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Special Committee on Taxation & Revenue

John Huber, Chairman

February 14, 1975

SENATOR HUBER - We will come to order. We expect more members from the House Finance Sub-Committee. Brenda Itta is with us now. We also have sitting in with us Senator Rader, Senator Orsini, Senator Pat Rodey, and of course the man who will be talking to us, Milt Lipton. Milt, I think that you know where we left off on taxation and revenues the other day and maybe you want to start from scratch. But basically, the questions have to do mostly with how it refers to taxation and revenue, both against our immediate needs and our long-range needs and the infrastructures of our revenue system. So, we are just going to start out with you and let you go.

MILTON LIPTON - Thank you, Mr. Chairman. It was several sessions ago that I referred to the practice of my appearing before legislative committees as a kind of a floating crap game, but I notice that you violate the principle of a floating crap game. For reasons of security you should never reconvene in the same place twice, but here we are reconvened in a hearing room where I was yesterday. I would like to start out discussion with you on reserves tax, perhaps go over quickly some of the things we have covered together before and many of the things I have discussed with other committees. Looking at the bill before you for the enactment of a tax on reserves from two perspectives: First, as a revenue-raising measure per se, that is by itself is it a good means (or what is the effect of it) to increase the aggregate amount of revenue which the State can expect to get from oil and gas operations? And then secondarily, as one among various alternatives that the State might turn to, not to increase the sum total of oil and gas receipts, but to provide a flow of revenues during an interim period when the budgetary needs of the State may compel us to look at some form of taxation or some source of revenue which it might not consider simply from the standpoint of raising more money. That is to say, the urgency of the State's budgetary position at the present time. Let me repeat very, very briefly, at the risk that you identify me as one among many lobbyists, what our objection has been to the principle of reserve taxation in the past and at present: That we feel that among the various means of raising funds from an operating and profitable oil and gas industry, the reserves tax is not a good tax. It hits the oil industry at the wrong time. It is not well

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identified with the respective profitability of profits, or of producers, or with a lifetime of their exploitation of State resources. And it is not only extremely difficult to administer, but it raises the possibility of very serious inequities among the companies and producing firms who might, at least theoretically, be subject to the tax. Very quickly, the problems in the administration of the tax are that--as the Senate Bill provides and as the House Bill provides and as the bills of the last legislature provided--What you are doing in effect is assessing the value of property where you include in the value of the property an estimate of the value of oil or gas (or oil and gas) reserves underlying the property. The problem of assessment, and you provide that in effect the valuation shall be the commercial value of the property as it had been obtained between a willing buyer and a willing seller. If you look at an acre or two acres of undeveloped land, the valuation of such land can generally be determined by a tax assessor on the basis of other transactions; similar land, similar location, there have been purchases, there have been sales so that you can determine what it is. To try to assess the value of improved property you appreciate in assessment the value of the land either on the basis of the cost of the property that has been built upon the land or what it would cost to reproduce the property at some later date if it is an old house or an old factory, or the income-earning potential of a factory which is operating, which is manufacturing goods, which is selling them. The minute you move to the valuation of reserves in place, you have an entirely new order of problems of assessment. I think I discussed some of these with the Committee last time so I don't want to repeat them in great detail, but one that's very difficult to identify: What the magnitude of reserves in place are. I put to you that in the last fifteen, twenty years in the United States where we have statistics on recoverable reserves with gross additions to our recoverable reserves each year, the biggest change in our estimate of reserves is not on account of new discoveries, or not on account of the amount of oil that we have depleted these reserves through past production, but through changing circumstances which lead us to change our own estimate of what the volume of recoverable reserves are. Secondly, after you have estimated what the recoverable reserves are, you must determine what their value is in terms of how much oil will be produced from those reserves, over how many years in the future, at what price will they sell. So you have, from an administrative point of view, an extremely difficult problem of determining what the value of those reserves are for purposes of assessment, since in fact there is neither willing buyer nor willing seller of those reserves and you couldn't possibly have trans-

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actions on the scale that would parallel the underground resources whose value you are trying to determine. Then, if you look at--if all of these problems had somehow been resolved, there is still the problem for one large oil field there or gas field here, or an oil field there which may have already been discovered or which will be discovered while the tax is still in effect. How do you determine the relative value of those reserves? Because the contribution in the payment on the oil or gas reserve which a lease owner will have to make will depend not only on the State's estimate of the volume of oil, but the estimate of when it will be produced, what the value of these are. It becomes an extremely difficult problem in not only determining for an individual field what the assessed valuation is going to be, but when several producers in different areas of the state may be both affected by it and determine the relative valuation and therefore the relative contribution. So that if this tax is looked upon as a means of increasing the aggregate revenues which the State will get from a functioning oil and gas industry, it seems to me that it's a poor and ineffectual way of doing that. If you want to increase revenues, you have other tax means by which to do it. Which is through your leasing policy, through your severance tax policy, through your royalty policy, through your income tax policy. So then I come down really to a perspective on this proposed tax, not so much as a means by which the State will increase the total revenues which it obtains from "D day" when the first lease is put up for bid, until "Z day" when on any particular lease the oil had been fully produced and the State has gotten all these revenues, but as a device to obtain for the State over the next several years a flow of revenues, which otherwise the State might not even obtain, or might obtain later, but which is necessary to bridge the gap. In other words, it now becomes a special form of taxation which is looked at by the legislature under the circumstances of today because the State faces this budgetary deficit. Obviously I am in no position to talk to the State's budgetary deficit or to other alternatives for improving the State's revenue position. But if the legislature is prepared to look at this task, not as the means of increasing over the span of oil and gas operations--increasing the total revenues, but as an interim budgetary measure, then I think at the very least it must consider what we have, I suppose, first suggested in the last session: Namely that since the State is trying to accelerate the flow of revenue, that it look upon whatever payments have to be made through a reserves tax, a tax on oil and gas in place, in fact as a prepayment of the taxes which otherwise would have been paid to the State at a later date when the oil and gas in those

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reserves actually moves into production and when the severance tax payments are made by the leaseholders and the oil and gas producers. Which means in fact, that the payment to the State this year and next year becomes an anticipatory payment, that in a sense, offsets the severance tax that would be paid in the future. You exchange current revenues for future revenues. From the standpoint of the State, it would not in any sense increase their total flow of revenue, but bring them closer to the present. From the standpoint of the producing companies, it does increase their total tax burden: Because to the extent that they must pay the reserve tax before they begin production, they must pay either out of other sources of corporate income or by anticipatory borrowing, so that in effect they carry an interest cost for a year, two years, or three years, or four years--as long as is necessary before in effect they recover what they have paid in the reserve tax by the abatement of future severance tax liabilities. Where the State would not feel a net increase in their income, it would be bringing forward to recent years income that would otherwise have been recovered, for the industry it represents a net increase in the cost of doing the oil and gas exploration development work within the state on their leases. And of course, it places an acute financial burden on the specific companies who are most heavily involved in the Prudhoe Bay area, but you are well aware of that. So in general, I think that we feel that it is not a good tax from the standpoint of raising revenue. It is not an attractive tax really, from the standpoint of even providing carry-over funds, but this is a choice among alternatives that you would have to make. Here or elsewhere we can talk about the alternatives such as the prior sale of future royalty oil and gas or other forms of taxation. But if it were to be done, then at least we would feel that the State would be best advised to provide that payments on the reserve tax should be credited by each company that makes those payments against what in the future will be their severance tax liability. So that for some period of time, a portion of the severance tax each year that might be paid to the State since in fact it had already been paid in advance by the reserve tax. One other aspect of the relationship between the State and the industry: If it commends itself to the legislature, that this tax is really not a tax that should be added to the arsenal of weapons that you use against the industry (that you have other forms of taxation much better to turn to if you want to increase your total revenue) and that it is, in a sense, an emergency tax which is enacted now because the alternatives are just now available, then I would strongly urge that

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in passage of the tax, and in the legislative debate and in the legislative history, that this be clearly understood. Whether there is a termination date on the tax, or whether there is a clear understanding that it is the intent of the legislature that this tax, as an interim tax, shall in a sense abate future severance tax; that this should be clear either in the language of this statute or at least in the legislative history. That is as far as I would want to go in terms of general remarks, and if you like I could turn to the specific language of the bill that is before you.

SENATOR HUBER - I think that might be a good idea if you did. The proposed bill on oil and gas taxes in place--He has a copy of both the House and Senate bill, and I believe he's been briefed on the Governor's bill. We have been joined by Representative Gruening and Representative Haugen, who are members of the House Committee on taxation and Revenue.

REPRESENTATIVE HAUGEN - Mr. Chairman, do we have a copy of this bill in our book so we can follow along with it?

SENATOR HUBER - You did have a copy in your books.

MILTON LIPTON - SB 103.

COMMITTEE MEMBERS LOCATED THEIR COPIES OF THE BILL.

SENATOR HUBER - Did anyone have any specific questions this far? Any members of either committee have any specific questions so far?

REPRESENTATIVE HAUGEN - Just one thing. I got in late, but putting it simply, what you are saying is that you are going to borrow against the future revenue, and what your caution was that that should be a credit against severance when the time came.

MILTON LIPTON - That is an alternative. That's not the alternative that's provided in SB 103.

REPRESENTATIVE HAUGEN - No. I know that, but I . . . Just to get . . . Putting it in simple form, that's what you said.

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MILTON LIPTON - Yes. What I was saying was that if the purpose of this type of tax legislation is to provide a bridge between the time when the State faces an acute budgetary deficit and the time when its great expectations come to fruition, and not just to raise total revenue, then probably the best way to do it would be to say that all payments of the reserve tax (the tax on oil and gas in place) will, in due course become credits against future severance tax liability to that resource.

REPRESENTATIVE HAUGEN - I understand.

SENATOR HUBER - The difference between the intent of SB 103 was that it provide that same bridge, but with no payback provisions. It had a phase-in and phase-out provision, and it had no intent to pay it back out of future revenues. It was just an additional taxation policy.

