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PIPELINE HEARING

TRANSCRIPT

March 6-10, 1972

OUTLINE OF PROPOSED TESTIMONY

BEFORE

THE SENATE COMMERCE COMMITTEE

AND

THE HOUSE LOCAL AFFAIRS COMMITTEE

2-6 p.m., March 6, 1972

1. Lieutenant Governor, H.A. Boucher - Introduction - overview of the problem.

2. Commissioner of Natural Resources, Charles Herbert - Description of Prudhoe Bay field , computation of royalty and severance taxes.

3. Attorney General, John E. Havelock - existing regulatory and taxation patterns.

4. Commissioner of Highways, Bruce Campbell - description of new state cost estimates.

5. Commissioner of Revenue, Eric E. Wohlforth - comparison of past and present estimates of costs and revenues and economic comparison of State versus private ownership.

   Investment Officer, Larry Eppenbach - Methodology of State and private ownership cases.

6. Commissioner of Administration, Joseph R. Henri - Effect of private ownership on the State budget .

7. Herbert Temple, Temple, Barker & Sloane - Issues and objectives raised by industry to the State's public ownership proposal and General outline of financing plan proposed by Temple, Barker & Sloane.

8. Charles Kades, Hawkins, Delafield and Wood - Statutory outline of the authority bond program.

9. L. E. Crowley, Salomon Brothers - comments on financibility of the pipeline by the State.

10. Kuhn, Loeb & Company, Robert Macy - Comments on financibility of the pipeline by the State.

Mr. Rettig:

Has been scheduled for the purpose of receiving testimony, in support of and in opposition to the proposed legislation, having to do with the construction and operation of the oil and gas pipeline in Alaska.

For the record, let me say we will be considering a variety of bills and I will name them:

SB 313 relating to the leases of rights of way;

SB 314 relating to the safety standards for oil and gas transportation;

SB 315 relating the Alaska oil and gas transportation commission;

SB 294 relating to the leasing board;

HB 569 establishing the trans-Alaska authority,

HB 578 authority to issue general obligation bonds.

Before we commence if I might I would like to introduce Mr. Dick McVay, a representative who is going to co-chair these hearings with me, Mr. McVay, and try to introduce the members of the Senate Commerce Committee. I'd like to have Mr. McVay introduce the members of his State Affairs Committee.

Senator, Cliff Row, will you please stand:

Senator Christensen.

Senator Veeland

Senator Donyabe

Members of the State Affairs Committee that are in attendance, Mr. John Holm, Mrs. Helen Fisher, Mr. Frank Ferguson on, Mr. Ed Barber, Mr. John Huburt, Mr. Mike Rose, and Mr. Mike Miller.

Before we introduce the first witness that is expected to appear, I would like to just review some of the rules that we hope to maintain during the conduct of these hearings. As most of you are aware the hearings were announced more than a month ago,

to allow all the different parties ample time to study the proposed bills, and to prepare evidence and testimony for or against them. Lets hope that all data and statments presented will be fully open, complete and factual as possible under the circumstances.

Further, it is our hope that in these hearings any tendency to draw or form battlelines can be avoided, recognizing that in any battle generally there will be a winner and a loser, or perhaps even that all could be losers. Rather it is hoped that we can approach these matters with as little discomfort and suspicion as possible, in recognition of our common goal, that is the orderly, safe and profitable development of Alaska's resources in the awareness that Alaska can and must be an attractive area for investment and industries in order to realize full and profitable employment opportunities for citizens of this State. This is not to imply that disagreement is not expected. In fact sharply contrary views no doubt will be voiced throughout these hearings.

Questions from members of the Joint Committee and from other legislators will be encouraged while making the complete testimony. We will deviate from that occasionally as we are informed that certain witnesses may have to leave the City, in which case we will permit questions of that particular witness as we go along. Legislators are encouraged to formulate their questions as concisely and correctly to the subject as possible, and Mr. McVay, do you have any comments you'd like to make before we commence?

I would like to welcome the people here that are going to give the testimony particularly the out-of-town people who have come a long ways to be withus, we know its an inconvenient and we certainly appreciate having you here. I will read you the tentative schedule for the hearing so that you will plan to go on until 6:00 PM this evening, and begin tomorrow morning at 8:00 AM, going through until 11:00 AM, re-convening tomorrow afternoon at 2:00 o'clock, going through to 6:00 o'clock. And Wednesday again at 8:00 AM, to 12:00 PM, and at 1:30 PM to 6:00 PM, and Thursday

again at 8:00 AM, going through hopefully to the end of the hearing.

Thats all.

Thank you very much.

The plan of the meeting is have the proponents of the various measures speak concerning them first, and in this case it will be the State administration, following the completion of the testimony of both witnesses we will go directly to the presentation by the Federal pipeline committee, concerning SB 294. Following those presentations we will have the representatives of the industry present their views.

So to start it off I am going to call on Attorney General John Havelock to introduce his first witness. Mr. Havelock.

Thank you, Senator.

For our first witness today the State administration calls upon the Honorable Red Boucher, Lieutenant Governor of Alaska, to read his statement on behalf of William A. Egan, Governor. Lieutenant Governor Boucher.

(we might caution the witnesses that there are a lot of wires down here, so be careful when you come up here.)

Mr. Chairman, Ladies and Gentlemen:

I have been asked by Governor Egan to deliver his message to several committees and to the people of the State of Alaska, in his absence.

As Lieutenant Governor I have had opportunity to watch our chief executive deal with the agonizing realities of the delay in the pipeline construction and spiraling costs, and while appraisals that do not view a protion of our future totally through those colored glasses are distasteful to some, I have never seen

our chief executive swerve from his duty to our stockholders, the people of the State of Alaska.

The future of our State is a brilliant one. No one knows this better than our governor who has devoted over thirty years of his life in service to Alaska and her people. There have been rocky shoals before, and our ship of state has navigated. They were not overcome by wishful thinking. We need not be at odds with our partners in the future, the oil industry. We recognize their corporate responsibilities. I am sure they as good citizens recognize our responsibility, and it is in this spirit that Governor Egan has asked that I read his message to the people of the State and the several committees, into the records.

(attached is Governor Egan's speech)

Mr. Havelock, will you present your next witness please.

Thank you, Mr. Chairman, and members of the committee. We appreciate the courtesy afforded us by the Chair, and arrangements made for the seating. We have handed out a list of witnesses which the State wishes to present. Although I appreciate the fact that many questions may be on the tip of the tongue as these witnesses speak, we appreciate being able to run through these witnessess to give us an overall view in advance. We are prepared in regard to members of the State Administration, to recall members of the State Administration individually, to respond to questions about their statements, or I will be available as when we get to an appropriate place to just take general questions, with the permission of the chair, and refer them to the appropriate member of the State Administration or consultants, for answers.

Mr. Peter Temple, who will speak on #7, the Advantages of State Ownership, Issues and Answers, has to leave to today, and with the permission of the Chair I would like to interrupt our testimony at approximately 4:10 or 4:15 to allow Mr. Temple to come on. In the case of Mr. Temple we would hope that when he completes his remarks

would with the committees would have at him, as far as any questions are concerned, as he will not be available later.

With that background, Mr. Chairman, at this time we would like to call the Honorable Charles Herbert, Commissioner of Natural Resources, who will speak to Alaska State and North Slope Oil. Mr. Herbert.

Mr. Chairman, Members of the Committee:
Perhaps it would be better if I got back to the map, here, from the beginning of this testimony. I want to outline something about the history of the development of oil on the North Slope, it would be short, and I presume it can be heard.
Can you all see the map that Mr. Herbert is working with here? This is a leasing map that shows the leases as of late last summer. It is the most recent one I happen to have.

In 1964 the State selected this land north of the green line, about on million, six hindred thousand acres. Now this land was considered to have a good potential for oil but no one at that time ever thought that it would contain the largest oil pool ever found in North America, which is outlined in this orange area here. Now, that area doesn't mean that all of that would be productive. We know there are some dry holes, in it, and there is some argument as to what the limits of it are yet. But gives a general picture of where the Prudhoe Bay oil field is. Now, in 1964 the State held its first lease sale, largely in this area here. There was some interest in it in spite of the fact that prior to that lease sale there had been quite a lot of drilling down on the Federal land, without any success. It was recently successful and it did help the State economy at that particular time when it was pretty badly needed.

Now, there was greater interest shown in the subsequent lease sales two of which followed, and then finally what was generally considered to be the last try for oil on the North Slope, Arco, announced a major discovery in the heart of the Prudhoe Bay field.

That was announced in 1968, in July, but actually the discovery was made the tail end of 1967.

So then the State selected another 2,854,000 acres, which is this area in here. Fortunately the land freeze came along and the State has not received tentative approval, and has not had an opportunity to lease any of these lands. However, you will note all these little squares that are filled are leases that are in effect, Federal leases that were in effect before the land was split. Some of those Federal leases have expired and quite a few will expire within a few years unless oil or gas is found on them.

Now in 1969, September 1969, fortunately considerable time, about a year had gone on since the announcement of the major discovery here, the area had been pretty well investigated, and that is the famous sale which brought in more money, I believe, than any other bonus sale held anywhere.

I can read off to you shortly the sales, the first one in 1964, December, some 476,000 acres leased; $9.20 was the average pay per acre.

In 1965 420,000, and the average had gone up to $15.25.
In 1967, the samll sale, January, 1967, 42,000, the average price was $34.87.
Then in September, 1969, 412,000, and the average price paid per acre was $2,181.66.
That practically exhausted the State lands that were up ther at that time, I'll come back to that.

The total bonuses then paid on this first selection have been $912,450,585.07.

Now, what may we expect in the future? About other bonus sales? Well, we still have not leased, those plots which are shown in green. Now all of this has been offered, but they just didn't receive bids. There probably not the best in the world.

TAPE #2

When AIDA gets in. An amount that is a little difficult for us to determine right now will certainly be over a million acres. It depends upon what happens to the Federal leases that are existent now.

Then we also have the offshore lands. There has been a little leasing on the off-shore lands, not much but some. If they extend out to a line here, that is three miles beyond the outer islands, except that the Federal government has a little argument about a couple of holes in here that have to be settled yet. They are rather bothersome. We can figure that about 300,000 acres safely up there. So we are talking about still amillion and a half acres and unquestionably more as leases are dropped here that will be available in the future. So since Alaska now already ranks second amont all the States, very close to Texas, in the total value of oil, or the total amount of oil that is proven, why we can look forward to many years of activity in oil production in that area.

I don't believe I'd better read this now.

Now the Prudhoe Bay field alone has a proven reserve of 9.6 billion and 46 trillion cu ft of natural gas. Now to the west of Prudhoe Bay - I shouldn't have gotten down there-the Ugnew has oil between - there has not been enough drilling for us to get a reliable estimate - our office up there says "well, you can probably figure a couple of hundred million barrels anyway" but we don't know that yet.

Now, those wells in the Ugnew Field, that is to the West, the shaded area there, are not anywhere nearly as productive as the wells in Prudhoe Bay, so we don't know just exactly what going to be except that they will be an important addition

to production up there.

Generally we feel that within the State lands there an estimate of proven and potential oil should be somewhere around 20 billion barrels of oil.

Now in addition to the production from State lands - no, I shouldn't have said that - we have other areas that probably will be developed. To the West here is the large twenty three million acre Naval petroleum reserve #4. That someday will certainly be open. We don't know when though. We certainly don't have much encouragement on it.

And to the east the Arctic Wild Life Range is close to leasing right now. But there is nothing in the law that would prevent it. And we do know that there is a major structure in here called the Marshbreak Anticline that very well could be an extremely important producer. There is a very well known and very highly regarded Canadian magazine called OIL WEEK. Their editors and experts looking over the Alaskan scene here, say that the North Slope should produce around 50 billion barrels of oil, which certainly would keep the pipelines going for quite a long, long time.

I think I should explain something about what the existing leases contain, what they amount to , and so on.

Now all the existing leases on the North Slope, the royalty is 12-1/2 percent, of the well earned value. However, those leases were issued prior to 1969, provid for a reduced royalty, down to 5% if a new field is made, is discovered on a particular lease. Now only one lease in Prudhoe Bay is entitled to this reduced royalty. And that privilege expires in 1978. Because the reduced royalty is in

Now all existing North Slope leases have a term of ten years, or as long as production is maintained. Leases may also be extended if they are committed to an approved unit agreement. A unit agreement, which are formed by pooling of interests of all leases on a geological structure, capable of or believed to be capable of producing oil and gas, carry specific drilling requirements, and must be approved by the Department of Natural Resources, if on State land, or by the U.S. Geological Survey if on Federal land, or by both, if there are both Federal and State leases involved in the unit.

Units are extremely important in conservation of oil and gas. It means that the pressure maintenance can be handled far better , and so on. Illustrative of that is the fact that the recovery from oil fields in the states has been going up as unitization has spread. Whereas in the early days I understand that some of the recovery from oil fields was down as low as ten or fifteen per cent, and the average for some time was around 20 or 25, it is now I believe 34%. We are estimating that Prudhoe Bay recovery will be 40%.

Now prior to 1969 all the leases on State land on which the State had received only tentative approval, were issued as conditional leases. The lease terms did not begin to run until the State received patent to the land. Now with the exception of the leases sold in September, 1969 sale, North Slope leases are conditional and the term of lease has not yet begun to run.

The wellhead price, which was already pretty well described in the Governor's statement, on which royalty and severance taxes are based, is stated in each lease as of #1: the price actually paid by a purchaser at the well (we just don't have any of those in Alaska) #2: the posted price by the lessee in the oil or gas field, which we do have. #" the prevailing price paid to other producers. Now

since nearly all Alaskan oil is sold on the West Coast of the United States, the wellhead price determined by...the well head price is determined by the field price at the point of delivery on the West Coast less transportation charges. Since these charges are variable among producing companies, there is enough confusion in producing fields in Cook Inlet to get us into a lawsuit between the State and one of the producers. Since this matter is before the court I wouldn't care to comment much more on it except that I very much hope that there will be clear guidelines for the determination of wellhead prices in the North Slope, ither established by a directive from the court or by a general agreement.

Now all oil and gas produced in State lands on the North Slope other than off-shore lands, is subject to payment of 2% of the gross valu , that is the wellhead price, to the Alaska Native Fund, until such time as five hundred million dollars has been paid into that Fund from all sources of State income subject to such payment. Although provision for payment to the Alaska Native Fund effectively reduced the State royalty on the standard oil and gas lease, to 10-1/2%, that payment is treated in State accounts as an obligation against the State Treasury so we do not take it into account in estimates of State income from minerals.

The way we figure royalty after the deduction of the royalty from the wellhead price, the remaining value is subject to a State severance tax based on the rate of production from each producing well. This tax on oil is 3% on the first three hundred barrels, 5% on the next seven hundred barrels, 6% on the next fifteen hundred, 8% on all production over twenty-five hundred barrels per day. Severance tax on natural gas is 4% of the wellhead price, regardless of the rate of production.

Now I have an example here of the derivation of State income from royalty and severance tax. If we assume and this is strictly for simplicity sake, the well-head price of $1.00 a barrel, the State royalty at 12-1/2% would be 25 cents, leaving a residual value of $1.75 that is taxable. I figure the severance tax - we don't know just what it will be at 7%. I note that the Governor's statement used 7-1/2%. We don't really know what the rate of production will be. Using 7% that is another 12 cents for severance tax, so we combine the 25 cents royalty and the 12 cents severance tax to get a State return of 37 cents per barrel, which is 18-1/2% of the wellhead price, and 18-1/2 or 19% is a fair figure to use when you estimate the value of the production from the North Slope.

Now, for natural gas, figuring it the same way, it is strictly 16% of the wellhead price.

I hope this may help some.

Thank you.

Thank you, Mr. Herbert.

Thank you Mr. Chairman.

JOHN HAVELOCK: Attorney General to the State of Alaska will now present his own statement.

I would like to give the committee some information about the Federal role in North Slope Oil, ITC Regulation, how it works, and the issue of Federal pre-emption.

The word "regulation" as applied to pipelines encompasses a broad spectrum of

North Slope.

Now, for natural gas, figuring it the same way, it is strictly 16% of the wellhead price.

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Thank you.

Thank you, Mr. Herbert.

John Havelock, Attorney General to the State of Alaska, who will now present his own statement..

Mr. Havelock: Thank you, Mr. Chairman. I would like to give the committee some information about the Federal role in North Slope Oil, ICC Regulation, how it works and the issue of Federal preemption.

The work "regulation" as applied to pipelines encompasses a broad spectrum of the police powers of the State. At this point I will discuss only ecomonic regulation, meaning some form of control over the rates that may be charged for transporting oil or gas. As has been noted, these rates or tariffs, together with tanker rates, make up the transportation cost for oil. The transportation cost is subtracted from the refinery sale price of oil in order to arrive at the value of the oil as it comes out of the ground and before it is shipped anywhere.

Since our State revenues from serverance taxes and royalties on North Slope oil currently depend on the wellhead value of the oil, the State has been studying the existing scheme of federal pipeline tariff regulation in order to see precisely

what controls there are to assure that a fair tariff rather than an exhorbitant one will be charged. Simply stated, our conclusion is that if existing federal regulation applies to the Trans-Alaska pipeline and applies alone, no assurance is provided that tariffs will be reasonable from a State point of view. Nor, despite common carrier status, does it assure completely equal standing among all who might need access to it in later years for shipment of oil.

Existing federal regulation is shared by two agencies: the Interstate Commerce Commission (ICC) and by the Antitrust Division of the U.S. Justice Department. The Interstate Commerce Commission is given authority by specific statutes. The jurisdiction of the Justice Department arises out of the fact that the pipeline is a monopoly.

While it is clear from the factual situations and stipulations filed with the Department of Interior that the Trans-Alaska pipeline is a common carrier, it is not necessarily clear that under all circumstances the ICC necessarily has jurisdiction. In general, if there is a break in the ownership of the transportation facilities so that the pipeline is a completely separable operation, then there is a good possibility that ICC jurisdiction does not exist.

However, it is my understanding that the method by which the owners now plan to operate the tankerage portion would involve ICC jurisdiction over the entire transportation route including the pipeline.

The ICC has some jurisdiction over all common carriers engaged in the transportation of oil from one state to another state; but jurisdiction over pipeline is far more limited both by law and in its exercise, than the ICC's sway in other areas, such as trucking and shipping.

The Commission ostensibly determines what constitutes a "reasonable" tariff and whether any carrier is charging in excess of that standard. According to regulatory standards previously established by the ICC, that tariff includes a maximum profit of 8 per cent of the valuation of a pipeline. Under an antitrust consent decree, the maximum dividend allowable is 7 per cent.

In its determination of whether any given carrier exceeds this rate the ICC reviews data sent to it by owner companies regarding the valuation of a pipeline. The companies also publish their tariffs, which the ICC may challenge as unreasonable in the light of a given valuation.

The antitrust aspects of regulation stem from a compromise settlement entered into between the United States and various pipeline owners in 1940. That settlement was arranged to satisfy a federal complaint that the pipeline owners were taking too much profit, constituting an illegal rebate of tariffs to a few owners at the expense of all non-owners. Basically, it limits the dividend that a pipeline owner can take from pipeline operation to a percentage of pipeline valuation.

We will present later an analysis of specific weaknesses in this regulation of tariffs by the ICC and the Antitrust Division of the Justice Department. Immediately, however, four difficulties are obvious when we consider Alaska's situation.

