	3,201.7	93.3	284.1	7,164	3
3	California	944.3	23.6	66.6	3,680	4
4	Oklahoma	710.1	7.7	79.3	1,638	5
5	Wyoming	432.1	43.3	93.5	1,041	7
6	New Mexico	376.8	22.5	88.8	1,085	6
7	ALASKA	235.4	1,019.4	1,396.3	10,097	2
8	Kansas	259.6	5.0	21.8	846	8
9	Mississippi	192.5	65.2	210.3	327	10
10	Utah	80.7	78.8	294.1	278	11
11	Colorado	109.2	48.0	53.3	342	9
12	Florida	53.7	320.0	NA	217	13
13	Montana	103.9	28.8	44.9	246	12
14	Illinois	121.0	3.9	17.1	176	15
15	North Dakota	67.6	35.9	78.9	211	14
16	Michigan	41.6	9.4	61.6	81	21

Source: Statistics adapted from information published by the Independent Petroleum Association of America in Publication, The Oil Producing Industry in Your State, 1973 Edition.

CHAPTER I

OIL TAXES IN THE MAJOR PRODUCING STATES

The oil producing states utilize a wide variety of methods in taxing oil. A few states tax oil and gas property solely on the basis of its value: California, Illinois and Ohio (see Table 3).

The largest oil producing state, TEXAS, has a severance tax as well as a property ad valorem tax. The physical structure, the reservoir, everything involved in the oil and gas production process, is included in the ad valorem tax.

The State of Texas has no strong ad valorem tax coordinating and regulating function concerning oil properties although they do have a small ad valorem tax staff within the State Comptroller office.

The comptroller retains the responsibility for designing prescribed forms, auditing tax roles (but only with respect to collection of State taxes) and providing a manual for assessors. The current edition, which has been in use many years, includes regulations, opinions of the attorney general, excerpts from statutes, and instructions in assessing procedure. It is not a cost manual for appraisers.

About 200 of the 254 Texas counties have oil or gas productive capacity. Texas has a myraid of local jurisdictions: cities, independent school districts, junior college districts, hospital districts, navigation districts, and more. As of 1972, Texas had 3,624 local govern-

TABLE 3
TAXES ON OIL - 16 MAJOR PRODUCING STATES

RANK AS OIL PRODUCER	OIL PRODUCING STATE	AD VALOREM TAX ON OIL PROPERTY	SEVERANCE OR PRODUCTION TAXES		CONSERVATION TAX (MILL RATE PER BARREL)	SEVERANCE, PRODUCTION & CONSERVATION TAXES COLLECTED (in thousands of \$)	
			% OF WELLHEAD VALVE	% OF MARKET VALUE		1972	1973
1	Texas	yes	--	4-6%	1.87	\$307,368	\$334,797
2	Louisiana	in lieu	6.25 - 12.5%	--	--	236,485	259,455
3	California	yes	none	none	.63	1,554	1,407
4	Oklahoma	in lieu	--	5-7%	2.50	73,342	71,457
5	Wyoming	yes	1-3%	--	.40	5,075	16,130
6	New Mexico	no	--	3.75%	1.40	13,536	15,695
7	ALASKA	no	5-8%	--	1.25	12,341	10,893
8	Kansas	yes	none	none	1.50	687	711
9	Mississippi	in lieu	.6%	--	3.00	13,143	13,666
10	Utah	yes	2%	--	1.50	1,432	1,530
11	Colorado	in lieu	(3-5% of gross income)		1.00	524	795
12	Florida	in lieu	--	5%	--	2,250	10,240
13	Montana	yes	--	3-4%	3.75-7.5	2,668	2,692
14	Illinois	yes	none	none	--	0	0
15	North Dakota	in lieu	--	5%	--	3,306	3,140
16	Michigan	in lieu	--	2%	(1-10 mills)	929	1,076

Source: Statistics adapted from three sources: 1) the Independent Petroleum Association of America, The Oil Producing Industry in Your State, 1973 edition, 2) Correspondence from the Tax Department of most of the states listed, and 3) the American Petroleum Institute State and Local Oil and Gas Severance and Production Taxes, Jan. 1974, updated to October 1974.

ment units, 3,005 of which had property taxing power (in 1972, Alaska had 125 units, all having taxing power). Most of these taxing bodies are responsible for the administration of the property tax which, of course, includes the assessment of oil and gas reserves. Property taxes comprised approximately 60 per cent of all locally raised revenue. Unlike the California and Kansas underlying philosophy on this taxation (the value of the right to produce income from oil and gas) in Texas, they are more direct: the physical property itself is taxed (all of it).

Most of the taxing jurisdictions contract with three industrial evaluation appraisal firms located in Texas. Nearly all the large oil producing properties in Texas are appraised by two of these firms: Pritchard & Abbott and Thomas Y. Pickett. Pritchard & Abbott is the largest (Alaska has current contract with this firm). Like California, assessments require competent reservoir engineering as well as consideration of the historical record of value of production and potential value.

The property tax system in Texas does not provide equity in local government finance. This becomes particularly evident in the field of education. In Texas, the "Rodriguez Decision" has created interest in the property tax in education and other fields.

The current system of financing public education in Texas discriminates on the basis of wealth by permitting citizens of affluent districts to provide a higher quality education for their children, while paying lower taxes, (and) this court concludes...that the plaintiffs have been denied equal protection of the laws under the Fourteenth Amendment to the United States Constitution.

Rodriguez et. al. vs. San Antonio
Independent School District et al.¹

¹Advisory Commission on Intergovernmental Relations, The Property Tax in a Changing Environment (Washington, D.C., Government Printing Office, March 1974) p. 252.

Even though the Rodriguez decision was not upheld by the U.S. Supreme Court, it has stimulated considerable interest and debate among Texas tax administrators and property tax opponents. In Texas a reasonable, but politically untenable alternative would be a statewide property taxation program supplanting the local property tax.

Besides the ad valorem tax on oil property, Texas assesses a straight 4.6 per cent severance tax. The ad valorem tax combined with the severance tax balances the comparative advantages of the sliding scale severance tax. The varying range of the ad valorem tax on top of the severance tax probably puts the local Texas tax at about 4.7 to 10.0 per cent. Ed Pritchard, of Pritchard & Abbott appraisal engineers, contends the average of both Texas taxes is slightly higher than the average of Alaska's sliding severance. The Texas tax on gas is higher, which when combined with oil taxes definitely places Texas taxes higher than in Alaska. The oil companies (particularly SOHIO, ARCO, and Union) contend the current Alaska sliding severance is equal or higher than the Texas combined taxes. The hard data to compare the two states is not yet available, however, it is safe to conclude that on oil only, current Alaska taxes and Texas taxes are close, but when combined with gas severances Texas is higher.

Of the total Texas ad valorem taxes collected, the state received 17 per cent of ad valorem taxes collected from the municipal taxing bodies in 1974. This will decline to 12 per cent for FY '75, and 10 per cent for future years, according to current Texas statutes. This minor proportion of ad valorem taxes collected for the state is dedicated to higher education (mainly the University of Texas). Although the State of Texas has a small

ad valorem tax-unit, they are totally dependent on the county assessors and other municipal taxing entities, most of which are, in turn, dependent on the industrial property appraisal firms.

Second to Texas in oil production is LOUISIANA which produces about ten times the Alaska level. The severance tax on flush wells in Louisiana has recently been raised to 12 1/2 per cent, the highest rate of any state. Although the tax is not in essence a sliding scale severance, oil wells are classified and subsequently taxed under three different classes. The 12 1/2 per cent rate applies to oil wells producing at a "full rate." The second well classification is an "incapable oil rate" which is taxed at 6 1/4 per cent of value and the third classification, "stripper oil rate" which is taxed at 3 1/8 per cent of value. Owen Van Manning of the Louisiana Department of Revenue defines the "incapable" and "stripper" wells:

An incapable oil well is a well certified by the Department of Revenue as incapable of producing more than an average of 25 barrels of oil per day and also produces 50 per cent or more saltwater. A stripper well is a well that has been certified as incapable of producing more than an average of ten barrels of oil per day.²

The Louisiana severance tax brought in \$388 million in FY '74, nearly all from oil and gas. Oil production, however, has declined, down nine per cent from the year before and down 19 per cent from 1973. The relationship, if any, of higher state taxes to reduced production is not known by this writer.

Refineries and manufacturers of petroleum products are subject to an additional tax, a graduated occupational license tax based on gross

²Owen Van Manning, letter of November 6, 1974.

receipts.

A minor ad valorem tax on wellhead and downhole equipment is administered at the local level. There is no property tax on oil reserves. The severance tax is "in lieu" of property tax on reserves. The local tax revenues from the property tax total \$12 million, an insignificant fraction of the severance tax.

The property tax combined with severance equals about 13 per cent; much higher than Alaska.

CALIFORNIA, the third largest producing state has only one tax on oil and gas, the ad valorem property tax. They use a unique system of determining the value. The total volume of recoverable hydrocarbons in a reservoir is estimated on the basis of the physical characteristics of the reservoir.

Most other states with ad valorem taxes on oil use a formula to estimate the value of reserves in a reservoir usually based on the value of production of the well from the previous year. As mentioned earlier, appraisal techniques in Texas (and Kansas) consider the characteristics of the reservoir.