MILTON LIPTON - This is very clear. I was going to call attention to this feature of SB 103. As it stands, I interpret SB 103 as an added burden of taxation upon the oil industry designed to increase the total payments which the industry will make to the State. If you look at section 3 of the Senate Bill, which is actually section 20 of AS 43, it says: Producing oil leases or properties which are paying the gross production tax (severance tax) during the assessment year in an amount which exceeds the tax that would otherwise be due under section 15 of this chapter (that is the reserve tax) are exempt from the reserve tax. Which means in effect you credit the severance tax against the reserve tax, but not the reserve tax against the severance tax, and there is a very distinct difference in what this means to the oil industry's liability. As this reads, and if this is your intention, what you are doing is you are not only increasing the flow of oil revenues during this interim period, but you are increasing the total tax burden on the oil-producing industry operating within the state. And my criticism is not that you are increasing the total tax burden of the oil industry, but that if it is your intention to increase the total tax burden of the oil industry, then it should not be through a reserve tax. It should be in due course, if it is on production, through the severance tax. If it is on the profitability of the industry, through your income tax. But not to say that the Legislature of Alaska in order to increase the total oil revenues for the State enacts this type of tax to increase the total.

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SENATOR HUBER - So we're clear on that now. You don't see any attempt there to double tax them after they are in production.

MILTON LIPTON - There is no double taxation. There is just an added taxation during an interim period which otherwise they would not pay, and no offset for that.

SENATOR HUBER - Yes, that is correct. Senator Rader.

SENATOR RADER - Doctor, are you prepared to make a recommendation to us if we made the assumption that all we wanted to do was to bridge our shortfall, as a matter of revenue, without adding significantly to the burdens of the oil industry? What mechanism would you suggest that we use?

MILTON LIPTON - There are many alternatives I presume, that the State might consider, that I'm not competent to talk about. If you are asking among all the alternatives that the State might consider which says that the oil industry is going to pay this deficiency for two or two and a half years, you see, then I suspect that probably among those alternatives, if one has to be selected, the reserve tax probably is the one that you will have to turn to. But if that's the case, then I would prefer that section 3 here reads not that the reserve tax becomes a credit against future severance taxes, but that all payment on the reserves up until such period of time as the lease goes into production shall, over a future period of time, be credited against the company's ongoing severance tax liability. Which means in effect, the aggregate payments of the company will not have been changed, but the time when they make the payments will have been advanced. It's the difference in whether the reserve tax is a credit against future tax liabilities, or if in effect you pay all this reserve tax, but then you simply stop paying it after the severance tax comes into being.

SENATOR RADER - Do I understand that you meant to say that you would not favor the preselling of royalty interests or anything of that nature?

MILTON LIPTON - Yes. Now we haven't really discussed that, and in a sense it is unfair to you for me just to say among all the alternatives which we haven't discussed--therefore the correct effort is this. But maybe we ought to hold off with this discussion on the presale of

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royalty oil and gas for a moment and concentrate on this thing. But I would certainly like to come back and tell you why it is in these fields that the sale in advance of what will be in the future royalty oil and gas is probably bad policy.

SENATOR HUBER - We have with us--there have been more people added-- but we have the prime sponsor of the House version of the bill with us (Are you finished, Senator?), who would like to ask a question, Fred Brown.

SENATOR RADER - Yes.

REPRESENTATIVE BROWN - I have heard some of Mr. Lipton's presentation on some of these matters in House Resources this morning. I just had one short question right now. What other major oil jurisdictions have taxes that are either taxes on oil and gas in place or are somewhat similar to this one, something comparable to this one?

MILTON LIPTON - There is nothing quite comparable to what is being proposed in this legislature. There are in other oil-producing states ad valorem property taxes which involve the valuation of the reserves under the property. They're usually part and parcel of local jurisdictions in which first of all, there is already production, and secondly in which the valuation tends to be relatively mild. There was in the Province of Alberta, in special circumstances and enacted by the Province of Alberta, which set up a resource tax in which every producer in the state had the option of paying either a mill rate on the valuation of the oil resources or a higher royalty rate (which the Province was enacting) than they had previously been committed to. They could choose between the two. But the Province at that time established the valuation only on producing properties, not on oil and gas in place that was not subject to production. And they had, and provided to the industry in advance a clear schedule by formula as to how the valuation of the oil reserves would be determined by their own Department of Energy and Conservation. And what that involved was to use ongoing estimates of reserves which were already (since there was a history of production) the basis of the Province's own prorationing program. So production was established on the same basis of reserve estimates, as the valuation was, and where there was no attempt to make forward projections of what the value of the oil would be, there was a simple formula which says the price that was obtained in the last accounting period for the

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production applied to this agreed-upon volume of reserves in allowing for a given rate of decline in the reserve. So that it was, in effect, a mechanistic device. The one which was applied simultaneously to all producers in the province on the basis of reserves that they were already producing and on the basis of reserve estimates which were the basis of their allowables to produce. So, it was a somewhat considerably different tax device than the one that is being proposed here.

REPRESENTATIVE BROWN - You said it was a special case, and you had this in the past. That is, they don't have this anymore? When was this and why was this a special case?

MILTON LIPTON - Well, it was adopted by the Province several years ago when there was an appreciable increase in the value of Canadian oil. By way of background I must explain to you that the Province of Alberta, for example--No Canadian Province has the right to levy production taxes or severance taxes the way U. S. States do. This is a matter of constitutional delineation of taxing powers. The Province, if they taxed, could only tax really on the basis of income of value, but not on gross relative value. But the oil industry in Alberta has constantly taken exploration and production leases from the Province of Alberta on the basis not of a fixed contractual or legal royalty. The royalty has always been subject to change by the Province, at the will of the Province, excepting that some years earlier the then government of Alberta had entered in an Orders of Council in which they held it out to the industry that for ten years the royalty would not be changed. Then, before the ten years expired, the Province of Alberta wanted to change the royalty. They could on many, many of the leases, but they didn't want to violate what seemed to be a commitment on some of the outstanding leases. And so they went this route of setting up an alternative form of taxation and gave the companies the alternative of avoiding the taxation by voluntarily agreeing to an increase in the royalty.

REPRESENTATIVE BROWN - This would have been about when that this happened?

MILTON LIPTON - Several years ago. About two years ago this happened. But if the question, "Are there other instances by U. S. States . . ."

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REPRESENTATIVE BROWN - I meant basic jurisdiction. I meant anywhere in the world that has anything roughly comparable to the way we have in taxing. Particularly in English-speaking countries where . . .

MILTON LIPTON - Well, the English-speaking world has less problems with oil and gas than other parts of the world. Now, I don't mean to be facetious. There may be, but to my knowledge, I cannot think of a place where there is any substantial taxation of reserves before they enter into production.

SENATOR HUBER - Clark.

REPRESENTATIVE GRUENING - Mr. Chairman, I would like to ask . . . Doctor, doesn't your suggestion that credit be given against the severance tax kind of help alleviate some of the problems you have in evaluation of the reserves as well as the value of them? In other words, you don't have to be so exact because you are going to give them credit anyway.

MILTON LIPTON - Well, let me say that if you are looking just at the problems of one oil field and the producers in one oil field, whose respective interests may probably be defined anyway by unitization agreement, then really the problem of assessment and the problem of the mill rate becomes secondary to how much money the State wants to take from it. In effect, if the decision of the State is that in a fiscal year we need \$200 million and willy-nilly it is the leaseholders in Prudhoe Bay who have discovered oil who are going to have to carry us over, it doesn't make a hell of a lot of difference at what rate you assess the oil in place and what kind of a mill rate. One or the other will lead to \$200 million. It does make a difference, I have to be brutally frank, because to play around with an idea that there is somehow a principle of taxation involved here because it is part of your general property tax, you are now going to . . . You really haven't established a new tax at all. You have broadened the definition of taxable property where before you had exempted oil and gas in place and now you are going to include oil in place. But this is fooling around because in effect you are creating an entirely new tax and you're entering into a principle of valuation which you have never done before, which can't be done that way, but arbitrarily it's done. Yes, in that sense for those producers, the only thing that matters is the \$200 million. (I shouldn't use a number, because then it can be quoted as somehow it is significant and I have no idea of whether it is \$200 million, or \$100 million, or what. It will probably be more than that over the whole period that I'm talking about, but I'm using it for purposes of example.) Then what matters to them, the only thing

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that matters to them is how much the money is and how soon they are going to extinguish that by taking the credit against the severance tax. But if in fact this is a general--(You are not in fact saying here, at least in this bill, you may be in some other bills saying that this tax is levied against the leaseholders in Prudhoe Bay)--this is a general tax for the State, to what extent will this tax be applicable to other fields in the State that either have been found for which we may not have any clear estimate of the reserves yet?--But when you go to your Oil and Gas Division, they will have some information about successful wells which are not in the general domain and within some period of time, there may be enough knowledge to assess the tax against them. Then it becomes a matter of equity, you see. Then it becomes a matter of difference as to just how you begin to evaluate this field's reserves against that field's reserves. And even if you take two additional fields that may--on the North Slope--that may fall within the jurisdiction of this proposed tax, both of which have reserves of 150 million barrels and therefore presumably both paying the same tax: But one has relatively unfavorable producing conditions so to exploit 150 million barrels of oil will require twenty-five, thirty years of careful production. The other has a favorable producing reservoir and can produce in fifteen years. The different rates of production, the speed at which one field or another recovers its prepayment on the reserve tax, will differ. Which means that the net cost to the companies will be different. Is this an important consideration to you or not? I don't know. But certainly, if you are thinking in terms of principles of taxation, it is a very difficult tax to administer equitably. If the tax is not going to affect anybody but Prudhoe Bay, that's a different story. But even so, you talk about Prudhoe Bay. Who really are going to be the producers in Prudhoe Bay? By the time production starts, the unit may not quite be the same. The total amount of oil produced . . . may be oil coming from outside the unit and these reserves may be subject to tax. It is not an easy tax to administer equitably. It is for the legislature, an easy way to find the kind of money to bridge the gap. And the only thing that I can offer, is that if it were to be done, and this you must decide, then I think that the one principle you should follow is to allow the extinguishment of these reserve tax payments relatively quickly as an offset against future severance taxes. And then one other thought. If you enact this law and the companies look forward and ultimately start producing, their severance tax is going to start to go down, and then the successor of this legislature meeting in this room two years from now, takes a look at the severance tax and says that the severance tax is too low, it really

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ought to be higher. So in fact, there may not be any offset in the future, depending on what the legislature does with the severance tax. Now that in itself--now there is nothing wrong with that in itself, if the severance tax decision then is made legitimately in light of the circumstances at the time because your severance tax, nor your income tax, nor your property taxes are chiseled in stone. They are all susceptible to change from year to year according to changing circumstances and all taxation in particular is in a very volatile state because of the changes that are taking place in the world and in the United States and in the valuation, and the pricing, and the taxation. But I think it should be part and parcel of your legislative discussion here that the action by this legislature, if you have this right of offset against future severance tax, is done in good faith--that this does not imply that this legislature is trying to tie the hands of the future legislature--that in a sense they will be violating good faith if they legitimately review the severance tax in the future. Because you will surely hear three years from now in a debate when someone suggests raising the severance tax, that this is bad faith on the part of the Alaska legislature because when you adopted this tax you committed yourself to freezing the severance tax. Which is not what I am suggesting at all. You must have in the legislature the right to adopt whatever severance tax is appropriate to the time, but still have at this time a carry-forward credit.