First, regulation merely on profits or dividends as a percentage of valuation provides no control over costs. An increase in cost can be added directly to the tariff per barrel so as to maintain the same percentage of profit. Consequently, even under the most responsible management, cost control is not subject to the usual incentives. This situation also creates an incentive to shift costs from non-regulated operations to the pipeline operation since profits on non-regulated

operations will be enhanced and the costs will merit an increased return on the pipeline tariff.

Second, you will recall that profits are restricted to the sense that they are restricted to all, merely to a percentage of the valuation of the pipeline. This restriction does not distinguish between the ways in which funds for the pipeline are obtained. The result is that a high level of debt financing enhances the profit. Pipeline valuation may well be made up of a large percentage of lenders' money and only a very small percentage of owners' money. As a consequence, the actual profit the owners make on their money may be as much as 100 per cent per year. By contrast, other regulated public utilities are normally limited to a return that will adequately compensate those who have provided the cash to run the business. The pipeline owners will be making a profit on lenders' money as well as their own.

Third, on the basis of past performance, it may well take the ICC four years to establish a value for the Alyeska pipeline. Obviously, since its regulatory program depends on knowing the pipeline's valuation, it cannot regulate in a meanful way during those four years.

Fourth, because of ICC procedures, the actual tariffs and profits on the Alyeska pipeline may be far higher than the 7 to 8 per cent limit I mentioned earlier. The reason is that the ICC will not consider the Alyeska pipeline alone initially in determining valuation. Instead, the ICC will lump it with all other American pipelines owned by the owners of Alyeska and in effect see that the over-all average tariff charged is "reasonable". By such an averaging procedure, tariffs and profits

on the Alaska pipeline may be set high since the overall figures may be brought down by lower rates on other lines.

How can an industry operate under such a weak regulatory program when it supplies a commodity that is a necessity to millions of users of gasoline and heating oil? The answer is that the industry is essentially self-regulatory. The owners of pipelines, who may also be producers, agree among themselves as to the fairness of particular tariffs. They operate under an unwritten rule not to wash their laundry in public. As long as the agreement is lived up to, no one complains; no one spurs a tariff investigation. The ICC has a right to complain on its own, but as a matter of practice in the years, it has never done so. With no complaints from any source, pipeline tariffs go unchallenged. Although the ICC has a section of personnel that review pipeline evaluations, no personnel are assigned to investigation or rate review otherwise.

Just from this brief explanation, it is clear that the ICC does not fully regulate the operations and tariffs of those pipelines which fall within its jurisdiction. It is also clear that federal law does not cover the whole area of pipeline regulation.

This brings me to the matter of pre-emption. Pre-emption is a legal doctrine which means, in the case of the Alyeska pipeline, that the State may not regulate the pipeline as to matters where specific federal legislation applies. Occupying the field the ICC does not regulate all aspects of all pipeline operation, even all aspects of economic regulation. For example, there is no effective regulation at all during the years when pipeline valuation is being set. Furthermore, unlike the situation with railroads, the ICC has no control over the construction of new pipelines, over the abandonment of pipelines, over security issues of pipelines, and

no basis for regulating consolidations and acquisitions of control. As can be seen, the internal proprietary arrangements of owners are relatively free from scrutiny by the ICC. To the extent that the State interest in pipelines are based on proprietary agreements between the State and owners in the industry, and not, on their face, regulatory, the ICC review is limited. In view of the limited scope of action by the ICC, and the notable lack of action historically by the ICC, we believe that federal law does not govern the entire realm of pipeline regulation. The State, with its strong interest in the Alyeska pipeline, may thus regulate on its own and such regulation, if carefully prepared, would not be pre-empted by federal authority; to the extent that such legislation is pre-empted it would not have any effect on the residual authority which would be retained by the State under the authority of its Statutes.

Even if we assume that the State were challenged because the matter of federal pre-emption was held to be unclear, the courts are required to balance the interest of the State and of the federal government in the specific regulatory program. Since the State of Alaska's interest in this case is so overwhelming, Alaska has a much stronger argument than any other state for allowing it to impose effective regulations to protect the State's oil value. Lastly, even if pre-emption were allowed, the findings of a State regulatory body would have a strong effect as an advisory opinion to the federal body on the reasonableness and appropriateness of rates. The means for implementing such state regulations will be discussed later. I should like to point out in conclusion now, however, that the whole complex matter of regulation vanishes with State ownership of the pipeline. With ownership, the State itself will be establishing tariffs, instead of being plunged into a maze of corporate accounting procedures from which it hopes to exit with a knowledge of "whether tariffs are reasonable". Pipeline ownership is a most effective means of assuring that transportation costs stay low, and the wellhead value of our oil re-

mains high. Ownership simply and directly works to assure Alaskans that they will receive what is due them for oil that is taken out of the State forever.

That concludes my statement, Mr. Chairman.

With your permission, at this time I would like to call out of order, Mr. Peter Temple, of H. H. Temple, Barker and Sloane, who are pipeline consultants to the State of Alaska.

Thank you.

Mr. Temple: Members of the committee. My name, as explained, is Peter Temple. I am president of Temple, Barker and Sloane, economic consultants to the State, for the past several months, on the matter of the pipeline.

I would appreciate the opportunity of addressing this committee on essentially three points which have fallen within the scope of our work with the State.

First is the question of the desirability of pipeline - of state ownership of the pipeline. Is this indeed desirable, essentially from an economic point of view, and if so, why?

Secondly, I would like to review with you the objections that have been stated against ownership, chiefly by the oil companies, but by others as well, and finally to explore with you some of the alternative means of meeting the objections that have been raised and considering how, if al all, State ownership might be possible as a means of serving the interest of both the State and the oil companies, in this vital issue.

Turning first to the question of the desirability of State ownership, there are essentially three points which, taken together, I believe argue very strongly for consideration of State ownership of the pipeline.

The first has already been - - - the protection of the State's existing interest in royalties and severance taxes.

The second is the need to establish and maintain in Alaska, both an oil transportation system and a general economic climate that will be conducive to not only further exploration and development by the companies already on the North Slope, but other companies as well who may be necessary to maintain a competitive market for the leases, which are of major interests to the future of Alaska.

Finally, there is the opportunity for additional revenues to the State that could flow from State ownership.

I believe the principal in originating reason for considering State ownership is to protect the State's existing interest in royalties and severance taxes. And these interests are substantial. We have already heard discussions of the royalty ranging from 12 1/2 per cent and severance taxes ranging from 6 to 8 per cent, which means that the State has an interest ranging from 18 1/2 to about 20 1/2 per cent in every barrel of oil. We further know that the Trans-Alaska pipeline will have an estimated annual thru-put of about 750 million barrels. In assuming a well has a value of $2.00 a barrel, that means the royalties and severance taxes would yield somewhere in the neighborhood of 300 million dollars a year. If the well had values as high as $2.50 it could rise to three hundred and seventy-five. Now while at wellhead value, there is a matter of considerable speculation. I think it is clear that the interest to the State that we have been discussing is

approximately double the State's present recurring revenues from all sources. I find that a fairly formidable figure the interest that we are talking of protecting is approximately double the State's present recurring revenue from all sources. Now the question is, what jeopardy is realistically posed to these interests under private pipeline ownership? That jeopardy I believe arises from a combination of essentially three factors.

First is the fact that the royalties and severance taxes are as we have discussed, based on wellhead value.

Second is the difficulty of providing for adequate regulation and - - - of the pipeline tariffs and costs under ICC jurisdiction.

Thirdly the particular problem of regulation that is posed by the form of ownership that the companies are proposing for - - -, that of the undivided interest. Now let's look at each of these.

When we say that the royalties and severance taxes are based on wellhead value, what we mean is simply that they are based on the refinery sales price less cost of transportation to the refinery, and the transportation in this instance consists not only of the pipeline move but also the marine move to the refinery itself. Now this means obviously the State has an urgent concern with economics of both of these transportation moves since the tariffs on both are deducted before the royalty and - - - transportation for the State.

However, most of the comments that I will be making are addressed to the problem of the pipeline cost because they are somewhat larger and also more susceptible to State control at this point. I would like to underscore that the economic marine

move is likewise not a matter of indifference to the State.

Some indication of the sensitivity of the royalties and severance taxes and transportation costs can be seen in the fact that with the pipeline to full capacity a difference of one cent - one cent a barrel - in the tariff, is estimated to result in a difference of roughly one and one-half million dollars a year to the State, in royalties and severance taxes. A difference of one cent per barrel in the tariff is estimated to result in a difference of roughly one and one-half billion dollars a year to the State. Put another way, that means this: a cone cent variation in the pipeline tariff involves a difference in state income equal to one per cent of your present recurring revenue. Now, what we see accordingly, I believe, is that the State has a vital interest in knowing the pipeline move and the marine move are both economically carried out and if the operations of both are efficient and if the costs are reasonable and rational. Now the question might well be raised, well then the oil companies likewise a motivation and interest in maintaining rational costs and tariffs, especially in view of the fact that an appreciable allowance attaches to the wellhead value. This, to think about it, it seems to argue that the companies have an interest exactly like that of the State in maximizing wellhead value. And within limits, that is true. But the limits may be important. First of all we have to recognize that the companies have heavy asset commitments in both the pipeline if they own it, and in their shipping operations. And they have an understandable interest accordingly in recovering all possible - - - costs and achieving maximum profit ability there. This may be possible.

Second, tax considerations may argue for allocating as large a proportion of earnings as possible to a company's pipeline operation. Now, do I understand, I thank we have to recognize that the pipeline operation for the most part, held and managed through pipeline subsidiaries and many of these subsidiaries have accrued

or will accrue under conditions of private ownership, a substantial tax loss carry-forward, which can be used to shelter their earnings, in some instances they can be used to shelter only pipeline earnings and they will, as I indicated, probably would accrue and increase the amount of losses in the early years of any TAPS operations.

Now if there is a specific time limit on the use of the tax loss carry forward whereas there is no time limit as we are aware on the depletion allowed, and this means that for some companies sound business strategy may argue for maximizing the pipeline tariff and profits for a given period in order to make sure that the tax law is beneficial to you, before the expire.

Our investigation of the TAPS - - -

P. Temple:

To the companies concentrating enough earnings in the pipeline to use those tax losses to their full. Now, one point to bear in mind is in making any choice between optimizing earnings along the wellhead, the pipeline and the shipping operations and these are essentially the three parts to which the oil companies can choose to allocate or concentrate, within contraints obviously, ah, revenues. The companies having 100% interest, collectively in the pipeline and in their shipping operations, whereas they have approximately an 80% interest in the wellhead owing to the fact that this state has approximately a 20% interest through the royalties and the severance taxes. I want to emphasize that in seeking to work out a sound business strategy, the oil companies are not doing anything improper or illegal, ah, in these motivations. It is to say that what is economically rational, from the viewpoint of the state, is not necessarily economically rational from the viewpoint of the oil companies. Now, given these differences in motivations, and given these differences in perspective, very honest differences as to what is reasonable, the quest in terms of the process or mechanism by which the state can be assured in the pipeline tariffs and costs and earnings, a reasonable, from his point of view, and that the state's royalties and severance taxes are based on a reasonable wellhead value. Now that process or mechanism by which the state can be assured in the pipeline tariffs and costs and earnings, a reasonable, from his point of view, and that the state's royalties and severance taxes are based on a reasonable wellhead value. Now that process or mechanism we know

is regulation and in this instance we are talking specifically of regulation in a situation where the ICC has jurisdiction. Now, this brings me to my second point which is the difficulty imposed in seeking to regulate under circumstances of the ICC jurisdiction. First of all, while there may be some differences among the lawyers as to the exact realities on jurisdiction, it seems to be fairly well foregone that TAPS, whether privately or publically owned, would be under the ICC_____. The problem that then is posed for the state is that under the supremacy clause of the Congress, that Mr. Havelock just referred to, the state's approach to pipeline regulation must, at a minimum, be consistent with Federal approach. Moreover, ecen when consistent with the Federal approach. Moreover, even when consistent with the Federal approach the state is constrained, ah, in extending that approach in such matters as reasonableness of tariffs, for example, on the grounds that the Federal role prempts the right of the State to enter the field and that state entry might even be interpreted as interference with, or an unnecessary burden on interstate commerce. The legalisms of this will be addressed by others.

The key question from an economic viewpoint I believe, is whether under circumstances of ICC jurisdiction the state first can readily systematically and economically obtain the information it would require to satisfy itself under reasonable pipeline costs of the tariffs and second, if it can get that information and in the detail required, can it then promulgate or effectuate reasonable tariffs, costs and earnings given the historical criteria and standards that the ICC has employed in dealing with such matters.

Now before addressing those questions directly, let me make an observation about the ICC rule in pipeline regulation. Neither legally nor administratively does the ICC play the same role in pipeline regulation as it does in rail, truck or barge operations. Ah, the legal differences others will address for example is the administrative differences ah whereas for example the ICC does have a group who are concerned with making the annual evaluations required on pipelines. It does not have a specialized pipeline section as it has a rail section and a truck section. Ah, perhaps related to this is the fact that whereas it is commonly known that the ICC docket is continuously filled with litigations and hearings and cases on rail and truck rates and other matters, there's not been a single hearing with regard to pipeline rates before the ICC since 1940 and that hearing was not an ICC hearing, that is, was established earlier ah, was at the intervention of the Department of Justice and ended in the well known consent decree to which we referred earlier. I think it's significant that, that consent decree has perhaps more regulatory force today in pipeline operations than does the ICC itself. That perhaps speaks a good deal to the point that if the ICC isn't exactly moribund ah, in pipeline regulation it at least is inert. Now the reason for this I think has been alluded to that the real limitation on what the ICC will allow for rates is what shippers are willing to agree to, and if the shippers agree to the rate there will probably be no complaint and the ICC will not intervene. In thus in the circumstances of private ownership the shippers will be agreeing with their subsidiaries essentially on rates and if perchance there is a user of the pipeline who is not an owner the custom within the

industry has not really been to challenge the rate because the situation probably will reverse itself fairly soon in which one of the present owners will subsequently be a shipper or he does not have ownership interests.

But now lets address the question of data avilable within the constraints of ICC jurisdiction and then the problem of effectuating reasonable tariffs. As to data the standard chart of accounts withing the -------, that is employed by the ICC in pipeline regulation is much too gross to provide a truly meaningful insight in economic terms into the operating costs of the pipeline. It does not permit, as Mr. Havelock established, an assessment of overall economics, but not in details that would be relevant to the needs of the state in attempting to regulate the pipeline to establish the reasonablness of those rates. Second, the data tends to be more oriented to the evaluation and control of overall pipeline companies than to the evaluation and control of individual pipelines. Now thats a point we will come back to when we speak of the undivided interests problem. Now as to the problem of effectuating reasonable rates, the major difficulty here is that the ICC uses the return on fair value concept as the principle basis in rate making and in practice return on fair value has become return on replacement value which seems to have a rather dubious relationship with the operating realities of a pipeline. By using replacement value as the basis on which earnings are measured, the ICC in an inflationery economy is allowing an absolute increase in earnings every year since the replacement costs are theoretically increasing every year. The fallacy in this so called fair value concept is that pipelines are seldom, if ever, replaced. Abandoned, yes, when fields go dry or sometimes rippedoup and installed elsewhere. They have virtually inexhaustible life and it's difficult to find a single instance of a pipeline ever being replaced as such. It may be replaced by a larger pipeline, but the concept of replacement of the line as such is virtually unknown, yet the ICC regulates rates essentially in the, on the, on the, on the assumption that replacement is the common rule of the industry. Now other measures which the ICC might reasonably employ which might result in quite a different rate structure, a return on equity, or

a return on the total invested capital. Some indication of how this would alter the rate structure I think might be found in the example of Humble Oil ah, in its pipeline subsidiary. By working under the ICC return on fair value concept in the year 1968 which gave it an implied limitation of 8% on fair value. The earnings of the Humble Oil pipeline subsidiary provided 30% return on sales and a 23% return on the stockholders investment. 23% return on the stockholders investment and a 30% return on sales. Now you want to think about those figures when you realize that is the level of profitability that would be allowed before the state would be entitled to come for its computation of the return on the well-head value. That is essentially the problem that we're concerned with here. Let's say if Alaska were to attempt to regulate the pipeline under ICC jurisdiction we'd have dual problem of getting data adequate to determine reasonable tariffs and then secondly attempting to effectuate changes in rate structure that are not consistent with the criteria employed by the ICC and which seem open to some question. But I think to get the problem of regulations full perspective you have to go to the next step and to understand the third of the factors to which I refer and that is the oil companies intended use of the ownership form know as the "undivided interest". Now, the ideal pattern of regulation, of rate rationalization, would be where we had a single pipeline owned by a single corporation and in a situation of that sort all cost and revenue information could be easily evaluated for rate rationalization and a single rate structure would be the result. Now what's involved in the undivided interest situation is about as far away from that simplicity as its possible to get. Under this form of ownership, the pipeline would be owned, not through a single corporation, but rather each of the seven companies will hold its interest in the line directly through its pipeline subsidiaries. I think it's easier to think of it perhaps as a partnership-type ownership, but the partnership of the companies is then integrated in the pipelines subsidiary. Now the most important thing is the impact this has on the tariffs. Under the undivided ownership pattern, undivided interest ownership pattern, the tariffs charged on the Trans-Atlantic, Trans-Alaska Pipeline will not be a function of the economices of that pipeline, but rather a function of economics of all of the pipelines owned by each of the companies.

I think that's a point you want to think about a great deal. The corallary of this is there will not be one rate structure which the State of Alaska would have to rationalize, but at least seven - one for each company that holds an interest in the pipeline. The complications posed here are pretty obvious:

Number 1 - This means one needs data to evaluate this not simply on the operations of Alyeska, but on all other pipelines that each company owns and operates. Think of the mountains of data that are required to make an assessment within that context.

Second: It calls for an evaluation of that data and the manpower and the cost requirements for that sort of rationalization are enormous. If your interest is in keeping consultants and lawyers occupied, it's a good way to go.

Thirdly, above all, is the difficulty then of trying to argue from whatever conclusions you come to because then the burden would be upon the state to rationalize and demonstrate in this welter of figures any differences of view that it may have with the oil companies or the ICC.

I submit that if the job of regulation is possible at all under these circumstances, it is surely one of the great and thankless labors of mankind and probably not readily within the capacity of any one of the states of the United States. I conclude accordingly that regulation within the context of ICC jurisdiction an undivided interest ownership affords very thin protection at best for the state's interest in royalties and severance taxes. This is the principle reason that state ownership merits the consideration of this committee.

And now may I address briefly the other two reasons that I think argue for consideration of state ownership. One is the necessity for maintaining a climate for encouraging further exploration and drilling on the North Slope, not only by the companies now there, but by others as well. This is necessarily, necessary to insure a strongly competetive market for peak release sales. The problem that is posed is the risk that ownership of the line by the companies now on the Slope could become a device for

minimizing future competition by making accessibility to the line unduly difficult or unduly costly. Now, I'm not saying this with any reference to the individual companies here involved. My reference point rather is the history of pipeline operations in the United States. This has been a problem that has plagued the industry from the time the first pipeline was layed and all of those who are familiar with the theory that ICC regulation is supposed to prevent this problem would be naive to assume it cannot arise in Alaska, as well as it has elsewhere. I think being able to assure future lease holders of equal access to and equal rates on a state owned pipeline would go far to assure the value of future lease sales.

