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SENATE RESOURCES COMMITTEE

TESTIMONY OF MILTON LIPTON

LEGISLATIVE CONSULTANT ON OIL & GAS

March 24, 1976

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

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

MILTON LIPTON:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(QUESTION INDISCERNIBLE)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

MINUTES
SENATE RESOURCES MEETING
FEBRUARY 14, 1975

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

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

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to purchase oil and gas sometime in the future.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

QUESTIONS:

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

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

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don't quite know the answers to, but if it were to be done, I see no objection to it being done with due regard for all of your environmentalists. I would rank it relatively high as a factor contributing to the potential revenues within the next year. Certainly I'm not suggesting that the State go scrounging around to find what kind of acreage to start lease sales with.

Senator Rodey: We are in the position of being forced to find enough acreage to meet our physical needs. Mr. Lipton stated: Again, that is not what I'm saying. that in a lease sale, even if it is in the Beaufort area, maybe you put together more acreage,..What I'm saying, is that you go ahead with the lease sale, pursuant to all the other interests of the State and with a really unknown contribution. I do think from the standpoint of how the administration and the Legislature looks upon the budgetary position, that what can be done through this lease sale if it is consumated, is a top factor in the balance prospect. I doubt that it will balance the whole thing.

Senator Rodey: We don't really know what the contribution of a lease sale will be. As a consequence our government would be required to put a rather large portion of land to assure that the physical gap be bridged. Mr. Lipton answered: I see what your point is. I would not recommend to the State that it design this lease sale in any other way than in the absence of any budgetary fund. I don't think you ought to gerry a lease sale to fit a budget, because a lease sale just like the sale of royalty oil and gas in a sense is selling of the heritage of the State. That would be a mistake..

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Senator Butrovich: Do offshore sales checkerboard as they do on land? Mr. Lipton answered: Not really. It depends on what you mean by checkerboarding. This connotates an idea that you draw a geographic grid. I don't think you can do that anywhere in Alaska. I believe that your administration would carefully consider how the geology matches the geography. It is not necessary to put up all of the geological structure for the first time around. It is probably impossible to because some of the geological structures may actually be federal acreage. But you have to put up enough so that the industry thinks the candle is worth the burning. If you want to hold some for a future lease sale, it is perfectly acceptable.

Senator Butrovich: Really in effect, haven't we checkerboarded on our sale up North? Mr. Lipton answered: Partly and partly not; To the extent that you did in 1969 worked very much to your advantage because people were so desparate that they bought alot of salt water instead of oil. This is outside of the explored area. It might make alot of sense for the State to put up a substantial amount of acreage because the companies know that the cost of exploration and development are very high. It is not necessary to stretch the amount of acreage to meet revenue purposes or that you deny yourself the right to withhold portions of what looks to be the geologic structure for potential future bidding. In other words, I don't think you ought to enter into this lease sale just as a revenue raising measure....I think you

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ought to follow what is a reasonable course of leasing for the State, no more, no less.

Senator Butrovich: If we felt that way, we probably wouldn't have a sale because we are out of money. Mr. Lipton answered: I think there are other reasons for having the sale. This is an area which the State in any event would have been considering around that time for prospective leasing. I think the industry always has an interest in leasing in an area where they think they will find alot of oil. The State has an interest in leasing in the area of the North Slope and just offshore to make sure that there is a substantial volume of reserve that can assure the optimum utilization of the pipeline. I don't think the State ought to go into a fire sale, but I think this is the area that in any case would have come up for relatively short term consideration by any state government whatever the budgetary condition is.

Senator Butrovich: Pursuing that, does it make any difference in a sale if for example, some of the companies that are on the Slope now who belong to consortium that is building the pipeline are in deep financial problems? Mr. Lipton answered: There is no question they are in there heavy. Senator Butrovich asked: Aren't we going to eliminate some of them from maximum bidding offshore in the same general area; they are not anywhere near their market place? Mr. Lipton answered: There are companies on the North Slope that have such

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a large position and with the financial circumstances of building the pipeline, and everything else upon them, this is not a matter of urgency for them. In a sense, this was reflected in the 1969 lease sale. The interesting thing is that there are a lot of companies who do not have a position on the North Slope who in the context of the U.S. oil balance, may find themselves short of crude production and in a sense be forced to buy crude oil from their own competitors in the market place. So that probably the most competitive bidding that you had in the 1969 lease sale was not from those who were there, although several of them were quite active. Now I don't think any company is going to feel that just because they have the share they do of Prudhoe Bay is going to turn their back on an attractive lease sale. The point is how attractive is the acreage? I would think you would have a fair number of companies who were most active in the 1969 sale who were relatively unsucessful and will be looking at a new geological prospect. I'm not here to guarantee you how successful a lease sale will be. I think you are right in that the companies who have a strong producing position and have all kinds of capital commitments and association with that will bear upon how active they are and what their position will be. I don't think however, that this quite adds up to the same thing of saying how can you really expect competitive bidding on the North Slope.

Senator Poland asked: In relation to selling our royalty gas, you said that it was preferable to selling the oil. Mr. Lipton stated: I'm really not urging the sale of oil and gas at all. It is that

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I'm so negative on the sale of royalty oil, that I'm trying to draw the distinction into negativism on the sale of the oil and the fact that the sale of gas doesn't have quite the negative factors. It is something that can be considered whereas I as a visitor to Alaska, but a lover of Alaska would hate to have to consider the sale of royalty oil.

Senator Orsini: Could you pursue the sale of the option gas further? Do we still run into problems there of loss of pipeline control and other problems with selling of royalties? Mr. Lipton answered: Not in the same way. In the case of royalty oil, we have always felt that the State's control over that oil; the fact that it could take it in-kind; that it could move it through the pipeline which in itself becomes a shipper; In a sense this validates the jurisdiction of the Alaska pipeline. There are other reasons. You certainly want to be in a position to make available, if necessary, a state royalty oil for development of refined capacity in the Fairbanks area. You wouldn't want all this to wait another three to four years, because your royalty oil hasn't been sold off, etc. In the case of gas, there is an implication that if the State sells royalty gas to one pipeline buyer or another, that particular transaction is with the Federal Power Commission. With a dispute before the Federal Power Commission at the present time as to whether the pipeline should come through Alaska and the gas exported in liquified form to Los Angeles, or whether the pipeline should go go through Northern Alaska

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and down through the MacKenzie Delta to California...that in a sense, any option or contract to sell becomes a public document and this could have a certain bearing upon the way in which the companies in their own presentations to the Federal Power Commission will be on the case. It may not be decisive, but the State ought to be aware of the fact that if you make this kind of sale or sale in options, that the buyer will be in a position to use it for whatever way he chooses in the argumentation before the Federal Power Commission. I think the leverage in the State of Alaska over the pipeline route is in any case, not all that great. This is a decision that if made on purely technical terms will be made by the Federal Power Commission. If there are political overtones to it, it will be made by the Federal government in terms of how they see the gas pipeline route fitting into the overall context of our energy balance, our relations with Canada, etc. I would guess that the probabilities are tilting against the Alaskan pipeline and for the Canadian route.

Senator Rader asked: Pursuing the same situation, in effect does the Federal Power Commission set the wellhead price on gas by approval of these contracts? Mr. Lipton answered: No, it doesn't. The contracts have no legal force until the Federal Power Commission in a sense authorizes the certificate of necessity - the construction of a pipeline to move that gas. For example, if a company has an option to buy EXXON or SOHIO Gas on the North Slope - being a member of the Alaskan and Canadian Arctic Group in the expectation the pipeline is going to be built. If the FPC opts for an Alaskan pipeline, their

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option to buy gas is still there, but they in a sense, have to sell the gas to El Paso as a contract carrier to move the gas. As far as the pricing of the gas on the North Slope is concerned, this is completely up in the air. The pricing practice of the FPC in the past obviously is irrelevant because there is no historical data on what it costs to find and develop gas on the North Slope. the national pricing system today just can't be applied on the North Slope. Nobody knows what the pricing practice is. Nobody knows if the President's recommendation for the decontrol of gas will be passed by Congress. So it is completely up in the air. What is most relevant to the standpoint of Alaska, is that to a gas transmission company that buys gas and then resells it, they are not the distributors of gas in the city, they are transporters of gas. The transportation is not on the contract. They transport by buying and selling. Whatever happens to the pricing of gas under the FPC policy or by Congressional legislation, has nothing to do with their regulation. They are being regulated as transporting - not as producers of gas. The regulation of those pipelines provide in a sense, that 1) they can recover the purchase price of the gas, and 2) they can make a profit on their operation by a controlled rate of return on their investment. This is what is to the gas transmission companies the freedom to go out and negotiate in advance for future supplies of gas to keep their pipelines full. So here in Alaska they are buying options on gas or reserves in gas. These same transmission companies in the Arctic Islands of Canada have committed

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millions of dollars not for the purchase of the gas....they have advanced it for exploration so that if the exploration is successful they will have the option to buy. In their own accounts, these capital advances to obtain supplies of gas to operate their pipelines become part of the capital structure of the country. They are entitled then in the rate they charge for transportation of any gas to recover all of these costs and earn a rate of return on them. They can be alot more forward looking and aggressive either in buying gas or in prefunding exploration.

Senator Rader asked: If they can include whatever the price of the gas is in their sale price, who controls their sale price? Mr. Lipton answered: It is controlled because it allows them to recover the purchase price and gives them a rate of return on their investment in the pipeline. The purchase price up until now has been controlled not by regulations of gas producers. This is a big distinction between the relationship the State would be entering when it is negotiating on any basis.

Senator Rader asked: What authority does the Federal Government have in forcing gas producers to allocate existing supplies between purchasers? Mr. Lipton answered: What they are doing is forcing pipelines to allocate among their buyers.

Senator Rader asked: What do pipelines do when they don't buy so

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many million cubic feet of flowing gas, they buy from the producer an entitlement to the reserves. Then what they are entitled to is all the production of their reserves. At the same time, the pipelines enter into a contract with a gas distribution company in a state or a community to sell the gas they have bought as it is produced and transported. What has happened is that we have found that out of the contract reserves the pipelines have bought, the flow of gas is not what we have anticipated. So the pipelines are unable to deliver the amount of gas they have contracted to deliver. The FPC is forcing them to pro-ration the supplies of gas available to them among their own customers. This is where pro-rationing takes place. We have not yet had to enforce allocation of wellhead gas among pipelines. It could happen.

Senator Rader asked: As I understand it, the State of Alaska has no hold at all on gas transmission lines by the way of permits, cross-state lands, right of way control? Mr. Lipton answered: I think you are right. But theoretically, the State of Alaska has the right to grant or withhold right of way. I very much doubt that in a real sense, if there is a decision by the Federal Power Commission supported by the Federal government, that a gas pipeline is going to go one particular route through Alaska, or another way. Aside from the argumentation you may make over the direction of the route, you can block that kind of a pipeline by having your BLM say we will give you a right of way across that. I would hate to

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that kind of a confrontation. The gas transmission pipeline probably will be decided outside of the State of Alaska. That is not to say of course, that you won't have an input. You have alot of interest in this and your interest ought to lay along with all the other arguments with the Federal Power Commission.

Senator Rader asked: On a slightly different subject: The problem here as near as I can tell, we are taking a passive position on this question of routing the gas pipeline. We did pass a resolution last year, which says if this is the best, we are for it. We did not, as I recall make the critical judgement of what was the best. Are we doomed to drift on this matter or should we, as a matter of policy, take an active role? If so, what should that role be? And how should we pursue it? Mr. Lipton answered: I recall at the last session of the Legislature when the joint resolution was before you, and was being very strongly urged upon by El Paso....I can only repeat what I said then. My feeling was that there are certain very visible interests in the State of Alaska and an all Alaskan gas pipeline route. The clear ones have to do with the value of investment and the continuity of employment. The ecological interests what you might have in using an established corridor instead of cutting through another part of the State...the potential value of moving gas through the communities that it might serve. I would still hold to the position that I took at that time. It is difficult to determine this early in the game what the final interest of Alaska really is. But there are certain obvious interests. I feel that if the Legislature adopts a resolution or the State of Alaska intervenes,

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as they are about to do in the hearing, that you ought to confine your representations to what I call self-evident truths. I don't think the Legislature ought to say that the movement of Alaskan gas into the west coast is best for the lower 48 states. Really you know very little about that. I don't think the State of Alaska should say that it is a danger to the national security for oil and gas to go through Canada. You ought to confine yourself to what are the self-evident truths - that there would be a distinct value to the State for an Alaskan gas pipeline because of the ability to provide gas along the route, because of the continuity of employment, investment, development and the possibility that there might be industries available on the basis of petrochemical feedstocks. All of these things which are relevant to your interests, I think you should forceably state. That doesn't mean that in my judgment that this is really the best thing for Alaska. I would like to suspend judgment until........... ....including the alternative of the cost of tranportation. But certainly the State of Alaska ought to make these representations because you are a party of interest to the hearings that start I believe in April.

Senator Rader asked: The problem is there may be a tradeoff in costs of transportation. And to make the critical judgment as to do we favor the trans-Alaska route or do we not, you'd have to say at what price, or at what costs? Your recommendation is then that we be passive? Mr. Lipton answered: No, I think you can be very active on what the State interest is. Nobody else is going to say it as

as you can say it for the Federal Power people. What I am saying, is that the numbers you have seen so far about the relative costs of transportation from Prudhoe Bay to Chicago or to Los Angeles via the two alternative routes.....I would say they are about the same status as the early estimates you heard on the construction of the Alyeska Pipeline. If the two groups are within five cents of each other, do you really think it can be estimated that closely? Orders of magnitude or differences between them; even so critical a figure as what can be a technical answer. How much gas is consumed in the process of transportation is a question that is under dispute between the two parties. We've looked at the submissions so far for the FPC and really they don't go much further than what you've already seen; what has been put out in the press statements. This is not to say that you're passive. You have an active interest because of the State and this is what you ought to be representing down in Washington. But it is going to be people that are much better advised in this than you or me; who will be interrogating before the Federal Power Commission. This is what I was most concerned about when the first draft of the joint resolution came out. This was that the credibility of State of Alaska's representation gets weakened when the State talks about things it doesn't know anything about. When you talk about the revelance of all of these things to the interest of the State, you talk about authority, but when you throw in there the dictum about the security of gas moving through Canada, this is a complicated problem that alot of people direct their attention to...when you say there might be a better distribution of gas in the lower 48 states because of the placment for the El Paso system. It may be so, but your saying so is

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an ill-informed judgment which distracts from the forcefulness of your own representations. Nobody can talk with such authority about the interests of the State of Alaska. But that is why I said that your resolution should be confined to what I call the self-evident truths. They are self-evident to you and make them self-evident to someone else.