SENATOR HUBER - Now if we'd go just a little further. If we could expand a little on the question--We had several versions of this bill that we were kicking around and we did ask some consideration for that aspect. In fact, we were thinking more in the line of, well if they are paying an ad valorem tax, maybe as much income tax wouldn't be levied or some other thing. We didn't know just what, but that's one reason we didn't have a phase-out on it. The other thing that we were thinking about is in the beginning, we were trying to figure a way to keep the tax from being a deterrent for new leases. Now, there is a difference between the House and Senate version on that. On the Senate version there is the five years that we put in there, and so you can see we were after an obvious time--five years would be enough to keep a new bidder so that he would never end up paying it. He would normally go into production. I would like you to touch on that and discuss it--Whether it is enough? How much of a deterrent it is? Whether it should stay in the final bill, or what?

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MILTON LIPTON - The bidders for leases on Prudhoe Bay in September of '69 would have bet that five years were enough for them at that time to have avoided any reserve tax that might have been on the books then. You know really, the tragedy (I should choose my words more carefully) --the problems of Prudhoe--there are no tragedies up there--but the problems are not only the delays but everything that has happened in the world while these delays were taking place: Inflation, and the run up of costs, and everything else. And it's very difficult to know in advance, and in particular for remote areas of the state which may be opening up to exploration in the future, what an adequate time is. This is paragraph (b), I guess, of section 15. The intent of it is very, very clear, but you see this also reads to the oil industry that this is not a temporary tax--that this reads as though it is an addition to the panoply of taxation which this State is going to impose upon the oil industry. And I really have one of the strongest objections to the idea that this is the kind of tax which by itself, standing on its own feet, is an appropriate form of taxation whereby the State of Alaska reaches out for the revenues which it is entitled to obtain from the oil industry. It's not a good principle of taxation. Anything which implies that it's part of your permanent tax package, I think, is counterproductive. I don't know whether you can go ahead and make this an emergency tax, or a tax with a direct termination date. This may raise special problems for you in terms of legislative practice, even constitutionality, and I am not competent to talk to that.

SENATOR HUBER - That was the next thing that I was going to raise. We will have to explore elsewhere for the constitutionality of it as a special tax which would be phased out.

MILTON LIPTON - Obviously, the tax can be passed by this legislature and repealed by another legislature. But whether this legislature can enact this particular form of tax with an expiration date, I don't know. But of course, it is of no help to those producers who are immediately subject to the tax to know that the tax is going to be repealed. But in terms of the interplay between the State and the industry, if we are correct, that this is really not a very effective or a commendable form of taxation, I would not like to see the legislature keep this as a piece of the permanent passage. And this has nothing to do . . . I'm not arguing here that the State already is taking too much money from the oil industry or anything else. What I am saying is that the appropriate relationship between the State and the industry in terms of taxation and revenue is best served by other

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vehicles other than this form of taxation.

SENATOR HUBER - I think you are basically telling us that it's an ends tax rather than a means tax. Fred.

REPRESENTATIVE BROWN - Mr. Chairman, I have another line of inquiry and then I have to go back to House Judiciary, next door. Some of the things you addressed yourself, some of the policy considerations (they aren't all there, I am sure) have been what the reasonable expectations of the oil industry are, of course depending on what those are--what affects what they would or would not bid in an oil lease sale for bonuses and that sort of thing. I know that you are in touch with the industry a lot more than many of us are and you talk to the people that they talk to and they fight with other countries and other states. I'm going to ask you a leading question, and maybe the answer is no, but isn't the industry already making business decisions based on the assumption that Alaska will almost certainly--just considering the political realities--almost certainly raise the severance tax after the oil goes on line and probably will either pass taxation of oil and gas in place this session, or keep it in the hopper and keep bringing it up and seriously considering it quite frequently?

MILTON LIPTON - The last thing I can do is to speak for the oil industry, which is . . . I give it to you as my personal opinion, that every prudent man who is in an executive position in an oil company in the oil industry is constantly anticipating tax increases in every jurisdiction where the oil company operates. Now, whether they look upon Alaska in some special light or different from other states, I suppose depends upon the whole flow of debate in the legislature and what their experience is and so on. I don't think that in any sense the oil industry has been poorly treated in Alaska. With all the jokes that may be made about the way in which Alaska operates, at least as I read it, all the legislation that has come out of the State of Alaska --including the taxation--the oil industry has not been treated poorly in the State of Alaska, and certainly not in comparison with the problems which they face in other jurisdictions, including other jurisdictions . . .

REPRESENTATIVE BROWN - My definition of other jurisdictions . . .

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MILTON LIPTON - There is a very realistic problem of what the passage of this kind of legislation might do to the kind of bonuses that you could obtain in a lease sale. This is a very real question. The answer has to be in general, that it's going to have an adverse effect upon the way companies regard the bidding in a lease sale. But how adverse, I don't think anybody could really quantify. And whether in effect it would ever have a measurable distance really depends upon how attractive the acreage is that you put up for bid. Because if the acreage is very, very attractive, and the competition is very, very keen, then it is difficult for a company to say that I am going to penalize Alaska in my bid by so many dollars as the quid pro quo for the reserve tax to which I may be subject. Because if he does that he's made a very careful calculation and he comes out just as well in theory as if there hadn't been a reserve tax. Do you follow my argument? However, if not everybody does it, the difference may be that he doesn't get the lease. And so maybe you don't quite assess the full disadvantage of the reserve tax against the bonus bid, and the other guy doesn't quite do it to that extent so that you don't really know in the end. Yes, it has a discouraging effect. Yes, there will be a reevaluation and certainly if the acreage is not particularly attractive, it may make the difference between a company bidding at all, or how many companies even come in. But if it's attractive acreage, realistically it's very difficult to say with assurance that every dollar of revenue which a State may expect to get out of a reserve tax, they will have given up in advance by lower bonuses. They only example I can give you of how an industry will operate . . . Well, for example, up until several years ago there was computerized study after computerized study of rates of return to the oil industry on the oil exploration in the U. S. Gulf. There was hardly a one of them that didn't show the industry to date and projecting ahead of the basis of discoveries and price expectations, that the rates of return would be much better than 7 or 8%, or something like this. Which every firm knows is not the incentive for which one conducts exploration. These were industry calculations all the way through. So if you read the newspapers or follow, you know, the kinds of bids that have been made for offshore leases in the Gulf of Mexico. Which means that just as you in Alaska must be concerned by the depressing effect of adverse expectations, there is a kind of coefficient of euphoria, the hope upon the hope upon the hope that what you discover is really big oil, which leads to competitive bidding. And I don't think the world has changed in that respect: If anything, the higher values of which are beginning to emerge for U. S. oil and gas production I think are a spur to exploration and the deductions are here in Alaska and I would expect that if the acreage is attractive that you would get pretty good bids. But I am not prepared to assure you against failure.

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SENATOR HUBER - John.

SENATOR RADER - Dr. Lipton, what if we had not only a temporary bridge with the credit that you suggest, but perhaps an interest payment also, so there is not even a penalty of interest on the prepayment? What if we had one other factor in it that would trigger that the tax would not be imposed in the event that a lease sale held within let's say six months produced a given amount of money?

MILTON LIPTON - Well . . .

SENATOR RADER - In other words, you develop a sort of scale like this: If bonuses received from lease sales held for calendar year 1975 are \$100 million or less, than the tax will be "x". If it is \$200 million or less the tax will be "x". If it is \$300 million or less the tax will be "x". And really use this as an alternative triggered by the shortfall revenue from sales.

MILTON LIPTON - I am sure the industry people would appreciate any device in the act which minimizes their tax exposure. I don't respond instinctively, you know, to this formula approach. It seems to me that one alternative is that if there is not an urgency in terms of timing or present enactment, that perhaps you can defer enactment until such time as the results of a lease sale (if there is a lease sale) emerge. Or, alternatively, one can go ahead with the enactment and don't establish a single mill rate on the thing. In all your property taxation, mill rate varies according to various criteria from time to time, and this may be subject. I don't know. If the legislature concurs with our evaluation of this tax in principle, and if there is any leeway in time before the urgency of enactment, then perhaps that would be the device that one follows and not rush into passage. But this I can't judge, you see. I can't judge that. But, perhaps this is a time for me to address myself to the question that Senator Rader put before, which is: Are there other alternatives, and how do we assess those? Would that be in keeping with your own thinking, Mr. Chairman?

SENATOR HUBER - I think so. I was wanting to comment. I hope that if we adopt the system that Senator Rader just outlined that we can get him to draw up the constitutional opinion on it and so forth.

SENATOR RADER - Just toying with an idea is all.

SENATOR HUBER - Before we get into this, I think Clark had a . . .

REPRESENTATIVE GRUENING - Mr. Chairman, this may dovetail into what you want to expand on in terms of other means, but I don't know if this has been asked in earlier sessions. But what effect will federal taxation have upon our taxing reserves in place, specifically the President's proposal that we put an excess profits tax on it? Isn't it a question of who pays it? Who the oil companies pay it to?