Finally it is the matter of the incremental revenues that might accrue to the state if it owned the pipeline, the revenue from pipeline profits. It's clear that some profits would accrue and I've seen figures that argue it might rise as high as $200 million dollars a year. I would make the observation, however, that its unlikely that state ownership will increase the profitability of the pipeline in strict economic terms. Incremental profitability that is talked of under state ownership derives chiefly from text considerations, namely the avoidance of the income taxes and tax exempt financing. These certainly can produce some significant savings but tax matters are always subject to legal and administrative interpretation, ah my own views that pipeline earnings could provide a significant addition to state revenues, assuming the proper tax approvals are received but that this is not the primary basis for considering state ownership. That is the protection of the states existing interest in royalties and severance tax.

I would like now, if I may, to return briefly to the question of the objection raised in state ownership. I think publically the oil companies have identified at lease three objections. The first is that they question whether the state is able to finance the pipeline without drawing an oil company credit in the form of the customary "hell or high water, thru-put agreement! Within the industry the typical instrument used to accomodate financing is a thru-put agreement and the term "hell or high water" is used to indicate that regardless of whether or not, under these agreements on ship oil, one

is obligated to pay for it. Highly binding, and within the oil industry when one speaks of a thru-put agreement, it is typically understood that the shipper pay, or "hell or high water" agreement is what is intended.

Now the oil companies are, I think, very understanding, I think, realistically have said if the state were to build and own the company, the pipeline on its own, could they do this without encumbering the credit of the oil companies and it's a very realistic objection. It hardly would be proper on the one hand for the state to own the pipeline and to finance it with the assets of the oil companies on the other. A second concern that has been raised by the companies is a matter of principle. A question of the propriety of the state moving into an area where private enterprize is prepared to invest. Thirdly, I believe publicly, the oil companies have indicated great concern that may, about the points that discussion and exploration might result in delay of the pipeline. Now I think privately, the companies have indicated a couple other concerns. One, they question the competence of the state to build a pipeline. Is it indeed a qualified source for what looms as one of the major engineering enterprises of world history. Second, even if the state could build the pipeline they've raised the question whether again undue delay might not result. Finally, I think there has been a good deal of concern about political manipulation that might result in state ownership of the pipeline. This could manifest itself in several ways; a higher cost of construction if under state ownership there were an inclination to use more local labor than might otherwise be used on the job. The question, likewise, if whether or not over the long term, the tariff structure might not be affected as fiscal problems arose and somebody suggested well isn't the easy solution to that problem to increase the tariffs on the pipeline, pump out a little more profit and apply that to the solution to our fiscal needs.

These are the principle objections that have been expressed, but before turning to the question of how these objections maight be addressed, I think it useful to recognize that there may be at least two respects in which the thought of state ownership may not wholly unwelcome to the oil companies. The first is that if the state owned the pipeline, it would relieve the oil companies of around 3 to 3 1/2 billion dollars worth of

financing they would otherwise have to undertake themselves. While we may think of the oil companies as being capable of financing almost anything, I think that if we understand a little bit of the situation in the industry today, some of the particular companies in the industry, this deserves a little further thought. The United States oil industry as a whole, in contrast with previous periods, is now in a relatively cash lean position. This has to do with the fact that there are many heavy cash obligations on the oil companies and what has been historically, a business that has been cash generating, is now a business that is increasingly going to banks and other financing sources. The cash is needed not only for exploration, of the type that is going on here, to try to expand domestic ------- sources, but also to expand refinery operations and to meet some of the demands for pollution control. Examination of the balance sheets of the companies that are on the North Slope reveals that the dead equity ratios of all of them, increased in the past several years confirming this point and that the current ratios have all declined. By dead ration we mean the relationship of debt to equity in the total capital structure and by current ratio we're speaking solely of the relationshipe between their current assets and their current liabilities. Current assets being income, cash or income convertible into cash within the year - current assets being liabilities that must be met within the year.

Now against this background, the original estimated pipeline cost, has risen from 1 billion dollars to approximately 3 1/2 billion dollars. This means that the companies in this situation are now confronted with triple capital requirement than they originally planned for the pipeline. Further, they've had to invest and keep going their exploration and drilling activities on the North Slope, preliminary to pipeline construction. I think we can construe that from this front might be welcome to at least some of the companies. The second possible advantage I think, in state ownership is the possible reduced opposition to the pipeline from some of the environmental groups. Some of the environmentalists have gone on record to the effect that they would feel easier with state

ownership of the pipeline as opposed to private ownership. The advantage of this of course is that it could reduce some of the expected legal delays and thus speed the start of construction.

Now as to the question of how some of these objections, at least to the oil companies might be met in a matter compatible with state ownership and indeed made to serve both state and company interests. Of the five objections that I cited, the first was the objection to the use of oil company credit to finance the pipeline and I think everyone would agree that is a fairly realistic objection. The real question that was being raised is, "Does the state have the ability to finance the pipeline other than by itself?" I think that there are at least two alternatives that are open and both of these, let me say, are informal plans, they by no means are plans of the state at this point, and you will have further testimony regarding at least one of these plans within the next day or so from my associate, Mr. Gilderhouse. But the first of the plan is based on the rather simple premise of cooperation with the oil companies and with the concept that the pipeline would be constructed by Alyeska under contract to the state. And the essence of the agreement is first and foremost that there would be no thru-put agreement of the conventional 'hell or high water' take or pay variety, but rather that the companies would enter into an agreement with the State of Alaska, or its authority, whereby they would agree to ship through the pipeline a minimum number of barrels a year, on an annual basis. Further they would agree to use only the Trans-Alaska Pipeline for the shipment of oil from the North Slope until all the bonds associated with the pipeline were amortized. Finally, that they would sell or otherwise assign oil at the wellhead to another company, or to the state if need be, should they not plan to ship the required minimum, so that another company or the state could ship the oil. Further the state would, in these circumstances, try to provide the users with some reasonable assurance about rates, some sort of

formula approach to rate rationalization so it could be understood from the beginning that the type of political manipulation that the companies are concerned about would be sheltered as far as possible.

Finally, as I said, the Alyeska would construct the pipeline under contract to the State with full performance and completion guarantees. And that as I say would be the essence of the agreement, it will in no way encumber the oil companies' balance sheets or draw on their full faith in credit. It would employ Alyeska, which has the prime capability to build the pipeline to do it, and I think one of the things that's interesting is that they would have a mutual interest in trying to minimize construction costs on that basis. The companies would want to minimize the construction costs because the construction costs is a primary consideration in rate formulation and the State naturally is anxious to keep that cost as low as possible as well. That is I say, would be a financing approach that is based on the assumption of cooperation between the state and the oil companies. There is another financing plan that is possible that we've had some discussions on, that would involve bringing in financing, probably from a private party, and in the magnitude that would be required. But in that situation, we would not be presuming the condition that is modified thru-put agreement, such as discussed here.

Now the second objection that the oil companies raised was that the state was not competent to build the pipeline. I think, I believe the Governor has stressed this from the very beginning that the proposal would be that Alyeska would build the pipeline under contract to the state, under a tentative agreement. Insofar as the concern about the pipeline becoming a political instrument which might eventually be used to try to solve future fiscal problems, I think the key here would be the creation of a pipeline or transportation authority which in its design and in its appointments would be insulated as fully as possible, both

legally and administratively from political pressures. I think that the Port of New York Authority may be an example of the type of institution that can be structured today and on the one hand to meet a public need and on the other hand to reasonably protect it from political pressure. I think a way of greatly augmenting the benefit of a structure of that sort would be to appoint to it people who demonstrably had an understanding of oil companies interests here as well as the interests of the state and the taxpayers of Alaska. There is finally the question of, that was raised by the companies as a matter of principle and that is whether the, whether it was indeed proper for the state to seek to take over a business enterprise where private enterprise was prepared to come in and make an investment. I think the resolution of that problem is not something that's appropriate for somebody from outside the state to try to address. It obviously gets its philosophic consideration of the broadest nature, it is a matter that has to be rationalized. The only observation that I would make on it is that given the magnitude of the figures of the pipeline investment and oil company operations that were introduced here earlier in testimony. It is very clear that Alaska is, in all likelihood going to become something of the pattern that is known historically as a single commodity economy and it is also, I think, pretty well known to us that where you have a single commodity economy, a typically political power and a good deal of economic influence gravitates to those persons, or corporations who control the commodity and therefore it seems to me that the argument that it may be necessary for the state to step in and seek to hold some of that economic power in its own hands as a means of achieving political balance deserves consideration.

The final question of course that was raised by the pipelines was that of the possibility of delay if the state sought ownership, I think there that the principle hindrance of delay now, if we understand the signals from Washington correctly, is in terms of suits from the environmentalists. As I have said it

would seem to be distinctly possible that there would be lessening of tension on that front if the state were to _____.

Thank you Mr. Temple. We are going to have questions now from members of the Legislature. First, members of the Senate Commerce Committee. Mr. Temple, do you want to stay there for questions? First the members of the Senate Commerce Committee and then the House State Affairs Committee and then other legislators that may have a question for Mr. Temple. We're doing this out of order because Mr. Temple must leave Juneau this evening and I'd like to say this before we get started with the questions, will the press please use a little restraint in photographing the witnesses in front here today. It is very disconcerting to have their microphones knocked over in the middle of a presentation.

Members of the Senate Commerce Committee, do you have any questions? Senator Groh.

Senator Groh: Mr. Temple, in connection with your premise that ownership is the most desirable end here, my question goes to how we presently acquire the interests of Alyeska in what they have in the form of private property, some 800 miles of pipe that has apparently been paid for and is spread in three locations in Alaska. Do you envisage how we're going to get their interest in that particular property?

Mr. Temple: No. 1, I would say that if the state were preparing to assume ownership of the pipeline, it would have to be prepared to reimburse the oil companies for all proper expenditures to date, including those items you called out. In the process of doing that I expect the first requirement here would be an agreement, have to be an agreement between the companies and the state, if they were indeed interested in exploring. This is a possibility of mutual benefit.

Senator Groh: And would you envisage further that whatever administrative and other costs they have had to date in promoting the pipeline also be reimbursed to them?

Mr. Temple: I would say that the next step would be to try to draw up a list of criteria as to costs that would be properly supported by the state. I would not want to say that all costs as represented by the oil companies should necessarily be accepted by the state. I think the state would have to

TAPE 4

Groth: to be expended. And their physical assets to date before ownership can proceed if the companies wouldn't agree to that. Doesn't that end the ownership discussion?

Temple: It ends the ownership discussion, I think only in so far as a finiancing plan based on the particular program I laid out. Other financing programs are possible.

Groth: You wouldn't suggest that the state duplicate 800 miles of pipeline?

Temple: No, I dare say that if the state, however in its infinite wisdom and this committee, should decide that they felt ownership was necessary that the state could exercise its powers to work out agreements whereby it would repurchase and build a pipeline. I understand.

Groth: But we don't have any powers of eminent domain over personal property. I want to know how you propose that the state get that personal property from the oil companies.

Temple: If it is taking, if the oil companies are ultimately decided they did not give up that property, there's no question., they would not have to do it.

Groth: So wouldn't it be more desirable from your view to find out from the companies whether they are willing to enter into that agreement at this stage of the proceedings before we pass ownership legislation?

Temple: I certainly think exploration with the companies is prime importance.

Groth: Absent their agreement we're not going to have any ownership ac-

cording to you.

Temple: I said I believe it is possible to have ownership by the state without their agreement. I think that's distinctly a less desirable alternative, but I can conceive that you could build the pipeline on your own if you choose to do it.

Groth: Just by duplicating what they have done in buying another 800 miles of pipe and leaving them with what they have.

Temple: It's theorically possible, I agree with you it is econcmically absurb, but its possible if you decide that the interests of the State so requires.

Groth: Isn't your thru put agreement that you talk about really a thru put agreement, you say its a modified thru put agreement made with cooperation, but it's really in the final anaylisis a thru put agreement which you have their agreement on isn't it?

Temple: You have to have agreement, the essential difference, Senator between the typical thru put agreement and the one that I discussed, will be presented to you in much fuller detail, is that it in no way encumbers the balance sheet of the oil companies.

Groth: Then may perhaps Mr. Chairman, if I might just, one other question, indicate that the undivided interest ownership formula is an undesirable thing, if they want the other way wouldn't they be in violation of anti-trust?

Temple: I'm not sure that they, you mean if they had a corporation.

Groth: Yes, yes

Temple: Well, as you are will aware even the undivided interest ownership

pattern is being looked at in by Washington today, so I think that the issue of the anti trust does relate solely to the question of the ownership pattern. I think there are much larger operating implications that are under study.

Groth: But, it is clear that the single corporation procedure at least in so far as we know it would create more anti trust problems than the undivided ownership?

Temple: You are in the batteries of legalism that are beyond me. I can't really comment.

Groth: Thank you very much.

Young: Mr. Chairman, due to the Governor's prediction in the last few days you mentioned a while ago that by state ownership it might speed up the construction of the pipeline? I fail to see how this could happen even if we were to go to bond by next election for $3 billion dollars. I can't even conceive selling these bonds very rapidly under the present situation, I can't see a speedy construction if possible. What did you base your statement on that would speed up construction.

Temple: The essential point that I was seeking to make here is that in so far as you anticipate legal delays from the environmental groups that would have a number of suits already filed, it is conceiveable that some of those suits could be dismissed or dropped, in so far as state ownership was regarded as a satisfactory alternative by the environmental groups.

Young: What leads you to believe that I have nothing from environmental groups that they would be less likely to question the state's ability?

Temple: Let me first of all say that this is not a clear position by any means

I am going on statements that have been made to me by representatives of environmental groups, by and large they feel the pipeline probable is going to prove and that the best that could be done is have it go through under state ownership. The feeling that the environmental issues would be more carefully addressed by the state than they might by Aleyaska. I am saying I found it to be.

Young: Do you invision any difficulties selling the bonds that we pass at legislation as far as ownership goes?

Temple: I think the answer to that question is tied up in the question that previous Senator Ray, I think that if we are to sell bonds predicated on the type of approach that I just suggested that the first requirement obviously would be the sort of common understanding between the state and the oil companies. I think that if that agreement is arrived at there is no particuliar problem in selling the bonds, I would add one thing, that if the bonds are to be tax exempt, to very clear that the state must not draw on the full face and credit of the oil companies or tax exemptions lost., so this is an added incentive to make sure the financing indeed exhibit form that the oil companies seem to have indicated that they want.

Young: Mr. Temple, are you aware that the federal legislation they proposed does not allow this tax exemption?

Temple: I'm not aware of that. No.

Senator Meland: Mr. Temple one of the problems that the average resident of Alaska is going to be asking when he's going to be approving this is the estimated reserves are 20 million barrels I think, but the only proven reserves are something like 9.5 or something like that. Then is this a good business deal or not? How can I tell just Joe Blow in the street? Is this

Is this a good deal or not when we only know we have so much.

Temple: No. 1, I believe that the estimate is that if we take figure of proven reserves 9.6 billion barrels that would appear to be worth about 15 years in capicity use of the pipeline. Is that figure roughly correct? Secondly, I have been given to understand that the proven reserves are increasing on an annual basis and the likelihood is that by the time you get to the actual operation of the pipeline, the proven reserves will be substantially greater, I'm not an expert in these matters, so I can only tell you what I have understood and what forms the basis of my economic assumption, but if those points are correct, then it would seem to me that it is a pretty interesting deal to use your phrase for the people of Alaska to have a pipeline that would have 25 to 30 years of reasonably guaranteed life. Nothing in this light is certain, but I think that if there is anything certain the domestic requirements for oil is our prime energy source are good for at least that time bracket.

Mr. Holm: Yes, Mr. Temple, I was interested, you predicating a lot of your argument .. condemnation of the ICC and that is is aloof or accomodating oil companies or its lethargic or non agressive or something like that. I would anticipate that the state would try to reverse that completely and try to enter into it as an interest party and with the ICC coming to life when the state challanges rate structure, wouldn't you expect then that maybe this 7 or 8% might be dropped drastically?

Temple: That's a perfectly reasonable question of what I've thought about fair amount. What change in behavior, you are really asking, can we expect from the ICC if the state gets in and plays a vigilant role? I would agree with you that I would expect it to be quite a change in the ICC's pattern. I have to tell you that I have been expecting the same change in the ICC for the last 25 years and I have watched the American railroads head into

bankruptcy, and therefore I can't really find satisfaction in that fact that the ICC will change it, but I'm not sure it's safe to make book on it.

Holm: Well, if we, I think that we darn well better see to it that they darn well change their policies whether or not we take over the ownership or not.

Temple: I would fully agree with them the question is, do you in Alaska have within your own resources the ability to force that?

Holm: Well, then if this did occur though, lets say that we did become a party to this and were effective in lowering this percentage. What effect would this have upon the argument for state ownership of the pipeline?

Temple: I would have to agree with you that if it is possible that you can accomplish truly effective regulation within the terms where you feel you can not worry about that cent a barrel change, then regulation does seem to be a buyable alternative. But you're placing a very big bet and there have been a great many people proceding you and me in the effort to reform the ICC. It remains perhaps the most obsolete of yourregulatory institutions in Washington.

Holm: Well then, if 7 to 8% is too high, and we don't like the oil companies getting it, what rate of return would you expect the state to get?

Temple: As I indicated in my comments, it's my feeling that 7 to 8 % of fair value works out to be the ICC practices which is essentually replacement value. But, perhaps we should look to some other measures of profitability that are more commonly accepted in business today. Return on equity, return on total investment, is the cost consideration that Mr. Havelock spoke of.

All those it seems to me are germain to the interest, by focusing on the return on fair value or replacement value the ICC is indicating an essential preoccupation with ownership and not with the operating effeciency or economic utility of the entity it's concerned with.

Holm: Then did I gather from your other remarks also that you don't expect the ICC to be a party to any rates set by the state if the state assumes control of the pipeline?

Temple: I wouldn't say that. Anything may be possible, and I'm certainly not trying to forecast what the ICC response will be. I think the problem is partly legal, partly administrative and partly what people will accomplish with vigilancy to speak of. The legal realities are there. Mr. Havelock addressed them. There are certain presumptions on the part of the state. What it can do that is not consistant with the federal legislation on the subject. The second question is administrative whether that agency would indeed change its stripes as you suggested. The third factor in it is how much energy the people of Alaska would bring to that.

Holm: I can assure that we'll put in a lot. But if the state gets into the pipeline business, whats the argument for not getting into the oil tanker business too.

Temple: Well, if you raise a theoretical argument you can go into the pumping business as well. I would say that the pipeline perhaps involves a group of interests that are more immediately concerned with the State itself. The pipeline is within the state. The shipping operation would be outside.

Holm: I'll ask you one final question. You've predicated the whole argument upon the well head price being the basis for our extracting our value, the state's value or the state's invested interest in our resource. There's

There's been some proposals on the per barrel charge to be made. Wouldn't that throw it all into a cocked hat if we went into a per barrel charge?

Temple: I don't know what you mean by a cocked hat. It would seem to me those are alternatives that deserve examination.

Holm: What would happen to the state ownership plan if we were on a per barrel return for the oil?

Temple: I think the answer to that is "why suggestions in favor of state ownership" and my position is related to the fact that right now we have this pipeline move as the tension between the state and the oil companies. The state is concerned that the oil companies will behave in such a way that the state won't get its fair shake, and, likewise the oil companies are concerned that if the state owned it, they wouldn't get their fair shake. Now what you would do in the situation you described, as I understand it, is possibly remove the transportation cost as an issue and it might be a ---------- decision.