Senator Rader asked: But we still never come to grasp with the problem in the Legislature of Alaska as to what tradeoff we are willing to make, in terms of costs, environment, industrialization. Mr. Lipton replied: There are several reasons why it is difficult to evaluate the tradeoff. First of all, you don't know how much difference in the costs of transportation there is going to be. So until you have all the facts at hand, you don't know what you are giving for what you are getting. Secondly, the tremendous appeal of the (blurred), which means minimum environmental damage. But suppose the 12 months of drilling on Pet. 4 indicates a very sizeable oil potential, not developed yet, but just there. Immediately the question comes up of how that oil is going to move out. Congress will have to make a decision on how it is to be developed and alot of other questions. The indication is going to be very clear that the next major movement of substantial volumes of oil out of the North Slope will tend to move eastward toward Canada into the U.S. midwest. If that is the case then in a sense, there are going to be two corridors, and the gas pipeline will not plow a new route. It will either move through a southern corridor or an eastward corridor. So maybe the ecological things have a

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different sort of balast. I'm not arguing with the case. I'm stating that these are the difficulties for the State of Alaska in knowing what the tradeoffs are. I would certainly assume that if the alternatives - simply an oil route southward and a gas line eastward - even with due consideration for the fact that pipelines have to cross borders - I know that Alaskan streams move south to north and when you move south to north the number of crossings you will have when you start moving eastward will be tremendous. There is a wildlife preservation, etc. If there are going to be two corridors, it is difficult for the Senate to have made a judgment of tradeoffs when you really don't know what you are trading off.

Senator Rader asked: Should we be addressing through our own expertise to find out what we are trading off? If it is a very important tradeoff its going to be made without the benefit of our knowledge unless we develope some way to participate in that. I'm reluctant to see the State appear to state the self evident truths when we are avoiding the real judgmental problem and that is the tradeoff in values. Mr. Lipton replied: It is not the Legislature actually that intervenes. The intervention is through the administration. The administration will be appearing at the hearings, not only making its own representations to which the Legislature can obviously have an input, but also is bringing back a feeling for the written evidence which is available to you. If one of the committees has a committee staff to go through the written evidence which piles up so high, I think you should.

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Somebody in Alaska obviously has to digest this evidence. A tremendously important part is the verbal hearings themselves. I don't see how the Legislature can be represented but the administration will be. Maybe there needs to be some kind of liaison so that a particular committee of the Legislature is not sitting back and reading about it in the newspaper to find out what is going on.

Senator Rader: Even if we could not technically intervene as a party - I'm talking about the Legislature participating and evaluating the tradeoffs as to what we think our administration should do. Again, that requires that we get some information before the hearing instead of after the hearing. If we try to influence our judgment on them and ask them to follow it? Mr. Lipton replied: All the information that you can possibly get before the hearings is what is available to you now. Unfortunately it is scant. If you look at the filings, they are so incomplete that you don't have the answer to most problems.

Senator Rader asked: If the decision is going to be made or is in the process of being made, shouldn't we be in there with the scant information and saying on the basis of the information presented up to this time, this is our judgment and this is our tradeoff? Mr. Lipton replied: I think this is a judgment you can make and can even make it forceably on the condition that unless there are differences in the cost of transportation which are so at variance from what we have said, or if there are ecological alternatives which are so substantially different, then these interests of the State of Alaska are paramount.

Let me be frank. I'm not at all convinced that from the overall national interests that an Alaskan gas route is desirable. What you are interested in from me is how I sense the interests of the State of Alaska. I think some of your concerns and the attractions of the Alaskan route - for example, the availability of gas along the route of the pipeline, are very attractive, but I don't know how realistic they really are. To take gas off the pipeline is not the problem, but rather how do you put that gas to use in the way that brings low cost energy to the communities and villages. You don't have a gas distribution system. Even in Fairbanks there is nothing and if you talk about the villages, what do you do with the gas; how do you reach them? Most of the villages will utilize either oil or liquids like propane, not natural gas in its own form. Is Fairbanks better off with a refinery and relatively low cost crude oil and the use of petroleum as a source of energy than trying to develop a gas distribution system? I don't want to be doctronaire about that. There are industries for example that use gas as fuel very economically without having a gas distribution system. I think one has to be kind of realistic about if the pipeline comes through what really would we do with it. The biggest possible attraction for the gas pipeline is the greater development. Even that though, I would temper. I don't think that you have, and rather doubt that you want, a Houston petrochemical complex in Alaska. But still there are certain benefits. One has to be realistic. The clearest value is that since you have the "benefit" of an oil pipeline, you clearly have the disadvantages that go along with the construction of the pipeline. At least if there

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is a gas pipeline that goes along the stream - the environmental community costs of damages, etc, that go over a longer period of time; it isn't so horrendous as if you have a boom and bust. In a real sense, the biggest attraction of a gas pipeline is that you get the benefits of investment, benefits of employment, and the horrors of everything else that goes with it. The horrors of it are still there, but the costs of bearing them is spread over a longer period of time.

Senator Rader asked: Should we not be undertaking to evaluate the very things you are talking about - the advantages and disadvantages so that we can make a judgment as to whether or not we think or how badly we think the Alaska route is or is not favorable from the Alaskan's point of view, not the national point of view. Mr. Lipton answered: If you are not, the reason you may not be is not because there is information available that is not available to you. The kind of information that is available in the world at large, which is really the filings of the companies before the Federal Power Commission and the National Energy Board of Canada. There was a lot of information filed before the Canadian Board. That ties in with what Alaska Gas Arctic was telling you down here. They are all part of the public record. So whatever is available is available to you to make your judgments. Nothing I know of is being withheld. To a very considerable extent, the representations have been made in eulogistic form, by El Paso and Alaska Gas and Oil.

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Senator Butrovich stated: I am very intrigued by this dissertation as it appears to me you are saying its going to be a political decision and we aren't going to have much to say about it. Mr. Lipton replied: Under any circumstances, I would suspect that is true. I would think at this particular time in history it is probably more true than general.

Senator Butrovich asked: That doesn't entrance me at all because when I look at that map, there is alot of Northern Canada that doesn't have many people in it. It is about as sparsely settled as alot of Alaska is. It would appear to me that 20 to 30 years from now we may be in the same position that alot of other states are, where all of our stuff has been piped out. We will have a much larger population in spite of our climate and will not have much to offer them in the way of resources. I'm not in favor of giving up an Alaskan line. It is frustrating to have your Alaska citizens paying 50¢ a gallon for heating oil. Alot of it is being shipped up from the Southern 48, just like our salmon; we ship it all out and ship it back and guess who pays the freight - the consumer. Mr. Lipton replied: If I may address myself to your own example for a moment...with the flow of oil out of the North Slope, you would expect that there will be a refinery in the Fairbanks area. I suggest to you that you concern yourself that when the refinery is there that the prices the people in Fairbanks pay for heating oil are a reflection of the costs of oil going into the refinery and not that you are still paying the same prices that you did

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before the refinery was built. There is nothing magic in the availability of oil, or in the construction of a refinery, which necessarily bears upon the prices that citizens pay for petroleum.

Senator Butrovich stated: You have really convinced me that my efforts in the future are going to be concerned more with severance taxes than any other segment of the oil and gas industry. We are going to have to get something out of this someplace along the line. Mr. Lipton replied: I hope that when you concentrate on that, that you don't ignore the corporate income tax. Senator Butrovich stated: we will look into that too.

Senator Butrovich continued: I really feel dismayed when I think that a bunch of U.S. Senators who could care less about Alaska are going to settle our problems for us. That is the brutal truth of the matter and that is what will happen. I have a selfish interest in my own state and could care less about the Canadians. The first thing they did was to raise the price of oil when we got into a pinch.

Senator Huber asked: I would like to go back to the oil and gas tax in-place for a moment. Would a resource tax be deductible from federal income taxes or perhaps would be plowed back into the pipeline tarrif? Mr. Lipton answered: The tax on oil and gas in-place is a tax that the company who pays it will certainly expense it for federal tax accounting

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purposes, to the extent that if it is exposed to the Alaskan income tax, they will expense it against that too: Senator Huber said: That certainly has a very identifiable desirability then rather than not. Mr. Lipton replied: I think it is too remote to bear upon whether it is a desirable tax or not. I would think the Legislature of Alaska should think in terms of whether it is a good tax or bad tax in terms of revenue and what we can do about it. I don't think if you carry it forward to the implication of the same company's income tax exposure, you would get very far in terms of should we do it, or should we not.

Senator Huber stated: I know they don't pay much income tax now. Could you expand on the $1.25 a barrel costs in moving 1.6 to 2.0 million barrels of oil a day? Mr. Lipton replied: We have, just as a matter of prudence, followed various estimates in Alyeska Pipeline construction costs, (these are a matter of public record), we tried to keep tabs of what this would imply for a potential tariff on Alyeska because of the implications for Alaska -- not on what the tarrif is going to be, because this is something which the companies must first determine and something which your own pipeline commission in the end will review. But if you took the tariff which is permitted under the ICC rate making rules on the basis of projected 6 billion construction costs and alot of assumptions about how allowances are made for interests, etc., you come up with what we call a base rate tarriff. We have caluclated always to the effect of other assumptions upon the tarriff. The figure I cited to you was that if you move from 1.2 million barrels a day to 1.6 million barrels a day - everything else being equal - construction costs, rates of interest being the

same, debt capital being the same, the income tax allowance in the rate structure by the ICC, the difference between 1.2 and 1.6 would be 75¢ per barrel. If you go to 2 million barrels a day compared to 1.2. million barrels a day, allowing for additional costs in the pipeline for additional pumping stations,etc., the difference i the in the permitted tariff by the ICC would be $1.20 a barrel. There is no other variable in the whole pipeline that has an effect upon the tariff as the rate of throughput. As you increase the throughput in the pipeline, your additional construction costs are very, very low. This is of tremendous interest to the State. For example, if you increase the capital costs, this is of interest to you because you have the indication of delays of the pipeline, and what every six month delay in the pipeline might do. If you increase the capital cost of the pipeline by 500 million dollars that would add for 1.2 million barrels throughput, 29¢ to the transportation costs. The rate of return is also tremendously important.

Senator Poland asked: Would you clarify for us something we discussed the other day - that excess capacity does not necessarily mean excess supply? In world oil? Mr. Lipton replied: The phrase that you most often read in the paper is "over-production of oil". You can't really have over-production of oil in the United States or anywhere else for very long. It means the wells are pumping more oil than people are using and burning up. You can overproduce faster than you burn up the oil, for as long as you have tankers in the ocean carrying the oil, or where you have storage capacity for the oil. After that you don't

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over-produce anymore. The real concept of over-production is not that you produce more than you consume, but that you have a capacity of wells to produce very much above the rate at which consumers want to draw upon the productive capacity of those wells. This is what we really mean by overproductive capacity. All through the Middle East, there were wells to produce lots of oil. The wells were in countries controlled by foreign governments, but were operated under concessions by private companies. Both the companies and the countries have a very great interest, since the wells and capacity were there. Each one could sell it in competition with some one else. It wasn't that much more oil was produced, but in the competition to get the markets, the price kept coming down. What has changed in the interim, is that the wells are there; the world is consuming more oil; but we have developed our productive beyond that also. We have today, 7 to 8 million barrels a day of surplus capacity. The difference is that this is in the hands of governments that a few years ago had to produce more in order to get revenues. But now when they get $10 for those revenues and they don't quite know what to do with their surplus earnings, the whole world criticizes them for having such surplus earnings; that they are destroying the economies of the world; that they should support the economies of Pakistan, India, or Italy. They don't have to compete among themselves for sales in a market where the productive capacity is greater than the demand for oil The companies no longer have these decisions, the governments have them. So in

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effect, the governments are prepared to set a price for their oil. If you don't buy it from us, we will simply produce less. If we produce less, we won't suffer at the levels of production. It is difficult in the changing oil environment where the political balance of power has shifted so much. The governments don't have to worry if the oil is in the ground five to ten years from now. By then the price of oil will be higher. They have no financial pressure to produce to capacity. There is no political incentive for them.

Senator Poland asked: What do you think the effect of the OCS might be upon the lease sale and whatever is done in Pet. 4. Mr. Lipton replied: It is hard for me to visualize Federal leasing of the OCS or the ultimate development of Pet. 4 as really being terribly disadvantageous to Alaska. This kind of implies that here is an Alaskan government and a federal government, and they are competing one with another in a narrow confined area. I think the urgency of oil development in the United States is so tremendous not only from the security standpoint, but also from the standpoint of having what tomorrow will be low cost energy compared to what is available from the other alternatives. It may look high cost now, but we are reaching the end of a petroleum age and there is alot of oil that remains to be found. What may look to be high cost today may not be high cost tomorrow. If the Federal Government in a sense is a purveyor of leases and if the State of Alaska is also a purveyor of leases, I don't think they are competing directly with each other, because both of them are in this

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portion of North America which we call Alaska. For the companies bidding on leases, they are always looking at the amount of capital available to them, and the potential profitability on the investment of capital. The lease sale by the State of Alaska in Beaufort competes as much with an exploration in Southeast Asia or in Canada as it does with a federal lease sale in the OCS of the Gulf of Alaska. It is a matter of arraigning the demands on their capital vs. their profit expectations. In general, the resource potential is really good. Whatever is done around you will help you, and will increase the potential interest on any acreage you have nearby. Just as the Prudhoe Bay Field made it possible for people to operate and explore on the North Slope, where as before it was fantastically expensive because you can't explore on the OCS without a base of operations, which will have to be in Alaska. This is terrifying from an environmentalist's point of view. There are pluses and minuses for that. But when all of it is done, anything that is on State lands will cost less than otherwise. You don't have to visualize that federal leasing is in competition with State leasing. I think it will work to your advantage. The development drilling by the Navy in Pet. 4 will be different than it was in WW II, as they will be forced to exercise at least the same constraints as the State of Alaska forced upon private companies on the North Slope. There won't be quite as much damage to the environment by the Navy as there was the first time they walked into it. I doubt if drilling in Pet. 4 would in any way adversely affect the potential lease

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sale of State lands somewhere between Prudhoe and Pet. 4, If anything it may excite more enthusiasm than otherwise.

Senator Rader asked: As I understand it, the primary of the gas reserves favor the Canadian route? Mr. Lipton answered: I don't blame you for assuming it, but I don't think anything they have done so far indicates that they positively favor it. I would guess that the most recent actions by them indicate that they are indifferent to it. They are all members of the original Canadian gas line. They were all original members of the first oil pipeline study group. It was out of the oil pipeline study group that the Canadian Gas Arctic went. They were all active in it for alot of different reasons. Most recently, they have sold off their gas reserves and let the buyer of the gas reserve worry about what the route is going to be. At least two of them have withdrawn from the Canadian Gas Arctic route. I'm not interpreting what their interests are, but to read the entrails of the chicken, so to speak, what is visible is that they are bowing out and have less of a direct interest than they had before.

Senator Rader asked: If the owners of the reserves intend to perform on the contracts that they have made, they have to favor that route which will permit those purchasers to buy won't they? Mr. Lipton answered: My recollection is that El Paso has already stipulated that they are prepared to operate the Alaskan Gas Pipeline

as a pipeline carrier. They are quite prepared to operate the pipeline and carry the gas. If they are also correct in that they can arrange for the reverse flow of lines, maybe the same buyers of gas can operate the other way. Whether they are correct or not, it isn't technically foreclosed that the same buyers of North Slope gas could not operate through El Paso. If they could not operate through El Paso, I think the El Paso case would (blurred) because of the problems of gas distribution in the lower 48. If it can be done by somebody else through El Paso, the El Paso's case before the FPC is weakened. I have probably said more than I should because I'm talking from memory without having recently looked at it, but my inclination is that the gas sale contracts do not entirely depend upon the Canadian route.