MILTON LIPTON - Not in this particular instance. As I see it, there are two variables again. One is, how will federal policy affect the valuation of reserves in place? And second, how will the tax payments on the valuation of reserves affect the company's federal tax liability? So you've kind of completed a circle. If the President's proposal for simultaneous decontrol of oil prices goes into effect (This of course, is irrelevant to crude oil because that oil would not be under price control under the present federal system), but at the same time that oil becomes subject to a federal windfall profits tax, that in effect would really diminish the value of Prudhoe reserves because of the fact if Prudhoe reserves today are completely not subject to control, whether they were being produced today they would have a relatively high value. The windfall profits tax goes into effect and if you have an honest assessment, then you would have to say that Prudhoe Bay's are less valuable because there is a windfall profits tax in effect. Realistically, if you were going to get the same amount of money from them by saying, "Well, if the value goes down, the mill rate goes up," doesn't make much difference. In any case, none of this is going to be in effect, I would expect, by 1978. No. I shouldn't say that. That implies a bad perspective on pipeline completion. None of this will be in effect in 1977, when the pipeline is completed. Now all of this, in effect, will represent a diminution or a potential diminution of the company's federal tax liability. Well, this is almost always the case, but that will vary from company to company, according to what their federal tax liability is, and that they are not in a positive tax paying position or in effect this is not an expensed item. This kind of State tax cannot be expensed against otherwise taxable income. It may not in any appreciable sense reduce their federal tax liability. I don't think there is much, one way or the other, that you really ought to concern yourself with respect to the proposed resources tax. There is something on the severance tax, but perhaps we can discuss that later in a different context.

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SENATOR HUBER - I think that we can go ahead now to Senator Rader's other questions.

MILTON LIPTON - I have been asked elsewhere on repeated occasions about the possibility of the State obtaining early revenue, not from taxation, but through the sale of royalty oil and gas to which the State will become entitled at some future date. Now you can regard that as two different ways. One, you can say that the State in effect is selling now what they otherwise would have sold later, or you can say that what the State is doing now is borrowing against the royalty income in the future. In one case you sell a good later or now, and the other perspective is that you are not selling anything, but what you really are doing is you are trying to get an anticipatory income against--because in the future you may take your royalty, well not as oil but as a cash payment. It has, for the industry, of course--it has two very keen attractions which I am sure they will quickly lay in front of you. One is that they're not paying taxes. They are spending money to buy something. And the second is that the incidence upon companies could be quite different. There is no question but that the reserve tax is going to hit most against Standard Oil of Ohio because of their proportionality of reserves (which happens to be a company this is already tremendously in tremendous cash pressure for the amount of capital they've got to put into the pipeline and the development of Prudhoe to go into production), then on to Atlantic Richfield and upon Exxon. And I don't mean to align these companies in order of magnitude, but there is a kind of continuity among these three companies. Whereas, if you sell royalty oil or an option on royalty oil, these companies may opt not to become buyers because they are already major producers and the more logical buyers could very well be other U. S. oil companies with major refining capacity who would not otherwise have direct access to Prudhoe Bay oil and would contemplate a look upon themselves as potential buyers in the future in any case. So why not try to buy from you now, instead of buying from you or from their own competitors later on. So, when it changes the total cash burden of the industry and it shifts it among companies within the industry, nonetheless I go back to what I said without explanation before, and now I'll try to give you that explanation. I think it is not an appropriate way or a good way for the State to approach a budgetary deficit. First of all, the worst time of all to be a seller of any kind is to be a seller under distress. If you have something to sell, you are in a much better position to choose the time and circumstances of sale than have to sell under distress, and

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especially when all buyers know that. Obvious. Secondly, what the State does not know is really how much oil it's going to be selling. Because what the State will sell is an option on its future royalty oil in return for a stipulated amount of money, whatever the State may need. A buyer is not going to give you \$10 a barrel or \$12 a barrel or \$9 a barrel or \$5 a barrel. No buyer can commit himself to pay a price today for oil he may not get until 1978, '79, and 1980. The price is too uncertain. It is completely uncertain. So what you may do is entertain the idea of taking competitive bids for your oil at some percentage of what is then the market price at the time delivery of the oil takes place. Are you with me? Now that percentage will be less than 100% of the value because the buyer, if he's not going to get the oil for two, three, four years, will put a discount factor on it. Under the reserve tax, the taxpaying companies carry the interest burden until they can extinguish it. Here, you carry the interest burden because they pay you in advance. So, it will be less than 100% of the value. But what you don't know is how much oil you'll be selling in the future to extinguish say, \$200 million worth of presell. If the oil is worth \$10 a barrel at that time, it'll take so many barrels to extinguish a prepayment of \$200 million. If the oil should be worth \$15, you are very fortunate because it will be less oil. But, if the price goes down, you may have in effect committed a hell of a lot more royalty oil in order to obtain this advance of funds than you had contemplated. And I know from past legislative hearings that this State has so often considered what the value of royalty oil or royalty gas will be to the State. Not in the dollar value of the royalty payment but the ability to take the oil as oil, not in the dollars and cents, and then dispose of that oil (the State itself) in ways which serve other purposes, other intentions of the State itself. There has been and there is, I'm sure, ongoing discussion of the extent to which that oil may be, for example, processed within the state. Or, what kind of petrochemical processing may be established within Alaska? Why the availability of oil and gas, at the disposal of the State, not under the control of leaseholding companies? You don't know for how long and to what extent. In a sense you hypothecate all of these possibilities to the immediate need for money if you go into this kind of a sale of royalty oil or gas. Then there is the further consideration that you have established an Alaska Pipeline Commission to exercise regulatory authority over the pipeline. None of us know the extent to which the tariff on the pipeline may be at issue. The importance--the significance of the pipeline tariff to the State itself is very, very clear. Because the higher the tariff, the lower will be the wellhead value of the oil. The lower the wellhead value, the lower the severance tax income, the

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lower the royalty income and so on. But if it was anticipation, among other things and not exclusively for that reason, but among other reasons, you established a Pipeline Commission with regulatory authority and jurisdiction over tariffs of that pipeline where the tariffs apply to the intrastate movement of oil. But for the jurisdiction of your Pipeline Commission to be enforced--to be reinforced--requires an intrastate movement. And it was always, I think, part of our thinking at least, that the State, so long as it had the access to royalty oil, was always in the position to take that oil in kind, to transport it through the pipeline and affect via buyer transportation services (and at the same time establish the fact of) intrastate business for the Alyeska Pipeline. Which then triggered the potential jurisdiction of your Pipeline Commission to review tariffs, to arrive at an agreement with the owners of Alyeska. What the appropriate tariff is and lack of agreement; to enforce a tariff; to fight the battle in the courts if it ever comes to pass. But in a sense to achieve sovereign powers in Alaska over a matter which is of very great concern to the State of Alaska. Now, if you have for temporary budgetary reasons in a sense given up control over very, very substantial volumes of royalty oil, my point is from unknown volumes of oil over an unknown period (because you can't anticipate how much oil you're selling for any given \$100 million of current income), then I think you have in a sense taken away from the State a flexibility of decision which the legislature has tried so hard for so long to establish. So between the uncertainties of the income and the fact that all of the uncertainties are more apt to have a depressing effect on the price you now get for your oil rather than an effect to increase the price, and because of depravity of control of the royalty oil which you may want to have in the future, I would think that this is not a very good way for the State to go about covering and expanding this prospective budgetary deficit.

SENATOR RADER - If you assumed that the price of oil the next ten years was going to be \$10 a barrel, what percentage (if we sold enough to raise \$600 million--\$200 million a year for say the next three years or something) . . . Playing with the figures, which I don't have a grasp of, what percentage of our oil would we be selling?

MILTON LIPTON - Senator Rader, that question is appropriate only if I'm the buyer of the oil. It doesn't matter what I assume the price of the oil to be. The real question that you face (and this is the tremendous problem) is what price the prospective buyers are going to assume for that oil. And I tell you as best as I can read the entrails of the hen, I don't think any executive is prepared today to make a

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hard and fast assumption as to what that price is going to be. Now, suppose everybody assumes that it's going to be \$10 (all right?) in the future. Then I would say, what rate of discount do you have to apply? If they're not going to get the oil for five years and they are going to assume a 10% discount for each of five years, and I won't even compound it, that's 50%. That means that they would be prepared to pay you \$5 a barrel today for what is \$10 oil five years from now. Now, if you want to ask yourself (if you want to do the arithmetic) if you're going to be paid \$5 a barrel--and mind you this is a purely hypothetical number, purely hypothetical--if you're being paid \$5 a barrel and you need \$100 million, then you're talking about 20 million barrels of oil. For every \$100 million, you multiply the 20 million barrels of oil. Now how much oil do you have? You have royalty oil as one-eighth of the production. If the production is 1.6 million barrels of oil a day, five, six, years from now, one-eighth of that is 200,000 barrels a day. 200,000 barrels a day times 365 days a year--You're talking about what is it--7 million barrels?--700 million barrels. How much of your royalty oil you are going to have to sell depends first of all on what the level of production is--how soon you get up to 1.6. Secondly, what kind of a price do you find are the buyers' expectations? Over what period of time are you prepared to tender to them? Can they claim all of it? Every buyer is going to have a limitation on how much oil he wants in one particular year. Chances are that he's going to want so much in one year, so much in the second--like a five-year contract. How many buyers are going to go for five-year contracts? I think that you have a tremendously difficult job, not only of estimating realistically how much income you could get out of this kind of an auction of options, how much revenue you'd get, but even after the fact is done--you've got your revenue--you will not really know how much oil you've committed. And you won't know for three, four, five years how much oil it's going to take to extinguish the cash payments that you have received.

SENATOR RADER - Now, we're talking about the sale price being the market price as of the date of delivery.

MILTON LIPTON - Yes, of course. Well, I would assume that nobody's going to commit himself to a--There is no oil company that today sells oil on a fixed basis so much as six months in advance, let alone five years in advance. And I'm sure they are not going to buy it on that basis, so I'd hate to be in a position to interpret what the market value is. But you can perhaps agree that the market value would be taken as the wellhead value. And the wellhead value is the basis for a severance tax royalty, and you'll probably be arguing about that

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anyway with the industry. It's not the technical problem. It's the conceptual problem of what the State is involved in. So if you start looking between the two and are forced to come back to what essentially is a bad tax which is ameliorated . . . Hopefully, by the offsetting clause which says in effect that it becomes an advance payment against the severance, and the net cost of the company is the interest cost in early payment of future severance taxes. And what that cost is, is a function of two things: What the interest rate is, and how long it takes them to offset it in the future. And if the effective interest rate is 10% a year and it takes them five years or six years or seven years to offset it, it is a very appreciable cost for the industry or for the select number of companies who are forced to bear that burden.