Huber: Chairman McVey, I have just one short little housekeeping question. It will help me find the lowest common denominator in Mr. Temple's testimony. And that is, how do you Mr. Temple, personally see the issue of state ownership as against right of way leasing and control by the state's regulatory and contract powers, with private ownership at this point in time? In other words, from your testimony so far, where do you stand? Which one of the two routes do you at this time believe is best?

Temple: Well, as I've said in terms of my personal philosphic beliefs, I believe very strongly in free enterprise. The problem I see passed to the state, is that almost impossible to assure itself, in the combination of ICC jurisdiction and tne undivided interest ownership, for the state to assure itself of the reasonableness of rates and costs and tariffs as related to

its interests in the pipeline. I believe that there is a responsibility on the part of you people who look our for the state's well being of the people of Alaska to be assured that the state understands what is going on here. And I'm concerned, frankly, that you will not be able to understand. So that in my oath to answer your question it would seem to me by the simple force of circumstances, I at this point would have to ---------- for state ownership if I could not find any reasonable assurance that I would have visability on those costs and tariffs that are so important to you.

Rose: Mr. Chairman, Mr. Temple, One thing that I wonder about is that in my own experience it seems that generally the state usually enforces regulations upon others much more than it does on itself. For example, in transportation, the state will insist on certain tariffs being applicable to the public but not applicable to the state contracts. If that kind of a history is true, then how could we expect better regulation by the state by its own line than regulation by the state of a privatly owned line?

Temple: I think this is a matter that is bound up in the type of objection that I indicated the oil companies would have to state ownership. There's a risk of that type of political manipulation or you say you know we'll be more concerned about controlling others than ourselves. I think the only answer to that really ---------the character of the authority that might ultimately be established...who will manage the line for the state and the character of the individuals who are appointed to it. That's the strength of any institution that I know of. That risk is there, and I think that if you do seriously consider state ownership you'll have to go the next step and ask how do we avoid that type of abuse.

Rose: I have another question Mr. Temple, I wonder about contracts are enforce, but they can also be breached. Everybody has the power to breach a

a contract of course and then face the possibility of damages. But, suppose that we have one thru-put contracts and you have come hell or high water agreement, and that for some reason the oil industry decides to either slow down or stop its operation in Alaska. And they say we are sorry but---other considerations have intravened into being and we just beat it. Any delay in the production at that point would meet a considerable cost to us in the debt burden, the interest on the debt burden would come. How would the state be able to withstand that kind of gaff.

Temple: Well, I think we have to ask what would be the motivation for the companies breaching the contract. I can see at least two possible motivations. No. 1, that an individual company decides for some reason or other, expedient for it to exploit its resources in Alaska. It is more economical for it to carry oil from some other source and it chooses accordingly, unilaterally to breach its agreement. Now that could be bound up in the economics of an individual company. I have to say I think that's an extremely remote possibility and we're really stretching, but it's a reasonable question. In that situation under the plan I suggested and it will be discussed more fully, at least two options are possible, No. 1, that some other company that would not be confronted by this same sort of unique economic pattern, might be willing to step in as long as it is profitable for one company up here to ship oil, it is presumably profitable for several. So that in that situation the first possibility is that another oil company will step in. The second possibility is in as I cited is that the State will step in and ship the oil. And then it would recover its transportation expense and it's marketing expense and make it the rest of the company.

Rose: But that would be dependent upon production.

Temple: That is correct.

Rose: But absent the production the state would not intercept.

Temple: I think that under your unitization agreements your production would be going forward its just that one company would be forsaking its particular sake.

Rose: I have one more area of concern here Mr. Temple, and that is what is the air polluetion problem and other areas of concern finally bring about a breakthrough in the state of the art, and we go to some other form of propulsion than the internal compustion engine, then where would we be?

Temple: No question, that's a risk, if you think that's probable this is a bad way to go.

Rose: Thank you Mr. Chairman.

Barber: Mr. Temple, through the chairman. Indication so far seemingly tend toward State ownership of the pipeline. Should it however develope that such ownership was not feasible or impossible, do you believe that the state while it owns 20% of the oil value on the north slope should participate in a partnership ownership of the pipeline in order to insure proper bookkeeping, proper tariffs , proper protection, of the interest of the people of the State of Alaska.

Temple: I think that that would be a possibility as well, I think that the question in my mind however, is what would the state have to pay to acquire that particuliar interest and what are the merits of that particuliar approach on a cost benefit basis when you've gone through that, versus total ownership with some of the simplicities that it would involve. There is certainly something to be said to the proposal that you made, I'm not sure that partial ownership would be responsive to all of the problems that have been addressed. It would for example, give you improved visibility on whats going on, your absolutly

right, but you still have the fificulty then in trying to essentuate any reforms or promoting changes in the rate structure that you want. Cause your back again to the question of , can you really carry these things out under the ICC Jurisdiction within the pattern of my undivided interest.

Miller: Mr. Temple, slightly on what Mr. Holm mentioned on the matter of strictly a cent per barral tax on the oil state now. Dosen't this present an oppertunity a lot simpleier mechenism than can bring a lot, the maximum amount of money with the minimum amount of recording worring about ICC or any thing else.

Temple: I would have to agree with you completely in theory. I think it really turns on what is a negotiation settlement to arrive at. I would certainly have to include that as a possibility.

Miller: Have you had the oppertunity to explore this possibility, I mean obviously you didn't love it. Could research and aspiration alalturnitives but, have you had the oppertunity to really explore this possibility?

Temple: The answer to your question is yes, I have had a small oppertunity to explore it and I have not found a great deal of receptivity, in other words that does not mean it's impossible I found a great deal of interest in it.

Miller: I think one of the problems is that the dialogue between the State and the oil Companies and this so often happens, in matters of this sort, has not been all with desire. I question weather the oil companies still even though they are in the room fully understand the tension that is created within the State, by this difference over

transportation costs owing to the sensetivity of the royalties and severence taxes to the transportation moves. But I would hope that such a dialogue might well include consideration just as the proposal you have made.

Miller; Actually, you know there might be problems in the other 1/4 of the oil companies. Actually the choice is ours, even though they might not be all as wild about the agreement.

Temple: I believe that you have already entered into these agreements, now I suppose you could conscrew that this is a reinterpretation of the lease.

Rose: Have you given any thought to the possibility to assure a full disclosure, a good honest look at the books ect. having set such a device as a option to a 20% ownership, not actually having to buy, but being ready to excercise if it need be.

Temple: That proposal seems to me one step removed from the proposal from the gentleman at the end. If you have the option, that does not necessarily give you the visibility, of which you are seeking, on the dated information. If you excercise the option then your in the position that the man described where you are an owner, but then even though you do have the informationor more information you still would have the question of weather or not you can really effect changes in working through the regulatory problems that I described. It would certainly improve your visibility, but you have to pay quite a price for an option, I assume and you then have to ask what the price is you are paying simply to improve your ability as opposed to affecting change.

Rose: You don't think that option could be obtained on basis of an agreement so as to avoid the possibility of outright ownership at this time.

Temple: You may pay nothing for the option, but the excercise is the option I assume would cost somebody some money.

Rose: You don't think it would be useful to be able to get his provision without having to have a fight.

Temple: I will try to answer you this way, I quess that if State ownership for some reason were forgone and you wanted then to still leave open the possibility of some degree of ownership, to approve visibility I would certainly consider it, but at the same time not commit any money now, then what you have suggested would perhaps be very worth consideration.

Senator Rader: Chairman, Mr. Temple, The proposal for state ownership seems to rest primarily on the possibility that we may not be able to effectively present our position.

Temple: yes

Senator Rader: What would your thought be if we permitted the construction of the pipeline as we presently plan, whether partnership or whoever it is, and then considered a condemnation action at some later date should it ever appear that if they ----. In other words, do we have to make the decision at this time that we have to buy the pipeline to protect ourselves? Why not rely so far as we can on regulatory authority whatever it may be, find out what it is, find out what the oil companies actually do by way of fairness in price and make our decision at the time by matter of condemnation.

Temple: I am not at all conversant with the legalizms of condemnations such as you describe. I do not know whether that is permissable within the, ant of the covenants you now have with the oil companies. I cer-

tainly don't believe that it's called for under ICC regulation, at least I've never come across it. So, it would be difficult for me to invision the exact legal circumstances under which that could be carried out. Theorectically, it sounds possible. I always think it's regretable to work with a gun at ones head, but I suppose that's possible.

Senator, are you through?

Senator Groh: Yes, thank you Mr. Chairman.

Chairman: Mr. Bowman and then Senator Josephson.

Mr. Bowman, Mr. Temple: In the projections about the pipeline, it has been stated that we probable have maybe a couple, or three, pipe oil lines and one or more gas lines. Would you advocate that the state own all of them?

Mr. Temple: Not at this time, I wouldn't so advocate, though I would not preclude that possibility. I would be a bit empirical on this. Watch the developements before making a decision one way or the other.

Chairman: Senator Josephson.

Senator Josephson: Mr. Temple, as I understand it, the governos's legislation is really for standby authority to opt for ownership of the executive branch sees that the public interest.....

Senator Josephson: What are the changes that might occur?

Mr. Temple: I can't comment anymore about the possibility or probability of changes of attitude in the oil industry than I can in the ICC. As I say I would hope that a dialogue between the state and the oil companies might examine a number of these possibilities and I assume that if logic could be found it might be as readily found in the near term as in the long term. I don't think either the state or the oil companies at this point can afford the luxuary of long delay. It's imperative from your view point, it's imperative from theri view point, make no mistake about that. Let this construction get started. I think the idea of delay which is incorporated in your remarks is perhaps the chief obstacle to the sort of deferred understanding that you speak of.

Representative Swanson: You mentioned that there are oppositions, you mentioned certain circumstances that increase costs, inflationary effected cash needs, position and so forth. I wondered if changes in any way in those factors might create a change in attitude assuming that they were to be hostile in their testimony here at this time.

Mr. Temple: I suppose that's possible.

Representative Swanson: Thank you, Representative Colletta. Mr. Chairman, I'd like to pursue just a little bit the remark that Senator Meland made about what we're going to tell the man on the street about the 3.5 billion dollar cost of the pipeline. I understood in your remarks that in the financing aspect of this, that it would be a profit on borrowed capital. Does this mean that we would make a profit regardless of how much money we would borrow to build the pipeline we're still entitled to a profit on the money?

Mr. Temple: I will now come to the ICC and ask them to plead my case. The way the ICC now operates, they make no distinction between equity capital and borrowed capital. Their frame of reference as I indicated for determining rates is what they call the fair value of the pipeline which effectively is replacement value. So, that in that

circumstance I would assume that this would also apply to the State of Alaska if it owned the pipeline under ICC jurisdiction.

Representative Colletta: Then we would be entitled to a profit on borrowed capital?

Mr. Temple: Under the present ICC mode of operation.

Representative Colletta: Mr. Chairman, Mr. Temple, in the early part of your testimony you made reference to depletion allowance and this is quite some interest to me. You're the first gentleman in a year and a half of hearings that I've been exposed to that has brought this factor into consideration. With a regulated line, hypothetically, at 7% and a depreciation allowance at double that amount of money at what point would your reservation that this is not an important factor in keeping the well-head price high?

Mr. Temple: The point that I made - first of all the depletion allowance at 23% is not figured on the same base when we're speaking of the 7% figure. That's 7% against a base of the total value of the assessed fair value of the pipeline. That is the base. If we're going to base it at 3.5 billion so that is the percentage against which the base, that's the base against which the percentages apply. Circumstances I cited, it could well be that in some situations the oil companies would have accrued tax losses in their operations. If they choose to employ under the undivided ownership situation and could be only offset against pipeline earnings. Now in that situation, and they rarely use even now the full 23% depletion allowance, there could be an incentive on the part of those people concerned with the pipeline subsidiary, to offset earnings against that tax loss as opposed to against the depletion allowance. Now the further justification to that would be the fact that at the well-head the oil companies have essentially a 80% interest vs a 100% interest within the pipeline.

Representative McViegh: Are there any other members of the Legislature that have a question for Mr. Temple?

Representative Farrell: Mr. Chairman, I don't want to mislead your testimony, but you're not arguing that state ownership and a strong or comprehensive regulations are mutually exclusive. You stated in your testimony that if state ownership succeeded that it would to an extent obviate the necessity for a regulartory machine. Is that true if the state were the owner of the Aleyeska Line and not the holder of the gas line that shoot the lines. Would you state that they're both necessary?

Mr. Temple: Absolutely!

Senator Josephson: Mr. Chairman I just have one question. As to the water carriage of petroluem, is that regulated by ICC or by the Maritime?

Mr. Temple: In this instance it is my understanding that the total move will fall within ICC jurisdiction.

Senator Josephson: Including the water carrier?

Mr. Temple: That is my understanding.

Senator Rettig: Mr. Temple, just one short question. First, may I ask you what time do you have to leave in order to catch your airplane?

Mr. Temple: That's a question I might better direct to somebody else, I'm on the 6:30 p.m. flight.

Representative McVeigh: He still has a half hour.

Senator Rettig: In your early remarks I think you referred to this undivided interest type of ownership of the pipeline. In your experience throughout the country is there a project cost of the pipeline and the likely tariff that would be required. Are you aware of any pipeline anyplace where the cost of transportation is as expensive as this is likely to be?

Mr. Temple: No, the indication that I have is certainly this is likely to be the costliest in terms of the throughout operating costs.

Senator Rettig: The most costly of which you're aware! You referred to the fact, I believe, that the oil companies in their establishing these tariffs for the Trans-Alaska pipeline they would merge in effect, their share of the operation of this pipeline with the operation of all other pipelines that they might own. Considering your first response where costs are lower in all other pipelines, wouldn't this merging or that sort of averaging, wouldn't that tend to lower the cost of transportation of the oil?

Mr. Temple: If we ~~went~~ West strictly on cost that might well be the case, Senator. The issue is that you are concerned not just with costs of the total of revenue, the total economics, the combination of revenue against costs may yield some losses in certain situations. It is conceivable here that the tariffs in Alyeska would be established on the basis of losses being sustained elsewhere. There is quite a variation in the profitability of pipeline companies. I made reference to Humble. They are a highly effecient and effective pipeline operating company. Few of the others are able to match them. So, I think, that we have to assume there would be some good and some bad. I think the drift of your question is, might not Alyeska occasionally benefit in this trade off? The answer is, it might. I think, the real issue is do the people of the State of Alaska want to play a game with their royalties and severance taxes that is really dependent on the economic well-being of a number of pipelines far removed from the state.

Senator Rettig: Thank you very much.

Representative McVeigh: Thank you Mr. Temple very much. We appreciate your being

with us this aftermoon. Numerous other witnesses - we have time I believe for one more presentation this evening, but before we go onto that, why don't we take a five-minute break?

A. G. Havelock: Mr. Chairman at this time I would like to call the Honorable Bruce Campbell, Commissioner of Highways to discuss the cost information on building the Trans-Alaska Pipeline System. Mr. Campbell.

Bruce Campbell: READING TESTIMONY, Chairman.

McVey: Thank you Mr. Campbell. I believe at this time contemplating that Mr. Wohlforth's testimony is next and is likely to be a lengthy - rather lengthy one - I think we will use the rest of our time and depart from our announced schedule to permit questions by the committee of the four witnesses gathered by the Administration. I would like to request of those who ask questions to please stand up inasmuch as you can not have microphones and speak as loudly and clearly as you possibly can. Mr. Holm, Please.

Senator Holm: Yes, a question for Mr. Campbell. In your critique, you say 1972 construction costs, are you saying that if the line were built this year, with this year's labor prices, or if it went to bid this year for three or four of your - predicated on three or four of year head construction?

Campbell: Mr. Holm, what I am saying is, the costs we have are based on dollar value as it is today. If there is some change in what a dollar will buy in pipeline construction in three years, this effect has not been considered in the $3.5 billion dollar construction costs.

Mr. Rose: Chairman. Mr. Campbell again. Mr. Campbell, the thing that --- the legislation I have seen prepared proposes a 3.5 billion bond issue which will - if approved now - will go to the voters in November, 1972, but wouldn't permit any

construction to begin or contracts to be written until 1973. And with normal inflation factor, the figure would be higher than the total bond-issue, would it not?

Campbell: I think the thing we are involved with here, Mr. Rose, is coming up with the date construction starts. This date, at this point in time, there is no one who has that answer. A variety of estimates of when this may start. Certainly to imply any inflation factors that may or may not exist - or for that matter deflation factors - we have got to have a date down the road that you are shooting for and we don't have one at this time.

Rose: Wouldn't we be between a rock and a hard place if we have a bond issue for less than we will have to spend?

Campbell: This could possibly be true. Yes. But I'm sure that as the permit - by the time the permit is issued, the final costs will continue to vary as environmental changes are placed upon the construction of the pipeline, we expect changes also inflation will have its effect.

Rose: Just one other, if I may, Mr. Chairman, that is that I have some difficulty with your presentation from the viewpoint, Mr. Campbell, that is that we start our 1972 pipeline figure with the year 2,000 barrel cost, with tanker costs spreading from 1977 - 78 - to 88 and how do we compare things at different times to arrive at that sum - computation or analysis at any particular point?

Campbell: Mr. Rose this question that you have asked will be answered when some of the witnesses behind me testify as to how the economic analysis were made. My presentation here is simply to verify that we did do this work and these are the figures that we have come up with. I am not the economic expert that can tell you how these fit into the determination of wellhead price.

Rose: Thank you Mr. Chairman.

Rettig: Are there any other questions of committee matters? Mr. Christenson.

Christenson: Mr. Campbell, supposing the voters turn down the bond issue. Then what would happen? Supposing it didn't pass?

Campbell: I'll defer that question to the Attorney General. (laughter)

Havelock: Senator Christenson. I think a clairfication might be in order here. This is part of the problem our not having a full presentation and a problem we are going to continue to run into, that is why we had hoped to put on a presentation and then move on to the questions. We are tomorrow morning, we will have some amendments to offer to the Legislatrion in theory. Nothing is static in the consideration of these matters. We have numbers of amendments to propose. One of which will be to provide with the bond issues will not be ordinary general obligation bonds with the State, but will proceed to a revenue issue with a constitutional amendment which is in the process of being drafted which would permit the legilature under appropriate circumstances to pledge, if necessary various taxes or other revenues so as to make guarantees of those bonds. The effect of this will also be to remove this problem of what has cost overrun the $3.5 billion, and we will have Mr. Kades talk tomorrow about this proposal. We will have a floor presentation on it.

Rettig: I did concur with Mr. Havelock yesterday that we would defer all questioning until the end of the presentations and I think in keeping with that understanding we will recess for now. Before we do however, I would like to state that tomorrow it is our plan to recess for short periods more ferquently than we did today in order to permit the room to be cleared and refreshed a little bit and again we would like to ask those who present questions - we do not have microphones - to

please stand up and face the audience so that they can be heard. It would be appreciated.

Havelock: Mr. Chairman, I would like the opportunity for the Committee's benefit tonight to distribute copies so they will have an overnight opportunity to look at these amendments.

Rettig: Thank you very much. With that we will recess brief hearings until 8:00 a.m. tomorrow.