California has no severance tax, no special tax on producing equipment, and no tax on oil and gas reserves as such. Instead, taxes are based on assessments that derive from annual total property income-type appraisals made by county assessors. The tax rate ranges from zero to nine per cent of income produced from oil and averages about seven per cent. The average seven per cent is close to what the Alaska severance tax will produce on Prudhoe oil. According to Robert Paschall, Senior Petroleum and Mining Appraisal Engineer of the California State

Board of Equalization (the closest California counterpart to the Alaska Department of Revenue):

The upper end of the range is affected by two elements -- profitability and the local tax rate. High profitability means high value, and tax rates vary here in California from one jurisdiction to another.³

Property taxes in California will amount to about \$115 million in FY '75, nearly all of which will go to the counties and school districts. Unlike Texas, the State of California has a strong coordinating role in the industrial property taxing function.

As mentioned earlier, the basis of the tax has varying philosophical underpinning. Kansas is similar to California in that the value of the right to produce oil and gas is what is taxed, although the method of determining the value of that right is generally computed similar to the method used in Texas. Paschall explains the philosophy behind the California ad valorem tax as not a property tax per se, but rather a tax on the value of the right to produce oil and gas. It is a tax on the net income from exercising the right. The higher the production, the higher the rate of taxes which are paid. As the production rate declines, and the future income promises to be lower, the present worth is reduced and so are the taxes. A properly administered ad valorem tax, although distinctly different, has the same effect as a sliding scale severance tax.

Paschall strongly advocates either the property tax or the severance tax, but not both at the same time. He explains the critical difference between the California property tax and the sliding scale sever-

³Robert H. Paschall, letter of February 27, 1975.

ance tax:

An equitable severance tax should not exact as high a levy on a barrel of marginal oil production as it does from a barrel of flush production. But how can one establish an equitable sliding scale severance tax unless it can be related to net income per barrel? The ad valorem tax, as it is administered in California, does this automatically.⁴

Of all the states surveyed, the California property tax system appeared to have solid recent administrative history and other beneficial aspects that could be applied to a similar tax if enacted in Alaska.

A recent report by the Advisory Commission on Intergovernmental Relations supports this relative excellence of the California overall property tax system:

The type of reassessment program once common in the United States -- massive revaluation efforts often followed by years of roll copying -- is a thing of the past in California. Every county now has a continuing reassessment program. This has resulted from a number of major developments which are still underway involving pioneering technical efforts by some local assessors and the staff of the State Board of Equalization; and involving a great deal of State-local collaboration and intercounty sharing of experience.⁵

State involvement in property tax administration is strong and effective in California:

Tremendous changes in property tax administration have occurred in California since 1962. Many of them stem from a scandal that broke early in July 1965 and was described at length in the September 10, 1966, Saturday Evening Post. After one county assessor had committed suicide and two assessors, as well as several deputy assessors and tax agents, had been convicted of felonies, the California legislature enacted Chapter 147 at an extraordinary session in June of 1966. This statute shifted the emphasis from local autonomy to State supervision of assessors, provided for vastly increased auditing of property statements, and gave taxpayers better appellate opportunities.⁶

⁴Robert H. Paschall, Valuation of Oil and Mineral Rights, Arizona State University, 1971.

⁵Advisory Commission on Intergovernmental Relations, The Property Tax in a Changing Environment, (Washington, D.C. Printing Office, March 1974) p. 61.

⁶Ibid. p. 56.

Those in the oil industry and consultants to the Alaska State Legislature who contend that the property tax is expensive to administer should consider the California experience. Paschall, testifying before the State Senate Resource Committee in April 1975 reported roughly \$6 billion is collected at a "central service" State expenditure of less than \$5 million. He stated that the assessments on oil and gas property alone amounted to \$115 million in revenue, with an overall cost of administration approaching \$548,000. The cost of administration came to about one-half of one per cent of revenues, a very efficient ratio. Comparatively, the much smaller scale property tax on oil equipment cost about two per cent of revenues.

Consideration of the property tax as a short term tax to cover the shortfall in Alaska State revenues, or to eventually be credited towards the future severance tax, brought forth a key point of contention on property taxes of oil properties: should oil property without a pipeline allowing production be taxed? Are there any precedents? Paschall offered some illuminating points:

You asked in your recent letter whether I could provide you with any examples of oilfields on which ad valorem taxes were levied at a time when a field had not yet been connected to a pipeline. I know of numerous instances of this nature involving gas wells, so it comes to the same thing. Quite commonly in the past gas wells have been drilled and completed but not hooked up to a pipeline as long as two years after the date of completion.

It may be useful to remark that it is not germane under California law whether a well is hooked up or not, so far as its ad valorem tax liability is concerned. The key element is that the well have demonstrable value, since "ad valorem" means "according to value." Of course, a well that is not yet hooked up typically has a lower value than a producing well with similar reserves, simply because the income of the first well will not be received until some perhaps uncertain time in the future.⁷

⁷Robert H. Paschall, letter of February 27, 1975.

Although similar examples of precedents were not requested from Texas, Pritchard was unequivocally opposed to enacting a property tax on oil property until the property was potentially able to produce revenue. The Pritchard and Abbott firm probably has considerable opportunity for financial gain from a potential Alaska property tax on oil properties as they would be prime candidates for contractual work on appraising the fields based on their significant record of accomplishments, as contractor and advisor, on the recently enacted 20 mill tax on oil and gas "chattel" property used in exploration, production and pipeline transportation. Although all executive personnel of the firm interviewed were strong advocates of the property tax on oil reserves as well as other industrial properties, they were not in favor of this tax on a resource which could not produce income.

In OKLAHOMA, the fourth ranked oil producing state, the primary form of taxation on oil and gas is the gross production tax, which is five per cent of the gross value. The payment of this production tax is in lieu of all taxes by the State or any sub-jurisdiction upon the producing leases, the oil or gas itself, or machinery and equipment used in the production of oil and gas.

Of the sixteen major producing states, twelve have a severance type of tax. Of these, only Oklahoma, Louisiana, Mississippi, Florida and Michigan provide that their severance tax is an outright in lieu tax. Property tax exemption, however, does not always mean the same thing. In Oklahoma, as in Mississippi, the severance tax is not only in lieu of property tax on the reserves in place, but also on all machinery and equipment used in production of oil and gas.

The gross production tax is administered by the Oklahoma Tax Commission. The production tax is dedicated primarily to the State where 78 per cent is appropriated to the General Fund and two per cent is allocated to collection and enforcement. Municipal sources receive the other one-fifth with ten per cent to the school districts.

W.L. Elvany, Director of the Gross Production Division of the Oklahoma Tax Division, describes the Oklahoma ad valorem taxes and their method of administration:

Ad valorem taxes in Oklahoma are assessed by the county assessor, except on railroad and public service corporations, whose assessments are administered by the State Board of Equalization on the basis of recommendation of the Tax Commission. Pipeline companies are held to be public service corporations. Their assessments are determined from year to year by appraisal rather than by fixed schedules of value per mile by pipe size. The Tax Commission also recommends to county assessors schedules of value to be applied to such properties as oil in storage, tankage, gasoline plants, pipe, etc.⁸

Undeveloped leaseholds are not taxed in Oklahoma.

The combined gross production tax and ad valorem tax of Oklahoma is lower than current Alaska taxes on oil.

WYOMING, the fifth ranked oil producing state has an ad valorem property tax in addition to a three per cent severance tax (one per cent on wells producing less than ten barrels a day). The ad valorem tax on oil lease property is based on the preceding year's gross production in lieu of taxes on the land, but in addition to taxes on surface improvements the oil lands with an appraised valuation of \$485 million in 1974 yielded \$27.4 million in ad valorem taxes. This is one of the few states which considers the oil and gas property to be personal property for taxing purposes.

⁸W.L. McElvany, letter of February 7, 1974.

According to Harold De Bolt, Director of the Ad Valorem Tax Division for the State of Wyoming, Department of Revenue and Taxation:

The Wyoming Constitution provides that a four mill levy may be levied for ad valorem property tax, however, the state financial condition has been such that it has not been necessary to apply the four mill levy during the past four years. Therefore, all the ad valorem taxes...have remained in the local taxing districts in which the production was held. Our legislature is now in session and there is a good possibility that the three per cent severance tax on oil will be advanced to four per cent. In addition to the ad valorem (property) and severance taxes on production, which our State assessed, the county assessors assess all the above ground oil or natural gas producing equipment, i.e., pumps, tanks, gathering lines, moters, etc.⁹

Wyoming has no taxes on corporate income. Oil taxes in Wyoming are less than in Alaska.

NEW MEXICO, sixth ranked and the only other state producing more than Alaska, previously imposed nearly every type of oil tax: a severance tax, a special excise tax on the income from the sale of oil and gas, and a net proceeds type of ad valorem tax. However, as of January 1, 1975, the ad valorem tax statutes were changed -- now there are no taxes imposed on oil and gas in place in New Mexico. One feature of New Mexico's tax system that Alaska should consider is that all oil related taxes are based on the same evaluation and are administered through a central agency (all in one building). Even the royalties are administered from this central agency. Antonio L. Martinez, Executive Director of the Oil and Gas Accounting Commission for New Mexico feels they have the most efficient oil revenue system in the nation:

New Mexico is considered to have the most efficient oil and gas collection and revenue distribution system in the nation since all production taxes and royalties due are based on the same evaluation and are administered by one central agency.¹⁰

⁹Harold De Bolt, letter of February 27, 1975.