SENATOR RADER - Would . . .

SENATOR HUBER - Go ahead, John.

SENATOR RADER - Would that tax follow the companies equitably though, as between companies or not?

MILTON LIPTON - Well, it would fall . . . If for the moment you assume that the only producing area that is affected is Prudhoe Bay--which I would not assume if you have this kind of generalized tax system because we don't know--but if you assume it would fall upon them equitably . . . (If you define equitably in proportion to their lease ownership of reserves, since one of the things they are battling out among themselves now in unitization agreement is who has what among the Prudhoe Bay reserves . . . And I don't believe that just because they are subject to a reserves tax that one company is going to say to another company, "No, you take the reserves. I give it to you." I mean, it doesn't weigh that much in the balance.) But you notice that the taxes on oil and it's not on gas, the holdings of the companies with respect to gas reserves are very different from the ownership of the companies with respect to oil reserves. And your tax--although it is referred to in your section 15 that it is on the full and true value of oil and gas leases within the state under which there are proven reserves and ownership interest in proven oil and gas reserves--that the actual tax is levied only on oil reserves. Now, I don't know if this is deliberate. Do you mean to exempt from the tax the undeveloped gas reserves of the Cook Inlet area? And if you don't, then you really introduce the question of equity. Because then it is not a matter of indifference how you

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assess reserves, because you make it up in the mill rate. Then it makes a real difference how you assess the value of undeveloped gas reserves at Cook against undeveloped oil reserves or gas reserves on the North Slope. I don't want to confuse the picture by introducing extraneous arguments, but as the thing is now written, there is potential exposure of the regional corporations, in terms of their leasing arrangements with the private companies for the exploration and development of the native land selection areas.

SENATOR HUBER - They are obviously exempt for twenty years.

MILTON LIPTON - Why are they exempt?

SENATOR HUBER - The native corporations themselves are exempt from tax for the first twenty years of their existence by the . . .

MILTON LIPTON - I'm not talking about the native corporations. I'm talking about the private companies that take exploration leases from the native corporations. Are they exempt from this tax?

SENATOR HUBER - No, and you're getting back to another one of the basics of the tax.

MILTON LIPTON - Well, if they're not exempt from those taxes, then the nature of negotiations between the native corporations and the industry becomes affected by the existence of this tax.

SENATOR HUBER - There was another consideration in drafting the tax to begin with. It was drafted as an ad valorem tax with one favorable idea in it that is not in any other ad valorem tax. That is that when the production tax equals or exceeds it, it phases out, which doesn't happen to the farmer or the tree farmer or anybody else. So, it was realizing that the petroleum industry with its depletion problem is special. But we also were thinking in the future. The Pet. 4 is talked about now for leasing by the federal government to private concerns. Certainly once a private concern had a leasehold interest in Pet. 4, this tax would apply to their leasehold interest although we could not tax the federal government.

MILTON LIPTON - I don't think so. I'm not a lawyer and can't give you a legal opinion, but my feeling is that if the federal government goes to leasing of Pet. 4 (private leasing of Pet. 4), your income will come under the revenue-sharing aspects. You'll get 90% of the bonus

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in royalty income on that leasing. This is an aside, but I guess it comes within the purview of your particular committee: It makes a tremendous difference to the State of Alaska along what route the federal government chooses to go in the exploitations of Pet. 4. Because if it does it by virtue of direct federal activity, either directly by the federal government or contracting out without any leasing to private operations, then you have no claim upon any revenue from or any value of oil and gases. It's strictly federal property, not in your tax purview. But if they go the route of leasing, the State of Alaska, I would believe would have the same entitlement to revenue as you have from any federal leasing in the State of Alaska. That is to say, 90% of all the oil and gas revenue.

SENATOR HUBER - I can understand that, Milt. But if we didn't, part of the idea behind the bill in the Senate draft is that we would be able to tax an ad valorem tax. Some of the other ideas that have been put forth, such as the idea of phasing it out, paying it back, and using it for a loan didn't cover that. I'm not sure that we've covered enough of the aspects of the ad valorem tax and how it compares to others. I understand what you've told us so far about it. But I have trouble seeing how it is different than the ad valorem tax that we've placed upon the land that belongs to a tree farmer, for instance. And the tree farmer then also has a round log tax placed upon him by the State for the logs that he's taking out of the land. Our law here would be much the center of the bill we're referring to (the Senate bill)--would be much the same as saying, "Well, he pays his ad valorem tax every year and when he's in production he can credit his round log tax against it." But then if we put a phase out on it, or like shall we say his supposedly coming down to the Governor's Office, we say well, we're going to pay him back all his ad valorem taxes. I think those ad valorem taxes are unfair to begin with.

MILTON LIPTON - Don't forget that was ad valorem taxes. He's paying ad valorem taxes on a heck of a lot of property in this state. On all kinds of facilities and everything else. The only thing he's not paying the ad valorem tax on--and this has been a feature of your severance tax from the first year you adopted it--is on the value of oil and gas down below there. And if there is no other distinction I can think of between the tree farmer and the oil explorer it's that you can see the logs on top of his farm before he cuts the logs down. But you can't see it and it's awfully damn hard to estimate what the oil is.

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SENATOR HUBER - We were considering it from the farmer, too. Like the onion farmer and everything like that who seriously depletes his land by every crop that he raises. His resource in the ground (his minerals that he uses) is invisible too. I basically am not an ad valorem tax man. I hate it in my own business, my own home, and everything else. I don't think it's a good, equitable tax. But I do have trouble seeing why it is less equitable for the oil company to pay, especially when we give him a credit against his production back, which we don't anybody else. I can't see really the basic differences.

MILTON LIPTON - I can simply repeat what I said before, which is not an argument for less or more taxation in the relationship between the State and the industry. What I'm saying is that the tax on the reserves is a difficult tax to apply by standard of purpose that you want to adopt because of the difficulty of estimating what the reserves are in one field as compared to another. Because of the virtual impossibility of estimating what the value of the reserves are, since the value of the reserves at any one moment of time depends upon how much oil inflates, how much oil will be recovered, or how many years will it be produced--five, ten, fifteen, twenty, twenty-five. What will be the prices that that oil can command? And I think the last time we met I suggested to you that you can estimate. Reasonable men today can differ as to what will be the value of Prudhoe Bay oil in 1977 when it first starts flowing, which is two years, two and a half years from now. Reasonable men can differ between a price as low as \$4 a barrel to a price as high as \$12 a barrel, because of the two horrendous uncertainties that bear upon valuation. 1) What is the political price of foreign oil that we will obtain then? And 2) What will be the federal government's policy that says this will be the price of U. S. oil compared to the price of the foreign oil? These are two uncertainties.

SENATOR HUBER - There was one other question and then I'll go to someone else on it that is in the same area. We've been sitting back with an amendment to this that we thought of drafting into it to begin with and it's the proper time now to explore your ideas on it. I'll see if I can get the idea of the amendment out. It was realizing the problems that we've had in assessment and that the oil company would say that the oil is worth so much under this land and the State assessor would try to assess it differently. And we were toying with trying to put a provision (in fact we have a bit of drafting done on the amendment) so that if it is overestimated--overcharged on the part of the State, that the State eventually--and this would be clear up

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to when the field is depleted if necessary so you had final proof of what could be produced and would be adjustable all the way along the line--that if the State had overcharged, the State would have to rebate. If the company had underestimated and been allowed to pay the tax on that basis, then they would have to pay the difference. This was

MILTON LIPTON - This involves you, you know, not only in establishing --as under your present proposed bill you have to establish an assessed valuation as of January 1 every year. That in itself becomes kind of a difficult administrative thing. But then you would have to have a post mortem assessment as you go along in order to determine overage and underage, and I just wonder whether under any circumstances you want to involve the State in such a fantastic administrative burden. If in fact this thing rests--is designed as an interim measure under the pressure of necessity--that's one thing. And then the problem of assessment would be minimized at least if not too many producers are affected and the impact is somehow assuaged by having a carry-forward credit and an expected termination date, in a sense you've made the best of a bad job. But I wonder whether you can pretend to make a bad job good by complicating the task?

SENATOR HUBER - Joe.

SENATOR ORSINI - Further pursuing John's question which was what I was going to ask, are there other possibilities of raising revenue in this interim period that we have not considered other than leasing, other than the presale, other than this oil and gas in place? Is there something we haven't thought of?

MILTON LIPTON - These are the three obvious ones, and I must confess that I can't conjure up other than the obvious ones, if it is the oil and gas industry to whom you are pointing and saying that it's out of your assets that we must obtain these interim funds. Now, don't misunderstand me. When I say that this is a bad tax, and if I point to the fact that the oil industry is made in a sense the object of taxation out of necessity for the State, I don't think this is an unreasonable point. That is to say, a State, if in fact the State legislature in expressing the intent of its own constituents, has an expenditure program and a revenue program and the two don't match and therefore the legislature has to contemplate where else do we go, I presume that it contemplates all other avenues of taxation and among them there is the oil industry which in its particular circumstances is an industry which has a certain capability. Now, this is not

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without limits, obviously. But it has a certain capability and I suppose in a way it's inevitable that in Alaska you can't contemplate budgetary deficits without looking at the oil industry, which is a horrible thing for the oil industry to contemplate. But this is a fact of life and so you might do it. I would only hope that if you feel obliged to turn to a form of taxation upon an economic group such as the oil industry, that the capability of the oil industry is one thing, but the form of taxation and the duration of it is quite another. And I again urge upon you, avoid it if you can; don't chisel it into concrete. Because this you don't have to do. I think that as I said, to enact this as part of an ongoing tax package I think is bad taxation. It doesn't have the proper effect in terms of what the relationship between the State and the industry is in terms of revenue. In other words, how much revenue? This is the wrong way to go about doing it because of its impact on the company and defeating the object of the State.

SENATOR HUBER - Milt, you are--when we're comparing the three methods of raising the interim revenue, shall we say, we're really saying if we can make lease sales, that would be the best.