STATEMENT OF WILLIAM A. EGAN
GOVERNOR OF ALASKA
AT PIPELINE OWNERSHIP AND REGULATION HEARING
JUNEAU, ALASKA
March 6, 1972

My Fellow Alaskans:

Before giving over the floor to a technical explanation of my legislative proposals and their background, I would like to give a brief explanation to the people of Alaska concerning the considerations which started me on the road to these conclusions and where I believe Alaska stands today.

Over a period of months my Administration has been deeply involved in studying and analyzing all aspects of the proposed trans-Alaska pipeline. My overriding concern in conducting this analytical review has been with the immediate and long-range best interests of all the people of Alaska.

At the time full-fledged study was initiated, we knew that hundreds of millions of dollars had already been lost to Alaskans as a result of the great delay in the start of construction of this mammoth project. The laboring man, the suppliers of other services and transportation, and the treasury of the State of Alaska had suffered immensely in this unprecedented denial of development. Numerous bankruptcies directly related to the North Slope oil resource development shut down had also occurred. The State's capability to make firm human resource and natural resource development plans had been seriously undermined because of the total deterioration of North Slope petroleum production plans.

As we commenced our investigation, several vital questions commanded our attention. Among them:

1. What is the total likely cost of the project?

2. Is State ownership of this unprecedented venture in the best interests of the people of Alaska?

3. Will State ownership bring more revenues to the people of Alaska than would private ownership?

4. Is State ownership feasible from a financing standpoint?

5. How is a fair wellhead value determined for the people's petroleum resources?

These and many more important questions have been explored in depth. If the people of Alaska are to receive fair return from the value of their crude oil resources, I believe ownership of the trans-Alaska pipeline should vest with the State of Alaska. I think

representatives of my Administration will present a convincing and adequate case for public ownership of this huge public utility conveyance, at these hearings.

About ten days ago, I requested the State Commissioner of Revenue to run several computer printout revenue projections, programming the latest likely construction cost figures as well as industry's scheduled throughput production volume rates. July 1, 1977, was programmed as the beginning trans-Alaska oil flow date in each printout. The various computer printouts will be made available at these hearings. None of these printouts paint a rosy picture. And I have been condemned in some quarters for telling it as it is, rather than burying these facts under the rug in an attempt to deceive the people.

The computerized projections, based on the most reliable increased pipeline figures available, clearly indicate that a more critical State budget revenue problem confronts Alaska in future years than we had previously felt possible. In addition to the ever escalating pipeline costs, industry contemplates a far slower production volume build-up after completion of the project than the time frame the State had worked into earlier projections.

The oil industry of America is permitted to develop the oil and gas resources owned by the people of Alaska under agreements, each in the form of a lease. Each company in the industry competes for the right to develop these resources by bidding a bonus sum. The highest bonus bid gets the privilege of developing the lease for the particular tract offered.

Each lease provides also for some of the income to go to the people of Alaska through the payment of a royalty of 12 1/2 per cent of the value of production as it occurs at the well. The State severance tax also provides a source of some income for the people of the State. The severance tax, in an approximate amount of 7 1/2 per cent on oil production, depending on the quantity of the oil, is also measured against wellhead value.

The need to protect Alaska's sustaining income is the basic source of the legislative program which I am urging today.

Value of oil at the wellhead is computed backwards from the price paid by the ultimate American consumer of oil and gas products. Although the wellhead price is customarily calculated only from the price paid at the refinery for crude oil, the cost of refining plus profits, and the cost of marketing and distribution plus profit, determine the price paid by the refinery. Finally, the cost per barrel of transportation from the North Slope to the refinery by pipeline and tanker plus profit is deducted.

When development of the North Slope was first contemplated by the Alaskan people, the cost estimates used still showed a fair

and equitable price per barrel at the well after all these deductions.

Low original estimates by the industry as to the actual cost of the pipeline, delay on construction of the pipeline and new and frequently changing design requirements have greatly increased the cost of the line. Inflation has also taken its toll on this picture. The estimated cost of the pipeline has moved from $1.1 billion, the figure the Alyeska Service Corporation gave us as late as last summer, to $3.5 billion, the figure our own cost engineering consultants gave us last month; and it may go higher with more delay.

While shrinkage of the wellhead value towards zero has not been encouraged by the industry, still, because single companies have operations integrated through to the consumer, it is still highly profitable for the industry to develop the oil even when the State gets nothing out of it.

Not only does the industry benefit from profit on the distribution and sale of products, on the profit from refining and on the profits from the operation of tankers but it enjoys a guaranteed profit on the transportation of oil by pipeline even if it doesn't put in a nickel of its own money. The fact that the pipeline, alone in the chain of processing from the well to the consumer, is a natural monopoly, free of the restraints of a competitive market place, is a vital factor in the consideration of solutions to the issues facing us.

Under Interstate Commerce Commission rules, pipeline profits or dividends are computed as up to 7 or 8 per cent of the value of the pipeline, regardless of the amount of equity invested. Joint and several ownership as proposed by the industry also allows the profits from the Alaskan pipeline to be effectively hidden in each owner's entire pipeline operation. Increase in costs of the pipeline from $1.1 billion to $3.5 billion under the public utility conditions enjoyed by the industry will give the pipeline owners a capability for increased profits in the amount of $168 million. This is without regard to basic profitability relating to low equity investments and anticipated profits still accruing long after the pipeline has paid for itself. While the short-term ownership of pipelines is handicapped by a cash flow pinch, long-term ownership is invariably very profitable indeed.

The oil industry, its employees, and families have become an important part of the Alaskan society.

But we must still be mindful that the primary obligation of the companies involved is to the stockholders and board rooms in New York, Los Angeles, and Houston. Alaskans must be vigilant and forceful in the protection of their own interests. The sheer size of the enterprise in Alaska demands effective public control or we will have an economic state, larger and more powerful than the political state which contains it. The income from the trans-Alaska pipeline is greater than the revenue of the State.

The value of the pipeline exceeds all the assessed value of the State.

To assure that Alaskans do not lose control of their destiny, to strengthen the hand of the people of Alaska in our development partnership with the oil industry, and to assure that a reasonable share of the wealth of Alaska is enjoyed by her people, is why I have proposed that the State of Alaska undertake to own and finance the trans-Alaska pipeline. I have made this proposal mindful of the awesome size of the venture. But it is no bigger than our stake in it and the heritage we leave our children and their children. The cost of the line is borne by the value of the oil under any form of ownership. And it is our oil.

So that all aspects of the problems involved are adequately considered, I have also submitted the complementary proposals for taxation and regulation of the pipeline. The joint pipeline committee of the legislature has also prepared proposals worthy of consideration. I would hope that taking the best elements from each, we would also adopt a vigorous and effective package of tax and regulatory measures.

Though the experience with taxation and regulation in the other states has not been a particularly successful one, and though there are substantial legal hurdles to effective regulation, there are indications we could do the job much better.

Still, when all is said and done, we should measure such a package--the proposal for public ownership, or any other proposal made--against the same standard; what system offers the best arrangement for the protection of the long-term interests of the Alaskan people?

I hope all the people of Alaska will take the time to follow the testimony offered in the days ahead by my Administration and the oil industry and to assess the ensuing debate so that each citizen can make up his own mind on this issue so critical to the future of our State. What we come out with as this issue is resolved, the extent of Alaskan control and the extent of Alaskan benefits, depends in the end on the determination and vigilance of the Alaska people.

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Statement of Charles F. Herbert
Commissioner of Natural Resources

In 1964 the State of Alaska selected 1,593,705 acres on the North Slope, between Naval Petroleum Reserve No. 4 and the Arctic Wildlife Range. The land selected was considered to have good potential for petroleum but none suspected that it would contain the largest oil pool ever found in North America. On the map, the lands north of the heavy green line are those selected in 1964 and the orange-shaded area covers the Prudhoe Bay oil field. I want to emphasize that not all of the land within the shaded area will be productive of oil or gas--in fact, there are a number of dry holes within the area shown as the oil field.

Although millions of dollars had been spent in an unsuccessful search for oil on Federal lands southwest of State lands, the first lease sale of North Slope lands by the State was moderately successful and provided revenue at a time when it was needed badly. Greater interest was shown in subsequent lease sales even though drilling on State lands had been disappointing. Finally, on what was said to be a "last try" for oil on the North Slope, ARCO announced a major discovery in July, 1968. The State then selected an additional 2,852,880 acres south of the original North Slope selection. This later selection, for which tentative approval by the Bureau of Land Management has not been received, lies between

the green and brown lines on the map. Note that over half of the area in the later selection is covered by leases. These are Federal noncompetitive leases which had been issued prior to State selection. Some have expired recently and many are due to expire within the next few years, unless oil or gas is found in productive quantities.

With oil interest at fever pitch, the State sold much of remaining tentatively approved North Slope lands at a lease sale on September 10, 1969. The total of bonus bids received at that sale is the largest ever recorded anywhere.

Bonuses received from the sale of State leases on the North Slope:

Date of Sale	Acres Leased	Bonus/Acre	Total Bonus
Dec. 8, 1964	476,147	$ 9.20	$ 4,379,729.91
July 15, 1965	403,000	15.25	6,145,472.59
Jan. 24, 1967	42,397	34.87	1,478,777.23
Sept. 10, 1969	412,548	2,181.66	900,041,605.34
	1,334,092*	$ 683.65	$912,045,585.07

* This figure includes some offshore lands and some duplication caused by forfeiture of leases and subsequent re-leasing.

Bonuses on future sales of leases on the North Slope are most difficult to estimate. Certainly, there is little incentive to purchase leases in the area until such time as construction of a pipeline is assured. About all we know is that the State does own, or will own, land that can be offered for competitive oil and gas leasing.

We estimate that the following land may be offered at some future date:

Unleased land on which the State now has tentative approval	200,000 acres
Selected land, less valid Federal leases - at least	1,000,000 acres
Offshore lands between Pet. 4 and and the Arctic Wildlife Range	300,000 acres

Since Alaska now ranks second among the states in proven oil reserves, and will probably outrank the leading state, Texas, when more active drilling is resumed, Alaska can look forward for very many years to substantial income from oil and gas royalties and severance taxes.

The Prudhoe Bay field alone has a proven reserve of 9.6 billion barrels of oil and 26 trillion cubic feet of natural gas. To the west of Prudhoe Bay, the Ugnu field has oil but there has not been enough drilling to permit a reliable estimate of reserves. Wells in the Ugnu field are much less productive than those in the Prudhoe Bay field but they should add materially to North Slope production. Other potentially productive structures are known so we think that an estimate of 20 billion barrels of oil from State lands on the North Slope is justified.

In addition to production from State lands and offshore lands on the North Slope, oil and gas will be produced from lands that may be selected by Native Regional Corporations and from Federal lands that are or may be leased. We expect that someday Petroleum Reserve No. 4 will be developed, and there is some possibility that the very attractive Marsh Creek anticline in the northwesterly portion of the Arctic Wildlife

Range may be drilled. The highly regarded Canadian publication, OILWEEK, estimates that the Alaskan North Slope will produce 50 billion barrels of oil and many trillions of cubic feet of natural gas. Most certainly, oil and gas pipelines from the North Slope will be busy for many years.

In all existing leases on the North Slope, royalty is fixed at 12-1/2% of the wellhead value. However, leases issued prior to 1969 provide for a royalty of 5% of the production from a lease on which a discovery of a new field is made. Only one lease in the Prudhoe Bay field is entitled to the reduced royalty and that privilege expires in 1978, ten years after the date of discovery.

All existing North Slope leases have a term of ten years, or as long as production is maintained. Leases may also be extended if committed to an approved unit agreement. Unit agreements, which are formed by pooling of interests of all lessees on a geologic structure capable of, or believed to be capable of, producing oil or gas, carry specific drilling requirements which must be approved by the Department of Natural Resources if on State land, or by the U.S. Geological Survey if on Federal land. Prior to 1969, leases on lands to which the State had only received tentative approval were issued as conditional leases and the lease term did not begin to run until the State received patent to the land. With the exception of the leases sold in the September, 1969 sale, North Slope leases are conditional and the term of lease has

not begun to run.

The wellhead price of oil or gas, on which royalty and severance taxes are based, is stated in each lease as the highest of (1) the price actually paid by a purchaser at the well, (2) the posted price by the Lessee in the oil or gas field, or (3) the prevailing price paid to other producers. Since nearly all Alaskan oil is sold on the West Coast of the United States, the wellhead price is determined by the field price at the point of delivery on the West Coast, less transportation charges. Since these charges are variable among producing companies there has been enough confusion in the Cook Inlet Basin to cause a lawsuit between the State and one of the producers. Since this matter is now before the court I cannot comment further, other than to hope that clear guidelines for the determination of wellhead price are established either by directive from the court or by general agreement.

All oil and gas produced from State lands on the North Slope, other than offshore lands, is subject to a payment of 2% of the gross value (i.e., wellhead price) to the Alaska Native Fund, until such time as $500 million has been paid into that fund from all sources of State income subject to such payment. Although provision for payment to the Alaska Native Fund effectively reduces State royalty on a standard oil and gas lease to 10-1/2%, the payment is treated in State accounts as an obligation against the State Treasury and so does not enter into estimates of State income from minerals.

After deduction of royalty from wellhead price, the remaining value is subject to a State severance tax based on the rate of production from each producing well. The tax on oil is:

3% on the first 300 barrels per day

5% on the next 700 barrels per day

6% on the next 1,500 barrels per day

8% on all production over 2,500 barrels per day

The severance tax on natural gas is 4% of the wellhead price, regardless of the rate of production.

Derivation of State income from royalty and severance tax is:

Assumed wellhead price of oil	$ 2.00
State royalty @12-1/2%	0.25
Taxable value of oil	1.75
Severance tax @ 7% (best estimate)	0.12

Total State income then would be $0.37, or 18-1/2% of the wellhead price, a percentage that is probably applicable to oil production from the North Slope, regardless of wellhead price. For natural gas, State income is 16% of the wellhead price.

3/6/72

Tape # 2 Meter # 7131

TESTIMONY OF ATTORNEY GENERAL JOHN E. HAVELOCK
BEFORE THE SENATE COMMERCE COMMITTEE AND THE
HOUSE STATE AFFAIRS COMMITTEE
MARCH 6, 1972

3.52 H21

The Federal Role in North Slope Oil
ICC Regulation: How It Works
Federal Pre-emption

The word "regulation" as applied to pipelines encompasses a broad spectrum of the police powers of the State. At this point I will discuss only economic regulation, meaning some form of control over the rates that may be charged for transporting oil or gas. As has been noted, these rates or tariffs, together with tanker rates, make up the transportation cost for oil. The transportation cost is subtracted from the refinery sale price of oil in order to arrive at the value of the oil as it comes out of the ground and before it is shipped anywhere.

Since our State revenues from severance taxes and royalties on North Slope oil currently depend on the well-head value of the oil, the State has been studying the existing scheme of federal pipeline tariff regulation in order to see precisely what controls there are to assure that a fair tariff rather than an exhorbitant one will be charged. Simply stated, our conclusion is that if existing federal regulation applies to the Trans-Alaska pipeline and applies alone, no assurance is provided that tariffs will be reasonable from a State point of view. Nor, despite common carrier status, does it assure completely equal standing among all who might need access to it in later years for shipment of oil.

Existing federal regulation is shared by two agencies: the Interstate Commerce Commission (ICC) and by the Antitrust

U.S.

Division of the Justice Department. The Interstate Commerce Commission is given authority by by specific statutes. The jurisdiction of the Justice Department arises out of the fact that the pipeline is a monopoly.

While it is clear from the factual situations and stipulations filed with the Department of Interior that the Trans-Alaska pipeline is a common carrier, it is not ~~entirely~~ NECESSARILY clear that under all circumstances the ICC necessarily has jurisdiction. In general, if there is a break in the ownership of the transportation facilities so that the pipeline is a completely separable operation, then there is a good possibility that ICC jurisdiction does not exist.

However, it is my understanding that the method by which the owners now plan to operate the tankerage portion would involve ICC jurisdiction over the entire transportation route including the pipeline.

The ICC has some jurisdiction over all common carriers engaged in the transportation of oil from one state to another state; but jurisdiction over pipeline is far more limited than the ICC's sway in other areas, such as trucking and shipping.

The Commission ostensibly determines what constitutes a "reasonable" tariff and whether any carrier is charging in excess of that standard. According to regulatory standards previously established by the ICC, that tariff includes a maximum profit of 8 per cent of the valuation of a pipeline. Under an antitrust consent decree, the maximum dividend allowable is 7 per cent.

In its determination of whether any given carrier exceeds this rate the ICC reviews data sent to it by owner companies regarding the valuation of a pipeline. The companies also publish their tariffs, which the ICC may challenge as unreasonable in the light of a given valuation.

The antitrust aspects of regulation stem from a compromise settlement entered into between the United States and various pipeline owners in 1940. That settlement was worked out to satisfy a federal complaint that the pipeline owners were taking too much profit, constituting an illegal rebate of tariffs to a few owners at the expense of all non-owners. Basically, it limits the dividend that a pipeline owner can take from pipeline operation to a percentage of pipeline valuation.

We will present later an analysis of specific weaknesses in this regulation of tariffs by the ICC and the Antitrust Division of the Justice Department. Immediately, however, four difficulties are obvious when we consider Alaska's situation.

First, regulation merely on profits or dividends as a percentage of valuation provides no control over costs. An increase in cost can be added directly to the tariff per barrel so as to maintain the same percentage of profit. Consequently, even under the most responsible management, cost control is not subject to the usual incentives. This situation also creates an incentive to shift costs from non-regulated operations to the pipeline operation since profits on non-regulated operations will be enhanced and the costs will merit an increased return on the pipeline tariff.

Second, you will recall that profits are restricted to a named percentage of the valuation of the pipeline. This restriction does not distinguish between the ways in which funds for the pipeline are obtained. The result is that a high level of debt financing enhances the profit. Pipeline valuation may well be made up of a large percentage of lenders' money and only a very small percentage of owners' money. As a consequence, the actual profit the owners make on their money may be as much as 100 per cent per year. By contrast, other regulated public utilities are normally limited to a return that will adequately compensate those who have provided the cash to run the business. The pipeline owners will be making a profit on lenders' money as well as their own.

Third, on the basis of past performance, it may well take the ICC four years to establish a value for the Alyeska pipeline. Obviously, since its regulatory program depends on knowing the pipeline's valuation, it cannot regulate in a meaningful way during those four years.

Fourth, because of ICC procedures, the actual tariffs and profits on the Alyeska pipeline may be far higher than the 7 to 8 per cent limit I mentioned earlier. The reason is that the ICC will not consider the Alyeska pipeline alone initially in determining valuation. Instead, the ICC will lump it with all other American pipelines owned by the owners of Alyeska and in effect see that the over-all average tariff charged is "reasonable". By such an averaging procedure, tariffs and profits on the Alaska pipeline

may be set high since the overall figures may be brought down by lower rates on other lines.

How can an industry operate under such a weak regulatory program when it supplies a commodity that is a necessity to millions of users of gasoline and heating oil? The answer is that the industry is essentially self-regulatory. The owners of pipelines, who may also be producers, agree among themselves as to the fairness of particular tariffs. They operate under an unwritten rule not to wash their laundry in public. As long as the agreement is lived up to, no one complains; no one spurs a tariff investigation. The ICC has a right to complain on its own, but as a matter of practice, in all the years it has never done so. With no complaints from any source, pipeline tariffs go unchallenged. Although the ICC has a section of personnel that review pipeline evaluations, no personnel are assigned to investigation or rate review otherwise.