Senator Rader: Then are we really saying that the owners of the reserves are really not parties to the case as to which line they think is best, and maximum their profits from their reserves? Mr. Lipton answered: I never like to appear as a spokesman for a private oil or gas company. But if you are asking me how I interpret it, I would say that whatever interest they may have had at one time in the route, that at the point when they start selling off their reserves, they have a less interest than they had before. Now, they haven't sold off all of their reserves, but indications are that they have less interest than before.

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Senator Rader asked: Why don't they have a tremendous interest because it is a flexible price and therefore the cheaper the line, the more valuable the gas at the wellhead, and they are the producers. It looks to me like they have the same reason we have which is an interest in the least expensive line. Mr. Lipton answered: They may be driven by the budgetary deficit like the State of Alaska. The advance payments are tremendously important to them.

Senator Rader: I thought that perhaps their own self interests were strong enough and dictated a particular type of line which I was interpreting to be a Canadian line.

Senator Rader: You say that has been diminished in that part of it has been sold. Mr. Lipton answered: That is so. Also it is awfully difficult at this state in our knowledge as to respective transportation costs to come up with the conclusion that one routing or the other will lead to a higher wellhead price. In point, the fact that differences in the transportation costs are most apt to be irrelevant to wellhead value unless they are really very substantial....I think the price at destination will be in terms of transportation differential.. But if necessary there may be even differences in the wellhead value and differences at the destination.

Senator Rader asked: What would the national interest be other than

the cost of transportation? The market? Mr. Lipton answered: Yes, the market would be much more important than transportation costs unless the differences are really significant.

Senator Rader asked: How significant would national interest be opposed to our more local interest? Is there any way you could evaluate that? Mr. Lipton answered: I don't think the interests of the State of Alaska are going to be ignored. It depends on how strong your interests are against the differences. Unless the differences between the two routes are overwhelming the State of Alaska, the interest to the State of Alaska is going to begin late.

Senator Rader asked: Where do you think the real market for the gas is at this time? Midwest? East? Mr. Lipton answered: Much less the west coast, but this has been knowledge all along, because you have displacement and so on. But probably the midwest and the east.

Senator Poland asked: You mentioned that the oil companies might be in a crunch like we were. One of the witnesses at the OCS Hearings in Anchorage brought forth the idea that the oil industry might be placed in a terrific bind were all these leases in the OCS to be offered as far as capital is concerned. What are your feelings on that? Mr. Lipton stated: There is no question but what there is a tightness of available capital over in investment in the oil industry. And borrowing is very, very expensive. But need of course means it is attractive enough to make the investment.

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So one is always looking at prospectives. The Federal goverment is always very careful not to have simultaneous leasing in several areas. Yes, there is a problem, but I don't think one should put an emphasis on the problem that you get in competition. First of all, it doesn't work that way. We know there are going to be two lease sales. Budgets are made for time periods. There is flexibility and they are going to respond where they think is best. We are dealing with a free enterprise economy whose motivation is profit. Yes, there is competition, you can't ignore it, but don't get into the rat race.

Senator Butrovich asked: The other day when we started out, you said that the production price for a barrel of oil was arbitrary. Mr. Lipton answered: The selling price ....the one thing I remember saying was that if you look at the price of foreign oil, that this price has nothing to do with supply and demand or the cost of production. It is a political price, arbitrarily imposed. It costs about 25¢ to produce and it sells for $10.50.

Senator Butrovich: We are bringing in 6.5 million barrels of oil and getting a heavy outflow of U.S. dollars, which I am sure alarms some people. I read an article in which this economist took the opposite view. He said they have all this money now, and they will need all the things that we manufacture. He thinks the outflow will turn around and start coming back. Do you think there is any validity to that theory? Mr. Lipton answered: Yes, in two respects. First, with this money they are certainly buying more than they did before.

They have internal development programs which they couldn't finance (they, of course, means a large number of countries and they differ among themselves)..They can't get the springboard for internal development without a tremendous amount of imported technology and services. Secondly, machinery and equipment of all kinds are needed for this. Yes, they do buy it and the United States is one of the prime beneficiaries of that. There is another kind of internal development and that is what they spend on armories and we are the prime beneficiaries of that too. But so far at least there has been quite an imbalance. That is to say, what comes back to us has been less than what goes out. In terms of what they have surplus to what they can concievably spend, they must invest in one way or another. Invest where? They invest in those portions of the industrial world where they have a certain degree of confidence in it and a great deal of that has come back to the United States. So while our balance of trade has deteriorated, it is not clear that our balance of payments has been that bad. Also, if we can live through this period, all of these countries will in the future years, develop a greater absorptive capacity. That is to say they can absorb more goods from other countries because industry will be building and a second generation industry will be building on top of the first industry. In due course, all these things might come reasonably into balance. In all these respects the United States really is one of the two or three prime beneficiaries in the world.

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It really costs us less compared to other countries in the cost of our oil imports porportionately speaking. We get more of the reverse flow than many other countries. The hemmorage that Senator Gravel talked about is very real. But it is a kind of modestly contained hemmorage compared to the problems of France, Italy, Germany, or Pakistan.

Senator Poland asked: With regards to President Ford's energy plan to increase the price of gas, how will this be distributed to the population. Mr. Lipton replied: Everybody will pay more for oil and gas and Alaska will pay a little bit more than everybody else will. You will pay as much more directly, but if you look at it indirectly, besides what you pay for a gallon of gasoline or a gallon of heating oil, you also pay for the price of oil in every commodity that you buy, including these plastic bags which are so essential to the Northern tier of Alaska, because you can't live all winter without having a place to dispose. Everything made of chemical products will go up. One of the indirect prices you pay for oil is in transportation. Oil is a big compound of the transportation costs. Everything you buy is related to the transportation factor. How much effect it will be on cutting down oil consumption nationwide however, is a matter of dispute among government people, oil industry people, Congress, and everyone else. If it is the purpose of the United States government to reduce oil consumption by a million barrels a day (which is one out of about 16 to 17 million barrels a day), where would you conserve 1/5 or 1/6 of your oil consumption

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in Alaska? I don't think you could. I don't think you have such wasteful consumption of energy that you can conserve very much. So you bear the higher price and all of the higher costs and you will contribute very little to the nation's objective of conserving energy. The oil industry which is being taxed will at the end of the first year, have about two to three billion dollars cash flow less than they had before. I don't think this is particularly to your interests since you're interested in the cash flow out of the industry. I'm being critical, but I'm trying to be critical in ways that have to do with the Alaskan interest. The purpose of the proram is very clear. The President wants a quick reduction in consumption through higher prices that will be reflected in a reduction of oil imports. If we import a million barrels of oil a day less in the course of 1975, we are less vunerable to an embargo. But more importantly we have said to the rest of the oil consuming world that we are prepared to be aggressive and decisive and this is what Dr. Kissinger was asking from them that strengthens his hand in the alliance with Western Europe and Japan to prove that we are being decisive. It provides a flow of 30 billion dollars to the treasury out of his energy program, which I think the Treasury Department wants very much to offset a terrifying prospective deficit from the rest of the anti-recession tax program that the administration has proposed. The administration believes this will be even worse by the Congress gets through with it, because Congress will cut the taxes more than the President has recommended and they won't cut back spending anything like the President has recommended. What I am trying to do is to give you a perspective on what the intent of the

program is and what the effect will be. But that is for the mean higher energy costs and the impact of the cost of living is very clear, if the Treasury Department itself estimates that the cost of living will go up by 2%, two percentage points because of the energy program. There are other outside estimates that suggest twice as much.

Senator Poland asked: When we were discussing this the other day, you mentioned that the larger user will bear less. Mr. Lipton replied: That isn't clear. The way in which the government proposes to regulate the price of petroleum products compared to the price of crude oil is designed to prevent the oil industry from passing on the high costs disporportionately to fuel oil, heating and diesel oil, becaur these are the really essential things, and hopefully pass it on more to gasoline because there is certain flexibility in the use of gasoline to the intention is that when the prices go up, everything will go up. But the price of gasoline will go up more than the price of diesel oil, heating oil, and heavy fuel oil. This again is the intention of the administration.

Senator Butrovich asked: Is all of the Cook Inlet production considered old oil? Mr. Lipton replied: Yes, it is.

Senator Poland thanked Mr. Lipton, stating that we had all learned a great deal and hoped that we could use it intelligently in the work we have before us. We will look forward to seeing Mr. Lipton again.

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MINUTES
SENATE RESOURCES MEETING
FEBRUARY 12, 1975

Senator Poland introduced Mr. Norman Lipton, Consultant to the Legislature on Oil and Gas, and added that it was a privilege to have him here today. She stated that she had asked Mr. Lipton to give a "State of the Oil and Gas", and that after his presentation, he would be available for any questions the committee may have.

Mr. Lipton began by stating since they had a relatively short time for the session he would not take too much time dwelling on matters remote from the State of Alaska. He continued: I put it to you that your concern about the oil and gas industries, your legislation affecting the industry and in particular, the economics of the industry as it provides a source of potential revenue for the State, are very closely interrelated, more today than ever before, with what goes on in the world at large. The nature of the federal energy policy is that it interrelates the United States as a whole with foreign oil. So I will take a few minutes to talk about what is happening in the world of oil; what is happening or is not happening in terms of federal policy in respect to how this relates to the United States. Just let me say that it is very difficult to be positive or omniscient in matters where political decisions weigh so heavily as they do with respect to oil balances, with respect to foreign oil prices, and particularly with respect to the way the United States adapts to it. But the fact that there is so much uncertainty in these areas is really no reason for foregoing decisions. The certainty is going to be a part of the world in which we live for a long time to come. Although I may not have any answers, perhaps I have some perspectives that are useful to you. I know everybody around the table, but there are a few new faces, so I might even dare tell you my favorite parable on the expectation that at least someone has not heard it before:

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There is this wonderful Irish Story about the little old man walking through the village street on a Sunday morning, bowler hat on his head, stick over his shoulder and all his worldly goods tied in a little pack at the end of the stick. But he was not going to village services; he was marching down the village street. Someone said,"Man, where are you going?" He said, "I'm going to Konnomara". The person asked again,"You mean you're going to Konnomara, Godwilla"? "I mean, the old man answered, "I'm going to Konnomara!" The Lord took offense at his boldness and turned him into a bull frog, croaking in the village pond. Years later, the Lord relented, turned him back into a man, bowler hat on his head, and he walked down the village street all over again. A villager asked "Man, where are you going"? He said, "Man, I'm going to Konnomara". The villager said,"you mean you're going to Konnomara Godwilla? The old man answered,"I mean I'm going to Konnomara or back in the pond."

A year to 18 months ago, the world was using oil as a cheap commodity. One looked ahead and said how long can the world continue to supply the consumption requirements of us all when we continue increasing our consumption each year at that rate. Even Middle East Oil has a bottom to the barrel somewhere. Its not a bottomless oil, and by the summer of 1973 we were beginning to see tightness in the world oil supplies. We, if you remember, were not that pessimistic about the world running out of oil by 1980 or 1985, but still this was part of the outlook. Under the circumstances, first of tightness of the world's oil supplies, then as a result of the Israeli-Arab War, the imposition of the Arab embargo against the United States and a few other countries, particularly because the Arabs enforced their embargo by reducing production, the world faced an acute shortage of oil and in the hectic scramble not only among countries to buy oil. but among countries to latch on to supplies and suddenly we find that the price of oil has shot up astronomically. explosively to completely unprecedented levels. Way beyond the level of prices which the Middle East producing governments themselves would have contemplated. Well now in a very short time, the situation has turned completely around. How completely? Because of the explosive levels to which oil prices rose, over

10½ dollars out of the Middle East, and because of the problems of countries not only in paying the price but in affording the foreign exchange that has to be paid from importation of oil; what Senator Gravel referred to as the hemmorage upon the US dollar. As a result the world was forced to conservation of energy to a degree that was unknown before. We entered into the petroleum age in the 20th Century. The petroleum age was 80 years old and in all that time there has never been an instance where world oil consumption was less than the previous years - not even in the great depression. Now for two successive years, we are faced with actual reductions in world oil consumptions. Meanwhile, productive capacity is going up. So today we have the surplus productive capacity on the order of 7 to 8 million barrels a day, which is probably 12 to 13% of world oil consumption at a time when prices remain high. This of course, is a result of not the economic balast of forces which creates a price, but of the political balast of forces which enables the major producing countries to sustain their price.

One further remark and then I leave the subject: By 1980 even if there is reasonable increase in energy consumption around the world...which means oil consumption and oil imports for those countries that are oil consuming countries. And without any extravagant projection of major new oil discoveries, simply with the development of the North Slope reserves , the North Sea reserves, the discoveries in Southeast Asia, or Latin America plus what is coming in in Africa and the Middle East,

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the world is likely to have 12 to 14 billion barrels a day of greater capacity than the world will need in terms of the amount of oil that is consumed. What we have had is this tremendous turnaround in a relatively short time, largely because the high cost of oil has had its effect on the rates of growth and consumption. This too can change. I'm not suggesting that we now have plenitude of oil for long times to come. We are dealing with a finite resource, and with the prospect that most of the world will for 25 years have to depend still upon petroleum for their energy.

So we are reaching a time when again oil will be in short supply. The question is: What is the timing of it? Will by 1978, 1979, or 1980 the overhang of surplus force the producing countries to drop their price? The political incentive to hold the prices....what reason is there for them really to drop the prices? To sell more oil, when if they keep their oil in the ground and the world practices conservation, their oil will be more valuable in 1980 or 1990? Can they afford to suffer losses of income because the world consumes less oil? They couldn't in the 1960's because the government revenue in those days was 85¢ a barrel. Each government desparately needs money and they knew that they could get more oil only by producing more. So the competition for revenue through higher production kept prices down. A government today which gets $10 more for every barrel of oil it produces, which is building up surplus accumulations of foreign exchange in dollars which they cannot spend, can well afford to forego production - potential production in order to hold the price up. But it really depends upon the political sensibilities of 4 or 5 countries who really

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sit upon the large reserve and because they sit upon the large reserve, they have to carry the burden of shutting in the production of carrying the surplus productive capacity. Will they be able to do it? Will they not? It is hard to tell.

But the picture I'm drawing is of continued high oil prices for a considerable length of time, even in the face of surplus. But with the availability of oil becoming more and more apparent and the uncertainty as to what happens to the future price of foreign oil, what is the US position? We are reluctant for many reasons to become unduly dependent on foreign oil; for foreign exchange reasons obviously because of the increased dollar cost to us, but also for strategic reasons. Not only because of another boycott, but because of the threat of a maneuverability limits the options of the administration on how they handle so many foreign policy decisions. So it is an economic incentive to reduce the volume of imports. There is a security incentive to make us less dependent on the voraciousness of foreign producing governments and there is always the long-range concern that that we must provide our future energy needs against the time when our world oil supplies will not be replenished.