MILTON LIPTON - Again, I don't look upon the lease sale as a device to raise interim revenue. If, for all other reasons, the State were not going to lease land, then I wouldn't say we'll rush out and start leasing just to raise revenue. But in the context of certain State acreage, which is already under consideration for leasing (which I believe it's an appropriate time, it fits in with a lot of interests of the State and of the industry), then I would certainly feel that to go ahead with State leasing, say in the Beaufort Sea, with due diligence with regard to all the other things we're concerned about: The environmental impact, the way in which you select the areas for leasing with proper regard, you know, or how much acreage you put up or what you withhold, or what the circumstances are. If in all other respects it meets your criteria, then certainly the bonus revenue that you may get should be a primary input into the State's calculation as to what its budgetary position is. And if it were possible to defer action in other areas until you know what the results of such a sale are, then I think this is certain to be desired. But I can't judge really how much you need, what you expect from the lease sale, whether you dare defer or not. These are questions which are far beyond my comprehension.

SENATOR HUBER - I think we've been at it an hour and a half. I think

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we'd like to take a ten minute break and maybe come back and we can either finish on this subject or go ahead with subject trailers so we won't chop it off. I note that Representative Gruening would like to have another question, so we'll start at that point.

THE COMMITTEE RECESSED FOR TEN MINUTES.

SENATOR HUBER - We'll go back into session. Joe, if you'll excuse me, I promised Clark that he could ask his question. He was in line, so if you'll excuse me.

REPRESENTATIVE GRUENING - Mr. Chairman, I'd like to yield to Senator Rader's question because we have a line of thought going and Senator Rader asked his advice on how to apportion the tax between oil and gas on the reserves in place. I'd like to hear that.

SENATOR RADER - Mr. Chairman, I'm sorry. We just got to chatting here while we were waiting, and my question to him was to elaborate on the policy considerations as against taxing gas, or oil and gas and between the different fields. He touched on it very lightly awhile ago, and I'm just asking him to elaborate on that a little bit, and get his final advice as to how he would handle the problem, should we be compelled to go to this mechanism.

MILTON LIPTON - Senator Rader, just for the record, let me repeat what I have said, that the broader the application of the reserve tax, the more difficult and the more pertinent is the problem of reserve valuation, because it has to do with equity among taxpayers you expose to the tax, and the sharing of the tax burden among them, or the apportionment of the tax burden among them. Now, in reply to your question, "What is my recommendation?", I would really not like to answer that question or at least defer the answer until your Committee, or some committee, really gets the advice and counsel of your Oil and Gas Division, as to what the circumstances are within the State. I mean, what are we really talking about? Is there a problem? To what extent is there identified within the Oil and Gas Division on the basis of what they know about drilling equity? First of all, already definable reserves (that is, reserves proved up), to what extent have there been successful wells that are outside of the public domain? Or which, even if the success is known (very little about it is known, but they have a certain amount of information), whereby there is a known discovery but as yet no evaluation of a reserve, and how soon is it likely that the reserve can be evaluated? In other

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words, if it's oil on the North Slope, I would assume that there would be sufficient evaluation for the companies to know how fast it's going to be produced at the end of the pipeline. In the case of gas, it may not be apparent, depending on the circumstances, and really what you most need is a practical definition of the way you have proven reserves in place to which this would apply. But the circumstances of the State, I think, require that you all should know something more from the Oil and Gas Division, before I would say, well, good grief, try to go up there and try to narrow it. There I just don't feel that well informed.

SENATOR RADER - Mr. Chairman, did you plan to have Mr. Lipton back again? After today? So that perhaps as information could be supplied to us we could tie it in.

SENATOR HUBER - Well, not during--not before this Committee or committees during this trip that he's on. We do hope to have his further input at public hearings, probably during March on various bills. I believe he is scheduled back--what date is that?

MILTON LIPTON - I have no schedule, but as a prudent man, I anticipate being back in Juneau before you adjourn. As I said to the Committee this morning, before you adjourn on February 28, but . . . but on the basis of previous consultations I would think that the guts of the type of legislation, whether it's on leasing policy or on taxation, is more apt to be coming up in April than it is in February. But I certainly anticipate being back and in point of fact I look forward to it.

SENATOR HUBER - I do understand that Milt will be before the Resources Committee and our three members are all Resources members and we intend to be here at least part of the time tomorrow. I don't know the full contents of what will be covered, and I know that House Finance still has something on tonight, do they not?

MILTON LIPTON - Yes. My social calendar is well taken care of.

SENATOR HUBER - I do know that this trip, that Milt is here, is going to be most of the information that he's going to be able to give us that's going to go into the infrastructure of whatever we come up with in oil and gas taxation or at least the oil and gas end of the taxation bit during this session of the legislature. I think what comes later will be I suppose mainly for public consumption--or whatever it takes to get the bills passed. But I'm sure that what goes into them, the

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guts of them now is going to be the information that we're getting. Senator Orsini.

SENATOR ORSINI - Milton, just to . . . We've talked mostly this afternoon about two of the three methods of raising short-term funds, the third one being briefly discussed--the additional leases you mentioned in the Beaufort Sea. In the Resources Committee we started discussing Beaufort Sea on occasion, and apparently there are some problems with the leasing and developing oil resources in the Beaufort Sea. Namely, the particular type of the problems trying to drill in the ice packs, etc., there. So, really the question comes that completes this triad. Are you familiar enough to know that if in fact we did offer leases for sale, that we would raise funds in the order of the amount that the State needs in the next few years? And secondly, is the state of our technology such that we could develop maybe another lease there?

MILTON LIPTON - I wouldn't dare to guess what kind of income you could get from competitive leasing in that area. I'm not really terribly informed on the technical problems, but I do know a considerable amount of work has been done in areas like that and I do know that there are companies that are quite prepared and are quite interested in this State's having that kind of a sale. So I would assume that they feel reasonably competent about being able to operate in the area. Whether their own belief in their technical competence will prove to be justified or frustrated by events is something that you need not be concerned about at the moment of the lease sale. They feel competent, and if they are interested and they like the geology and they are prepared to bid, then presumably they will go ahead. But what they're prepared to bid competitively, I wouldn't have the foggiest notion. And obviously, no one company, or at least no one--there are groups of companies that are prepared to go together--no company or group of companies would have the foggiest notion of what their competitors are apt to do. So, it's very difficult for any of them to come up with an estimate of what that kind of a lease sale is really going to be in this state. I think one has to suspend judgment on that. But from the expression of interest on the part of companies in the industry, one gets the impression at least that this is highly attractive exploratory acreage.

SENATOR ORSINI - Of course that's a nice statement, but it didn't mean anything.

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MILTON LIPTON - What else can anyone say?

SENATOR ORSINI - Are there other areas of State-owned land that are possible leasing of the magnitude we are talking about?

MILTON LIPTON - This looks to be the area of prime interest. For many reasons, including the fact that it now becomes accessible to a pipeline which will be operating and probably can use their volumes of oil by the time such exploration comes to fruition. But I would suspect that over a good part of the North Slope there is probably State acreage which may be available. But this is a judgment that, as I said, one doesn't--but I don't think one makes that kind of a judgment from a revenue standpoint. This is something your own people in the State government would have to estimate in terms of what State leasing policy is. The only reason I would rank the revenue from a lease sale high among the alternatives is because the lease sale is already, for many reasons, looked upon as something that fits in with the State's scheme of things. I would certainly not suggest to the State that they turn everybody in the Bureau of Land Management and the Oil and Gas Division loose now and try to scrounge around and find what areas of the State can be thrown on the auction block in a hurry just to raise revenue. That I think would be a most inappropriate thing. But because Beaufort Sea is under active consideration--I think the Governor has an environmental impact statement he projected for the area, although it's not legally required. This has been the subject of consideration both by your Executive Department (or the professional people in the Executive Department) and by the industry which has looked at it, and I believe has indicated what their own preferences are. I mean, they've made certain selections for competitive bidding, and so on. So you have a latitude of moving in that direction. If it's a question of specific timing, again I wouldn't even suggest that the timing of such a lease sale be unduly accelerated just because you want to get in within a budgetary deadline. But if there are environmental concerns, if there are technical problems that the State should pursue, then I would pursue them with deliberate speed but no more than that. I wouldn't throw things precipitously into auction for revenue reasons. But if it's going to be done, and if you can withhold in other areas because it's going to be done, then I would consider the potential income as an important factor and I would rank it first in the array of alternatives for State revenue.

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SENATOR ORSINI - You mentioned the problems with presale of State's royalty, of selling under the stress of financial crush. Wouldn't the same problems exist in the case of a lease sale?

MILTON LIPTON - No. Entirely different. Entirely. Among other things, I'm saying that you should not lease under the pressure of a budgetary deficit, and for a very good reason. And secondly, the competitive urgency in bidding for very attractive leases is quite different from the competitive urgency on the part of oil companies to buy the State's royalty oil today with delivery in 1978, '79, '80, and '81. The uncertainties are of a different order of magnitude.

SENATOR HUBER - Milt, while you're on that subject, would you care to comment on the possible value changes, or whether it's practical on that lease sale now based upon the federal-State dispute over what boundaries might be, and so forth?

MILTON LIPTON - Well, I don't think that's particularly involved in the potential lease sale in Beaufort.

SENATOR HUBER - I believe it is, because I think that we're involved with the offshore islands in the Beaufort Sea and I think . . .

MILTON LIPTON - I don't know enough about the specifics.

SENATOR HUBER - You haven't looked into that yet?

MILTON LIPTON - No.

SENATOR HUBER - As I understand it, I believe that the federal government contends that the State's limits are within three miles of the shore, which doesn't mean very much, and that the State says, "Oh no, we've got a whole lot more because we own the offshore islands, and that means we own within three miles of them, too."

MILTON LIPTON - I don't know whether the acreage that may be under dispute is that vital to this particular sale. I just don't know. I mean, there's another part of Lower Cook Inlet which is also under dispute under different circumstances and I certainly feel that the proposals that have been made periodically for revenue-sharing or escrow in order to expedite lease sales would have made sense from

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both points of view.

SENATOR HUBER - Well, if there is a dispute (federal-State) there, then as far as being a money-raising measure, it would be in limbo like Lower Cook Inlet, wouldn't it?

MILTON LIPTON - Yes. At least to that extent. Any revenues obtained on a lease sale in disputed areas . . . I don't know what policy the federal government would--whether they would try to enjoin the lease sale or . . . I really don't know enough about the circumstances to speak of. I was under the impression just from what I have discussed with other people, both in the Administration and the industry, that there was very considerable interest in acreage which was not in dispute. So, I don't know. I may be completely misinterpreting what I've heard.