Just from this brief explanation, it is clear that the ICC does not fully regulate the operations and tariffs of those pipelines which fall within its jurisdiction. It is also clear that federal law does not cover the whole area of pipeline regulation.

This brings me to the matter of pre-emption. Pre-emption is a legal doctrine which means, in the case of the Alyeska pipeline, that the State may not regulate the pipeline as to matters where specific federal legislation applies. occupying the field The ICC does not regulate all aspects of all pipeline operation, even all aspects of economic regulation. For example, there is effectively no regulation at

all during the years when pipeline valuation is being set. Furthermore, unlike the situation with railroads, the ICC has no control over the construction of new pipelines, over the abandonment of pipelines, over security issues of pipelines, and no basis for regulating consolidations and acquisitions of control. As can be seen, the internal proprietary arrangements of owners are relatively free from scrutiny by the ICC. To the extent that the State interest in pipelines are based on proprietary agreements between the State and the industry, and not, on their face, regulatory, the ICC review is limited. In view of the limited scope of action by the ICC, and the notable lack of action historically by the ICC, we believe that federal law does not govern the entire realm of pipeline regulation. The State, with its strong interest in the Alyeska pipeline, may thus regulate on its own and such regulation, if carefully prepared, would not be pre-empted by federal authority.

Even if we assume that the State were challenged because the matter of federal pre-emption was held to be unclear, the courts are required to balance the interest of the State and of the federal government in the specific regulatory program. Since the State of Alaska's interest in this case is so overwhelming, Alaska has a much stronger argument than any other state for allowing it to impose effective regulations to protect the State's oil value. Lastly, even if pre-emption were allowed, the findings of a State regulatory body would have a strong effect as an advisory opinion to the federal body.

The means for implementing such State regulation will be discussed later. I should like to point out in connection now, however, that the whole complex matter of regulation vanishes with State ownership of the pipeline. With ownership, the State itself will be establishing tariffs, instead of being plunged into a maze of corporate accounting procedures from which it hopes to exit with a knowledge of whether tariffs are "reasonable". Pipeline ownership is a most effective means of assuring that transportation costs stay low, and the well-head value of our oil remains high. Ownership simply and directly works to assure Alaskans that they will receive what is due them for oil that is taken out of the State forever.

TESTIMONY OF STATE OF ALASKA
Trans-Alaska Pipeline Cost Estimates
March 6, 1972

My name is Bruce A. Campbell. I am Commissioner of Highways for the State of Alaska.

The single most important economic factor in any analysis concerning the ultimate impact of a trans-Alaska pipeline upon the State of Alaska is the initial capital cost of the line and its appurtenances. This factor is the prime variable in determining the yearly amortization cost and in determining the dividend which the owners may receive by virtue of the line's operation.

As many of you recall, the initial publicity concerning the pipeline estimated the cost of the project at approximately one billion dollars. In the ensuing three years there has been a variety of every-increasing estimates by owner companies and by Alyeska Pipeline Service Company ranging upward to the $3.0 billion cost estimated by Alyeska in December of 1971. In looking for the true return to the citizens of the State of Alaska, it became immediately apparent that a reasonably accurate initial cost figure must be determined before any meaningful analysis could be performed.

In addition t State in-house capabilities, we engaged the consultant engineering firm of Tippe, ts-Abbett-McCarthy & Stratton to aid us in the determination of the probably cos . We also met with Alyeska Pipeline Service Company in December 1971 and learned something of their cost analysis. We were not, however, allowed access to the basic cost data so that a comprehensive analysis could be made.

Before making our cost estimates, we reviewed the basic designs of all the components of the pipeline. We especially reviewed such crucial items as total through put capacity of the line, handling and dock facilities at Valdez, and proposed construction techniques in highly unstable permafrost areas. We are convinced that this line is now probably one of the most thoroughly engineered projects of its type ever proposed.

The line is proposed to be constructed in basically three phases. The first would be for a 600,000 barrel per day capacity, the second a 1,200,000 barrel per day capacity, and the last a 2,000,000 barrel per day capacity. The second two phases will require primarily the addition of pumping horsepower and tankage.

If you will review the handout given to you, you will find a breakdown of the costs of construction of the various major features of the project as we have estimated them.

Our total estimated cost of the project, based on 1972 dollar value, is 3.5 billion dollars, of which 2.9 billion dollars will be required for the initial phase, 249 million dollars for the second phase, and 314 million dollars for the third phase.

These costs are based on 1972 construction costs and do not contain any estimate for inflation. The costs that we have determined have been compared to the total cost of initial construction as prepared by Alyeska and compare reasonably well with their December 1971 projected cost of 3.0 billion dollars. Any inflation

which may take place and any increase in construction costs may modify these costs in future years. Concurrent with these cost studies we estimated what the operation and maintenance costs of the line would be and have shown these in the handout. These range from $22 million in the first year to $65 million at full throughput.

In order to evaluate the probable well-head price of the North Slope oil we, thru our engineers, investigated the probable refinery gate price of crude oil in the Los Angeles area. We have forecast the price variation of crude during the study period. Our estimated price ranges from $3.45 to $4.85 in the year 2000.

Tanker transportation costs were likewise studied and evaluated for the future years so that their eventual effect upon well-head price could be determined. The tanker costs were estimated at $.45 in 1977 and range to $.67 in 1988.

We believe that the cost items used in our analysis are as accurate as can be determined at this time and give us a firm basis for projecting economic impact on the State of Alaska.

Commissioner Eric Wohlforth will now discuss the revenue aspects of the proposals before you.

Testimony of Eric E. Wohlforth
Commissioner of Revenue

March 6, 1972

I am Eric Wohlforth, Commissioner of Revenue. I will summarize past projections of North Slope revenues and those presented today based on private ownership, and contrast the revenue effect of private ownership case with the case of a pipeline owned by the State.

The most recent public North Slope oil revenue projections, before those referred to the Governor last week, were made by the Division of Oil and Gas in cooperation with the Department of Revenue as part of the State's contribution to the federal pipeline Impact Statement released by Governor Egan on July 30, 1971. These projections were developed from a computer model which was based on the information then available to the State and showed numerous economic cases on differing assumptions again based on facts then assumed to be ascertainable.

The July 30 report states on page 166 that, "the originally estimated $900 million cost of the pipeline has already increased considerably. Present cost estimates range from about $1.0 to $2.3 billion." The revenue projections used the assumption of $1 billion as the lowest installed cost and $2.5 billion

as the highest estimate. The footnote to this statement gives the backup for the State's cost estimates. It notes that as late as June 19, 1971 Alyeska furnished the State Department of Revenue an estimate of $969 million as the cost of the entire contract and concludes with reference to a statement from Interior Secretary Rogers C. B. Morton in late spring of 1971 that environmental precautions are contributing to a higher price tag of around $2.3 billion. This figure of $2.3 billion total cost was used in the State's "most likely" estimate of North Slope revenues. The revenue estimates included in the State's Report developed from this estimate of total cost, assumed refinery values in fiscal year 1976, the then estimated start up year, of $3.37, marine transportation costs of 44 cents, a pipeline tariff initially of 80 cents per barrel, giving a wellhead value of $2.12. From these figures it was estimated that total royalties and taxes would amount to $164 million a year in fiscal year 1976, the first year of pipeline operation. In the second year of operation, fiscal 1977, total revenue was estimated at $278 million, the third year $282 million, and the fourth year $311 million. In the then estimated fifth year of production, fiscal 1980, the pipeline tariff was calculated at 47 cents a barrel with the marine transportation costing 52 cents leaving a wellhead value of $2.56. In that year we showed a total of $348 million in total royalties and severance taxes from the pipeline.

Other estimates were also run with different assumptions. For example, one set the pipeline cost at $1 billion with again the initial production year assumed in fiscal 1976. A wellhead value of $2.75, with lower marine transportation and tariffs produced $212 million in revenues in the first year of production and the fifth year of production on this optimistic projection the State was assumed to capture $412 million in oil pipeline revenues. A pessimistic case which assumed a pipeline cost of $2.5 billion shows a wellhead value of $1.76 in the initial year of 1976 and royalties and taxes of $136 million in that year. In 1980, however, at a wellhead value of $2.20 per barrel, royalties and severance taxes reached a figure of $297 million. Incidently, in all of these cases, one of the main reasons wellhead value increases over the years is that transportation costs go down as the volume of oil shipped increases.

Several important events have now come to light which have required the State to revise downwards drastically its revenue estimates. The first indication of the fact that the State was incorrect in assuming as it did in the Impact Statement that a production flow starting at 600,000 barrels per day would reach 1.7 million barrels per day in the second year of production was disclosed in the summary project description of the trans-Alaska pipeline system received by the State this fall. On page 55 of that document it is stated that

the pipeline system will be brought to its full capacity in stages. In the initial phase of operation the system will have the ability to transport 600,000 barrels per day. The report goes on to state that the second phase is tentatively scheduled to be completed approximately two years after initial start up. In this phase the system will have a design capacity of 1,200,000 barrels per day. The final phase is expected to be completed approximately seven years after initial start up at which time the pipeline will reach its ultimate capacity of 2,000,000 barrels per day according to the project description. In other words, there will be at least 500,000 barrels per day less production in the second year of operation and every year thereafter for the initial seven years.

The next shock to the State was disclosed by the SEC Registration Statement filed by British Petroleum Co., Ltd., on October 12, 1971. In the offering circular accompanying the registration statement the following statement is made at page 24:

> ... "The initial construction phase of the pipeline is expected to provide a minimum aggregate throughput capacity upon completion of 600,000 barrels per day. This capacity is designed to be expanded in two stages, the first stage resulting in a total capacity of 1,200,000 barrels per day, and the second in a total capacity of 2,000,000 barrels

per day. It is presently estimated that the cost of the pipeline upon completion to the 600,000 barrels per day capacity would be approximately $2.3 billion, and that increasing the capacity to 2,000,000 barrels per day would increase the cost by approximately $400 million." (Emphasis added.)

On November 10, 1971, Atlantic Richfield filed a Registration Statement with the SEC stating that:

... "The cost of the system upon completion to the 600,000 barrel per day capacity is presently estimated to be approximately $2.4 billion, of which the Company will be responsible for approximately $675 million. The additional cost to all participants of increasing the capacity to 2,000,000 barrels per day is estimated to be at least $400 million." (Emphasis added.)

Thus, by mid November, the total pipeline cost had escalated to $2.8 billion or $500 million over the average case assumed in July when the State made its revenue estimates. In fact it increased $100 million in less than one month

between SEC filings. This dramatic increase in pipeline costs revealed in official documents at the time of Governor Egan's first announcement on State ownership made it urgently necessary that the State finally determine the likely magnitude of pipeline costs. Commissioner Campbell has already indicated the independent study which the State has made through its consulting engineers, Tibbets, Abbott, McCarthy and Stratton, and the foundation for the present estimate of $3.5 billion. These figures have just recently been developed along with an independent evaluation of operating costs so that for the first time the State can make a reasonable projection of the probable amount it can expect to capture from North Slope oil revenues.

The base case shown to you today in graphic form assumes the total pipeline cost of $3.5 billion financed 90% by debt at an interest rate of 8%. It conforms to the Alyeska throughput assumptions of full production only in the seventh year of pipeline operation. It shows the same ICC permitted rate of return as shown in the State's projection in July. In the fourth year from the beginning of construction and the first year of production, or 1977, we now show a negative wellhead or no State oil revenues. This was the year comparable to that in which it was earlier shown that the State would capture at least $164 million in revenues. The fifth year, 1978 the second assumed year of operation,

we earlier estimated $278 million in State revenues. In those two years alone the net revenue loss to the State over earlier estimates amounts to $442 million. By the sixth year or 1979 the new projection shows $84.6 million in oil severance and royalty revenues. Earlier we estimated $282 million for that year. The net loss by that year over earlier estimates is $640 million. Not until the 15th year of the pipeline operation do royalties and severance taxes amount to near the amount shown to our previously calculated second year. In the 15th year we show severance and royalty revenues of $277 million.

The question may be asked whether this is most pessimistic of cases which can be produced. The answer is clearly no for three reasons. In the first place the revenue loss figure mentioned above gives no effect to our expectation now of first pipeline operation in the year 1977, whereas in July we estimated a full year of revenues starting on July 1, 1975.

In the second place we show State taxes in each year of operation of approximately $33 million. For the first three years of operation State income taxes are estimated to total approximately $100 million or $33 million a year. This assumes the full State income tax rate on pipeline profits. Experts have indicated that this may not be a realistic assumption. Even, however, with the most optimistic income tax estimate net revenue loss from earlier projections amounts to $540 million during the critical first three years of operation.

Thirdly, calculation of the 7% permitted rate of return on valuation may err on the low side. The leading text on the subject "Petroleum Pipelines and Public Policy" by Arthur Johnson cites numerous instances of the slowness of the ICC to actually evaluate pipeline costs and its heavy reliance on industry figures. The Cook Inlet pipeline valuation itself took three years to complete.

The 7% figure is not high also when it is remembered there are seven separate proposed pipeline owners, each of which may aggregate earnings of other pipelines when the 7% rate is considered. It is entirely possible that higher return rates may be permitted until the valuation of the line is complete and even thereafter when earnings of other pipeline companies are aggregated to arrive at a total rate of return.

The next case presented shows the possible economic effect of State ownership of the pipeline. Financing is assumed in the amount of $1 billion in each of the first two years of construction at 8%, $900,000,000 in the third year of construction at 6-1/2%, $250,000,000 at 8% in the first year of operation, and $310,000,000 in the second year of operation. This case also assumes the same ICC permitted rate of dividend payout as assumed for the private case, namely, 7% which is a cash dividend payout limitation in each year of the projection. In arriving at the State's net cash flow, operating expenses, amortization, and interest on bonds are deducted from the gross income. During the

first year of operation net cash flow to the State through its tariff on the pipeline is $230 million and royalty and severance taxes of $15.7 million for a total of $245 million. Obviously, in State ownership no federal or state income taxes are calculated on pipeline income. In the fifth year from beginning of construction or the second year of operation net cash flow is $228 million which together with royalty and severance taxes of $17 million produce a total of $245 million. In the sixth year from the beginning of construction and the third year of operation net cash flow amounts to $227 million through the tariff and total royalties and severance taxes amount to $123 for a total of $350 million. In the 15th year cash flow is reduced to $183 million by reason of the fact that the pipeline has depreciated but total royalties and severance taxes amount to $297 million for a total to the State treasury of $480 million.

It is emphasized that this case makes almost identical assumptions to that for the private case described above. It should be emphasized that the net income shown to the State is computed after debt service on State bonds. To avoid a speculative argument on the possible differential between interest rates on the State's debt which may be tax exempt versus taxable interest on the private borrowing we show all but $900,000,000 in State bonds at the same 8% rate. The main differences, of course, lie in the fact that the State is not subject to federal income tax and will receive no state income tax from pipeline operations

since it is the owner. The timing of the bond issues for both private and public ownership is the same although the term of the public bond issue is shorter indicating heavier debt service loads and the State of course is financing the pipeline 100% on a debt basis.

Numerous additional assumptions can be made on the question of the manner of public financing, the rate of return permitted either to the State or to private pipeline owners, interest rates payable by the State and private owners, the effective tax rate in private ownership, to mention only a few. We know that estimating the effect of economic projects based on events three to seven years away must rest on assumptions which are to a degree speculative. You will hear testimony that our assumptions are incorrect. The point is that no one can say with positive certainty what our revenue picture will be with the pipeline in private ownership. We have, however, tested prior assumptions based on official information now before us. This effort has convinced the administration that it must do what it can now to remove the uncertainty of the revenue picture in the late 1970's and in the 1980's. Mr. Eppenbach will explain how our projections were made and some of the detail on the charts before you.

Testimony of Lawrence Eppenbach
State Investment Officer

March 6, 1972

Mr. Chairman, Committee Members. In testimony already presented you have heard a great deal about revenues, costs of pipelines, calculations of royalties and severance taxes and permitted dividends. Rather than to add more numbers, more formulas, more calculations, I think it would be prudent now to pause and develop perspective on the numbers already given to you and about the many charts. To do this, I should like to talk first about how the State brought all of its pipeline information together to calculate what is really the most important piece of information thus far and that is an estimate of total revenue from the North Slope.

We employed a computer model which simulated each year, economic operation of the pipeline under varying conditions regarding ownership, financing, taxes, and earnings limitations. In a sense, an income statement was prepared each year for the owner of the line. This income statement does not appear so very different, at least in terms of its expressions, from that of any other income statement. Gross revenues to the pipeline are derived from its tariff charge on barrels of oil transported through the line. That gross revenue less the cost of operating and maintaining the line, less depreciation, and less interest costs for financing

the line, will produce a net income figure. From that we deducted any federal or state income taxes paid to yield a net after taxes income.

Similarly, the cash flow to a pipeline company is much like that of any other business. The net after tax income plus any additional cash flows which may be generated because the depreciation charge that is provided for in the income statement happens to be greater than the bond retirement actually made by the company. The only place that pipeline operation appears different, economically, to that of the ordinary company, is in the dividend payout allowed each year by the pipeline company to its owners.

That dividend is not some percentage of equity or some rate of return of capital investment, it is a percentage dividend allowed on the valuation of the pipeline as determined by the ICC. The ICC valuation approach takes into account many issues: original cost of the line, depreciation, percentage increases for going concern value, and additional percentage increases for inflation. Our computer model had to also simulate this ICC valuation. In general terms, during the first year of operation ICC valuation was about $3-1/4 billion. In the following years it increases slightly as additional phases of operation were under way providing for higher throughput and then decreased in value as the line began to depreciate.

The dividend limitation on ICC valuation is a critical variable in the

economics of pipeline ownership. Our model, given a dividend rate calculated back up the income statement to find out what kind of tariff would have to be placed upon the pipeline in any year to provide gross revenue required to generate the appropriate cash flow for the dividend. During the first year of operation of the trans-Alaska pipeline, the 7% dividend limitation provides for a dividend to the parent company of over $230 million, a legal dividend provided only to the owner of the pipeline.

If I may turn your attention now to the large chart: it is that very dividend that accounts for the vast difference between estimated income to the State of Alaska under conditions of public ownership on the top line, versus conditions of private ownership, the bottom line. You will note that both lines slope upward as the throughput of oil through the line increases, clearly shown as a step increase between operation of the line in phase one, a capacity of 600,000 barrels a day up to phase 2, a design capacity of 1,200,000 barrels per day. But the graph does not display all of the information which is in the tables alongside of it.

First, in public ownership, the major part of revenue during the early years is derived from dividends with positive and growing amounts of revenue coming from wellhead value royalty and production taxation. You will note that there are no state income taxes included here as a revenue source to the State

under conditions of public ownership.

Under conditions of private ownership, a very different case develops. Here in the initial year a total of about $37 million should accrue to the State. Where does it come from? $3.2 million of it only comes from the North Slope in the form of gas royalty and production tax payments. This is gas that is assumed to be shipped in a trans-Canadian gas pipeline. The remaining $34 million comes from state income taxes. In the 7% dividend case displayed here there is no positive wellhead value for oil during the first two years of operation under private ownership. In this case, for there to begin to be some positive wellhead for oil during the first two years, the dividend payments must be no greater than 4.75% and even if the dividend were lowered to zero the State's income from royalty and severance tax of approximately $53 million would be less than one third of that estimated as recently as last year.