The policy of the United States with respect to oil and energy is linked between the price that we would have to pay for foreign oil and the costs we must sustain for developing our own energy resources. It is not the costs of foreign oil in the sense that there is this much labor or this much capital in producing the foreign oil, the real costs is 25¢ a barrel, but the price we must pay in the United States - $11 to

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$12 a barrel, against what costs we must incur in order to develop our own energy resources. From the standpoint of Alaska and its developments, I suggest certain numbers too. At the present time, foreign oil in the Middle East - say $10.50 a barrel, reaches the United States at $12.00 a barrel. What are the relevant prices of oil within the U.S.? Under our domestic oil control program, the old oil which is now being produced has a price ceiling of about $5.20 on it. We have decontrolled new oil..that is to say..if someone goes out and drills a well, with no control on it, he is able to get whatever price he can sell that oil for, or for whatever value that oil has if he produces it in his own refinery. So that oil commands a price which is very close to the only other alternative, which is import oil at say $12 a barrel. Average it all together and the amount of old oil we produce, the amount of new oil we produce, and the amount of oil we import, the average cost to us as a nation, the crude oil from which we refine our products and sell them to our consumers is around $9 a barrel. If we were as a matter of policy, as Senator Gravel has suggested, to eliminate all price controls from oil and gas, in due course the value of domestic oil production would go from the present $5.20 for old oil up to the only other alternative - imported oil which is about $12 a barrel. The corresponding value of gas would be about $2 in Seattle if it rose to BTU equivalent.

The president's proposal was not only to decontrol oil and a new gas, but also to levy a tax, an oil import license fee, of $2 per barrel and an equivalent tax on gas. That would raise the price to $14 a barrel. These numbers are relevant to something you must consider

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if you think about: a) what the value of Alaskan oil is going to be if we go to leasing, b) what kind of revenues will the State get from such taxes and royalities which are related to the value of oil, or, c) how can we contemplate new taxation upon the oil industry. All of these involve a projection of what the value of oil and gas may be in 1977 or 1978 or up through the 1980's, if you consider resources. So look at the uncertainties that we face. a) the level of oil value as it now exists because of the control of oil and gas. b) the price to which it might raise if controls were taken off and some form of taxation were imposed by the federal government which would then give you still higher value for your oil. c) how much might be siphoned off if there was an excess profits tax, or as the President has suggested, a windfall profit tax. Put these together with the fact that all of these prices I have discussed are no more related to $10.50 Middle East oil as of today. What will it be in 1978 when the first oil moves out of Prudhoe Bay? What will it be in 1980? What will it be for the 15 years of exploitation of Alaskan Oil Reserves which is the basis upon which you might have to construct the value of reserves in place.

The range of uncertainities here is so great that I think one must move very cautiously in designing legislation relating to the expected profitability of an industry where you are thinking that this can be predictable as such. And therefore there is a known profitability or a known relationship between what is a reasonable tax today and what it may be when the oil action starts.

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The thrust of my remarks here of course, is not to say that the Legislature must be doing nothing. But it is a word of caution to the effect that we are living in a period of greater uncertainty, 1) is to the value of energy all over the world when it depends upon the political price of making abilities of 4 or 5 foreign governments; 2) whatever they do becomes translated into what is U.S. energy policy and therefore what is the value of Alaskan oil and gas resources under U.S. enegry policy. If congress today asks the question which it is asking the administration: why if foreign oil has reached such astronomical levels as $12 a barrel, and we could get it sentenced for domestic exploration, even investment. in alternative energy resources... ...if we allowed our prices to go up to this horrendous foreign price which we are so critical of, why must we raise our prices even higher? The other answer is also tremendously appropriate. Can we have a National Energy policy which allows our domestic energy to be valued in relation to foreign oil? If foreign oil prices collapse in the future? Can we afford the government initiative towards a development of alternative energy uses which have grown incredibly expensive, compared to commensurable resources. The most optimistic thing I have heard in the last 18 months is Senator Gravel's statement that if we put as much money into solar research as we did into the breeder reactor we would be supplying some percentage of our energy today. A tremendously impressive state,emt. I doubt very much if he really meant today. He may have been thinking 15 to 20 years from now. But we do not have these kinds of breakthroughs in completely new forms of energy which take place at that rate. But if the government is going to inspire

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a resource development program; if private industry is willing to invest; whether it is a conventional exploration or the development of Alaskan resources, can we afford to let that investment proceed in the expectation that we will have energy values of $10 to $11 in the United States; if the foreign oil prices collapse to $7 or $8. Never mind that $3-$4 that it used to be. Even with $7 or $8 we will then say that we will allow our domestic prices to go down. So the uncertainty is whether we are going to allow our U.S. energy prices to go above foreign oil. Is it necessary? Would we allow it to go down if foreign oil prices go down. This is the range of uncertainties that we face.

One note of certainty - a very personal, but dogmatic opinion. If you look at all the possibilities of Project Independence that the government is banking on to minimize our dependence on foreign oil and you look at these realistically: what can be done with oil sharing, what can be done with coal, what can be done directly with the gasification or hydrogenation of coal, what can be done by accelerating a nuclear power program. And then you say within the time frame of the next five, six, or seven years, where will the big contributions be? To our nation's ailing supply of energy the answer is Alaska. The answer has to be Alaska. What you have in sight is the 1.62 million barrels a day out of the North Slope that will come through the Alyeska Pipeline. What you have is the belief or reasonable expectation, that

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there is a very large reserve of oil in Pet. 4. Now what the policy will be for exploration and development in Pet.4 by the Federal government, I think we are some steps beyond that...But to find out for sure what the reserves and potential of Pet. 4 are is a tremendously important factor, not only for Alaska in terms of what it means to the whole potential or auxilliary development, but for the nation as a whole. It's not only the oil that may come out of Pet. 4, but it's the probability that the combination of the development of the Federal lands plus the spur to exploration in the North and the fact it may in all probability come down from Canada and therefore be linked with and will accelerate resource development in the MacKenzie Delta. This would enable Canada to turn from what is essentially a program of conserving their own resources, reducing exports to the United States because they are afraid of the pace at which their own exploration can proceed. but if we provide them with a relatively low cost transportation and they see this volume of potential oil coming out of Canada long before the actual production of Pet. 4, before the pipeline is built, it enables them to reconsider their own policy, which says we must slow down the rate of production and we must reduce in 1975 already exports of oil to the United States. And by 1980, 1981, 1982, no oil at all shall be exported at all to the United States from Canada.

As we broaden our conception, our appreciation of what the Arctic potential is, it not only contributes directly to Alaskan development, to the United States oil balances, but I think it offers the opportunity for a new realignment of Canadian and United States energy policy which has been horribly lost over the last two or three years.

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I've spoken at great length on this, and would like now to turn from the general to the specific. The best way to do that is to elicit from you an expression of either disbelief, you don't believe a word of it, or what in the world are you talking about anyway? or we've got some very specific things in front of us, what do you think about those?

Senator Orsini asked: With respect to countries other than the U.S. how long can they continue paying $10 to $12 for oil? Mr. Lipton stated the answer is very simple. They couldn't even have done it last year. But they did. They could surely not afford to do it this year. One way or another they are bumbling through. Now this doesn't mean that they have solved the payments problem. It has not been solved. It is not being resolved, but without any design on the part of the world to solve the problem, little things are being done here and there. Last year a 2 billion dollar emergency fund from the INF which is now hopefully going to be extended to 5 billion. There is the Kissinger safety method, whereby in effect the United States and the Common Market would make available up to 25 billion dollars of credits among themselves to those countries within the group who are in the weakest position. This means of course, that the United States and Germany would bear the brunt of it. Italy, France, would be the major borrowers for some time to come. The U.K. for awhile would be until the North Sea production comes on. It is difficult to believe that a couple of potential lenders like the U.S. and Germany are prepared to anty up that amount of money. In principle, the concept is there

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because we after all, are the beneficiaries of the reinvestment by the oil producing countries. They buy more things from us and Germany than they do from Italy. So we have some of the reverse flow.

There are direct loans by some of the producing countries to some of the weakest. India and Pakistan have gotten loans and cut in oil prices from Iran, and Iraq - not from any other oil producing countries. There has been direct borrowing. Britain borrowed 2 billion dollars directly from oil producing countries. This doesn't solve the problem. Witness the fact that the entire world is in a recession which means we haven't solved any problems, but we have mitigated the problems and if we can bungle through for enough years til alternatives are developed and among those alternatives that matter of course, is the ability of the oil producing countries to absorb some of their own revenues, and to spend it productively. If they spend it productively, they must spend it in those parts of the world that have something to offer in return, which is technology, etc. The tragedy is of course, that here is what was almost inevitable in any case by 1984. If one made projections of what foreign oil prices would be in 1973 we would have said that in 1984 it would be $8. $9, or even $10 a barrel. And at that same time, if the world had moved slowly towards that, there would have been economic adjustment to it. Why should energy always be cheap? Nothing is cheap in this world unless it is plentiful. As long as its plentiful, its cheap and as long as its cheap you use it in a profitable fashion. But energy can not always be cheap and when its not profitable it will go up in price and when it goes up in price, will we conserve? Unfortunately, a 1984 was dropped in our lap in 1974. We didn't have

those ten years and this is a tremendous problem of adjustment. If foreign oil prices should for any reason come down sharply in 1978 or 1979, and if the world for that reason were so short sighted that it started burning up energy at a 5,6,or 7% increase over years in the past and so short sighted that it wouldn't pay the money for nuclear power and gassification of coal - how long do you think the price of.oil would stay down? We would be in another crises by by 1981 or 1982.

Senator Huber asked: I would like to explore one area you stated, about possibly turning around the Canadian policies, by getting production shipping through Canada. Aren't we just likely to do exactly the opposite by building major oil and gas through Canada, because we now give Canada the ability to tax that line that is carrying our oil and thereby providing them with needed income off our our resource and then they won't need to exploit their resource anymore. Won't this work just the opposite way? Mr. Lipton answered: I'm going to predict something about public policy. There is not going to be an oil or a gas line out of Alaska thorugh Canada without a treaty with the Canadian government. To my mind, this is a sine-ne-quon. The terms with which such a treaty can be negotiated depends upon what we are prepared to ask them, and what the Canadians are prepared to give. It is my opinion that the Canadian government has a very substantial interest in having the certainty of a gas or oil line coming down through Canada. Because as of now, three oil companies have made substantial discoveries in the MacKenzie Delta, not only of gas but oil. They are at least projecting a pipeline with a capacity of

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of perhaps 500,000 barrels a day. This will link up with the major transportation system of Canada. Now we've discussed the economics of pipelines often enough that you know how quickly the economics of a pipeline is improved. First of all the capacity and the utilization of capacity. If the Canadians wanted to build a line scaled to 500,000 barrels a day it would be a relatively expensive line. They would say if we are going to find lots of oil, we will scale it to a million barrels a day pipline when they only have 500,000 barrels a day input. If the line can be scaled at a more economical size from the beginning, it improves all of their transporation economics. It provides a tremendous incentive to the continued exploration and development. You will not have Alaskan oil moving through Canada if the Canadian government is in a position to say if we find more oil you have to take yours out of the line. Obviously, this is a sine-na-quon. But once the intrastruction is gone; once one scale line is in there, the additions to the capacity of the line, either thru pumping are improved........What I am suggesting is that this is a tremendous interest to Canada. I'm not addressing myself to the interest of the State of Alaska in what direction in transportation it takes. But you have your crude oil pipeline. What route the gas pipeline takes is an open question as yet. But the development of Pet. 4..at least the determination of the oil potential opens up whole new concept of future volumes of oil, transportation, and directions of oil movement. I think this would be a springboard to a change in the relationship in energy between the United States and Canada.

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Senator Huber asked: The specific thing I'm getting at is the tremendous long line in Canada has such a high value that just reasonable ad-volorem tax alone place against that line has to carried by the product going through that line, which means Canada has a very large potential to tax us on our resource without having to give us any of theirs. This is my concern. Mr. Lipton answered: The economics of transportation - oil or gas - why in Alaska, Why in Canada, One can debate those. If Alaska is always interested under any and all circumstances in minimum transportation costs for its natural resources, the lowest possible costs must inevitably work to the benefit of Alaska. Now if what you are saying is that there may be inordinate transportation costs imposed through Canadian taxation, this ought to bring together something covered by treaty. If what you are saying is that even ordinate or reasonable transportation costs go to the Canadian government when they should go to the government of Alaska, that I can't answer. If you feel that the economic well-being of the State depends upon keeping all transportation facilities for Alaskan oil and gas within the State so that you can tax that property, I can't answer that. I'm not sure that is in the best interests of the State in any case.

Senator Huber asked: You did have some figures about the ordinate costs of transportation on such large investment through Canada would be a drain on our balance of payments and would be a considerable amount.

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Senator Poland stated she wanted to make it clear that any of the other legislators present that were not on the committee were perfectly welcome to ask questions of Mr. Lipton.

Senator Butrovich asked: What is the ratio of the foreign oil that we are using now and the so-called old oil? Mr. Lipton answered: We are now importing about 6.5 million barrels of oil a day. That is not all crude oil. There is less than 4.5 million barrels of oil that is crude oil. The rest is heavy fuel oil. We don't as yet have in the U.S. the refining capacity for this. We are producing in the U.S. liquids, crude oil, nitro gas, etc., - about 10 million barrels of oil a day. Of this 10 million, about 6.5 million is controlled. This means that it moves at a price of about $5.25 a barrel. The other 3.5 million is essentially decontrolled oil. It is new oil. It is what is called released oil.

Senator Butrovich asked: How far in the future would you look before the decontrolled production would reach the controlled production? Mr. Lipton answered that, In terms of price...Senator Butrovich stated he was thinking in terms of time. Mr. Lipton continued: you mean that the controlled or old oil production which is less and less each year ....Senator Butrovich stated he was not interested in price controls at the present time, just the production. Mr. Lipton answered: You have controlled oil - the 6.5 million barrels. What we mean by controlled oil is that the price is being held there. The amount of oil that is produced without price control we hope will be increasing each year. The amount of oil that we will be producing subject to price control will be decreasing each year, because that is old oil coming out of

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existing wells. These existing wells have less capacity each year.

Senator Butrovich asked: Then at some point in time they will even up? Mr. Lipton stated at some time they will be even, and if we maintain our present control system, theoretically everything will be uncontrolled oil because we will have exhausted our old oil. The decline rate of old oil in the U.S. is perhaps 2.5 to 3% a year. So if you talk about 6.5 million barrels of oil a day and you take 3% of that, you talk about perhaps 200,000 barrels a day less production each year. In other words wells (the old oil) are losing the capacity to produce at about 200,000 barrels a day. Unfortunately the new is not increasing as fast as the old has been going down which is why our total U.S. production has been going down..

Senator Butrovich asked: Why, if we are bringing in as much foreign oil as we have under the controlled price, do we have a controlled price on our own oil? Mr. Lipton answered: This is not my policy so therefore I can only give you the rationalization of what has been Federal policy up until now. There are several reasons for it. One is that the big increase in the foreign oil price going so far above the U.S. price took place in inflationary environment and it has now become a part of the recessionary environment. There is a reluctance on the part of some people to say, Can we really afford to let this large volume of our total oil supply up so much in price that it imposes a cost burden upon the American Consumer? Secondly, all those instances with the increase in foreign oil prices, was a substantial increase in oil industry profitability. In the first instance it came from foreign

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profits, but in the second instance it came from improved profitability in the United States. Its a very difficult political thing to say time when the industry in the United States has been improving its profitability. We must also give them higher prices. Third, its a very difficult position we are in worldwide if we are saying that foreign governments ought not to raise their oil prices to $10-$11 a barrel. Can we really lecture them as what they ought not to do if we in effect let our prices go up?