SENATOR HUBER - I have heard that raised and I think that . . .

MILTON LIPTON - It seems to me that one can get a very, very straightforward answer very, very quickly either from the Administration's office or from the Bureau of Land Management, where this thing has been going through the mill for some time. They must know the answer to that.

SENATOR HUBER - Our Division of Oil and Gas I'm sure would be able to answer that. You made reference already to some of the questions that have been asked here that we should be entertaining with that committee and we certainly will take your recommendations into account. I believe Clark wanted the floor next.

REPRESENTATIVE GRUENING - Senator Orsini asked the very question on the forced sale problems. I'm still troubled with it in that I don't see why the uncertainties are so much greater from the industry's point of view when you're dealing with sale of future oil and delivery sale for future delivery of oil and gas, when we all know that the United States is in a sort of, I think, a situation where gas is always going to be needed in greater and greater quantities. And I think that just the contract to have that at a certain time would be very marketable. In other words, they could take that, get the money they needed. From the financing point of view, they could raise the revenue.

sell reserves. What you sell is a claim on ongoing production for a year, two years, three years, or what have you. In the gas transactions, because of the interrelation between the owner of the gas and his participation in the pipeline and the financing, typically what is sold is not so many cubic feet of gas per year or three years or four years, but so much of the gas reserves. For example, I believe that Exxon announced that they have . . . What is it? . . . Their estimate is (if I remember the numbers correctly) 8 trillion cubic feet of reserves in Prudhoe and the announcement is that they've sold to (I believe) Northern Natural something on the order of 50% or less than 50% of the reserves. Which means that the buyer in effect has taken an economic interest in the reserves and will be the owner of that gas as it is produced, which is very different from selling a certain volume of oil on a short-term contract or a long-term contract. In a sense you're not only selling off royalty gas, but you're selling off the royalty portion of the reserves--of the gas reserves. There's a difference in the economic venture of the transactions in oil and gas that you'd have to consider very . . . I don't think you can sell gas, you see, so much gas for two years. You can sell so much oil production for two years, but you can't sell so much gas production for two years. The gas buyer has to have access to a continuous flow of gas which he then integrates into his entire system. So you sell gas reserves, but you sell oil production.

SENATOR HUBER - If we amplify that, then the obvious thing I'm sitting here wondering about . . . If we sold our royalty gas reserves to an organization that was part of Transarctic at this time, and they intended to move it in some other method than through Alaska to market, would we in effect have weakened our stand that we want access to the gas for petrochemical, that we want to have something to do with the routing?

MILTON LIPTON - Sure. If you've sold it without condition, of course you will have.

SENATOR HUBER - We'd just be a busybody then? If we sold it without condition?

MILTON LIPTON - And if you sell it with condition, it depends upon what condition. Because the conditions will always bear upon the price. One of the things you may want to do is to strip a certain

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MILTON LIPTON - I think there's no question in my mind but that the advance sale of royalty gas in this state is subject to far less uncertainty than the advance sale of royalty oil. The circumstances, the financial circumstances, and the investment circumstances of the potential buyers are very, very different. They're very different. And as you know, I think all--I believe all three of the major producing companies in Prudhoe have already made some sale of their gas reserves in return from the gas in this case. Now this is in the public domain. I don't remember who has made what advances. Certainly Sohio has. Exxon has just announced it. And I believe Atlantic Richfield has also made some advance sales on gas reserves. So to that extent the State could do it also. But I recall so many discussions here before the legislature as to what the alternative disposition of royalty gas might be, particularly the potential petrochemical feed stocks that might be derived from royalty gas. Now, when you make a decision to sell royalty gas, you have not only in a sense given over control of a certain proportion of the gas, but you have identified yourself with part of the battle over the route of the pipeline. Because among the things which become involved in the Federal Power Commission's decision as to which of the competing applicants shall have the right to transmit the gas will be the nature of contractual control over gas reserves by companies who have already entered into the purchase of gas--what the disposition of the gas will be. That doesn't mean that it automatically predetermines what the Federal Power Commission is going to do. Because if in fact they say that one route . . . For example, I think the contracts to sell gas that have been made up until now, I believe, have all been made to companies who have been active in both the Alaskan and Canadian gas arctic routes. El Paso will not enter into any gas purchasing contracts. That doesn't mean that the FPC may not turn around and opt for the El Paso. But in a sense, it has had an effect. It does bear upon the evidence that's been going up to the Federal Power Commission. Now, if the State goes ahead and sells royalty gas, I think this also implies, or certainly will be entered into the record--with what implications I'm not sure--but the State in a sense has made a choice to sell to one potential buyer or another. Now this is not necessarily a reason not to do it. I just call your attention to the fact that it will have political overtones that you may not have anticipated in advance, and you want to consider what those are. But from the standpoint of the question you've asked, I think it is correct to say that the problems of selling for advance payment, the right to lift State royalty gas . . . See, there's another difference between the typical transaction in oil and a typical transaction in gas. In oil, you do not typically

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amount of the liquids out of the gas to have it available, perhaps for co-mingling with your oil as it comes down through Alyeska to have petrochemical feed stocks available. And how much do you strip? I mean this becomes a matter of how much has to be stripped to obtain pipeline quality gas, or how much do you want to strip, which adversely affects the b.t.u. value of the gas. So this becomes an economic calculation. It is not as simple a kind of transaction as would be involved in selling oil production--royalty oil production--as when you sell royalty gas reserves.

SENATOR HUBER - And if we did it, and sold the gas for future delivery, would we still be up against that same thing we are up against in oil, that maybe five years down the line there would only be--the gas would only be worth about half as much as it is five years down the line . . .

MILTON LIPTON - No. I . . .

SENATOR HUBER - . . . Like we predicted?

MILTON LIPTON - No. I think that when you sell gas reserves, what you're getting is the present value of whatever may be the future price of gas as the gas is produced.

SENATOR HUBER - As the value of the future price of gas? You threw me.

MILTON LIPTON - Anything that you sell for future production has a present value.

SENATOR HUBER - Which is considerably lower than its future value.

MILTON LIPTON - How considerably lower? It's difficult to say. In the case of competitive bidding for control over gas reserves, I would suspect the discount factor is much less than in the case of oil. But I think any way you look at it, it does not commend itself to me as a very attractive way of bridging the gap--to sell off the royalty oil and gas. If you could do it you see, if in fact, if constitutionally you could do it, the attractive thing of course, would be to sell royalty anticipation certificates, instead of taxing just anticipation certificates, royalty anticipation certificates. Which says in effect that you are borrowing money on the basis of--the security being the value of the oil and gas. You haven't given up control over the oil; you haven't given up control over the gas. You can do with it what

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you will, but in a sense the security against the borrowing is the value of your royalty interest. But constitutionally, apparently, you cannot do that. Because it exceeds your constitutional limitation on borrowing for general budgetary purposes.

SENATOR HUBER - Well, is . . . isn't that the same thing as though we . . . It takes an amendment to the Alaska Constitution. Say we amended the Constitution or had it . . . the people agreed with us. And then we went to our banker and borrowed it and used that as collateral.

MILTON LIPTON - Yes. Well, Mr. Chairman, I'd just remind you that the constitutional limitations on what the Administration of the State of Alaska can do today are a very frustrating thing. Because it ties your hands on many, many more attractive alternatives. But the constitutional limitation on what you can do today was put in by the population of Alaska for many reasons, which in the past and in the future, they may consider as valid even though it's frustrating you today. Because the constitutional limitation is what--is the constraint upon the government of Alaska to do things in an irresponsible way, which otherwise they cannot do because they're forced to this budgetary deficit. This is why it's in so many state constitutions. In the inestimable wisdom and the foresight of the populations of the State, they're not prepared to give all powers of government to their elected representatives. And it becomes a terribly frustrating thing at this particular moment, where you have these, as I said, these great expectations. That the problem is not perpetual imbalance and overspending (hopefully not), but the fact that the revenues that will be coming in and which may be well surplused to your needs, are revenues that you can't put your hands on today.

SENATOR HUBER - Well, some of us are just absolutely, unalterably opposed to that kind of a course anyway. I don't think it could ever get far enough to get before the people to change it. Senator Rader.

SENATOR RADER - There's one other source of (possible source)--I mean we haven't had to roll up tax on the pipeline. We could increase that mill levy substantially. The pipeline is going to be producing a lot more revenue than we had anticipated because the value of the pipeline is so much greater than what we had anticipated. Administratively it could be done very easily by tagging onto a system we've got already functioning. It's a change in a number. That would--just thinking through that I'd--that would have to--Is there some way we could condition that reasonably? As a prepayment of something else? Or as

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not increasing the total burden on the industry?

MILTON LIPTON - It does. There's no way of taxing an operation of the industry without actually increasing the burden of the industry. What you must say, what you must contemplate, is the circumstances of the companies who are the only undivided interests of the pipeline. They can recover in the tariff of the pipeline any taxation which you impose upon the pipeline. Now insofar as they pay the taxes before the pipeline is in operation, that becomes the burden, probably capitalized, and to that extent they recover it in future tariffs. Now, the future tariffs have to be paid by anybody who transports oil. However, they're not really in the position, because the oil costs more to reach Valdez, to get more for the oil at the other end, because they're operating in a competitive environment. So that the industry in a sense must absorb those costs. Now, how do they absorb those costs? In effect, since the pipeline tariff cannot be carried forward to a buyer of the oil, the pipeline tariff is passed backwards to the seller of the oil. And who is the seller of the oil? It's the man who produces it at the wellhead. The fact that the buyer and seller in most instances will be the same company doesn't matter. It is, in effect, that the tariff is passed backward to the seller of the oil which depresses the value of the oil at the wellhead. Now, to that extent, you would yourself when the industry starts producing, carry about 20% of the pass-back of the higher cost of transportation, in lower severance tax, and in lower royalties. But the producers, who are in part the same and in part different companies, and where they are same, still will not have precisely the same interests in production and transportation, will have to bear the other 80%.

SENATOR RADER - But wouldn't the burden, except for the amount that the State assumes here, be identical to the burden of tax on reserves? In other words, it's going to be based upon oil production and the amount of oil that they have in their rate, in their tariff, so the burden would be identical and fall on the same people.

MILTON LIPTON - The burden will not fall upon the oil companies as owners of the pipeline. Because those added taxes are recovered.