¹⁰Antonio L. Martinez, letter of December 26, 1974.

KANSAS, ranking eighth, produces slightly less oil than Alaska. They have a property tax on the production of oil and gas, and on oil and gas reserves. There is no severance tax in Kansas. Kansas enacted a severance tax on oil and gas production in 1957, however, six months later the State's Supreme Court declared it to be unconstitutional. Since that time the severance tax issue has surfaced in various legislative sessions, however, there has never been a major effort towards it's re-enactment. Although the State coordinates and administers the property tax for the municipalities, some oil-rich municipalities contract with the Texas firm, Pritchard & Abbott, for oil evaluation appraisals. Kansas statutes specifically state that oil and gas leases are assessable at their actual market value.

Although Kansas has a "good reputation" among oil taxing states, there are gross inequities in the spread of oil tax revenues. The oil-rich counties simply get all the revenues. This also occurs in California and Texas. The ad valorem tax contemplated in Alaska is a statewide tax. However, pressure can be expected from the municipalities to gain a large proportion of the taxes collected, as property taxes accruing to the local taxing jurisdictions have strong precedence throughout the states. Although the Alaska Constitution prohibits dedicated taxes; a property tax on oil reserves if dedicated to revenue sharing and education would eliminate the local taxing jurisdiction and at the same time provide alternate revenues to cover the shortfall in state revenues.

In Kansas, oil and gas property is assessed as personal property. The property is appraised at fair market value and assessed at 30 per

cent of that value. The State of Kansas, Division of Property Valuation, is required to furnish property assessment manuals to all local assessors. Kansas statutes require the local assessor to conform to the State manual.

The conservation tax rate is 1 1/2 mills in Kansas and one additional mill accrues to the State Board of Health. Kansas oil taxes are well under Alaska oil taxes.

MISSISSIPPI, the ninth ranked oil producing state, has a severance tax at six per cent of wellhead value. As in four other of the top sixteen producing states, the severance is in lieu of property taxes. All producing oil equipment, including wells, pumps, derricks owned by the producer and all leases in production including mineral rights are exempt from ad valorem taxes of the local taxing districts. The exemption does not apply to oil exploratory equipment. All drilling equipment, including derricks utilized in drilling, machinery used in drilling, oil gathering systems, and the surface of lands leased for oil production are assessed as other properties in Mississippi and are subject to ad valorem taxes. The State provides part of the severance tax collected to the county in which the oil is produced. One-third of the first \$600,000, ten per cent of the next \$600,000, and five per cent of that collected over \$1.2 million is paid to the county.

Mississippi imposes a franchise tax of \$2.50 for each \$1,000 of capital assets. Also, they have an insignificant maintenance tax of three mills per barrel, similar to the Alaska Oil and Gas Conservation Tax of 1.25 mills per barrel. Of the sixteen major producing states only in Montana is this conservation tax rate exceeded. Virtually all oil producing states have this tax to cover the expense of administration of

the oil regulatory agency, however, mention of this tax has often been omitted in earlier state tax analyses because of its relative insignificance in comparison to property, production and severance taxes.

Mississippi has a State income tax amounting to three per cent of the first \$5,000 of net income and four per cent of all income over \$5,000. Overall, the taxes on oil in Mississippi are slightly lower than the comparable oil taxes of Alaska.

UTAH, the tenth ranked oil producing state, has experienced the largest percentage increase in production over the past two years. Utah has a form of severance tax called an occupation tax as well as an ad valorem tax. Both are assessed at the state level, with the revenue from the occupation tax going to the state and the revenue from the ad valorem tax going to the county where the oil producing property is located.

The ad valorem tax is based on the gross proceeds and does not apply to oil reserves. According to Robert Cooper of the Utah State Tax Commission:

The ad valorem assessment on oil and gas is based on 80 per cent of the gross proceeds, times the interest the owner or operator has in the property. In other words, if the oil is recovered from privately owned land, the assessment would be 80 per cent of the total revenue. In addition to this, there is a flat well assessment made on flowing and pumping wells. This assessment is static and allows for no depreciation. ¹¹

The occupation tax rate on oil and gas is only two per cent of the gross proceeds realized from the sale of the product, converted to the wellhead price, and allowing a \$50,000 exemption per tract (depending on whether exempt royalties are paid by the operator).

¹¹Robert H. Cooper, letter of March 12, 1975.

The conservation tax in Utah is 1-1/2 mills, slightly higher than in Alaska, but at the median of the sixteen major producing states.

Cooper makes an interesting point concerning the reluctance of Utah to tax oil in place.

The State of Utah has tried to steer clear of a tax on oil reserves, partly because of experiences we have had in assessing coal reserves, which have proven very unsatisfactory. The element of the unknown, which is constantly involved in establishing reserves, seems to continually haunt states where an attempt is made to tax on a reserve basis.¹²

Current Utah taxes on oil are less than Alaska taxes on oil.

COLORADO, the eleventh ranked oil producing state produces at about one-half the Alaska level. A corporate income tax serves as the basic source of revenue from oil to the state.

In addition to the state income tax, they have an additional tax on gross income from the production of oil and gas. The tax rates are: under \$25,000 gross income - two per cent; from \$25,000 to \$100,000 - three per cent; from \$100,00 to \$300,000 four per cent tax; and all gross income over \$300,000 at five per cent. It is an in lieu type of gross income tax, however, the ad valorem taxes paid to the municipal taxing districts are credited to the gross income tax.

The responsibility for property valuation in Colorado is delegated mainly to local jurisdictions, most of which are too small to afford a professional organization. The state property tax agency operates with a relatively slim budget and limited supervisory powers, but according to the Advisory Commission on Intergovernmental Relations, Colorado, has developed a useful program for the measurement of assess-

¹²Ibid.

ment levels and variations.

At the county level, the ad valorem property tax in effect covers all oil property and equipment. An average rate of 89 mills on 30 per cent of actual value is collected by the municipal taxing authorities. According to Jack O'Donnell, Senior Property Appraiser of the State of Colorado, Division of Property Taxation:

In Colorado, producing oil or gas leaseholds and lands have an assessed value equal to 87 1/2 per cent of the gross value of the oil or gas produced during the preceding year. This value is in addition to the regular actual value of the land.

Severed mineral interests (nonproducing) are assessed at 30 per cent of actual value in the same manner as other real property. If there is no market in this type of property, a minimum assessed value of one dollar per acre is used.

All surface oil and gas well equipment is separately valued for assessment as personal property at 30 per cent of its actual value.

The ad valorem taxes are determined by multiplying the assessed valuation by the total levy in the tax jurisdiction wherein the property is located. The statewide average mill levy in Colorado is now 82.02 mills. However, many of the oil and gas fields are located in rural areas where the total levy is less than the state average.

All taxable property, except that of public utilities, is valued by the local county assessors under the guidance of the Division of Property Taxation.

All ad valorem taxes are collected by the local county treasurers and remain in the counties wherein collected. The State of Colorado receives no income from ad valorem taxation.¹³

The oil and gas conservation levy is one mill, slightly under Alaska's 1.25 millage rate. Overall, the Colorado oil taxes are slightly lower than Alaska's taxes on oil.

FLORIDA, the twelfth ranked state in oil production has an excise

¹³Jack A. O'Donnell, letter of March 27, 1975.

tax of five per cent of the gross value of production. This production tax is in lieu of ad valorem taxes. The state general fund receives 80 per cent of the proceeds and the county in which the oil is produced receives the remaining 20 per cent. In essence then, one per cent of the production tax on gross value reverts to the county to pay the ad valorem tax on the "personal property" used in production.

The county tax assessors are prohibited from increasing the value of property on the basis of proven oil or gas reserves.

Florida, like Alaska, has experienced moderate increases in oil production over the last two years. Of the sixteen major producing states, only two others have realized advancing production levels.

MONTANA, the 13th ranked oil producing state, has three direct taxes on oil production: the Oil Producers License Tax, Resource Indemnity Trust Tax and Net Proceeds of Mines. All three are administered by the State with the proceeds of the License Tax and the Trust Tax becoming part of the state general fund and the receipts of the Net Proceeds Tax going to the local taxing jurisdictions.

The License Tax and the Trust Tax are both based upon a percentage of gross value. These two are more commonly referred to as severance taxes. They are actually one in the same and are separated only for the purpose of assigning the proceeds to different funds.

Montana makes heavy use of the property tax. Only two of the top sixteen oil producing states do not have a statewide sales tax, Alaska and Montana. Conversely, when looking at the relative burden from property tax as a proportion of personal income, Table 4, Montana has the highest rate and Alaska the lowest (in 1970-71).