Senator Butrovich stated: I'll buy that, but on the new oil we are doing that. That to me is not consistent. Mr. Lipton answered: My own feeling for whatever its worth is that first of all in talking about what the foreign oil price used to be - we have the economics of oil and we have the politics of oil and now we throw in the theology of oil. Its a losing battle to argue theology of oil pricing with the Arabs because Allah gave them the oil; he surely knows more about what the price ought to be than we do. If your point is that there is a price of oil in the United States that serves the economic function which is twofold: a) the price will induce consumers to consume oil at a rate that is consistent with the rate at which that same price brings forth new supplies, you're saying that the U.S. oil price is an economic price when it does two things. When it discourages consumption at too high of a rate, and encourages production at an adequate rate. Then I agree with you. You have defined what is an economic price for oil. But the politics of energy policy are often quite different from trying to achieve a price. A price must achieve those two functions. A price which is too low and

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and encourages people to consume at a profligate rate is not an effective price. A price which is too low and discourages the development of oil and gas is not an economic price.

Senator Butrovich asked: What does the ceiling on the 6.5 million barrels do? Mr. Lipton answered: It keeps your cost and my cost of oil lower than what it would otherwise be. Senator Butrovich asked: But by the same token, you are turning around and paying the foreign governments twice that. Does that make sense? Mr. Lipton answered: It also keeps the profits of the oil industry lower. Whether we want these things to happen or not is a matter of public policy. I am not trying to be a protagonist of this policy, I'm trying to give you the rationalization of whay we are where we are today. No, the president has said in effect that he will, as of April 1, under the executive authority that he has, remove all price controls on crude oil in the United States. He has also said that he will not only allow all of our oil prices to go up to the foreign price of $12, but wants all oil prices to be $2 more than that by putting an import duty on the foreign oil and putting an excise tax on domestic oil. so we are not only going up to the foreign oil prices, but we are going up $2 a barrel - 17% above the foreign price.

Senator Butrovich asked: If you had some of this so called old oil, wouldn't you be reluctant to pump it out at this point in time? Mr. Lipton answered: It depends on what I thought the future price was going to be.

Senator Butrovich asked: It is hard for me to understand why we pay

these foreign countries in U.S. dollars twice what we pay our own people. Mr. Lipton answered: the question you're asking is at what rate we could replace foreign oil that costs us $12 with domestic oil, if we raise the price of domestic oil. Why shouldn't we be able to be willing to pay to our own producers instead of foreign producers? That is the difficult question to answer. At what rate could we really displace it, or will we in effect, for a considerable time be importing 6 million barrels a day of foreign oil and not getting very much more domestic oil, but still paying domestic producers $12, not for the oil that they are going to find, but for the oil that he found 20 years ago at a very low cost. That goes by the name of windfall games and raises the question of public policy. Even the President when he asked Congress to enact what he calls a windfall profits tax, which would take away all but about a dollar a barrel of the increase in price that producers of old oil would get and would take away a very large porportion of the price which producers of uncontrolled oil are getting today. The oil industry under the President's energy package would be left at the end of the first fiscal year of operation with about 2-3 billion dollars less cash than they have today. after the control because of this tax program. I would never presume to say that there is anything simple about this. It is obviously not a simple thing anywhere. We are facing in the United States as far ahead as one can look, energy crises that will be very significantly determined by public policy. We kid ourselves and I think that we are being flattered by the administration that tells us that we are going to free-market prices. We are not. We cannot have free-market prices so long as

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the world oil price is politically determined. Do we have to always pay as high as they do? To decontol oil doesn't really say that the government is taking off all controls. If we have governmental intervention in the whole field of energy in effecting the price, what is the price that is going to do the job? What is its effect on consumption and its incentive. How fast do you move to that price? Do you go whole hog and say that everything in the United States shall be sold today at the price we think will be the price we have to pay for sharing or do we say everything is sold at the price that we think is enough incentive for domestic exploration? There are no easy answers to this. There is the question of what is the price that will do the job and how fast do we move towards it. The value of Alaskan oil and gas resources over this period ahead is not going to be determined as it was in the past by this interplay of market forces, but rather out of the juxtaposition of a) the political pricing of foreign oil, and b) the energy policy of the United States which says that whatever the foreign oil price is going to be, this is the relationship between our energy values. It will be this interplay of United States energy policy with the politics of foreign oil which is really going to be our problem.

Senator Butrovich asked: Is it not a fact then that the oil-in-place on the Slope that we know about now, would be classified as old oil. Mr. Lipton answered: No, it wouldn't. The North Slope oil, if it were being produced today, would be free of control and you could sell it at the decontrolled price. That is to say, it would be worth somewhere

around $11.50, delivered in California. Any new production which you can establish in the Cook Inlet over and above the production of a respective base period would also qualify as new oil and therefore command a higher price. Whereas today the bulk of oil in the Cook Inlet production is in a sense old oil subject to the price control.

Senator Poland stated that we had three people here - Senator Sackett, Senator Meland and Representative Gardiner and that she knew Mr. Lipton had another appointment. Mr. Lipton stated that he hoped he'd have a chance to meet again while he was here, as he has been talking in general terms and would like to talk in more specific terms in what the Alaska Legislature anticipates.

Senator Meland asked in reference to Senator Gravel's statement this afternoon concerning future legislation that may be planned for a tax on oil in place and as long as there is a possibility of a lease sale coming up in the near future , that would be a bad thing to do, for Mr. Liptons comments on that? Mr Lipton stated: "anything which is discouraging to the industry you have to translate into disincentive. How much of a disincentive I don't know under the circumstances. A more important question with respect to the resources tax which was before the Legislature last year and is before you again, is really whether this is a good tax per se, and whether among the alternatives this is the route you would like to take. I would like to answer that question in much greater detail. In general, yes it is quite correct that if you take an industry which is taking a look at profitability, and taking a lease and exploration, anything which smacks of taxation is something they don't like. But whether that would keep them out -

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there is not a chance in the world of keeping them out, I don't think there is anything you could do that would keep the industry under the present circumstances of U.S. energy from coming up and exploring in Alaska where there are really attractive exploration opportunities. How much it will affect the bonuses or royalities that you get, obviously has to have an effect. There is just so much which the State of Alaska can get from an industry from a sum total of revenue - bonuses, royalities, severance tax, resource tax, income tax, - all of these things are contingent on what the utlimate profitability of the industry is. Industry is bound to regard anything that pays early as something which has to come out of future profitability. So if you tax the resources while they are undeveloped for some length of time, this might alter the calculation as to the value of the lease. But that it would discourage exploration - not if its very attractive.

Senator Sackett asked: A couple of years ago, I was told that during the Special Session we had then, that if we took action then, they would never come back to Alaska. My question has to do with the statement you made as to the extreme caution we should take with regard to legislation. Could you elaborate specifically? I would refer to the reserves or oil-in-place for example. Mr. Lipton answered: For reasons I have expressed before, I would like to elaborate in more detail. But from the standpoint of tax policy, I don't think it is good to consider such taxation. I would hope we could consider it in the context of just how it happened. Really is it preferable among the alternatives? How would it really be applied? Basically, I think

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it is a bad tax legislation.

Senator Sackett asked: Are you suggesting perhaps that we have an in-depth study over a period of time into the tax question. Mr. Lipton stated: Absolutely into the corporate income tax. You have a corporate income tax and you will have an oil industry that earns profits. For the purpose of a corporate income tax, the tax of profits or corporations operating in the State you have an ineffectual legislation in the books today and it ought to be improved. I sense from what is going on in the Legislature and also in the administration that you are in the process of doing that.

Senator Sackett asked: Do you express hesitation in these other taxing possibilities, either severance, in place, royalties, etc.? Mr. Lipton answered: Only in a general sort of way, cause I have not yet been confronted with legislation on the table yet and would like to look at that before I comment.

Senator Sackett asked: You're speaking of why we should be hesitant and look in depth at this. Mr. Lipton answered: What I'm saying is that whether it is a resource tax or whether it is a change in severance, there are some aspects of the severance tax that you might very well want to consider now. One has to be very careful...Somehow the tax on the books today can be improved because afterall it is adapted to the present environment. But the present environment is not really what you want to adapt it to. It is the environment in the future that you are looking forward to. I would be reluctant to suggest to the Legislature that they try to foresee the future. It is much better to

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to handle your tax legislation when you are coming upon the circumstances.

Senator Sackett asked: That implies then that we shouldn't do anything? Mr. Lipton replied that: No, one should measure what you feel you have to do against the uncertainty. As I said if you become immobilized by uncertainty then you never do anything. The question is at what speed and what particular passage?

Senator Colleta asked: Following up on Senator Butrovich's earlier question, how broad is the regulation on old and new - the North Slope has been producing in essence for many years. Mr. Lipton answered: The definition of old oil vs. new oil has to do with the volume of production out of the particular producing area and the historical. Old oil would be under present regulations. New oil is something different of course.

Senator Huber announced that Mr. Lipton would be meeting with the Special Committee on Taxation and Revenue, and the people present here would certainly be welcome to come.

Senator Poland announced that we would meet again Friday at 1:30 with Mr. Lipton and continue for as long as it would take.

This meeting was taped and the tape is available through the Legislative Affairs Office.

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

HOUSE AND SENATE RESOURCES COMMITTEE
JOINT HEARINGS
ON PROPOSED OIL & GAS LEGISLATION

TESTIMONY OF MILTON LIPTON
CONSULTANT TO THE LEGISLATURE ON OIL & GAS
Tuesday, March 23, 1976
8:00 a.m.

Legislators in attendance were: Senators Kay Poland, Chairman, Joseph Orsini, John Butrovich, Pete Meland and Chancy Croft. Representatives Nels Anderson, Jr., Chairman, Mike Herschberger, Jimmy Huntington, Red Swanson, Leo Rhode, Al Osterback and Ted Smith. Staff Assistant Guy Van Doren was also in attendance.

Our time is limited this morning and I would like to utilize this time to discuss with you what I consider to be three very critical questions which will be basic to your consideration of the legislation before you.

The first question is why we think it is so appropriate for the legislature at this time to review critically and carefully the whole structure of petroleum taxation in Alaska.

The second to which I will address myself is what do we think is the significance of recent studies that have been made, by the legislature on the prospective profits of the oil industry.

The third question comes down to the implications of the previous two points for the various pieces of past legislation which are before your committees.

Rather than make a mystery story out of this I want to give you very quickly and succinctly, before discussing the law, what we think are the relevant factors in each of these categories. One, we think it is absolutely inevitable that the oil industry in Alaska because of the scale of its investment and because of the scope of its prospective profitability, however it's defined, is extremely relevant to any kind of tax or revenue policy which this state is going to adopt. Second, we think that there are interesting insights provided by the various studies as to the potential profitability of oil operation in Alaska. But we think that the particular measures of profitability, known as a DCF rate of return, however useful it may be for other purposes, is virtually irrelevant to any tax policy this legislature should focus on. Third, we think that it is a consideration of the various tax proposals before this legislature faces a very decisive question which only it can answer -- and that is to say, whether the state of Alaska shall at this time seriously consider a basic new approach to the taxation of the income of the petroleum industry. That is to say, to separate all taxation from other forms of taxation upon income within the state. This is posed by legislation before you and you must decide whether in your judgement this decisive new approach holds merit to the state or whether it does not. We will discuss some of the pros and cons.

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Now going into a little more detail of each. We think that the importance of oil taxation to the state is overwhelming because the level of investment by the industry in the past transcends that of all other private investment in the state because the level of prospective earnings will transcend the earnings of all other private interests in the state. However important the oil industry may be in other states, and it is much more important today in terms of production in other states, it will continue to be in some of them for a long time to come. The major producing states, Texas, Louisiana, California. The oil industry although important to these states, does not have the overwhelming pivotal role within their state economy that it will have in Alaska. All three major producing states are major agricultural states. All three major oil producing states have other vital and important industries. But for Alaska, the significance of the oil industry is in the decisive role that is played within the state, which means that you must have due regard on the one hand, for the risks that we are taking, the outlays that were made and the necessary profitability to sustain it, but it also means that it is inevitable, in our opinion, and I am sure the industry believes this too, that future tax policy and future spending policy by the legislature cannot really ignore what the prospects and the potential is of the oil industry.

Secondly, since the last major piece of tax legislation was adopted in this state, it would be vital to the ____________ ________. They work in two directions. There was a tremendous increase in costs that was imposed upon the industry. There was a spectacular increase in the value of oil resources and at prices that they can expect to obtain. How these balance out depends upon what kind of measure of profitability you use. One can come up with very, very many different answers. But the fact remains that cutting through everything else, there will now obtain for the industry if all goes well -- this is the big provider. But there will be a flow of income out of oil operations in Alaska which is multiplied several-fold, the flow of income that the industry could possibly have obtained, if the old historical circumstances had persisted. Lower costs, lower prices, these are gone.

The industry has been faced in the past with the need of the state to depend upon its potential profitability, not its real profitability, its potential profitability, to meet budgetary requirements within the state. When the state came to a crunch, to whom could they go? They could go to the oil industry. It was absolutely inevitable because the potential ability to meet the state's revenue needs were there. But looking ahead, the profitability of the oil industry must also be a pivotal factor in the way in which the state organizes its thinking. Both about what the potential sources of taxation are and about what kind of state undertakings, this access to a tax base has made possible.

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Second, the significance of recent studies of prospective profitability. I think that the studies have been useful in one very important respect. They have put down in public a series of assumptions about what determines, what are the vital considerations, what the variables are, that may affect the future profitability of major oil operations in Alaska, notably the Prudhoe Bay area. These are all prospective, they are not in hand. But whatever their importance is in focusing attention on what may result from oil operations in the state of Alaska, if all goes well. And, incidentally, bringing to the fore, one of the question marks that still remains. The culmination of the studies, where they end up with discounted cash flows and DCF rates of return. We believe, that not really, in any sense, is it germane, to a legislature's decision as to what the nature of oil industries taxation ought to be. First, all of these DCF calculations are as yet prospective. What enters into a DCF calculation to date, when what is known are past expenditures. What remains unknown are all the critical factors which enter into a future projection and which enter into future profitability. A tremendous number of uncertainties as to what future prices will be, when production will start, at what level it will start, over how long it will be produced and what levels will be sustained. The assumptions may not be there. The assumptions may be perfectly good assumptions. But they remain assumptions and the DCF rate of return as it is calculated is extremely sensitive to any of these various assumptions. Second, suppose these were not DCF rates of return calculated today for the next ten to fifteen years of Prudhoe Bay operation. Suppose they were calculated at the end of the day. That is after the Prudhoe Bay field had been completely worked out. Then one would have a correct DCF calculation. One would know in a second, what the rate of return had been on a particular development. And what is the relevance of that? What is a high DCF rate of return for Prudhoe Bay and what is a low DCF rate of return for Prudhoe Bay? If one is to say, what rate of return is somehow adequate, is somehow correct for what is probably the most successful exploration venture west of the Suez Canal. What should it be? 25%, 35%, 50%, 100%? And don't think that there is a number which is a proper criterian for that. You have all heard that the rates of return on successful ventures have to compensate for the losses on unsuccessful ventures and for marginal operations. How does one balance that off? How does one judge the adaquacy of the rate of return for the single, most profitable, against something which is half as profitable, or something which is simply marginal where the candle was barely worth the burning or all of the loss. I put it to you that the DCF calculation, there is no answer to that question.