I shall present at the close of the testimony this afternoon a series of cases for the committee to study that explore this question of taxation and dividend limitation. For the present, however, let us return to these two cases that we have displayed before you. Again, they provide a legal 7% ICC dividend. In the private case even though a negative wellhead value is indicated for the first two years it is quite possible that the oil companies would still pump oil

as their true cost of shipping their own oil through their own pipeline may be different than their calculated cost of shipping the State's oil through their own pipeline. Not only is the dividend permitted legal, but together with the costs and throughput capacity limitations as stated in the Impact Statement, this case of private ownership of the line appears quite possible. So are the revenues it generates. Speaking next to the very important question of what these revenues will mean to the State will be the Commissioner of Administration, Joseph Henri.

STATE OF ALASKA

EXHIBITS TO

SUPPORT TESTIMONY

GIVEN BEFORE

SENATE COMMERCE COMMITTEE

AND

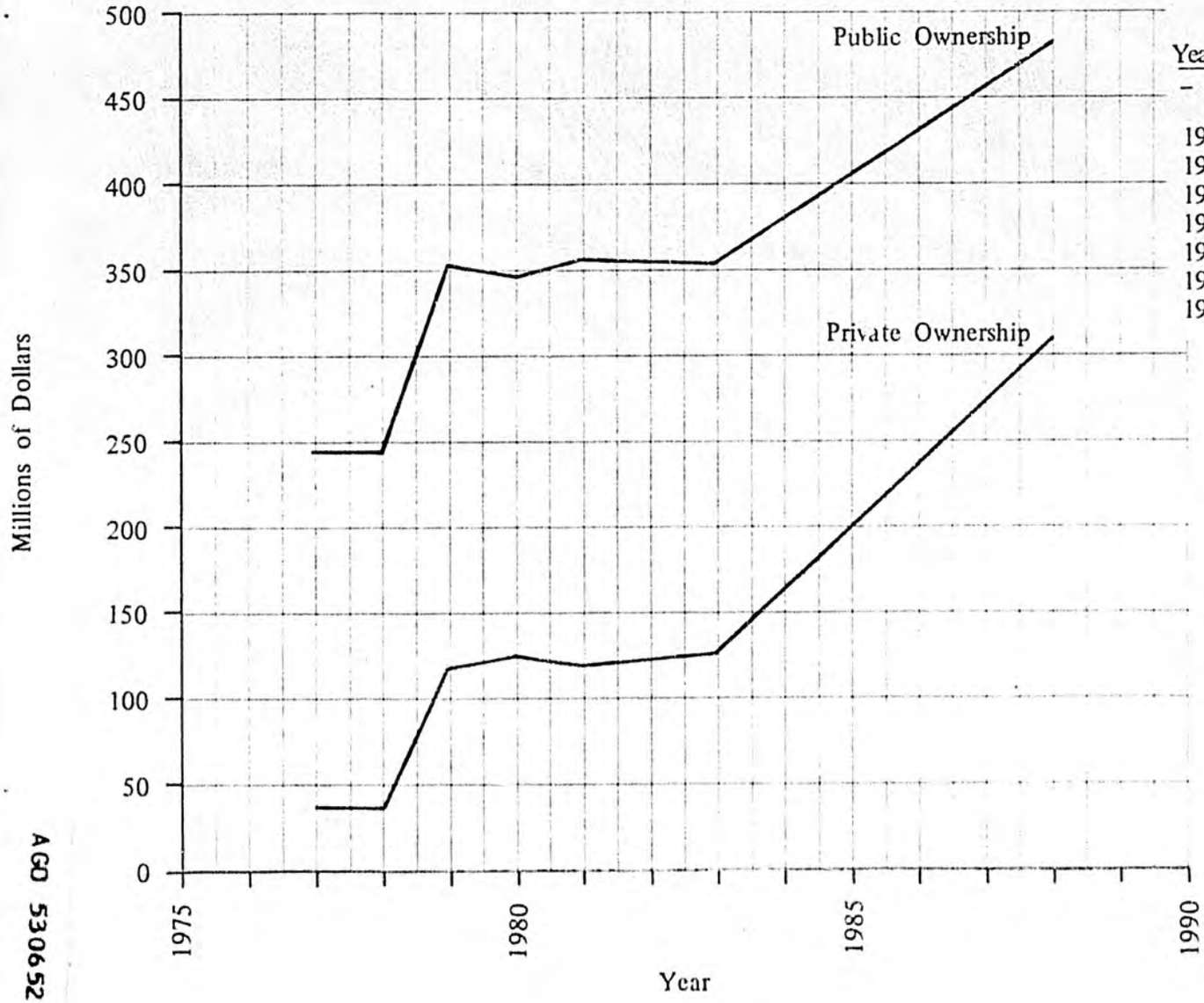
HOUSE STATE AFFAIRS COMMITTEE

CONCERNING REGULATION AND

OWNERSHIP OF THE TRANS-ALASKA PIPELINE

MARCH 6, 1972

ESTIMATED INCOME TO STATE



Assuming Public Ownership

Year	Pipeline Income	Royalty & Production Payments	Total
	(Millions of Dollars)		
1977	$230.86	$ 15.70	$246.56
1978	228.00	17.28	245.28
1979	227.47	123.47	350.94
1980	224.60	122.26	346.86
1981	243.56	123.35	355.91
1983	234.69	117.53	352.22
1988	183.00	297.92	480.92

Assuming Private Ownership

Year	State Taxes	Royalty & Production Payments	Total
	(Millions of Dollars)		
1977	$33.73	$ 3.22	$ 36.95
1978	33.62	3.22	36.84
1979	34.01	84.66	118.67
1980	91.82	33.97	125.79
1981	82.91	37.05	119.96
1983	36.67	89.48	126.15
1988	30.98	277.15	308.11

ESTIMATED CAPITOL INVESTMENTS

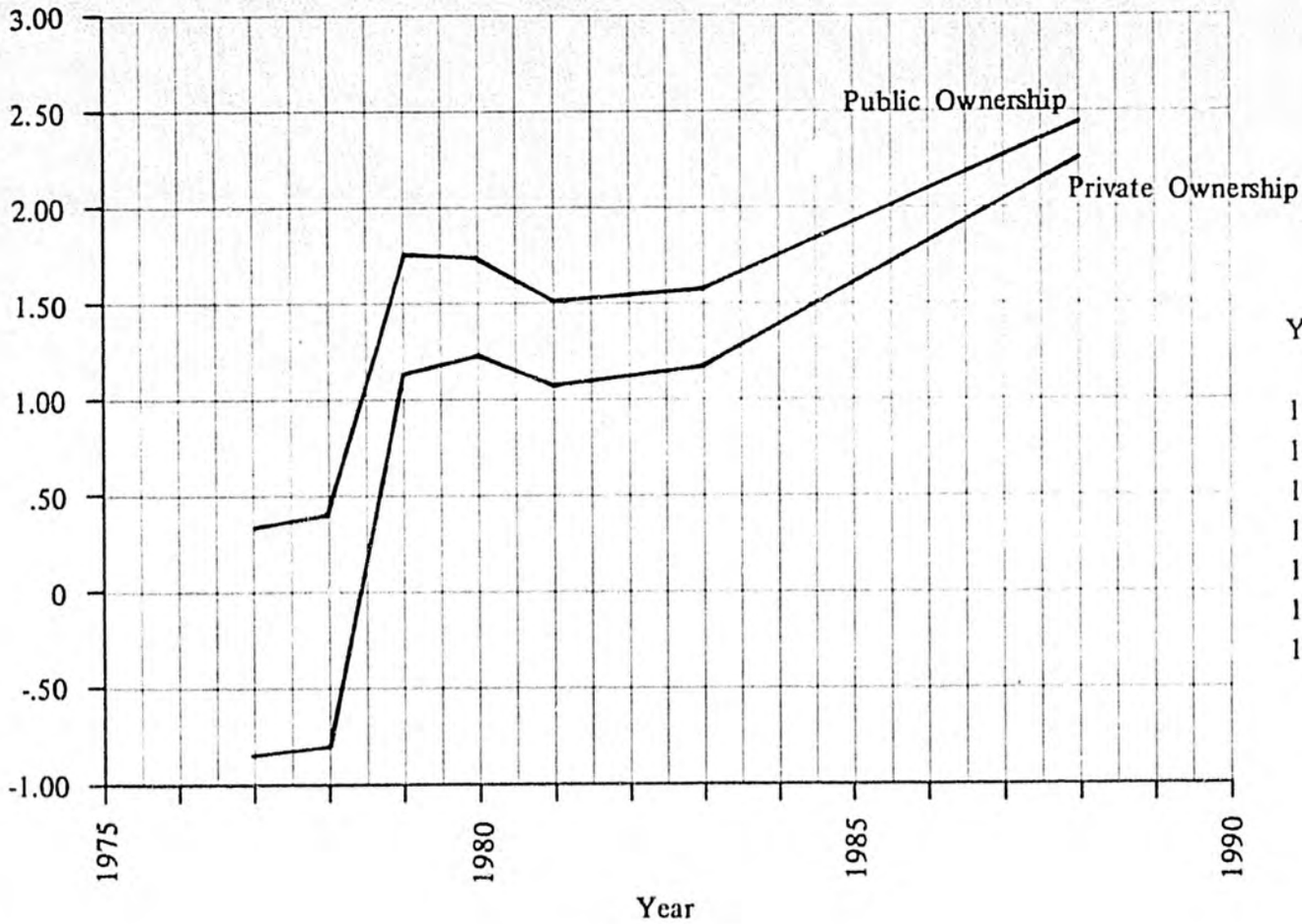
January 1972 prices

(Million of Dollars)

	PHASE I			PHASE II		PHASE III		Totals
	Before start of Construction	Construction	Supervision & Admin.	Construction	Supervision & Admin.	Construction	Supervision & Admin.	
Pipeline and stations	144.50	1,935,22	130.12	106.35	6.85	197.57	9.97	2,530.58
Valdez		219.04	13.57	130.75	5.00	101.84	5.00	475.20
Communications		25.08						25.08
Sub-total	144.50	2,179.34	143.69	237.10	11.85	299.41	14.97	3,030.86
Design Engineering	273.70							273.70
Sub-total	418.20	2,179.34	143.69	237.10	11.85	299.41	14.97	3,304.56
Roads and Airfields		133.00	6.15					139.15
Yukon Bridge		8.50	.41					8.91
Total	418.20	2,320.84	150.25	237.10	11.85	299.41	14.97	3,452.62
			2,320.84		237.10		299.97	3,452.62
			418.20					
GRAND TOTAL			2,880.29		248.95		314.38	3,452.62

AGO 530653

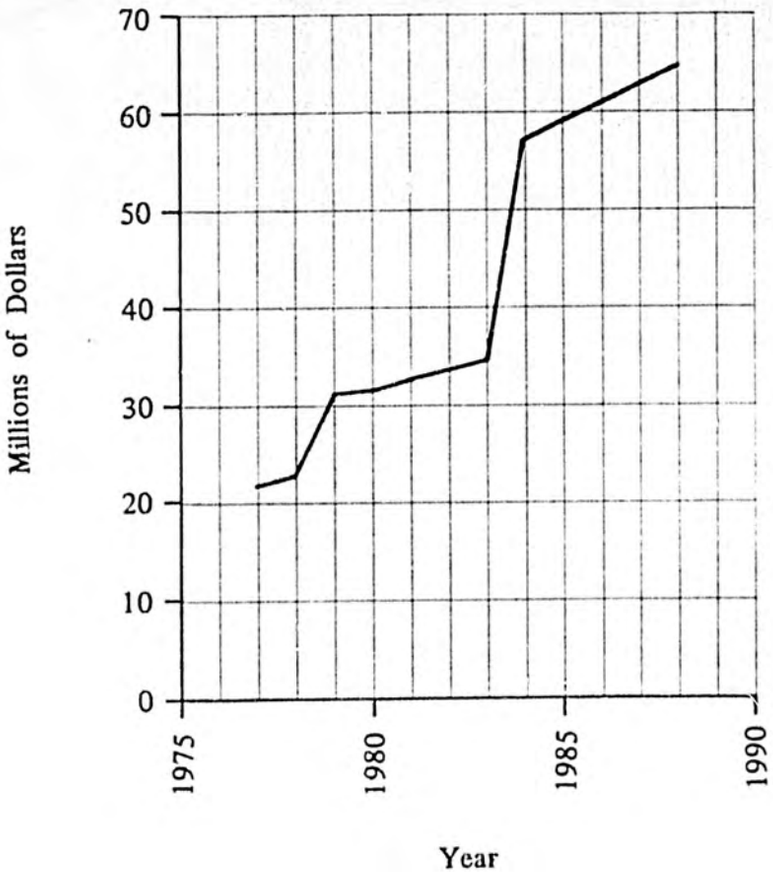
Estimated Wellhead Price



Year	Public Ownership	Private Ownership
1977	$0.36	$-0.84
1978	0.40	-0.80
1979	1.67	+1.12
1980	1.65	1.22
1981	1.51	1.09
1983	1.58	1.18
1988	2.45	2.27

AGD 530654

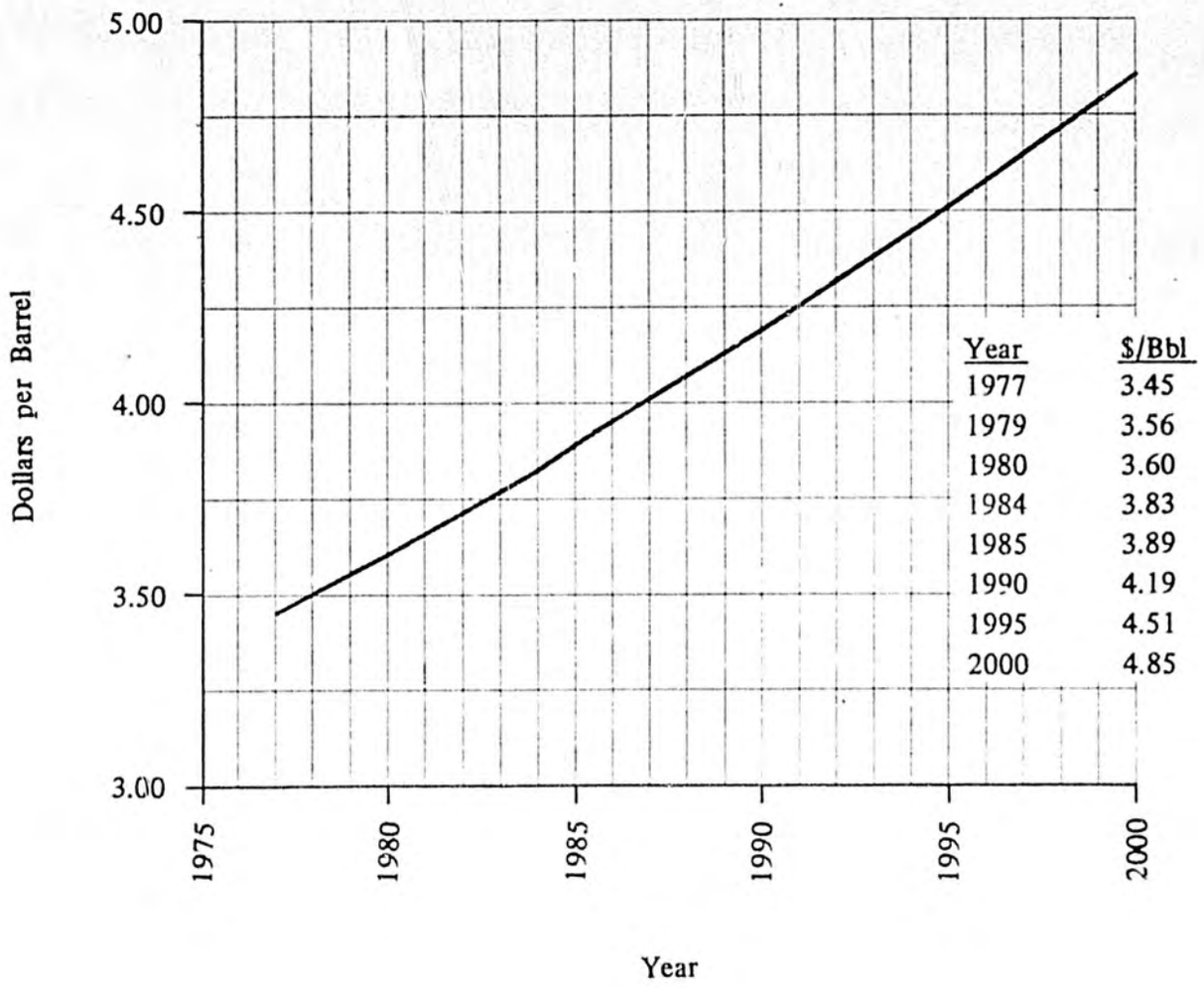
Estimated Operating and Maintenance Cost
Public Ownership



Year	Operating and Maintenance Cost
1977	$21.99
1978	22.65
1979	30.89
1980	31.82
1981	32.77
1983	34.77
1984	57.42
1988	64.99

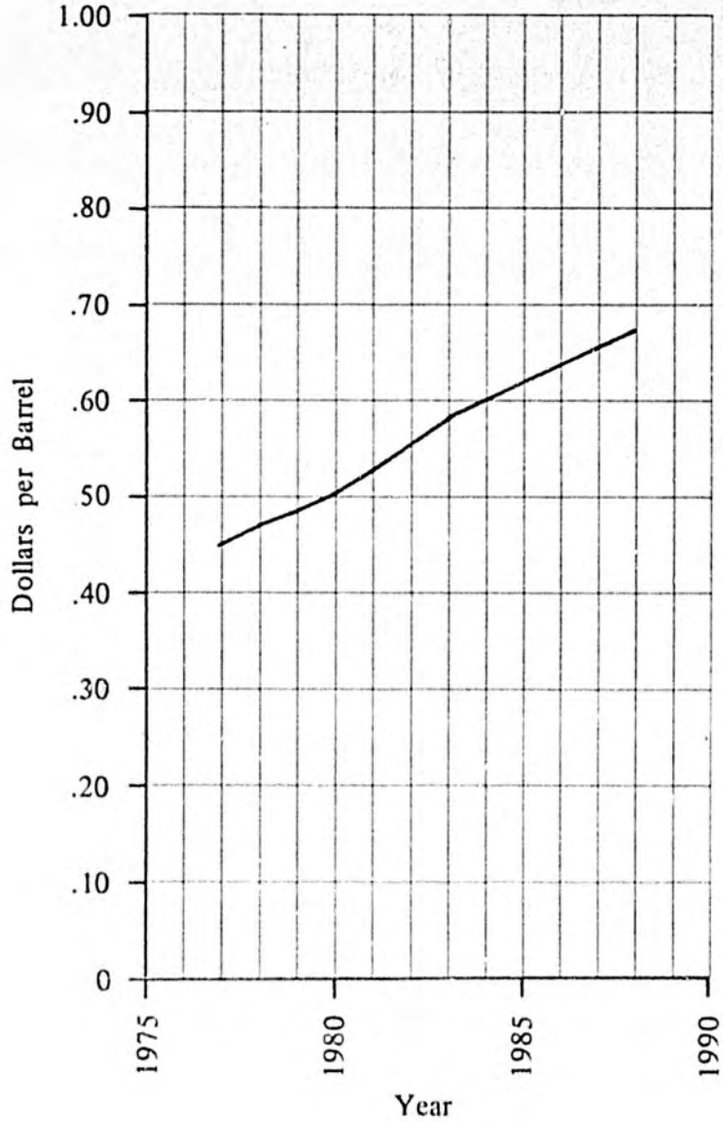
AGO 530655

Estimated Refinery Gate Price of Crude
Los Angeles Area



AGO 530556

Estimated Tanker Transportation Cost
Valdez to Los Angeles



Year	$/Bbl
1977	.455
1978	.472
1979	.484
1980	.503
1981	.526
1983	.580
1988	.670

AGO 530657

ANALYSIS OF STATE INCOME

OF VARIOUS CONDITIONS OF

PIPELINE OWNERSHIP & OPERATION

STATE OF ALASKA

MARCH 6, 1972

The attached charts display the total income to the State under various conditions of pipeline ownership and operation. In every case total revenue to the State is the appropriate combination of dividends from pipeline ownership, state tax on pipeline income, and the total of oil and gas royalty and production tax payments.