K.K. Morrison, Chief of the Intercounty Property Bureau of the Property Evaluation Division of the Montana Department of Revenue describes the ad valorem tax:

The Net Proceeds Tax is an ad valorem tax upon oil, as it is produced. The State of Montana is charged with the determination of the net proceeds from information provided by the oil producers. Upon determining the Net Proceeds, the State furnishes the county assessors with the information. The Net Proceeds then become part of the county's tax base the same as all other taxable property. The tax rate applied to the Net Proceeds would depend upon the mill levy in effect for the location of the oil production. The State does not receive a portion of the receipts, except to the extent of a State permissive levy may be included in the total mill levy.¹⁴

Montana was the only state surveyed which has centralized all property tax assessment at the state level (constitutional amendment effective July 1973).

Unlike the Alaska tax on oil exploration and producing equipment at 100 per cent of value, the states with ad valorem taxes on oil property assess at a rate less than 100 per cent. Montana, like Texas, assesses at 40 per cent of full value. The equipment in Louisiana is assessed at 20 per cent of value and in California, everything is assessed at 25 per cent of its full value. Concerning the assessed value in Montana, Morrison explains the process:

There are two steps which are taken to arrive at the tax base. First assessed value is approximately 40 per cent of full value. Secondly, the base or taxable value is between seven per cent and 100 per cent of the assessed value, as determined by a classification system.

The State permissive levy including University millage is limited to 18 mills. In 1974 only six mills were applied. It should be noted that the funds generated by the State millage are earmarked to finance local schools as a supplement to county millage for schools.¹⁵

¹⁴K.K. Morrison, letter of February 21, 1975.

¹⁵K.K. Morrison, letter of February 13, 1975.

TABLE 4
STATE AND LOCAL GOVERNMENT PROPERTY TAX REVENUE IN THE 16 HIGHEST OIL PRODUCING STATES, 1970-71

Oil Producing State	Property Tax per \$1,000 of Personal Income	Per Capita Amounts		As of % of Total Tax Revenue			As of % of Government Revenue		
		Total	Local	Combined	State	Local	Combined	State	Local
Montana	\$70.84	\$235.04	\$222.90	55.6	6.3	96.6	31.6	2.7	60.2
California	67.45	296.27	284.20	49.1	4.3	88.1	32.3	2.4	42.5
Wyoming	65.74	228.35	202.25	47.3	9.5	97.0	23.8	4.1	41.7
North Dakota	63.63	188.15	185.89	44.9	1.0	96.8	24.3	.4	51.3
Kansas	55.06	209.67	205.04	50.4	2.3	97.1	32.4	1.3	49.5
Colorado	50.52	187.40	186.52	41.9	.4	83.9	25.6	0.2	42.6
Michigan	50.39	202.33	192.32	41.2	3.5	92.2	27.5	2.3	41.5
Utah	44.95	139.74	127.83	36.1	4.9	89.5	20.4	2.4	39.9
Illinois	44.56	199.54	199.50	38.9	---	85.7	27.7	---	46.6
U.S. AVERAGE	47.37	185.51	178.03	39.9	2.2	84.6	26.1	1.3	39.9
Texas	39.62	137.15	131.58	40.0	2.9	87.2	24.4	1.7	40.9
Florida	35.80	126.83	121.76	33.9	2.2	81.6	21.9	1.5	32.1
Oklahoma	29.99	97.53	97.53	30.2	NA	84.3	16.2	NA	34.3
Mississippi	29.93	76.72	74.87	24.3	.8	90.6	12.9	.4	24.3
New Mexico	28.38	87.78	72.35	22.4	5.0	87.6	11.4	2.6	20.2
Louisiana	23.79	71.95	64.27	19.0	2.9	58.0	11.0	1.6	20.4
ALASKA	23.64	105.74	105.74	22.7	NA	75.4	6.8	NA	19.4

--- Less than .05 per cent

NA Not applicable

Source: Taxable Property Value and Assessment - Sales Price Ratios, Volume 2, Part 2, 1972 Census of Governments, U.S. Department of Commerce, Social and Economics Statistics Administration, October, 1973.

In comparing the approaches to oil field taxation by Alaska and Montana it appears that the Alaska severance tax rate exceeds the Montana severance tax by as much as 4.8 per cent. The ad valorem rates in Montana would make up the difference, resulting in an overall tax impact of state and local to be about the same in Alaska and Montana.

ILLINOIS, the fourteenth ranked oil producing state, has no severance or production taxes only an ad valorem tax. The formula for determining value includes four elements: the volume of production, the depth of the well, age of the well and nature of the reservoir (sand or limestone which is more or less determined by the depth factor). The assessments are made locally and the entire tax collected accrues to the local units of governments.

Although Illinois receives no taxes from oil or gas, a detailed formula is published by the Illinois Department of Revenue for use of local taxing entities. The Property Assessment and Equalization Supervisor for the State of Illinois, Department of Local Government Affairs, Gregory Lafakis, states, "the recommended formula is felt to be outdated and not reflective of the current value of oil reserves. Accordingly, the entire formula is in the process of being updated."¹⁶

Of all the states checked in this paper, the State of Illinois receives the least from the production of oil. The local taxing authorities in Illinois receive far less proportionately than the combined state/local taxes in Alaska.

In the states with ad valorem taxes that have relatively minor

¹⁶Gregory J. Lakakis, letter of March 27, 1975.

production, the assessment formula is simple - usually total production in barrels times average field price equals full market value to which the level of assessment, usually 20 to 40 per cent is applied. The obvious shortcoming of this type of formula is that it doesn't take into account the costs of production. A full flowing well gets the same value and assessment as a stripper well with high operating costs. The Illinois formula, similar to the procedure in the major producing states of California and Texas, eliminates these inequities.

E. Lee Bryant, Manager of the Property Tax Department of Marathon Oil Company discusses the Illinois ad valorem formula:

The Illinois formula provides for additional value on the royalty interest, which is done in many states, based upon the premise that the royalty interest does not bear any of the costs of production and hence should command a higher market value.

The value per barrel is lower for flush (and in some instances for intermediate) production than for settled production. This is done primarily to reflect the characteristic of Illinois production of a relatively high rate of initial production followed quickly by a rapid rate of decline, particularly in the limestone formations. It was concluded that to use the temporarily high initial production levels as a measure of the remaining recoverable oil would be to exaggerate the latter. The credit for secondary recovery operations embodies this same theory, plus the factor of added production cost.¹⁷

NORTH DAKOTA, the fifteenth ranked oil state, produces at about one-fourth the Alaska level. A five per cent production tax is in effect which applies to the gross value at the wellhead. This production tax is in lieu of all ad valorem taxes.

In MICHIGAN, the sixteenth ranked state in oil production, a two per cent severance tax applies to the gross market value of oil produced. This low severance tax is in lieu of all other state or local taxes

¹⁷E. Lee Bryant, letter of December 26, 1974.

including ad valorem taxes on oil property.

Concerning the Michigan property tax in general, it serves as a major source of revenue to the municipalities, providing about 92 per cent of local government revenues. (See Table 4.) Property tax per capita in Michigan takes a higher proportion of personal income than the U.S. average. The State Tax Commission has supervisory powers over municipal assessors and actively assists them (similar to the situation in California). Additionally, each county is required to establish a Department of Equalization to assist the local assessors in equalizing the assessment rolls.

The remaining states produce less than one-fourth the Alaska level and subsequently have relatively minor tax receipts from oil. At least three other states have an ad valorem tax on oil and gas reserves: Ohio, Nebraska and Kentucky. All three use a simple formula of production times value per barrel without regard to reservoir engineering which would bring a lower tax on marginal wells.

One Canadian Province, Alberta, was compared to the sixteen oil producing states. Alaska has more similarities with Alberta than the other states; in climate, in population and in oil reserves. Alberta relies on the royalty for revenue and have only one other tax, a Freehold Mineral Tax. The royalty is a sliding scale royalty. The Director of Finance of the Province of Alberta, L.H. Montgomery describes the tax:

In addition to the sliding scale type of crude oil royalty which dedicates approximately 15 % to 25 % of the value of production to the Province, there is an incremental royalty of approximately 65% of any price increase in excess of \$4.71 per barrel (select price as of January 1, 1975).¹⁸

¹⁸L.H. Montgomery, letter of April 9, 1975.

The Province now realizes a crude oil royalty of approximately 36.4 per cent of the production from Crown (national) lands. The combination of Alaska taxes and the royalty do not approach the provincial revenues from their rich oil resource.

In Alberta, the title to about 81 per cent of the oil and gas reserves are held by the provincial government. About nine per cent is within national parks or Indian reservations. The remaining ten per cent is under freehold title (privately owned). A mineral tax of 16 mills on the assessed value over \$50,000 applies to the privately owned oil lands.

According to Montgomery:

With respect to mineral tax, owners of freehold minerals are assessed on petroleum and natural gas at the fair value of remaining recoverable reserves of crude oil and raw gas. The rate of tax levied upon the assessed value in excess of \$50,000 was 16 mills on the dollar for 1974.¹⁹

So, Alberta has a simple system which extracts more revenue from the petroleum resources of its territory than any state of the Union. They have no severance, no production, one specific corporate income tax and an ad valorem tax applying only to the one-tenth of the resource which is in private lands.

The oil companies which contend the Alaska rate is already too high may wish to change their frame of reference to include other Northern regions of North America.