The third point -- we have to go back now to U.S. oil policy, U.S. price policy and what it is which in fact is going to determine the profitability in the future. Without spending a great deal of time on the recent changes made in U.S. policy as layed down in the Energy Act, let me just say that Congress has stipulated for the period of the next 40 months, that there shall be an average price for all crude oil produced in the United

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States. And around that average price there shall be at least two and possibly more different prices for different kinds of crude oil. One is now a lower tier price and the other is an upper tier price. Think of them for simplicities sake as the price that goes to old oil and the price that goes to new oil. The average price to begin with is $7.66, the old oil price is something above $5.00, new oil price is somewhere around $11.28. This average price is going to go up over the next 40 months, according to various formula which are contained in the Energy Act. What happens to the new oil price during this period of time depends upon a large combination of circumstances. How much old oil to new oil, how much of the price increase in the average goes to old oil, how much to new oil.

The complications are unfortunate, but what I call to your attention is that the Congress has deliberately, during a period when an imposed price control was on every barrel produced in the United States, Congress specified that there shall be an upper tier price and this upper tier price shall go to new oil, starting out at $11.28. What is $11.28? Why $11.28? Because this relatively high price for new oil is expected to bring forth certain results. The results the relatively high price is expected to bring forth, is that the industry shall look farther and the industry shall look harder for oil. And as the industry looks farther and the industry looks harder, there should be more leasing, more geological and geophysical work, there will be more dry holes drilled, there will be more adandonments. Which means that the industry faces larger losses than they would have if the price had been lower and the incentives to explore had been less. Secondly, it means that Congress expects that there will be oil fields found and developed and produced at a price of $11.28, which would not have been produced and developed at a lower price. Not profitably, just marginal. Congress is extending the margin of exploration, it is saying to the industry, go ahead and look harder, go ahead and look farther, and we're giving you something that is the incentive to develop even a marginal field. A marginal field becomes profitable at $11.28, or $12.13 in the future -- we will not have at lower and lower prices. Why this interest in marginal fields? How much oil is going to be found in marginal fields? The Lord alone knows that. But, I put it to you from the whole history of exploration that the incentive of the industry to go out and look for marginal fields, to explore modest prospects, may find a lot of big oil too, and the industry that looks only for big oil fields, may lose a lot of prospects. This is part of the uncertainly that is part of the whole history of the exploration method.

But having said all of that, look what it means about the implications for the negative return on the successful venture. It there is going to be more dry holes, more unsuccessful exploration, and Congress wants it and therefore gives the $11.28 price, it implies also that the rate of return on the very successful ventures, because they will be fewer and they will have to pay for

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more losses, probably must be considerably higher that the rate of return on the successful venture when U. S. oil prices were in the range of $3.00 per barrel. What is done is to shift the whole perspective on how much the industry is expected by the United States Government to invest unsuccessfully in behalf of the national effort to achieve a higher degree of resource development within the United States. Which means that Alaska too, as part of the United States, must accept that the purpose and function of these higher prices which create the profitability and the cash flow and the future revenue of exploration in Alaska are those which are returning to the nation. One cannot accept the purpose of a higher price as a matter of national purpose and deny that this shall also pertain to a highly successful venture in Alaska.

The DCF rate of return, per se, is not the appropriate criterion for the determination of tax policy. But, the level of total profits in the industry, is an appropriate criterion for the state to look at. Not just the rate of return, but the total level of profitability over the lifetime of all exploration ventures in the United States and in Alaska when you consider your own taxation.

What the effect of higher costs and higher prices will be upon rates of return depends upon what you select as a calculation. I would suspect that most DCF calculations will probably yield a somewhat lower rate of return based at Prudhoe Bay today than it might have if the Prudhoe Bay had been developed in 1972 under the circumstances then existant. There is absolutely no comparison between the total flow of profits which the producers of Prudhoe Bay or any other successful oil field in the future will obtain when in effect, even if their DCF rate of return is somewhat lower, their total profits are so much higher because it provides them compensation for the higher level of investment. It is not just a DCF rate of return that is relevant to the industry. As a matter of fact, I have yet to see an oil company or any other corporation, report to its stockholders what its DCF rate of return is. They will talk about the inadequacy of the return on the stockholders net assets or they will be proud of the high rate of return on the stockholders net assets and this is something which will inure to the benefit of the oil companies, quite apart from the DCF rate of return. In due course, if all goes well, as some of these studies suggest, and the returns are anything like that level, whatever the rate of return on a DCF basis may be, there will be over the history of oil exploration in Alaska, a fantastic contribution to the profitability of those companies as measured by that which is of the greatest interest to the stockholders, namely the return on their assets. And if in between you take other measures of rates of return you may get different results, but it remains that if things go as suggested, and I don't believe there is anything that is suggested by the oil companies, which really suggests no matter how critical they may be of the DCF calculations as a basis of principle of taxation, I would be surprised if they would deny that the aggregate flow of profitability to the oil industry over the history of Alaskan oil

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development for successful ventures will not be in many times multiplied of what they might have made if the old low costs and the old low prices had remained. Changing circumstances are important to the whole profitability of the industry, the flow of their future profits and for purposes of taxes.

One quick illustration... In the North Sea, there was a great deal of argumentation over the adequacy of the rates of return. The United Kingdom proposed to raise the taxation, the companies obviously faced with tremendously escalating costs in the oil sale, argued that this would in a sense be confiscatory taxation that might interfere even with the development of marginal fields. A familiar argument and a vital argument. The government of the United Kingdom conceded a great deal and it revised and eased up on some of its tax proposals, whether they are good or bad is not my point, the point is that the next step of the UK government was to say, well, now that we have given you what is an acceptable rate of return by equitable taxation, we want government participation. We would like to have the government of the United Kingdom to have a 50% tax on every one of the offsea oil fields. And we commit ourselves to you, that when we take our 50% interest, either by paying for it and reimbursing the capital or whatever, we will not further interfere with your rate of return. The industry argued. Argued, I think, very correctly, that the same rate of return on half an oil field is not the same thing as the same rate of return on the whole one. The rate of return on the whole oil field is necessary to compensate the industry, to pay the industry for all the risks it takes, its exploration ventures. If you leave them with the rate of return, and you cut it in half, you interfere with the total cash flow of a successful venture and that is not the same thing for the industry. I will put it the other way. In Alaska, it may be that the rates of return are not as attractive as they had been before but the total industry profitability is going to be a multiple of what it was before. Not just rates of return ____________________.

Well, now I turn to what is of greatest interest to you, what is the implication of all of this for your tax policy. I look at three aspects of the tax policy, severance tax, income tax and the proposed sur taxes. On the severance tax you have before you House Bill 638 and Senate 567. I don't have too much to say about these bills. I think the state of Alaska has today a very good approach for severance taxation. I think that what you have in the sliding scale schedule of your severance taxation makes your severance more sensitive to the nuances of operating fields that severances taxes of other states which are either cents per barrel or a certain flat percentage of fixed value. What you are able to do is distinguish since every severance tax is a percentage of gross wellhead value, but lease by lease the relationship between them differs. Your severance tax has this sensitivity and it means that it is __________. The changing in severance tax rates from time to time without necessarily adversely affecting those fields which may not be able to pay the highest rates. There

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is some question as to whether or not you want to retain the cents per barrel floor on your severance tax rate. I think perhaps we ought to hold discussion of that until there is detailed consideration of the bills before you. Any change now in your severance tax, I think that the legislature would be very well advised to hold off until it has made decisions on the whole package of tax legislation. That is to say, what you may want to do about the severance tax ought not to be independent about what you do with your income tax and whether or not you are prepared to adopt some kind of a sur tax on private industry producing oil in the state of Alaska. I would like you to hold off on that and see what you're inclination, what your directions are, what your final decisions are.

On the income tax, again, I will try to be relatively brief. You have been saying for many years that your corporate income tax statute as it exists, is an ineffective statute for reaching out and taxing profits made on producing ventures in the state. Without repeating all of the details, and you've heard this many times from us, what it comes down to is that neither approach to the accounting of income in the state, neither the formula approach which arises at an interstate tax compact which the state of Alaska is a member of or the direct accounting approach really works. Too many of the companies do not have any sales in the state of Alaska and so you lose tax income. On the apportionment approach, none of the three elements of the apportionment formula really works effectively. We have suggested many times that the state should explore an alternative which allows direct accounting of profits made especially in the oil producing operations in the state of Alaska, by changing from ___________. The net proceeds tax which is before your committee, H 699 and S 620, both attempt to get direct accounting of all producing profits in the state of Alaska by indirection, by the method of the net proceeds tax. Again, we can discuss details of that from time to time, we have some reservations about it. I am sure that there are other possible ways of going about it and I rather expect that you will get long comments from your own _______ both about the bills and about their possible alternatives. But I put it to you again, that this is a second step in your whole tax review that you must seek to get an appropriate access to produce in profits just so that you tax the income from oil production on the basis comperable to the income of other economic activities.

Now I come to the third aspect of the legislation before you and I think that it is far and away the most important of all. There are two bills, H 703 and S 621, which is an excess value sur tax and H 803 which is an oil production income tax. What these bills propose to do is to introduce an entirely new principle of taxation. What they say is that it is not necessary and therefore the interest of State of Alaska does not require that every dollar of income generated from oil producing operations in the State of Alaska shall be taxed exactly the same as the income which is generated by other economic activities. It segregates the oil producing industry from other aspects of economic activity in the

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State of Alaska and says that we will introduce new principles of taxation. The new principles of taxation is very briefly put forth here, that up to a certain level the profitability of an oil producing operation shall be taxed approximately at the same rate as other income. That is to say, a dollar of all income from production shall be taxed the same way as a dollar of income from any other activity. But a billion dollars of oil income does not necessarily be taxed the same way as a million dollars or a thousand dollars of income. It commits the segregation for tax purposes of the income from oil producing operations and then it says that tax policy will be written separately and apart for some aspect of that oil producing income. The legislature must resolve and recognize that this is a separate and distinct principle of taxation to be applied to the oil industry. And to decide whether it wants to go that route in principle. If the legislature does not want to go that route in principle, then there is no use discussing the details and the alternatives of the excess value, sur tax or the oil industry income tax because they both attempt to achieve this new principle of taxation. If the legislature feels that there is something in the nature of oil producing operations such that in due course and under proper safeguards they may want to tax oil income on a different basis than other income, then it is worth looking at the pros and cons of both of these pieces of legislation and perhaps to consider some other alternatives.

I don't want to take up your time, in the remaining days of your 90 day session, to speak on behalf of the industry and tell you why separate taxation is inequitable to the industry. You are going to hear this in very great detail I am sure. The moment that you tax the oil industry in a different way than any other industry, you are doing violence to a lot of ________. I do want to say one thing which is a proper and I believe a cogent position of the oil industry -- the greatest risk of this form of taxation for the oil industry. This is the greatest risk that the oil industry finds that it is exposed to. That's wherever or whenever it throws up by some definition, a relatively high level of profitability, that the government, within whose jurisdiction that high profitability occurs will say, we tax it separately and we tax apart. And if then, the oil industry finds that the government here, within whose juristiction says, Oh Boy, this is a high level of profitability, we have a separate form of taxation for the oil companies. The only place the oil industry would be left with a normal rate of taxation is where they are not making much money or where they are losing money. How then, does an industry in effect, cover its average rates of return, its average profitability to sustain exploration activity. If in fact as is exposed in every tax jurisdiction where returns are abnormally high, where government seizes the __________ bases for ________ taxation. The exposure abroad is very clear. The argument that other countries should not tax successful ventures too high, that got nowhere with kings, shas and sultans. As a matter of fact it didn't get very far in the anglo-saxon world either. Not in the North Sea, not in Alberta, Canada. But the United States is a

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different story. I think it is different because there is an integrity of both investment decisions, pricing policy, and hopefully, a flow of capital within the United States. Therefore, the industry would like to feel that if it has lost the battle elsewhere, at least the battle should be fairly ________ within the United States. I don't think it's correct for industry to say that it wants nothing more anywhere and everywhere than the same tax regime to which other industries are subjected. The industry has argued for many years that there was a purpose to special tax treatment for the oil industry where it ____________. The resource industry which has the benefit of a depletion allowance is very important to the oil industry and we have agrued in defense of this for many years. So there are circumstances under which they can benefit from separate treatment and circumstances from which it can suffer. I don't believe that it necessarily follows that the income from oil producing operations must always, under every circumstance, be treated exactly the same as any other industry. It is for you to decide whether or not you choose to go this route in Alaska. But I put it to you, that when you weigh this in the balance there are two criteria that are so important you can never avoid them. One is that however you decide for separate treatment of the oil industry, your taxation must strike a balance between the interest of the state and the interest of the industry. Whatever you do, it it must not involve that level of taxation which destroys incentive and says in effect that we look at profitability and we will either forget past costs incurred, past contributions, or even the fact that there is a need for this profitability to sustain other exploration in Alaska or perhaps elsewhere in Alaska. There must be a balance there. Secondly, I don't believe that the State of Alaska can reasonably expect to adopt a separate tax regime for income from oil operations in Alaska which is inconsistent with U. S. policy. But Alaska cannot presume to have first and unrestricted call on the profits made from oil producing operations in Alaska, when the touchstone of that profitability is a price policy that the United States government adopted.

The price of Prudhoe Bay oil is not ___________. Under the Energy Act, Congress has stipulated that the president may propose subject to the consent of Congress that up to two million barrels a day of oil coming down the Alaskan pipeline shall be outside of this average price for all U. S. crude oil. And its basic reason for that is not to give Alaska a high price, but to keep the amount of Alaskan oil from reducing what is the new oil price or the upper tier price with everyone else. The Act specifically says that if the president exempts this up to two million barrels per day, the price for Alaskan oil that is exempt shall be no higher than the upper tier price. It does suggest that for a considerable length of time there is an unknown which could be in the range of $1 or $2 a barrel as to what the actual wellhead price of Alaskan crude is going to sell for. If Alaska gets itself into a tax posture here which looks to be running counter to what is a price policy and the incentive policy of the federal government. It is not that I think that the FDA is going to reduce the price of Alaskan oil in retaliation, I don't believe

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it, but there is so many interests which involve the position, the confrontation of the State of Alaska with the federal government, that I think it would be very dangerous and probably and very poorly advised to the State of Alaska to take a tax policy which goes so hard and to such extremes that it begins to run counter to U. S. policy. Again, I give you an example. The example comes from Canada. The Province of Alberta, like the State of Alaska, has a tremendous interest in sharing in the profitability of oil producing operations in that province. And as the profitability looked to be going up, because prices were going up, the Province of Alberta moved to increase its provincial pay, it is called the royalty there but it is somewhat different, it is in lieu of severance taxes and so on. But it went from 16-2/3% which had been an old price of about $4.25, to 60% on that increment of price between $4.25 and $6.00. Which in effect meant that they were siphoning off a large part of the total increase in the profitability of the producing industry before ___________. The federal government in Ottawa reacted violently. Up until then they had acknowledged the 16-2/3% royalty as a deduction in the computation of the federal income tax. They removed it, not only the added 60% but even the first 16-2/3%. As a result the oil producing industry was caught by this constitutional confrontation in Canada between a Province which lay first claim to what it believed was its maximum entitlement and the arguements of the federal government that what they did was to violate the interest of all of Canada to the extent that it interferred with what was the federal income tax statement. This was resolved by a whole series of comprising on both sides but for one year this confrontation in Canada was so acute that it virtually brought up to a halt, oil exploration operations in Alberta. Because as a result of the confrontation between a provincial and federal government the actual per barrel profitability ______________________________. If you consider that there is something in this whole concept of a special approach to the taxation of income derived from oil producing operations in Alaska, that approach must meet two criteria. That in the principle of taxation and in related taxation, it does not do violence to the interests of the industry vis-a-vis the state, or the state vis-a-vis the industry. And secondly, that it does not involve that form of taxation which sets Alaska in juxtaposition in confrontation with what is the policy of the U. S. Government and the reason for giving to all new producing operations, newly discovered wells, a price as high as the federal government is willing to give.