SENATOR RADER - That's right.

MILTON LIPTON - The burden will fall upon people who have reserves, who produce, and who ship.

SENATOR RADER - It's going to be the same people then as who would be . . . reserves.

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MILTON LIPTON - But the difference between the kind of reserve tax that we were discussing is on the one hand that the State will bear automatically about 20% of the tax burden. They bear 80%. Here, under the proposed reserve tax, if there is a carry-forward credit, the burden that the owner of the reserves will carry is the interest cost on his payment of taxes until such time as it becomes an offset. Now, how you calculate these two burdens, I think, one has to sharpen his pencil and take a look at the tax involved. But I think you're quite correct in saying that without putting the dollar and cents figure upon it, the incidence will ultimately be upon the same companies. Yes. I think that's correct.

SENATOR HUBER - Methinks he might complain less about carrying the interest burden if he doesn't have to carry the principal burden, too, huh? In other words, it's a lesser problem on that.

SENATOR RADER - Why do we always go back to saying that the burden of carrying the interest? Why couldn't we write into the bill an alleviation of that problem for the companies?

MILTON LIPTON - I'd rather not answer that . . . I mean, talk to your legal authorities on that. Whether in fact a tax on reserves, for example, which becomes an offset, but becomes not a dollar-for-dollar offset but a dollar-and-six-cent (6%) offset, is it going to be a fixed amount of credit? Or is it going to vary with the number of years that it carries forward? At what point is it possibly subjected to the Constitution? In effect you are borrowing against your severance tax.

SENATOR HUBER - That's what I wanted to know.

MILTON LIPTON - I don't know the answer to that. It's just beyond my purview. Mr. Chairman, I beg your indulgence, but I have another committee meeting at four o'clock across in the Assembly Hall, so if you'll keep that in mind in terms of how you pace the rest of the session, I would appreciate it.

SENATOR HUBER - I would like to get--if the rest of the Committee is satisfied that we have chewed around and got most out of this oil and gas in place--I'd like to get you to give us a little dissertation about maybe something a little further in the future, a little bit more long-range, but something that this Committee is interested in, and that is the effectiveness of our income tax now on the oil companies, or the oil and gas companies. Are we getting taxes out of them--income taxes? What part of our income this should be? And what importance it should be, and should we look to doing something? And in what

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manner do we need constitutional help? Do we need expert tax accounting help? You touched on these things the other day, but I hope you have time enough to give this Committee a little briefing now.

MILTON LIPTON - I wish in a way that we had started with that at 1:30

SENATOR HUBER - I wish we had too.

MILTON LIPTON - . . . instead of now. I'm so many times on the record that this is something that I think of prime and continuing concern for the legislature. Let me just say here that what kind of tax revenue you get from those corporations that you identify as members of the oil and gas industry, you can get from your own Finance Department very, very quickly. To describe the present structure of your income tax is not very difficult and therefore to define what we think is the problem is not very difficult. Perhaps I can take a few minutes to do that. To move into the directions of tax reform is much more complicated and I think it would be a mistake to start on something like that when we have just a few minutes of time left us.

SENATOR HUBER - I would ask, Milton, that you do maybe give us a letter in that direction addressed to the Committee with your thoughts in that area. In the area of the tax reforms that you may recommend--The details of them.

MILTON LIPTON - I'll do that.

SENATOR HUBER - Thank you.

MILTON LIPTON - You have now a corporate income tax--well at least the last time we had looked into it with your people--as set at 18% of the federal income tax that would be payable on such income at the federal rates existing in 1969. You see, in a sense, your tax is not a percentage of the federal tax, but a percentage of what the federal tax had been. I think the effective rate of taxation on that income in excess of \$25,000 is something like 9.3% or something of this sort. The problem is not really with the tax rate, because that you can change in a very simple form. The problem, it seems to me, is how you identify taxable income in the state. And to identify taxable income by an apportionment formula such as is commonly used, which uses three elements of a ratio--value of property (value of property in Alaska) and total property of a company, payroll (payroll in Alaska) versus total payroll of the company, sales in Alaska versus total sales of the company. Well, the sales in Alaska are obviously an infinitesimal thing. It means, in effect, now what is apportioned is the tax base in the federal income tax laws. So they make their income tax to the

federal government. This figure can be brought to Alaska and then is apportioned by formula in Alaska. And mind you, this is not by the company that's operating in Alaska. This is by the parent of the company operating in Alaska on the basis of that parent's federal income tax report on all of their operations worldwide. And you allow (which is perfectly appropriate, I suppose, since income is being apportioned), you allow them to apportion their foreign tax credits. Because their foreign income is also apportioned by this method, you allow them to apportion depletion and everything else. It seems to me that if we are correct, that at the end of the day, the major relationship--income relationship--between the State and the oil and gas industry is in the profitability of the oil and gas industry's operation--that the major problem in tax reform is not so much in the tax rate, because this can be changed from time to time. It's not so much in the deductions and the expenses which are allowed or which are disallowed, because that also is subject to change from time to time. It's in the very concept of what is taxable income that's earned within the state. And it seems to me that the State should shoot for what is in effect a direct accounting of the income that's earned within the state. The State should not be interested in the entirety, to some kind of a proportioned share of income that may be earned in some other state, any more than it's prepared to give up the direct right of taxation on income (on corporate income) that's earned within the state. So the problem in tax reform (and there are two aspects to it) --the problem in tax reform is the legislative means and the regulations pursuant to your legislation by which you identify the income earned within the state which is subject to your federal corporate income tax. Now the problem in the regulations pursuant to it is not only--the problem is first of all, the special problems arising in the identification and definition of income earned within the State of Alaska for an industry as complicated as the oil and gas industry. I don't believe they're insurmountable problems, but obviously there are problems. On this we would hope to be able to work both with your Administration and the other states'. But what we have to say about what may be appropriate to the oil and gas industry has yet to be tempered against the specific problems of other industries that you have here that are also important in the state that operate both within the state and outside the state. The fishing industry, of course, is another industry that is domiciled in Alaska but which sells the bulk of its product elsewhere. And what we may feel is an appropriate pattern of income taxation in the light of oil industry operations may not be appropriate for other industries. This is something that you would have to consider very carefully. But the basic problem for the oil and

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gas industry, of course, is that if you define income earned within the state as deriving only in the first instance from sales within the state, from which you deduct expenses, then you're left with virtually no income earned within the state. Because the bulk of the sales take place outside of the state, whether it's oil today, your larger volumes of oil, or gas. So the problem is to arrive at an equitable and a legally supported definition of the value of product that leaves the state, even if it leaves without a sale having been consummated. Now, this is done all the time in income taxation where national jurisdictions are involved, and I don't believe there's any reason why it can't be done where state jurisdictions are involved. The reason for the apportionment formula, where many different states may have a claim upon the value of the product and therefore on the profit of the product, is because there is such a complicated movement of products among the various states. But in the case of Alaska, where there is a distinct passage of oil and gas produced within the state across the border, and where in effect the value of your product is determined in the other market, but the valuation of the product at the wellhead is determined by the transportation costs backwards, if you have a value of Prudhoe oil at the wellhead, it's not that difficult to get the value of Prudhoe oil in Valdez. So, the problems of valuation as the basis for income are not different from the problem of valuation for the purposes of severance tax or royalty payments. So, I think the problems . . . Now I don't pretend that this is simple. How you value products which come into the state for operations, how you value the services that are performed within the state which have to be subtracted before you can get a profitability when the services are imported. This is not simple; it is relatively complicated and if it is done in an arbitrary and capricious manner, you obviously have all kinds of legal problems. But the concept of identifying income earned within the state therefore subject and amenable to State corporate income taxation, I think, is a valid concept and I don't believe the validity of it should be denied or effectively shoved aside because there are complications in the actual determination, either in the wording of an amended income tax law, or in the interpretation of revenues, expenses, and profits in the administration of the law. But I do believe that so long as you are left with an apportionment formula, you are at a distinct disadvantage in ever being able to apply your corporate income tax in such a way as to get what is the State's entitlement to corporate income ~~to~~ revenue from what hopefully will be in the future a highly profitable producing operation. And everything I've said here goes with equal--applies with equal force to an operation which is distinctly within the state, where all the revenues

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and costs are incurred within the state, and you still do not have under your present state law the opportunity to identify for tax purposes the profit, and that would be Alyeska Pipeline. Because the pipeline is in no circumstances an income tax payer. The corporate owners of the pipeline, and the independent pipeline companies, are not even themselves federal income tax payers. Because they are consolidated in the accounts of their own parent companies. So here is a completely distinct operation wholly within the state, by definition profitable (we hope--unless thank God knows what goes on), and yet this is something beyond the reach, you see. Even when you can identify the operation. The whole apportionment thing leaves them beyond the reach of your star. And this has nothing to do with the profitability of the pipeline. Because in a sense your State income taxes are recoverable by the companies, you know, in their tariff. But the point is that this is a distinct operation and we feel strongly that for a long time you have operated under a corporate income tax law that was never considered or deemed to be appropriate to the circumstances of a state where resource development is now reaching the proportions that it is. And I would hope that since this is the Year of the Rabbit, you would get hopping about it.

SENATOR HUBER - Milt, with that pun, this is . . . What you're telling us here is the same as we're being told by our Revenue Department. But it's interesting that on the income tax return, no sales in Alaska, therefore no income in Alaska is sufficient to keep from paying State income tax.

MILTON LIPTON - Well, it doesn't quite work that way. Under your State tax law, as I recall . . . Now all of a sudden I don't want to appear as the expert on this. From the time we became concerned, we've had some conversations with your finance people about it. My recollection is that it is within the legal right of the State to determine whether the income tax filing will be on the basis of a direct accounting of state income or apportionment. But they don't have the capabilities really to --if a company says no sales within the state (this becomes a direct accounting, you see) and they don't have the capabilities of going to that corporation and saying, "No--We, the State, opt for the alternative due on the apportionment basis." Now, that's a separate problem in and of itself. That's an administrative problem. What I'm saying is that even if you ask for apportionment, I don't think that's going to fit the emerging circumstances of the oil and gas industry. May I be excused, Mr. Chairman?

SENATOR HUBER - Thank you for being with us, and we look forward to seeing you again. We'll see you here tomorrow at 1:30 again on Resources.