¹⁹Ibid.

CHAPTER II

OIL COMPANY TAXES

How do the oil companies active in Alaska regard a property tax on oil reserves? Seven of the eleven major oil companies active on the North Slope responded to a letter of inquiry which asked their evaluation of alternative oil taxes in terms of fairness and equity. All inquiries were directed to the Property Tax Divisions within the oil companies. The question basically was phrased: "Any information you can provide on the general topic of property taxes on oil reserves; and specifically on your position on this type of tax in contrast to royalties or severance taxes would be of considerable value." It would have been preferable to exclude the concept of royalties in the inquiry.

Royalties are negotiated between the producer and owner of the oil and, therefore, on leases already firm need to be considered independently from production or property taxes. On future leases though, they should be considered within the framework of a broad based, well balanced state revenue system. The recent change in royalty rate in Alaska from one-eighth to one-sixth is comparable to recent movements in other large oil producing states. Unlike Alaska, other oil producing states receive insignificant payments from royalties because most oil producing properties in those states are in private ownership.

Standard of California felt the subject too complex for a response. Evidently, Exxon, Mobil, Phillips and Amoco also considered the subject

overly complex, as they did not respond. Marathon provided an in-depth analysis. Of the six companies which did send information; Atlantic Richfield and Sohio were most strongly opposed to a property tax. Sohio speaks for British Petroleum on tax matters, and with Atlantic Richfield have the largest known reserves on the Slope. Atlantic Richfield has a section established in Anchorage exclusively to monitor Alaska oil taxes. Thus, Atlantic Richfield serves as the industry "bellwether" through its Alaska tax manager, Robert Underwood.

The principal objections to the property tax on oil reserves follow a similar pattern. According to Underwood:

-- A tax on oil reserves is probably the most difficult to administer and the most controversial form of oil and gas taxation.¹

D.M. Parker of Shell Oil mentions the same point:

Generally an ad valorem tax on reserves is a difficult and costly tax to administer. Determining an equitable value on the reserves (which involves estimating both the amount of the reserves and their unit value in their unproduced state) requires the skill and knowledgeable background of highly qualified petroleum engineers... Severance taxes are generally considered to be easily administered from the collection standpoint...²

In contrasting the advantages and disadvantages of the severance and property taxes; R.S. Broberg, Manager of the Property Tax Division on Union Oil explains:

A property tax system requires expertise in evaluation far beyond that which is necessary to police a severance tax. The appraisal problems are continual because of the requirement that the valuation be established every year. A severance tax, while easier to administer, is also easier to revise should a taxing jurisdiction choose to do so. A property tax system requires an annual review of the basis for taxation.³

¹R.M. Underwood, letter of November 14, 1974.

²D.M. Parker, letter of November 4, 1975.

³R.S. Broberg, letter of November 9, 1974.

The complications of appraising the oil field are also noted by E. Lee Bryant, Manager of the Property Tax Department for Marathon Oil Company:

Reservoir engineering is not an exact science and differences of opinions between competent engineers occur frequently as to the amount of recoverable reserves that can be produced from newly discovered fields or even in existing fields with a long history of production. Add to this the problems encountered with predicting production costs in times of inflation and income to be produced under government controls and you arrive at an answer with adversary results.⁴

Although the oil companies unanimously contend that a property tax is difficult and costly to administer; those who administer this type of tax do not agree. Basically, they feel that the advantages far outweigh the relatively slight higher costs involved. The two largest oil producing states which have a property tax; California and Texas discount the arguments of complexity and excess cost of administration.

The ad valorem tax on oil properties in Texas and California have developed through the decades concurrent with the growth in the industry. Strong historical precedents underly the system utilized in both states.

As noted earlier, those that administer the property tax contend that it is relatively easy to administer. In California Paschall comments on the cost of administration, "19 appraisers and 13 clerks handle the annual reappraisal of about \$3.5 billion worth of properties, that yield over \$80 million in taxes."⁵ In Texas, the cost is higher, how much higher is not known because of competitive reasons of private valuation firms. However, the point of cost and complexity of administration cannot be

⁴E. Lee Bryant, letter of December 26, 1974.

⁵Robert H. Paschall, The Valuation of Oil and Mineral Rights, Arizona University, 1971.

seriously considered a deterrent in the Texas experience since the cost would be a minor part of the ad valorem taxes collected.

The second major issue in opposition to a property tax on oil reserves, suggested by all oil companies responding to the mail inquiry is that the Alaska tax rate now in effect is equal to or higher than the other major producing states. This issue is more important and also more difficult to assess. According to G.W. Ashmore, Manager for Alaska Taxes for Sohio (Sohio also handles tax matters for British Petroleum):

Alaska's severance tax on oil of about 8 per cent plus its ad valorem tax on production equipment, equals or exceeds the tax imposed by California and Texas and may be just slightly under the Louisiana tax. Overall, Alaska's tax is equal to or greater than the effective rate of the other important oil states and higher than many of the lesser important oil states.⁶

Broberg of Union Oil stresses the same point:

The State of Alaska, under its present statutes, has imposed a rather high severance tax and, in addition, has recently imposed a further burden in the form of a state property tax on all producing and transportation facilities, ...As you can see, if a property tax on oil and gas reserves is imposed, such added tax would push an already high burden to a point beyond all reason. ...The three levels -- severance tax, property tax on producing and transportation facilities, and property tax on oil and gas reserves -- could bring the level of tax burden above that imposed by other states where Alaskan crude oil must compete.

From Atlantic Richfield, Underwood approaches this point from a somewhat different angle:

-- In those few areas of the United States where underground reserves are taxed (most are at the local level) there is a notable absence of some of the other taxes imposed on the petroleum industry in Alaska, i.e., the oil and gas production or severance tax, the 20 mill facilities tax, and the corporate income tax.⁸

⁶G.W. Ashmore, letter of November 26, 1974.

⁷R.S. Broberg, letter of November 9, 1974.

⁸R.H. Underwood, letter of November 14, 1974.

Underwood is the only oil company tax official noting the corporate income tax, probably because the oil companies have been able to avoid any significant tax payments under this particular tax. Although Marathon Oil Company did not compare the Alaska tax rate with that of other major oil producing states, Bryant wrote:

...We feel that the present severance tax as imposed by the State of Alaska plus the 20 mill tax levied against our producing and transportation properties constitutes more than our fair share and we would be opposed to additional property taxes on reserves.⁹

According to H.A. Roberts, Tax Representative of the Property Tax Department of Texaco Oil Company:

According to the latest statistics we have, Alaska is already taxing oil at a rate as high as any in the nation.¹⁰

If Alaska oil is to be considered solely in competition with the other states, the rate of taxation is a critical issue. However, Alaskan oil will be competing with international oil. The rate of taxation or income to foreign countries is substantially above any domestic taxing rate.

A third argument made by the oil companies is that a state should have a property tax or a severance tax but not both. Roberts of Texaco makes the point:

Texaco is not opposed to a severance tax on oil and gas production, or a property tax on the value of reserves per se, providing they are part of a well balanced system. If property tax rates are uniformly applied to all classes of property, including the value of oil reserves, then no severance tax should be imposed. To do so, would only discriminate against a single industry, and result in its bearing a disproportionate (sic) or unfair share of the tax burden.¹¹

⁹E.Lee Bryant, letter of December 26, 1974.

¹⁰H.A. Roberts, letter of October 28, 1974.

¹¹Ibid.

There are some pretty strong arguments for higher proportionate taxes on more profitable industrial enterprises. This paper will not diverge into the issue of "windfall profits." Although the "fair share" argument is not an overly convincing one, the necessity of having more than one major tax on oil is questioned by industry and taxing agencies alike. Parker, Senior Tax Representative of Shell Oil Company argues:

A severance tax is a compulsory payment imposed by the state upon individuals or firms for the privilege of severing or extracting certain natural resources from the earth or water ...Such severance taxes are generally in lieu of a tax on the resource itself, such as an ad valorem tax on oil reserves. Severance taxes are generally considered to be easily administered from the collection standpoint and believed to be geared to the ability of a taxpayer to pay since the severance taxes are uniformly exacted from current production revenues.

In addition to the severance tax, Alaska imposes a State Income Tax, an Oil and Gas Conservation Tax for the support of the Division of Oil and Gas, as well as a significant State and Local Borough Property Tax on oil and gas production and pipeline transportation equipment. ...The State already exacts a considerable tax burden from the oil and gas industry by imposing most of the taxes generally levied by other oil-producing states. Usually a state does not impose both a severance tax on production and an ad valorem tax on reserves....

Your letter does not indicate whether this ad valorem tax on reserves would be pyramided on top of the present tax burden, or whether it would replace the Severance Tax.¹²

Other oil company responses included recommendations for either a severance or property tax but not both. Paschall agrees: "one or the other should be utilized, not both." The severance tax officials in Texas feel the severance tax alone would be more efficient, but the property tax officials and evaluation firms strongly feel that both types are important.

¹² D.M. Parker, letter of November 4, 1974.