You will have to consider whether or not this principle of taxation commends itself. Let me say a few things more about how these bills have to operate. The excess revenue sur tax says in effect, that Alaska will acknowledge a long term price, a price which is adequate to sustain exploration over a long period of time, and any profits earned within that long term price will be taxed at what is essentially the normal income tax rate. On the other hand, any profits earned on prices received by the producer above that long term price can be taxed at a higher rate. The

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amount of the higher rate is not germane to what I believe is the problem. The long term price is about the most elusive thing imaginable. You don't really know what kind of a price is necessary to sustain the level of exploration, to find the kind of reserves and replace the reserves that are being used up. The long term price which was used in the ________ $7.00. There is a certain amount of authority for it. The foremost authority on long term pricing and adequacy of pricing is up to the Secretary of Treasury. And our Secretary of Treasury once said that a $7.00 price, he thinks is a long term price. It is on the record you see. The International Energy Agency has adopted $7.00 a barrel as a floor price. I don't think that it is reasonable to say to an industry that the legislature of Alaska has within its competence an ability to so discern the future that it knows what an adequate long term price is and before the future comes to ________, start already, today, to tax the profits on this theoretical long term price, as though it really was added profitability. The thing is that the long term price is a prediction about the future, but the excess revenue tax becomes effective immediately as though one knew what this long term price were going to be. This is not a principle of taxation which would meet either of the criteria that I set down for you which are absolutely essential to serious consideration of this kind of special taxation for the oil industry.

The other bill which sets up what is the oil production income tax takes a somewhat different approach. What it says in effect is that we're looking at the continuing profitability of the oil industry and we will, from the effective date, subject the oil industry to no more than the normal rate of taxation on profit of up to 1.25 times allowable costs of operation. That is to say, there is a built-in margin of profit within which the industry pays no more than what would be the equivalent of the normal income tax rate. But above that, on any income above that, the industry will pay a sur charge, a higher rate of taxation. Again, our difficulty with the specifics of this proposal apart from technical problems, which, again, I wouldn't want to quarrel with the bills as they stand, I am sure that all sponsors were looking for an approach and quite agreeable to changes of language and so on. The difficulty is that it says, as of today, without regard to what may be, over time, the true profitability of the industry, however you measure it, immediately the industry becomes subject to this relatively high rate of taxation. Why not from a field like Prudhoe Bay? Why not subject themselves immediately to it? Because we don't know what the ultimate profitability of Prudhoe Bay is going to be. I suspect the industry is going to tell you that the DCF rate of return is nothing like what some of your studies show. Suppose the industry is wrong and the DCF rate of return is much more than these studies show. Does that mean that then this kind of taxation in the first year of operation or the second year of operations, is acceptable to the industry. If they argue that I think they argue a poor case for themselves. One can't begin already to tax presumptive profits which are going to be very large before they occur.

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Our quarrel with the legislature on advalorum reserve tax in the last session and the argument that this was a clear principle of taxation. It was not that it was inconsistent with the industries' ability to pay, but that it presumed something about the industries' ability to pay. That is to say, taxed the value of future revenues before the revenues even started. These other taxes begin by putting the sur charge, not in advance, but from the first day of operation and make very big presumptions about what the ultimate profitability will be. Let me suggest that if you are considering this, there is another alternative, and there is an alternative that could at least be consistent with the criteria that I suggested before. And that is that no more than the normal rate of taxation shall apply to oil producing profits until there is multiple recovery by the industry of all of the capital expenses that were involved in obtaining the leases, in doing the exploration, doing the development and so on. This means in effect that so long as the industry is getting back its capital and a multiple of the capital, how large a multiple - this is an unknown, but I am going to suggest to you for a moment that is one of the areas where the State of Alaska can afford to be extremely generous and not worry too much about the multiple recovery of capital. Which means that there cannot be for any income in the State of Alaska other than exposure to the normal rate of taxation until the profitability is assured. That is to say, these uncertainties that exist in oil producing operations -- When are you going to go on ____________? When will the pipeline be constructed? What is going to be the well's producing ability? When you really get 1.2 million barrels a day? Can you go to 1.5 million barrels a day? Will the wells sustain as much as 10,000 barrels a day or an average of 5,000 barrels a day? -- All of these great uncertainties will have been resolved. The companies will have made multiple recoveries of capital, before they have ever been thrown in a position of being exposed to any sur tax over and above the normal rate of income taxation. This also means that there can be many future results, exploration successes in Alaska, which will never pay more than the normal rate of taxation on their income. Why? Because the capital investment relative to the amount of oil and the price of the oil, will require a long period of time before this multiple recovery of capital takes place. What you are doing is protecting the incentive to look for marginal fields, you are maintaining the incentive to continue producing, even fields of modest profitability. It means that while the State of Alaska will forego anything other than its normal tax revenues, from the most successful fields, it does say that it is in the position to ask that the industry make something more than the average or normal contribution out of what, by then, will be the sure and established profitability of the most successful ventures.

There are a host of problems in almost any aspect of this taxation. I hope that the record will not lead nor the presumption taken by the legislators who are listening that we are proposing this as something that you should adopt. What I am saying is that you are confronted now with a package of taxes which involve possible changes in the severance tax, which involves strengthening and supporting your income tax approach so that even at the rates that

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any other industry pays, the industry would be subject to and liable for that amount of taxation. But beyond that, that you consider whether or not there is something in the prospective profitability, not the present profitability, but the prospective profitability of the oil industry, which suggests that as this kind of an important venture it can have all the incentives necessary to continue exploration in Alaska, that it can be subjected to a form of taxation which is not inconsistent with federal policy and the purposes of the prices which the federal government gives to the State of Alaska. It is for you to decide whether you even want to introduce this new form and new principle of taxation. If you do then I think you might consider, along with what we feel are the disadvantages of the two particular bills before you, a similar principle of taxation but with a method of determining when and to what extent there is exposure to any higher level of taxation by means of this multiple recovery of capital.

I don't think for a moment that the industry is going to accept anything I've said about the reasonability of special taxation of the oil industry if only you assure profitability by meeting their multiple recovery. They will always feel not only that they shouldn't pay high taxes, but that if the principle of separate taxation, apart from the general taxation of income from whatever source, is once accepted by this legislature, that future legislatures, after the oil industry has recovered its capital one and a half times or two times over, or more, boy, at that time you can put on all kinds of taxation. Why not? They have been obviously profitable, they recovered their capital. I'm sure this is an inherent fear of the industry and it could happen that way. But the whole principle of taxation, as I've said before, a new concept of taxation, which is before you, proposing two different forms, under the best of circumstances can only work and ought not even be considered by the legislature, unless it is within the framework of understanding that there cannot be, even if there is separate taxation, there cannot be a raid of taxation upon the oil industry, which is destructive of incentive and too, which is inconsistent with what is federal policy.

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REPRESENTATIVE TED SMITH: (QUESTION INDISCERNIBLE)

MILTON LIPTON: There are so many ways in which it could be done. If I give out any specifics, it would sound as though I think that's the only way of doing it. In general I would say this. It makes sense only, really, if the company is liable to this form of taxation by virtue of its earnings in the field, therefore you would want to allow for each company participating in the earnings, the profits out of that field, multiple recovery of all the expenses on the field. I would also feel, and I feel very, very strongly, that it would make sense for Alaska to allow as a charge against earnings before any sur tax comes in, not only multiple recovery of capital in the field, but allow the expensing of a lot of other expenses elsewhere in Alaska if they have no where else to expense it, that is to say, dry hole costs, by a company against whatever tax exposure has by virtue of its earnings as participation in a producing field.

REPRESENTATIVE TED SMITH: (QUESTION INDISCERNIBLE)

MILTON LIPTON: Yes, I would allow them to take exploration expenses elsewhere, which cannot be charged against operating income anywhere, against both their normal tax liability and their sur charge tax liability, whatever they are producing. And let them pick the most advantageous place for it. What I am really saying is that since there must be a limit in any case, upon the intensity of state taxation on the profitability of the oil industry. It cannot be regarded as an open sesame to unrestricted state revenues. If so, it falls apart, by both criteria, it can be destructive of the industry. If then, there are limits in the restrictions, it means that the State is postponing any added taxation on the industry until their profitability is assured and the State can lean over backwards, I believe, in providing that assurance in terms of a multiple. When the State leans heavily against the oil industry by what we regard as a poor form of taxation which was the advalorem reserve tax, because it had to. The State can afford to lean backwards in terms of its principle of taxation when it doesn't have the pressure __________. If this is looked upon as a means of the State getting what is a reasonable share of what will be, over a long period of time, a very profitable operation, even if it is not under DCF. Then I think the State can afford to lean over backwards without doing violence to the position of the State. Just as it would during periods of budgetary __________ it leans heavily on the industry.

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SENATOR JOE ORSINI: You started off your remarks by saying that Prudhoe Bay is the most successful endeavor west of the Suez Canal. Yet you are saying now that we should tax based on Alaskan ____________. What about dry holes in other parts of the world __________?

MILTON LIPTON: I would say that the State of Alaska should take into account dry holes east of Suez, when the producing countries east of Suez allow the oil companies to take account of dry holes in Alaska. No, I don't think that you can worry about the entire world. You don't have to allow the expensing of dry holes elsewhere in the United States against your tax regime, but you have to have a principle of taxation which recognizes that before you start taxing profitability here in Alaska, that profitability has somehow to compensate that company as part of an industry. What I am saying in effect is, that Alaska ought not to draw a ringed fence around Alaska and say we measure the adequacy of rates of return by what the industry does in Alaska. Certainly not around Prudhoe Bay, and say that well, if that great of return is adequate for Prudhoe Bay, what the heck, this is going to be the principle of taxation. I think that the ringed fence should really be drawn around the United States in terms of the consistency of your tax approach. But it doesn't mean that you therefore have to __________ expenses. You can decide in your infinite wisdom how much credit you give for overhead outside the United States, but this will be a small matter.

SENATOR JOE ORSINI: You say that after a field has a multiple of its expenses then sur tax on the profit. Would this discourage the marginal exploration?

MILTON LIPTON: No. I assume that that tax is not going to be a prohibitive tax. It is not as though you are taking away 100% of the added profitability. I presume that whatever percentage of taxation you are talking about is a modest percentage which makes your tax regime consistent with national policy. I don't want to talk about tax rates, or multiple recovery of capital. There are no neat answers to any of this. It would be wonderful if a consultant could sit before you and say, "Look, the answer is clear. If you give the companies 1.63 times recovery of capital and then you put a sur charge on profits after they have recovered that of 21.5%. This is absolutely right." Well there is no magic answer to it which is why I find myself so often cast in the position here, before the legislature, saying "on the one hand and on the other hand". And I know some of my friends in the legislature would wish that at one time I had my hand tied

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behind my back. On the other hand, I have never figured out when he looks at me that way, what his politics are. What does he want -- my right hand tied behind my back or my left hand? There aren't any easy answers and no more so if you go this multiple recovery of capital route rather than a DCF rate of return or a long term. This is all very much in never-never land, excepting that you are not likely to do great violence to an equitable sharing if you.... Because if you go the rate of return route or if you go the long term price route, what you are saying is, we start out immediately taxing what we believe to be is a higher rate of profitability. This is before the profitability is ever established. Whereas if, for example, -- I don't like to use Prudhoe Bay as an illustration because I hope that you don't write tax legislation which is designed for Prudhoe Bay per se, any more than you should be constrained in how you tax Prudhoe Bay by the problems in some of the less prolific fields in Cook Inlet. Your tax legislation ought to be appropriate to not only oil that is present but for the future as a whole. There has to be a decent principle of taxation. Which means that you protect both the marginal field because there is not going to be any income subject to a sur tax because they need to recover their capital. You protect the profitability even of the most profitable fields by allowing a heck of a lot of capital recovery and then presumably by coming up with a sur charge which is not confiscatory. Which doesn't say to them, "You made your profit, we are taking it all away from you."

Please don't misunderstand me, I have no idea whether it makes any sense whatsoever for Alaska. In your own thinking as legislators, to say we have to go beyond our present tax structure, you may want to say that we have a tax structure if only we can get our income tax, which assures us we collect the normal rate of income tax on what is the profitability of producing ventures here. We will try to utilize what is a good approach in severance taxation to get what we think is appropriate. We have a relatively high degree of various forms of advalorem taxation on the industry. This is sufficient unto our purposes and we can work within this framework. And you may very well want to make that choice. But on the other hand, you do have opened up before you legislation which is new, it offers new approaches, it opens up

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in new directions. What I am saying is that you must understand what these new directions are. Be very, very careful about it. If you want to go there, then you've got to find some principle of taxation which is consistent with what you want to achieve for the State of Alaska and with what you must give to the industry and with what is also conciliate with the U. S. policy.

QUESTION: When you say multiple recovery of capital costs, are you saying that in current (INDISCERNIBLE)

MILTON LIPTON: No. That is why you have multiple recovery of capital. I don't think that is necessary. You don't have to give them replacement costs. But let the multiple be large enough.

REPRESENTATIVE OSTERBACK: The overall cost to the state, would that be including the offshore drilling? (INDISCERNIBLE)

MILTON LIPTON: Not in federal lands. If it is offshore federal it doesn't fall within the Alaska tax regime one way or the other. It would with offshore drilling in State acreage.

REPRESENTATIVE SMITH: I presume from our standpoint the principle problem with the recovery approach would be that the ____________ deferring taxes ________ for a substantial period of time ____________.