The valid and meaningful argument for both severance and property taxes relates to the stages of a field's development. A new field has more potential value, and is at that time more valuable, therefore, it should be taxed at a higher rate at the onset. The ad valorem property tax effectively derives revenue from this profit potential whereas the severance tax would impact on oil property evenly whether it was highly profitable or barely economical.

The argument is a valid one, but Alaska's sliding scale severance tax also takes into account the difference in the producing capacity of each well. By spreading the low and high rates of the scale from two or three per cent for the barely economical wells to twelve per cent (similar to what Louisiana presently uses) on the wells producing at an extremely high level (over 1,000 barrels a day) the severance tax would then give nearly all the advantages of the separate and additional property tax and at a lower administrative cost.

What is the financial condition of the companies active on Alaska's North Slope? Scrutiny of 1973 annual reports reveals that the eleven companies posted earnings of 7.9 per cent of revenues in 1973, see Table 5. Tax information and earnings information were solicited from the same eleven companies, which explains the omission of the British Petroleum from the tabular data.

Standard Oil of California registered the highest earnings rate at 9.5 per cent and Standard of Ohio (SOHIO) the lowest at 5.1 per cent. Income averaged 8.3 per cent of total assets for the eleven companies. At Exxon as well as all other companies surveyed, the spurt in income in 1973 came mainly from "the translation of affiliates earnings from foreign

TABLE 5
EARNINGS OF MAJOR OIL COMPANIES ACTIVE
ON ALASKA'S NORTH SLOPE
(Millions of \$)

OIL COMPANIES	<u>GROSS REVENUES</u>		<u>OPERATING EXPENSES</u>		<u>NET EARNINGS</u>		<u>EARNINGS AS % OF REVENUES</u>
	<u>1972</u>	<u>1973</u>	<u>1972</u>	<u>1973</u>	<u>1972</u>	<u>1973</u>	<u>1973</u>
ARCO	\$ 3,899	\$ 4,561	\$ 3,706	\$ 4,291	\$ 193	\$ 270	5.9%
EXXON	22,438	28,508	20,907	26,065	1,532	2,443	8.6%
MARATHON	1,509	1,859	1,429	1,729	80	129	6.9%
MOBIL	10,295	12,756	9,721	11,906	574	849	6.7%
PHILLIPS	2,568	3,074	2,419	2,843	148	230	7.5%
SHELL	4,850	5,750	4,589	5,417	260	333	5.8%
STANDARD - CAL.	6,746	8,927	6,199	8,083	547	844	9.5%
STANDARD - AMOCO	5,477	6,468	5,102	5,956	374	511	7.9%
STANDARD - OHIO	1,629	1,734	1,572	1,645	57	89	5.1%
TEXACO	10,749	13,868	9,860	12,576	889	1,292	9.3%
UNION	2,458	2,962	2,336	2,782	122	180	<u>6.1%</u>
						Average	7.9%

Source: Annual Reports filed in 1973

currencies into more dollars as a result of devaluation of the dollar."¹³

The domestic vs. foreign situation at Texaco was even more striking:

Texaco's earnings attributable to the United States failed to keep pace with other areas, increasing only 3.6 per cent to \$454 million in 1973 compared with \$438 million in 1972. Regulation of petroleum prices, sharply rising costs of doing business and lower production of crude oil and natural gas adversely affected United States earnings despite vigorous efforts toward controlling costs.

Earnings attributable to operations outside the United States were \$848 million, an increase of 86 per cent. Approximately 30 per cent of the \$387 million increase in foreign earnings represents the effect of the higher net value, in terms of U.S. dollars, of the operating earnings realized in currencies of those countries where our operations outside the United States are conducted...¹⁴

SOHIO registered the lowest rate of return, primarily due to their relatively high expenditures in developing their Alaska property. At Prudhoe Bay in 1973 they drilled eight wells, all successful. This brought their drilling activity at Prudhoe Bay to 57 wells; all except three suspended and preserved for future use, have indicated to be oil bearing in the main productive zone of the field.

Taxes paid by the eleven oil companies totaled \$25 billion in 1973 or about 29 per cent of revenues for the year. The tax rates listed in Table 6 reveal that Phillips had the lowest rate at 14.6 per cent and Exxon the largest company with also the highest proportionate tax burden at 37.2 per cent of revenues. Generally, the companies with the proportionately higher taxes had more extensive foreign operations where the effective tax rates were considerably higher.

Of the eleven oil companies, only six chose to publish in their annual reports a detailed listing of the various taxes paid in 1973. By

¹³Exxon 1973 Annual Report.

¹⁴Texaco 1973 Annual Report.

TABLE 6
TAXES OF MAJOR OIL COMPANIES ACTIVE
ON ALASKA'S NORTH SLOPE
(Millions of \$)

OIL COMPANIES	EXCISE PROPERTY & OTHER OPERATING TAXES		FEDERAL & OTHER TAXES ON INCOME		TOTAL TAXES	TOTAL ASSETS	TAXES AS % OF ASSETS	TAXES AS % OF REVENUES
	1972	1973	1972	1973	1973	1973	1973	1973
ARCO	\$ 629	\$ 624	\$ 122	\$ 197	\$ 821	\$ 5,109	16.1%	18.0%
EXXON	5,750	6,856	2,346	3,752	10,608	25,079	42.3%	37.2%
MARATHON	246	290	179	220	510	1,572	32.4%	27.4%
MOBIL	2,395	3,375	803	1,194	4,569	10,690	47.7%	35.8%
PHILLIPS	361	356	128	94	450	3,607	12.5%	14.6%
SHELL	878	953	83	122	1,074	5,381	20.0%	18.7%
STANDARD - CAL.	1,274	1,459	394	485	1,944	9,082	21.4%	21.8%
STANDARD - AMOCO	1,039	1,135	123	268	1,403	7,018	20.0%	21.7%
STANDARD - OHIO	299	291	23	39	330	1,963	16.8%	19.0%
TEXACO	2,031	2,388	556	733	3,071	13,595	22.6%	26.0%
UNION	397	436	62	81	517	2,909	17.8%	17.5%
						Average	29.4%	28.6%

Source: Annual Reports filed in 1973

far the most substantial of the various forms of taxation was the excise tax. This motor fuel tax, collected directly from the consumers and paid to governmental agencies in the United States and abroad, exceeds all other taxes combined for each company. It was interesting to note that only Texaco did not include their consumer taxes collected in their listed deductions, choosing to publish gross income, not gross revenue including these consumer taxes.

All six companies reported property taxes higher than severance and production taxes. In relation to earnings; property taxes were 16.8 per cent and the production taxes including severance were 10.1 per cent. Care should be taken on drawing statistical inferences on this data. What Table 7 shows is that property taxes on oil are more substantial than other oil related taxes utilized in the states. The broad range of severance, property and other tax rates stems from the variety of production localities of each of the six companies.

Five companies published a breakout of foreign, federal and state income taxes. Four-fifths of the tax on income goes to foreign governments. The Federal Government share of these taxes is only 17.6 per cent of income taxes paid and state revenues derived from these taxes are insignificant as shown in Table 8. This data lends little credence to Atlantic Richfield's argument that Alaska corporate income tax should even be considered a factor in comparing the state to state tax burden.

While a full comparison of the overall tax burden on the oil industry as opposed to other industries would far exceed the scope of this analysis, it appears most likely from available data that the oil industry pays higher taxes in relation to their volume and profits than does bus-

TABLE 7
SPECIFIC 1973 OIL TAXES PAID BY SIX OIL COMPANIES ACTIVE
ON ALASKA'S NORTH SLOPE ^{1/}
(Millions of \$)

OIL COMPANY	EXCISE		PROPERTY		PRODUCTION & SEVERANCE		ALL OTHER OIL TAXES EXC. INCOME		PROPERTY, SEVERANCE & PRODUCTION TAXES IN RELATION TO EARNINGS ^{2/}	INCOME TAX ^{3/}	
	TAX	% of REVENUES	TAX	% RELATIVE TO EARNINGS ^{2/}	TAX	% RELATIVE TO EARNINGS ^{2/}	TAX	% RELATIVE TO EARNINGS ^{2/}		TAX	% OF INCOME
ARCO	\$506.6	11.1%	\$53.4	19.8%	\$30.2	11.2%	34.1	12.6%	43.6%	\$196.5	42.1% ^{4/}
PHILLIPS	287.0	9.3%	30.2	13.1%	14.6	6.3%	24.1	10.5%	29.9%	94.3	29.1%
SHELL	817.3	14.2%	57.0	17.1%	34.0	10.2%	44.5	13.3%	40.6%	121.8	26.8%
AMOCO	963.5	14.9%	68.4	13.4%	55.4	10.8%	47.2	9.2%	33.4%	267.7	34.4%
SOHIO	251.8	14.5%	14.6	16.4%	6.3	7.1%	18.0	20.2%	43.7%	38.7	30.3%
UNION	<u>361.3</u>	<u>12.2%</u>	<u>48.0</u>	<u>26.7%</u>	<u>22.9</u>	<u>12.7%</u>	<u>3.5</u>	<u>1.9%</u>	<u>41.3%</u>	<u>80.6</u>	<u>30.9%</u>
Cumulative Average		13.0%		16.8%		10.1%		10.6%	37.6%		33.1%
Percentage of Total Taxes Paid		<u>69.4%</u>		<u>5.9%</u>		<u>3.6%</u>		<u>3.7%</u>			<u>17.4%</u>

^{1/} Of the eleven oil companies, only these six itemized taxes in thier 1973 annual reports

^{2/} Taxes compared to earnings; not to be confused with "percentage of earnings."

^{3/} Federal, state and foreign income taxes as percentage of earnings plus these income taxes only.

^{4/} Income taxes proportionately high due to heavy foreign income taxes primarily in Venezuela, Libya, Indonesia and Iran.

Source: 1973 annual reports filed by the six companies.

TABLE 8
INCOME TAXES PAID ON 1973 EARNINGS BY FIVE OIL COMPANIES
ACTIVE ON ALASKA'S NORTH SLOPE ^{1/}

	<u>UNION</u>	<u>PHILLIPS</u>	<u>ARCO</u>	<u>TEXACO</u>	<u>MARATHON</u>	<u>AVERAGE</u>
FEDERAL						
Current	\$19,700	\$42,830	\$ 36,276	\$ 30,000	\$ 36,675	
Deferred	14,400	(1,307)	14,400	46,145	(6,375)	
Total	<u>\$34,100</u>	<u>\$41,523</u>	<u>\$ 50,676</u>	<u>\$ 76,145</u>	<u>\$ 30,300</u>	<u>17.6%</u>
STATE						
Current	8,300	---	4,908	6,500	2,647	
Deferred	1,500	---	1,250	---	---	
Total	<u>9,800</u>	<u>8,984</u>	<u>6,158</u>	<u>6,500</u>	<u>2,647</u>	<u>2.6%</u>
FOREIGN						
Current	35,900	39,819	139,242	562,300	164,737	
Deferred	800	4,022	432	88,307	22,000	
Total	<u>36,700</u>	<u>43,841</u>	<u>139,674</u>	<u>650,607</u>	<u>186,737</u>	<u>79.8%</u>
TOTAL TAXES ON INCOME	\$80,600	\$94,348	\$196,508	\$733,252	\$219,684	
% FOREIGN TAX	45%	46%	71%	89%	85%	

^{1/} Of the eleven oil companies, only these five reported the different type of income taxes paid in 1973

Source: 1973 Annual Reports filed by the five companies

iness in general.

The importance of state taxes on oil and gas should not be underestimated.

Tax is of such pervasive importance in the financial reckoning of this industry that even the least financially-minded oilman, asked for his opinion of any unexpected move by any major company, immediately tries to figure out the "tax angles" that may have affected its decision. The tax treatment of oil profits in the country where any international company has its headquarters is likely to condition its industrial strategy all over the world.¹⁵

Companies with foreign operations get the benefit of the same deductions for drilling and development and depletion allowances as domestic companies, even though the risk of unsuccessful drillings is much less. In addition, the payments made by them to foreign governments, which are in reality royalties, are not merely treated as deductions against income, but are permitted to be taken as credits to offset their U.S. income tax liabilities dollar for dollar. The foreign royalties usually equal or exceed the amount of U.S. tax and usually wipe out all U.S. income tax liability on their foreign operations. U.S. oil companies with foreign operations also have the prerogative of using the cost of drilling and development abroad that results in operating losses to reduce the taxes they owe on income earned from their U.S. operations. J.E. Hartshorn, makes a convincing argument concerning taxes on oil companies:

No sensible business firm anywhere arranges its affairs for the benefit of the tax collector. The international oil companies differ from those in most other industries only by having to operate within so many tax systems that their perfectly legal arrangements to avoid leaving most of their shareholders' profits in the hands of tax collectors, by comparison, have to become somewhat three-dimensional. Other liabilities to tax - and other collectors' pressures to maintain the amount paid in taxes - again occur in between producing government and home government.¹⁶

¹⁵J.E. Hartshorn, Politics and World Oil Economics, New York, Praeger Publishing 1962, p. 176.

¹⁶Ibid, p. 183.

The analysis of state government taxation is directed to a number of key policy questions. The most important normative question: Who should pay? Two principles can be considered: Who is able to pay and who is entitled to the benefits. The ability-to-pay principal hinges on the economic capability to bear the burden. Without a doubt the oil industry in 1974 through 1980 can bear the burden and can bear a proportionately higher tax. The second principle, the benefit principle of taxation rests on the presumption that those who receive benefit from the services provided by government should bear the costs - under this criteria the tax should be shifted to sources other than the oil industry. There are some strong political forces at work in Alaska against further taxes on the oil industry. Nationally the oil industry has received preferential treatment on oil related taxes which can be attributed to the policy of the 1950 and 60s of utilizing foreign oil and conserving U.S. oil. The oil industry expects these privileges to shift to the state and local sectors.

Concerning administration of income taxes and the relatively small federal tax; Amoco intends to go to court over \$49 million in taxes for the 1967 to 1969 period. The company contends the tax, which amount to about one per cent of their revenue, is "in large part without merit."¹⁷ This has interesting ramification if applied to Alaska's intentions of "tightening" up the State corporate income tax. Possibly a higher severance or initiation of the property tax and dropping the corporate income tax for oil companies would achieve the same end with much less hassle.

¹⁷Standard Oil of Indiana, 1973 annual report.

Of the eleven companies, Marathon has the highest proportion of it's production in Alaska. One-fourth of Marathon's North American oil production is in Alaska's Cook Inlet, more than any other state:

TABLE 9
MARATHON OIL COMPANY OIL PRODUCTION¹⁸

	1973	1972
Alaska	47,776	49,473
Texas		
Yates Field	23,957	22,530
Other	21,782	21,488
Wyoming	35,138	38,084
Louisiana		
Offshore	11,978	10,926
Onshore	5,782	7,036
Other U.S. (18 states)	28,120	31,396
United States	174,533	180,933
Canada	9,129	9,554
North America	183,662	190,487

Comparison of Marathon's tax burden shows the company right in the middle of the eleven companies, except in state income tax where Marathon has the lowest level of state tax.

This chapter has shown that oil companies pay significant taxes, but the largest share accumulates to foreign governments. These circumstances stem from U.S. policy over the last three decades to subsidize the exploration of foreign oil and preserve part of this countries reserves. The oil companies are adamant in their objection to additional taxes by the state and rely on the argument of total taxes paid in encouraging the states not to raise their tax levels on oil and gas. The treatment of company taxes in relation to revenues has been cursory; however, the basic fact is evident that the industry is not overtaxed by Alaska or any other state.

¹⁸Marathon 1973 annual report.

CHAPTER III

PROPERTY TAX IN GENERAL

The ad valorem tax is basically a tax on wealth. It is levied against the value of tangible (and in the case of potential oil reserves, intangible) real or personal property. The term value is defined by the property tax assessor as the price paid by an informed willing buyer of a piece of property to an equally informed willing seller of the same property. The property appraiser considers three basic elements: 1) the cost incurred in creating the property, 2) the market value, the sales value on an open free market, and 3) the future income to be gained from the property, then converts that into an estimate of current value.

Few hydrocarbon properties are bought and sold, so the potential to produce income becomes the basic consideration of the value of the property. The estimating techniques on underground reserves are an educated guess of the volume of oil in the geologic structure, the relative oil, gas and water saturation, the viscosity, the porosity and permeability of the structure and the pressure of the reservoir. Upon this is placed the estimate of the percentage of the reserve which can be recovered. The determination of recoverable reserves from a new field is more difficult than determining the remaining recoverable reserves from an old field.

Once the value has been pegged, the future price of the oil, the demand in the market, and the discount rate (future value to today's

money - combined with the risk factor) are the remaining critical factors in determining the appraisal. Oil company officials argue that the reservoir estimates are based on inexact scientific judgements. Engineers and appraisers contend that the engineering judgements on the reservoir are less of a problem than such factors as the future market price and more importantly - realistic discount factors.

Each property is assessed on a different combination of factors. The ad valorem tax on oil reserves can seldom be judged an equal tax among the various producers; but then the production taxes as they relate to income or profit are often not more equitable. Looking at the ad valorem tax from the standpoint of an equitable spread of revenue among the localities within a state -- historically it has been highly inequitable.

As outlined in Chapter I, seven of the 16 highest producing states have oil property taxes on the books which provide revenue for the local governments. In these seven states, nearly all revenues accrue to local government, almost none to the state government. In an additional six of the 16 states, severance taxes are levied in lieu of ad valorem taxes on oil property. One state has a gross income tax (separate and in addition to a corporate income tax) an in lieu type of income tax. New Mexico recently abandoned its ad valorem tax on oil reserves. Alaska is the only other state which has neither ad valorem tax provisions or an in lieu type of severance tax.

Severance taxes based on wellhead value ranged from one to 12.5 per cent. Severance taxes on gross market value ranged from two to seven per cent. Property tax rates vary from state to state and from county to

county within each state and are usually based on an assessed valuation less than full value. The rate was most commonly applied to 20 - 50 per cent of value. An attempt was made to convert the property tax average rates per state to something comparable to the severance or production tax rate; but because of complexity and time limitations this effort was abandoned. Let us examine the taxation further in general terms.