MILTON LIPTON: You would be deferring additional tax income over and beyond that which you would get from your normal rate of income taxation. You are not giving that up. You are saying that all income becomes subject. You presumably still have a severance tax, and you have your advalorem taxation. What it says is, if we are looking for, what in the future, is a possible contribution of tax revenue from successful and profitable ventures in Alaska, over and above that which our present tax regime... You can review severance taxes, you can do all kinds of things but this is one possibility, that what you are looking at, as I have said before: The reason for it is not that calculations throw up high prospective DCF rates of return. The reason is that there is in prospect a totality of profits out of producing operations in Alaska which dwarfs what is likely to take place in other producing areas. Let me be very clear about where the problem here lies. When you talk about tax policy in principle, reasonable men can reasonably disagree. When one looks at the bills that are before your legislature, which imply for the industry -- they vary from bill to bill and it depends upon which field ________, we've done all kinds of calculations. But it may involve for

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Prudhoe Bay as much as a dollar per barrel reduced income, net, after all taxation. A dollar a barrel, on a round number of a million and a half barrels a day, is a million and a half dollars a day, 365 days a year, we are talking about something over half a billion dollars a year, give or take. It is awfully hard for reasonable men to disagree reasonably when that amount of money is involved. And particularly when it is all based upon a presumption before it comes to pass. And yet, if you add up the totality of profit that may derive from a successful venture such as Prudhoe Bay, under the levels of prices which probably we'll obtain, may come. The magnitude of the profitability is awesome. And then the State has to decide what is a reasonable contribution. Does it mean in effect that billions of dollars of income earned from oil producing operations shall pay a tax rate identical with a thousand dollars earned from other economic activity in the state. You may decide, yes. But it opens a question, that is all I am saying. When I say, if there are no answers, you know there are really two philosophies also of how one strikes the balance. You can have one approach which says the interests of the state of Alaska are poorly served if you leave an oil company with one more dollar of profit than it needs. But if you leave an oil company with a dollar more than it needs, then you are not serving the interests of the state. The industry has said that whatever the taxation in the State of Alaska is, that another dollar of taxation is onerous, it threatens the viability of the industry, that it can't stand it. That the rates of return, all things considered, aren't that high. Well this is another extreme position. And maybe that is so. But if in due course you can find out, without making theoretical calculations, as to what profitability is going to be, but somewhere in between I think is a positions which the State of Alaska can reasonably take. Even though nobody will agree if there is too much money involved.

REPRESENTATIVE SMITH: (QUESTION INDISCERNIBLE)

MILTON LIPTON: The upper tier price will rise as the average rises but no one knows by how much it will rise as the average rises. For example, if the FEA decides that an increase in the average by 10% a year should go both to the lower tier price and the upper tier price, that very distinctly limits how fast the upper tier price could go up. If they decide that none of it goes to the lower tier price, the old oil, and all of it goes to the upper tier price, then the upper

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tier price goes up faster. Furthermore, it can give part of the increase in the average to the old oil and more of the percentage to the new oil. And whichever route it takes, it's not only their policy but it is the proportion of all the new oil which will determine how fast the new oil price goes up, which is why they don't want, in effect, the 200 million barrels a day. I hope so. One million barrels a day, 1.2 million barrels a day of North Slope crude all to claim the upper tier price within the average. In 1978, 1.2 million barrels a day of Prudhoe Bay production could depress the upper tier price if it is included by over a dollar a barrel. If the average goes up at 10% per annum and the old oil price is held, the new oil price, by June 1979 should go to $15.42. There are a lot of assumptions about how much production, how fast old oil goes down and new oil goes up, this is the figure. If the North Slope is included, the new oil price will be $14.03 and will have an affect of about $1.40 on the new oil price.

(QUESTION INDISCERNIBLE)

MILTON LIPTON: No, I am at the disposal of the committee and as I said, I tried to address myself today to what I think are some of the most important considerations that you've got to have in your minds as you view the kind of legislation that is before you. As far as the specifics of the legislation are concerned, we are available to you. We plan to be here for a while because we have other committees to meet with, and we will go over any and all bills with you at your convenience.

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SENATE RESOURCES COMMITTEE

Testimony of Milton Lipton

May 3, 1976

I would like to take a few minutes to give your our impressions of the bills in the form that they now are before the Legislature. There are three forms of taxation which have been before you all through this session. There are first of all the various amendments of the severance tax. Secondly, two separate bills which are designed to implement or be substitutes for the regular state corporate income tax and the third are the several bills designed to impose a higher order of income taxation on profits from oil producing operations than from other industries in the state.

On the severance tax, our office sent to the legislature, the week before last, a note on the proposed changes in Alaska's gross production tax, and I don't propose to summarize all the material, but in this note, as in our previous report to the Legislature a year ago and our comments before various legislative committees, we have consistently said that we feel this is an appropriate time for the state to review its severance taxation on oil production. We feel that the gross production tax as a percent of wellhead value can be increased without getting out of line with what is the going rate of taxation in the various states. Sponsor substitute for bill 569, which in effect imposes the highest rate of taxation in the last step schedule of taxation, would take production averaging about 9,450 barrels per day in order to yield an effective tax rate of 12 1/2 percent which is the tax rate which applies to all production across the board virtually without regard to the producibility of wells in the state of Louisiana.

We feel that the step schedule can be increased, with increased rates in the upper bracket and I think the idea of reducing rates for marginal wells makes a contribution also to a balanced severance tax spectrum. But we point out again that your severance tax, like all severance taxes, is a tax on the gross value of oil at the wellhead. Not on the net value. Therefore, it is not an income tax. It is not a substitute for income tax and therefore, one has to be very careful as to how high the marginal rates of severance taxation even within the step schedule go, because of the effect upon the gross value of production. We talk about wells producing 3,000 barrels a day or more or 5,000 barrels a day or more or 6,000 barrels a day or more, but the taxes are on the gross value. Even two wells, each of which average 5,000 barrels a day can have very different costs of operation. As the difference

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between Cook Inlet and Prudhoe Bay and other fields that may be discovered. So that in general, the virtue of the severance tax is that it can be measured against the standards of taxation in other states which is particularly appropriate for taxes on gross value, whereas where we discuss an income tax there is no reason why income tax rates necessarily must be the same state by state any more than property tax rates are the same state by state or excise taxes.

But for the gross production tax it is a useful guideline to the state of Alaska to stay reasonably in line with what taxation is within other states. We find that the cents per barrel aspect of your severance tax faulty in the way in which has been operating and probably undesirable in the way in which it would be operating, from the standpoint of the state itself. The revenue to the state from Cook Inlet today from the cents per barrel tax already constitutes a higher percentage of wellhead value than is being proposed under the amended severance tax legislation in any of the bills that are before you. The reason that this has happened of course is because you have an escalation in the cents per barrel tax geared to the crude price component of the U. S. wholesale price index. That had been going up ever since January of 1973 consistently through January of 1974, consistently through January of 1976 whereas most of the Cook Inlet production as old oil has been frozen to a constant price. So the cents per barrel tax has been going up while the actual price, the value of their oil at the wellhead has been constant and you now have relatively high rates. Just to illustrate with regard to a few numbers. Wells averaging 2,000 barrels a day at Cook Inlet would be paying a tax as of the February wholesale prices 39.6 cents. The percent of value of that tax is 8.4 percent. Under the committee substitute bill 295 the percent of value tax which is being proposed is only 7.2 percent. And under SSSB 567 the tax rate being proposed is only 6.9 percent. So that already you see you have the cents per barrel tax imposing a higher rate of taxation relative to the wellhead value of Cook Inlet than is being proposed in the amendments. We would feel that if there is any amendment to the severance tax along the lines of increasing the incremental rates of the higher brackets, lowering them at the lower brackets, that the cents per barrel tax should probably be eliminated. Excepting possibly if you want to maintain the present level of state revenues from Cook Inlet as a fixed figure, in other words, freeze the cents per barrel at what the present payment is, so that it can't go any lower, if it is necessary for state revenues, no further escalation on it, and then allow the severance tax law to go higher only insofar as wellhead values in the future go up and new severance tax rates go higher as a percent of wellhead value than what is already being paid in cents per barrel. But if you continue to allow the cents per barrel to escalate under the unpredictable regulation of crude oil prices that we have in the United States you may very well end up with such onerous taxation for old oil in Cook Inlet that the producers of old oil in Cook Inlet will be paying a higher severance tax than the producers of new oil will be paying in Prudhoe Bay.

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Now the final comment about the proposed changes in the severance tax law. They are apt to have very little current income effect for the State of Alaska. That is to say, the major impact of increases in marginal tax rates even within the structure of comparability with other states would come after Prudhoe Bay comes into production and it will not have very great impact at the present time. So I guess the question before the Legislature is to revise now or not to revise. There is at least one technical amendment proposed which I think is a major contribution for purposes of administration. That is to put the computation of the tax not on a per well basis but the average production per well per lease or per property. Simplify the administration of the tax tremendously from the standpoint of your operating department. I guess it was proposed initially by them although we discussed it as a factor some time back. Whether or not you should follow this course, one the technical amendment, two restructuring the step schedule to more towards higher incremental rates of taxation at the top, somewhat smaller rates of taxation for marginal wells at the bottom and either eliminating the cents per barrel or using it as a floor to protect state revenues, but with no further escalation, whether or not these, which I think we would commend to your attention, are worth doing at the present time in terms of the legislature you yourself must decide. We do not believe that it would be difficult for your committees to finalize a reasonable and offerable amendment to the severance tax. I don't think you need be deterred particularly by the fact that other aspects of oil industry taxation may not be finalized in this session and may be subject to review between sessions, may come up again in the future. I believe that within the range of observations which I have given to you today and discussed further in our report, the severance tax alone will stand on its own feet. I don't think it necessarily need inhibit whatever other consideration pro and con you give to other aspects of oil industry taxation. On the other hand, I would not regard these amendments as terribly urgent at the present time and if in your own wisdom you feel that it is worth weighing the severance tax in the balance with other types of taxation which may not actually be resolved this session which will be reviewed in the interim and possibly coming up later there is no great urgency, because as I have said the revenue impact on the state of the kind of amendments to the severance tax which are before you and within the limits of what are considered to be reasonable for the state, the revenue implications are not very great.

You will, of course, without my invitation, jump in and ask questions any time you want. I call your attention to the fact that this is about as much as I propose to say unless there are specific questions about the severance tax. I'll go on to the income tax.

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ORSINI: Are you going to discuss gas in a different context than the oil severance tax?

LIPTON: I'll be perfectly willing to if this is of interest to you. I'll just say very quickly our position is that the state has to be very concerned about the cents per barrel form of taxation on oil. Because this is an aspect of taxation applied on gross value coming out of the presumptive profitability of the industry which cannot be passed on. There is no way of passing on this form of taxation which is not geared to income tax or anything else. In the end whether it is the producer of crude oil in Alaska who refines it in California or whether it is a producer who sells his crude oil to be refined in California or elsewhere the recovery of all costs, including all forms of taxation can only take place when gasoline is sold in competition in the marketplace. And gasoline is sold in competition with gasoline processed from all other kinds of crude, domestic crudes, imports and so on. So in a sense, a change in the severance tax, an increase in the severance tax is not recoverable. This is very different from the case of gas. In the case of natural gas it is not even inappropriate for the state to consider a cents per MCF tax on gas. Because, within limits, Alaska's tax on gas production will be recoverable in the market place from the ultimate consumer whether the consumer is in Alaska or whether the consumer is in the lower 48 states. It will be recoverable in the same sense transportation costs will be recoverable. Because you don't sell natural gas in a one price market although the ultimate consumer, whether it is an individual in a household, or a business corporation that's using gas for industrial gas or process gas, although he pays one price for the gas, the price he pays is an average of many different streams of gas coming into his distribution network, or being delievered by a gas transmission company, many different streams of gas that carry different costs and different taxation. And within limits, the state is in a position to say that if our tax, for example, is five cents per MCF, this five cents per MCF along with production costs of gas and along with transmission costs of gas will enter into the price at the end of the transmission line to be rolled in with the price of all the other gas supplies which are commingled and then sold to the ultimate consumer. So from the standpoint of gas, the state can regard the severance tax in a somewhat different way than it can an oil tax.

However, at the present time, almost 50 percent of all of your gas in consumed in Kenai and in Anchorage so that with contracts that provide for pass through of the severance tax, so that whereas the tax on gas can be passed through to the ultimate consumer almost half of it will be passed through to your own Alaskan consumers. The other part of the severance tax can be passed on to industry which is using the gas in processing or for export purposes. It's your decision whether or not you want to impose a higher severance tax on gas which can be passed on to the consumer when so large a percentage of the consumers are Alaskans.

You may want to regard it in an entirely different light in the future when Prudhoe Bay gas is coming on steam, when the bulk of your gas goes into export. And when you have a better handle on what production costs are gas pricing out policy is going to be, and so on. I would not think there is tremendous merit at the present time in revising your severance tax on natural gas.

RADER: I think you get that Alaska gas under any routing may not be economically acceptable for a lower 48 market because of the costs. Would you anticipate that a natural gas severance tax at this time would have anything to do with gas routing or the feasibility of either route, or anything like that?

LIPTON: Senator Rader, first of all, it is very difficult for me to conjure up the transportation costs which will price Alaska natural gas out of lower 48 markets. If you look at the natural gas balances in the United States and you see what the alternatives to them are you are talking about very high cost gas. If it is SNG, manufactured either from coal or naptha, or if it is imported liquefied natural gas, all of these by the 1980's when Alaska gas starts to flow will be incredibly high cost. It would take a multiple run up of any present estimate of transmission costs even to get these things close to the alternative. If you're talking about gas transmission costs on such an order of magnitude that Alaska gas lays into the lower 48 states at $3, $3.50 per MCF, as someone suggests may be the case, then a five cents severance tax is not going to weigh that much in the balance. I don't think the severance tax is going to be a disability on the movement of Alaskan gas, nor do I think transmission costs are going to be a disability. When the time comes that gas will have a very high value in the lower 48.

CROFT: You pointed out that some 50 percent of the gas out of Cook Inlet was used in the Anchorage area and there have been several different methods proposed by which you could increase the severance tax on gas yet minimize or eliminate the affect on Alaskan consumers. There may be mechanical or constitutional problems with some of the various proposals, but laying those questions aside, do you see any adverse affects other than the political one that suggests we don't bother with, increase the tax on gas. Is there going to be a reallocation of use of gas? Are we going to make other fuels more admirable in the Anchorage area rather than gas or any of those types of impact?

LIPTON: The highest value in your Alaskan gas is when it is transmitted to the lower 48 states to be used basically in households. On that basis I don't see that an increase in severance taxes is going to be a disability. It is a different story if you are talking about the internal utilization of gas as feedstock for example, for petrochemicals

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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 explansion 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.

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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 SSHB 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 produc.ion 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 unneccesarily 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

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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 leigslature 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.

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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 transation, 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.

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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 criterian which determines whether and if there is when, a company becomes exposed to this surchage 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

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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 surchage. 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.

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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 he 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 responsibilty 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

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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 consession 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 yo 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 indsutry. 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

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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 profitabilty 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 becasue 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.

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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 Norht 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 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 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 the listened to the industry, and to a very considerable degree revised their terms.

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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 representive 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.

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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 definintion 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 expections, 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 propects 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 . . .

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January 20, 1976

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

Dear John:

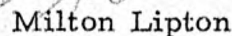
Needless to say we have heard and been intrigued by the proposals that have originated within your committee with respect to petroleum taxation. I do wish we could have gotten this first hand, and that is the point of my writing to you.

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,



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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.

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C. Oil and gas field <u>valuation</u> (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 <u>the present worth of anticipated future net income</u>.
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

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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	135,000	
TOTAL		$548,000
Costs as Percent of Taxes		.48 of 1%
Or Conversely, Net Tax Collection		99.52%

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