The property tax is the most important tax in the revenue structure of local governments in all 50 states. Last year the property tax accounted for about 82 per cent of local revenues. The national average of state revenues from property taxes comes to about two per cent. The average of the 16 highest oil producing states was slightly higher, see Table 10. Of the states, New Mexico had the highest proportionate reliance on the property tax at 9.5 per cent of total state revenues in 1970-71. That figure will drop considerably with the abandonment of the ad valorem tax on oil and gas. Montana receives 6.3 per cent of it's revenue from the property tax.

California had by far the largest monetary revenue from the property tax; still only 4.3 per cent of state revenues were derived from this source.

In fiscal year 1970-71, property taxes in Alaska amounted to only about 19 per cent (see Table 4, Chapter I) of all local government revenue. The combined state-local revenue is less than seven per cent. No other state has as low a reliance on the property tax for state-local revenues.

TABLE 10
GROSS ASSESSED VALUE AND PROPERTY TAX REVENUES OF 16 OIL PRODUCING STATES, 1970-71
(In Millions \$)

RANK - PROPERTY Tax as % of PERSONAL INCOME	OIL PRODUCING STATE	GROSS ASSESSED VALUE			PROPERTY TAX REVENUE		
		TOTAL	STATE ASSESSED	LOCAL ASSESSED	STATE	LOCAL	% of STATE REVENUE
1	Montana	\$ 966	\$ 191	\$ 775	\$ 8.6	\$ 157.8	6.3%
2	California	59,176	4,493	54,683	244.0	5,747.5	4.3%
3	Wyoming	1,384	748	636	8.9	68.8	9.5%
4	North Dakota	627	70	557	1.4	116.2	1.0%
5	Kansas	6,476	1,086	5,390	10.5	463.0	2.3%
6	Colorado	5,454	561	4,893	2.0	425.8	.4%
7	Michigan	36,593	---	36,593	90.0	1,730.4	3.5%
8	Utah	1,966	667	1,299	13.1	140.5	4.9%
9	Illinois	49,683	1,167	48,516	.5	2,233.6	---
10	Texas	23,778	134	23,644	63.8	1,508.0	2.9%
11	Florida	51,761	299	51,462	35.7	857.3	2.2%
12	Oklahoma	4,266	867	3,399	---	254.6	---
13	Mississippi	2,579	566	2,013	4.1	166.7	.8%
14	New Mexico	2,358	655	1,703	15.9	74.5	5.0%
15	Louisiana	5,816	1,223	4,593	28.3	236.6	2.9%
16	ALASKA	2,430	---	2,430	---	33.1	---

Sources: Property Values Subject to Local General Property Taxation in the United States, (Dec. 74) Table I and Taxable Property Value and Assessment - Sales Price Ratios, Volume 2, Part 2 (Oct. 73) Table I, U.S. Department of Commerce, Social & Economics Statistics Administration, Bureau of the Census.

Because of this apparent disparity, it has been recommended that Alaska rely more heavily on this type of tax for the State as well as local revenues. Alaska actually is in an enviable position. The literature on tax equity almost unanimously places property tax as the least equitable of all types of taxation. The Texas Research League reports a public opinion poll on the property tax.¹

The property tax does not stand high in the estimation of the American people according to a recent opinion poll undertaken on behalf of the National Advisory Commission on Intergovernmental Relations (ACIR).

Asked to select the tax considered to be the least fair, a cross section of the public designated the property tax far more often than any other major source of public revenue...The survey results:

What is the LEAST fair tax?	
Federal income tax	- 19%
State income tax	- 13
State sales tax	- 13
LOCAL PROPERTY TAX	- 45
Don't know	- 10

What is the FAIREST tax?	
Federal income tax	- 36%
State income tax	- 11
State sales tax	- 33
LOCAL PROPERTY TAX	- 7
Don't know	- 13

The property tax is not only the least popular but is considered least equitable by tax administrators. The same questions of the previous poll were asked of 145 attendees of the annual conference of the National Tax Association.²

The national ACIR public opinion questionnaire was distributed at the 1972 Conference of the National Tax Association and was returned by 145 of the 450 registrants.

¹U.S. Advisory Commission on Intergovernmental Relations, Public Opinion and Taxes, May 1972) as cited by the Texas Research League, The Texas Property Tax: Background for Revision, Austin, August 1973, p. 5.

²John O. Behrens, "The Public and the Publicans Talk Taxes," National Tax Journal, XXVI, No. 2 (June 1973) p. 22 as cited by the Texas Research League, Ibid.

The results:

What is the LEAST fair tax?

Federal income tax	- 13%
State income tax	- 5
State sales tax	- 14
LOCAL PROPERTY TAX	- 60
Don't know	- 7

What is the FAIREST tax?

Federal income tax	- 54%
State income tax	- 11
State sales tax	- 28
LOCAL PROPERTY TAX	- 4
Don't know	- 3

While the demographic and socioeconomic traits of the first group polled (e.g. age, region of the nation, occupation, income level, ethnic background, etc.) was not documented, the respondents of the second poll were a select knowledgeable group. They considered the property tax to be unequitable and in definite need of tightening the administration of the tax.

The unpopularity and inequities of property tax in general should not be extrapolated to the Alaskan experience, particularly to the potential ad valorem tax on oil property. The State has very competent administration in the Property Tax Division of the Department of Revenue. Additionally this division has good council.

Moving from the opinions of the general property tax to the most often quoted reason for the unfairness we find: 1) it is regressive, 2) those least able to pay usually must carry the relatively highest burden, 3) it differs appreciably by region of the country, is extremely high in some states and moderate in others, 4) it tends to reduce home ownership, and 5) it perpetuates ghettos. None of the five reasons against a property tax in general apply to Alaska oil property. There are other reasons that make it an undersirable tax and these will be examined in the next and last chapter.

CHAPTER IV

APPLICATION TO ALASKA

The Alaska House and Senate Resources Committees have heard considerable testimony on this subject, particularly in April 1975. From the oil companies came the plea - no further imposition of taxes; and the implied threat - the State would receive less in the long run through lower bonus bids on upcoming leases. Possibly the classic nadir of this testimony was the tenuous argument that a tax on oil reserves will cause such rapid development of the far north oil resource as to spur uncontrolled economic growth which will destroy the Arctic environment. British Petroleum proposed this argument.

From the other side of the issue came testimony of the pro-tax people, those who administer it or will profit from its enactment. Texas and California experts in particular were relied upon for factual information. About the only shortcoming in the testimony was an occasional non-response. For example members of the House Resources Committee tried to gauge the number of months that the State might be in litigation on ad valorem tax legislation. They asked Pritchard and Abbott representatives, including the senior administrative officer, Pritchard, the length of time in court on the original Texas decision on property tax on oil. The firm had been built for 50 years, to a current level of 150 employees based on the historic precedent setting court decision on this very question. Yet

None from the firm offered the simple fact of the court time involved in that decision.

This report required considerable interview time with oil property taxing experts from Texas and California. One finding was that the California people, from my experience were more candid and straightforward. If they knew the answer, they provided the information. If they promised to gather some information needed in the research, it was compiled and sent.

If legislation is enacted on taxing oil reserves, however, it appears the Alaska Department of Revenue will contract with Texas consultants 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.

Emphasis on this report should not be placed on testimony of obvious vested interests. Two witnesses, consistently "middle of the road," provided exceptional in-depth analysis of the factors involving an Alaska tax on reserves from the viewpoint of covering the shortfall in State revenues. Walter Mead, Professor of Economics, University of California at Santa Barbara and Milton Lipton of Walter J. Levy Company, provided strikingly similar testimony. Salient points made by these two witnesses show that a tax on oil reserves is not a preferable method of gleaning the required revenue.

Lipton, emphasized the unpredictability of world oil prices and

demand.¹ A few highlights of his presentation concerned world oil prices and the importance of the Alaska oil resources. He suggested that the price of foreign oil could not be supported indefinitely at the \$13-14 per barrel level. If Prudhoe oil were delivered into California in early 1975 it would command a price of \$11.50 a barrel.

Mead spoke of the current attractive price of oil at \$12 per barrel.² He placed the Prudhoe bonus sale in perspective by emphasizing that the \$900 million was achieved on \$3.50 oil, not an \$12 oil. (Underestimated discount factors and rising operational costs partially offset this, however). Like Lipton, Mead suggested that prices will go downhill from now until 1980; that the \$12 price is temporary.

Paschall estimated the value of the Prudhoe Bay field at \$4.7 billion in 1973. He estimated that oil production for the first 25 years of the field's operation would total 9.4 billion barrels. He said the most difficult part of the assignment on the Prudhoe field was in estimating the price of the oil at the time of production. He assumed a price of \$2.95 per barrel; since then the price has tripled which, if extrapolated, would place the value of the field closer to \$15 billion.³

The matter of current price, the fact that the pipeline now under construction is projected to have 25 per cent idle capacity, and the attractive nature of the Beaufort Sea oil potential immediately north of Prudhoe combine to make the proposed Beaufort lease sale extremely important.

Mead testified to the importance of the early lease sale in the

¹Milton Lipton, testimony to Senate Resources Committee, February 12, 1975.

²Walter Mead, testimony to House Resources Committee, April 15, 1975.

³Robert Paschall, personal interview, December 10, 1974.