Method of Analysis:

The major portion of the analysis was performed by an economic computer model developed to simulate pipeline operation each year under a variety of conditions. Under varying assumptions regarding ownership, debt structure, taxes and earnings limitations the computer model forecasts pipeline net revenues, cash flows, tariffs and wellhead values.

Description of key variables:

Variables held constant:

1. Total cost - equal to $3.5 billion. This total cost reflects the full expenditure for engineering construction and overhead for the pipeline and terminal through all phases of construction.

2. Oil throughput - calculated at a rate consistent with the capacity limitations as stated in the Pipeline Impact Statement. The design capacity of the line for the first two years will be 600,000 barrels a day, for the next five years 1,200,000 barrels a day, and after seven years of operation would increase to 2,000,000 barrels a day. In addition, an efficiency factor of 85% was applied against the design capacity of the line to provide an effective daily average of 510,000 barrels per day during the first two years, 1,020,000 barrels a day for the next five years, and 1,700,000 barrels a day thereafter.

3. Operating expenses - were calculated by independent consultants to the State for operation of the trans-Alaska pipeline. Each year's operating expense estimate fully reflects the cost of labor, maintenance, fuel, materials, supplies, contingency reserves, insurance, and the effect of an assumed 3% price level increase each year.

4. Depreciation - was calculated on the basis of a straight line depreciation over a 30 year life to a salvage value of 15%.

5. ICC Valuation - was simulated on the following basis: pipeline investment less ICC calculated depreciation plus 6% of that value for going concern value plus 4% of original investment value each year.

6. Wellhead price calculation for oil -

Wellhead price (oil) = Refinery price less tanker charges less pipeline tariff.

a. Refinery prices - the price of Alaska crude oil at a typical District 5 refinery in 1977 is calculated to be $3.45 rising approximately 5 cents each year thereafter.

b. Tanker charges - the charge paid to transport oil from Valdez to Los Angeles was calculated to be 45.5 cents per barrel in 1977 increasing to 52.6 cents by 1981 and 67.0 cents by 1988. The increase in tanker charges over this period of time was due to the estimated continuing increase in labor costs and purchase prices of tankers. These estimates were prepared for the State by Temple, Barker, Sloane, Inc. who used a computer model in their analysis.

c. Pipeline tariffs - as calculated.

7. Wellhead price calculation for gas - The price of gas at the wellhead was assumed to be 20 cents/MCF during the first year of production in 1977 and increases one cent every five years thereafter.

8. Effective royalty and severance tax rates - The royalty payments for both oil and gas were calculated at 12.5% of wellhead value. The severance tax rate for oil was assumed to be 7.2% for pipeline oil volumes less than 1.7 million barrels per day and 6.751% for 1.7 million or more barrels per day.

Wells with lower individual production rates are expected to contribute a significant share of oil during phase III operation of the pipeline. Because the severance tax rate varies with the volume of production at each well, a lower average tax rate of 6.751% was calculated to represent the effective average rate.

Variables:

1. Dividend limitation - The 1941 Consent Decree held that the dividend paid by the consolidated subsidiary pipeline company to its parent company must not exceed 7% of the valuation of the pipeline. The dividend is composed of net income after tax payments plus additional cash flow from any excess of depreciation charges greater than bond amortization payments. The dividend percentages calculated were 4%, 5-1/2%, and 7%.

2. Financing of pipeline:

a. Private Ownership - In the case of private ownership of the pipeline 90% of the cost of the pipeline was assumed to be financed by bonds of 30 year term with an 8% interest rate and semi-annual interest payments. The level debt service costs of five bond issues were calculated:

Issue 1 - $900 million for the first year of construction.
Issue 2 - $900 million during the second year of construction.
Issue 3 - $810 million during the third year of construction.
Issue 4 - $225 million during the first year of operation to finance phase two.
Issue 5 - $279 million during the fifth year of operation to finance phase three.

b. Public Ownership - In the case of public ownership of the line, 100% of the cost was assumed to be debt financed. All bonds are of 25 year average term with semi-annual interest payments:

Issue 1 - $1 billion for the first year of construction at 8% interest.
Issue 2 - $1 billion for the second year of construction at 8% interest.
Issue 3 - $900 million for the third year of construction at a tax exempt interest rate of 6-1/2%.
Issue 4 - $250 million at 8% during the first year of operation to finance phase two.
Issue 5 - $310 million at 8% during the fifth year of operation to finance phase three.

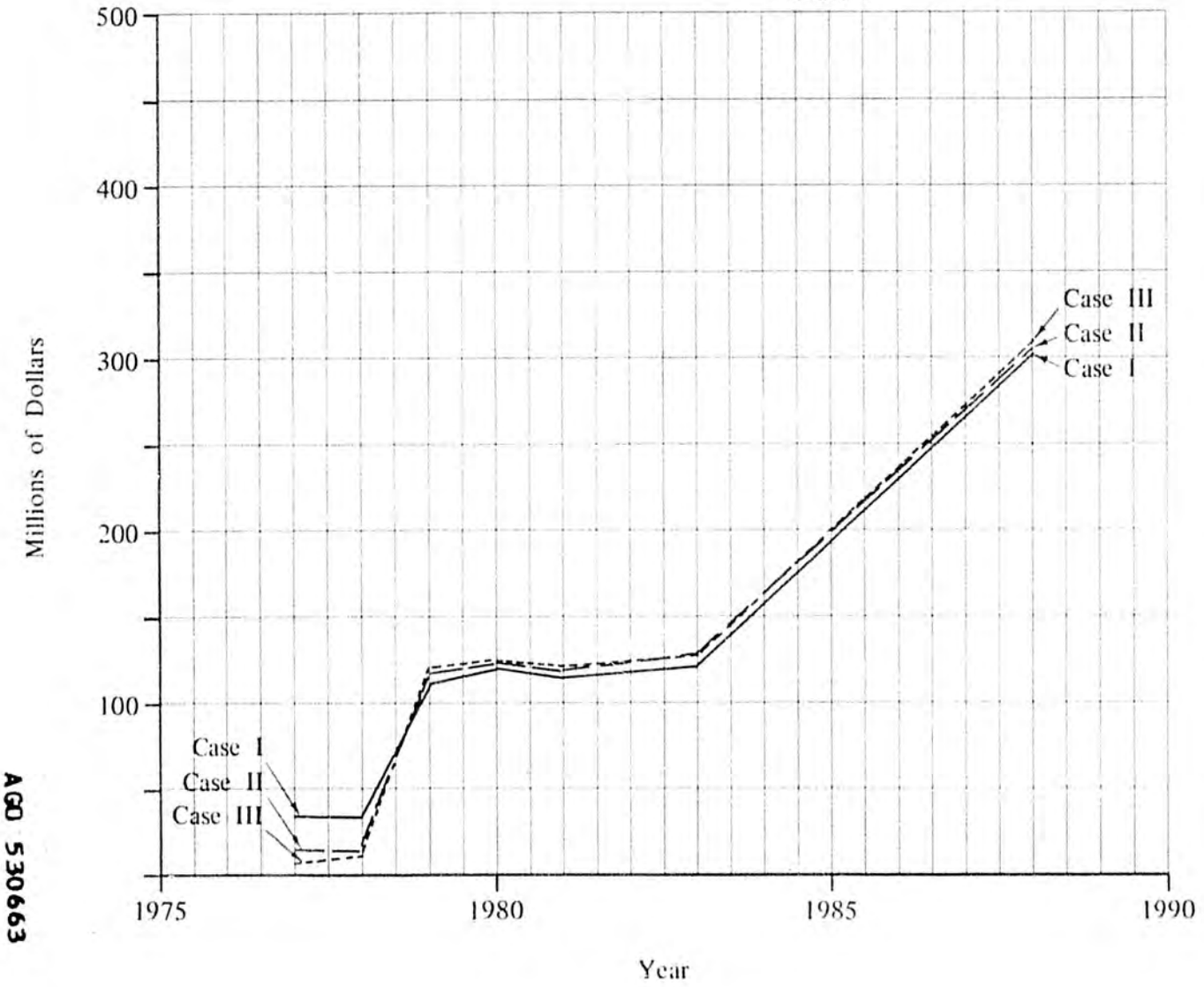
3. State and Federal tax on pipeline income:

Case 1. The full effective state income tax rate of 9.36% of net income and 43.51% of net income for federal income taxes.

Case 2. An overall tax rate of 30% with the same distribution between state and federal taxes as in Case 1. This calculates to be a state income tax rate of 5.31% of net income and federal tax rate of 24.69% of net income.

Case 3. That of no taxation with both state and federal taxes at a zero rate.

Estimated Income to State
Private Ownership
Chart I



Case I - Base Case
7% Dividend Full 9.36% Tax

Year	Pipeline Income	Royalty & Production Payments	Total
	(Millions of Dollars)		
1977	$33.73	$ 3.22	$ 36.95
1978	33.62	3.22	36.84
1979	34.01	84.66	118.67
1980	33.97	91.82	125.79
1981	37.05	82.91	119.96
1983	36.67	89.48	126.15
1988	30.98	277.13	308.11

Case II
7% Dividend, Industry Average Tax

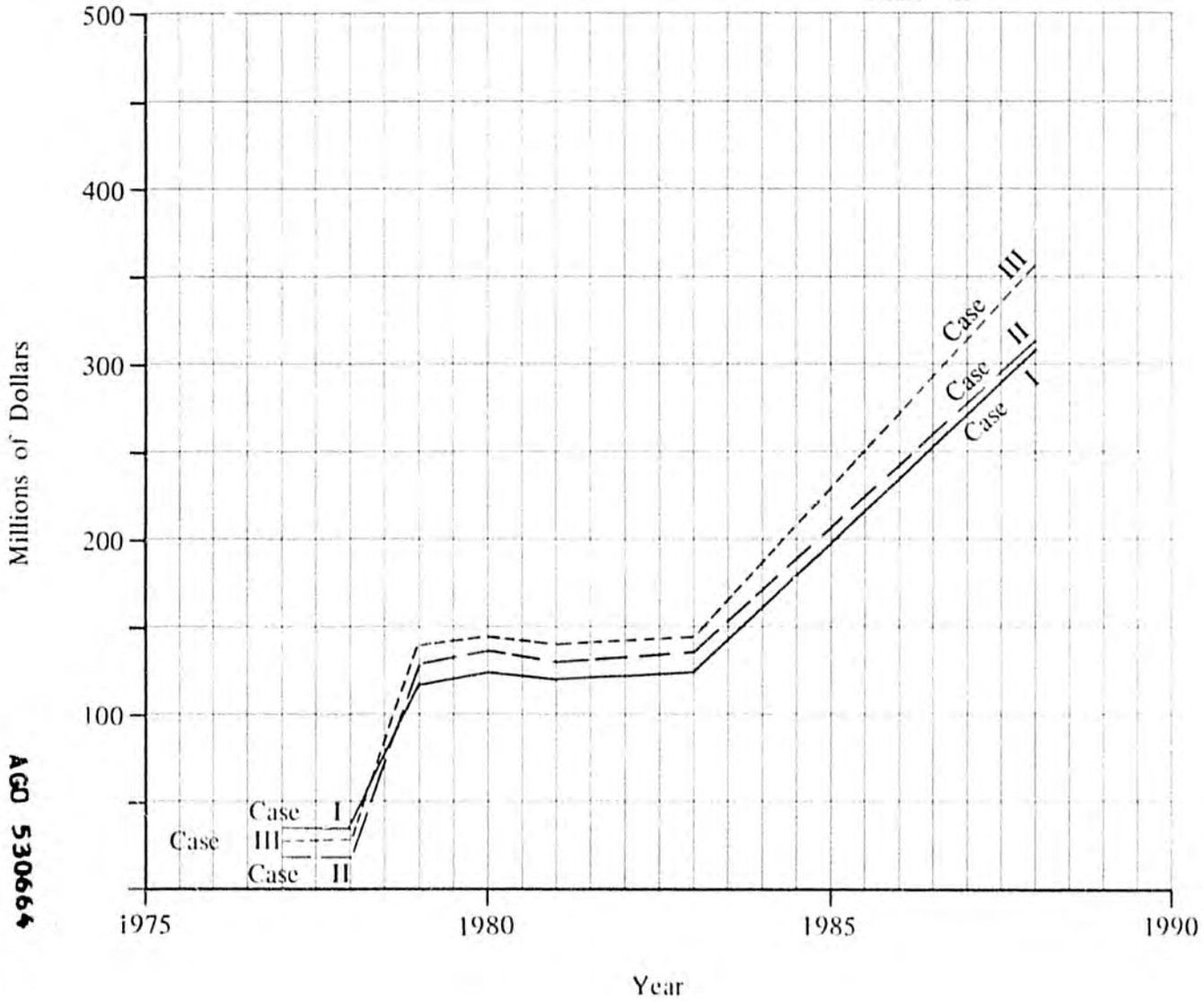
Year	Pipeline Income	Royalty & Production Payments	Total
	(Millions of Dollars)		
1977	$12.88	$ 3.22	$ 16.10
1978	12.84	3.22	16.06
1979	12.99	106.98	119.97
1980	12.98	114.12	127.10
1981	14.15	107.22	121.37
1983	14.01	113.54	127.55
1988	11.83	297.46	309.29

Case III
7% Dividend Zero Income Tax

Year	Pipeline Income	Royalty & Production Payments	Total
	(Millions of Dollars)		
1977	0	$ 9.68	$ 9.68
1978	0	10.96	10.96
1979	0	120.78	120.78
1980	0	127.90	127.90
1981	0	122.25	122.25
1983	0	128.42	128.42
1988	0	310.03	310.03

AGO 530663

Estimated Income to State
Private Ownership
Chart II



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Case I - Base Case
7% Dividend Full 9.36% State Tax

Year	Pipeline Income	Royalty & Production Payments	Total
	(Millions of Dollars)		
1977	$ 33.73	$ 3.22	$ 36.95
1978	33.62	3.22	36.84
1979	34.01	84.66	118.67
1980	33.97	91.82	125.79
1981	37.05	82.91	119.96
1983	36.67	89.48	126.15
1988	30.98	277.13	308.11

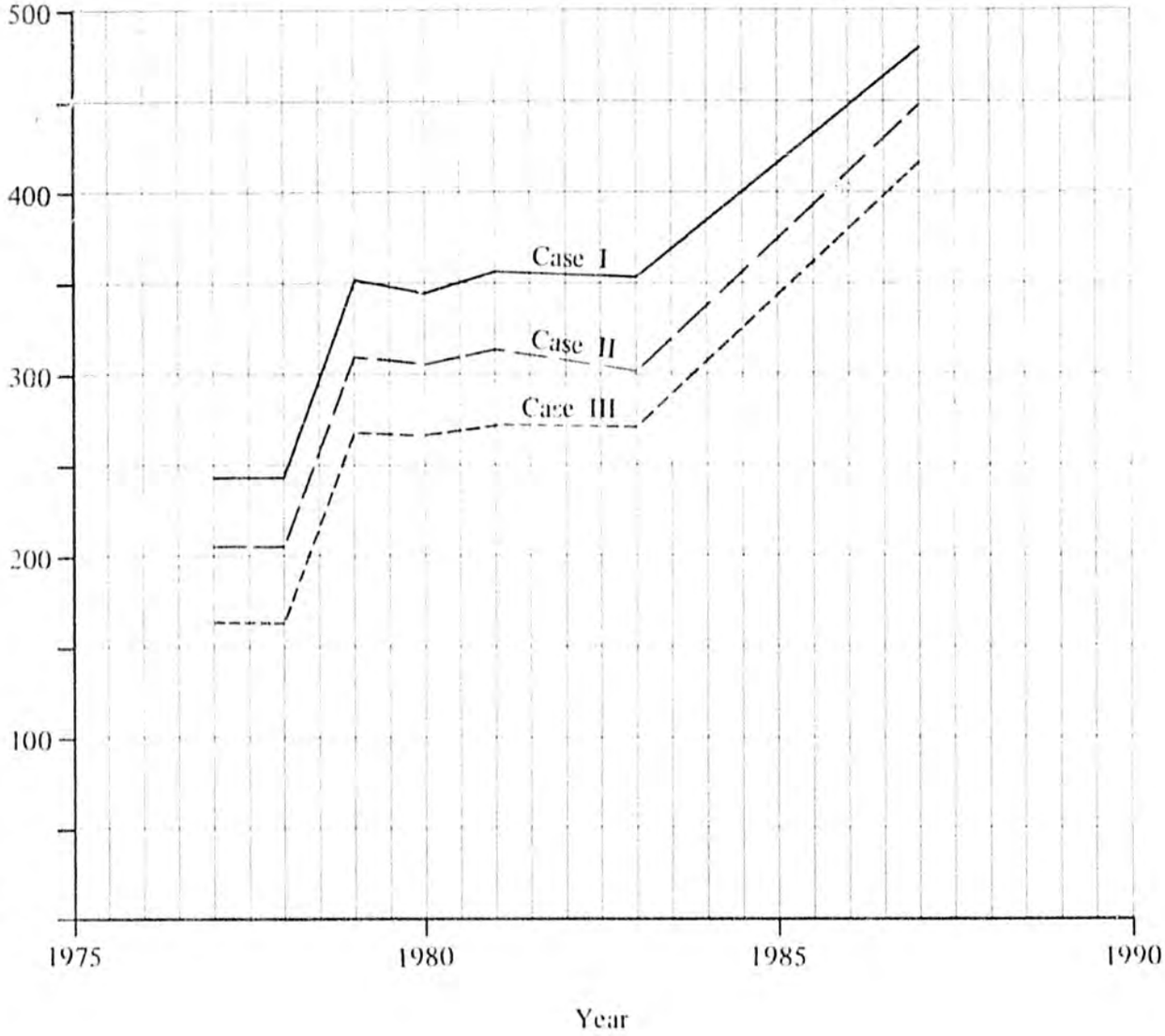
Case II
5.5% Dividend Industry Average Tax

Year	Pipeline Income	Royalty & Production Payments	Total
	(Millions of Dollars)		
1977	$ 9.13	$ 9.28	$ 18.41
1978	9.13	10.44	19.57
1979	9.29	120.07	129.36
1980	9.33	127.04	136.37
1981	10.19	121.23	131.42
1983	10.19	127.05	137.24
1988	8.86	307.99	316.85

Case III
-0- Dividend Zero Income Tax

Year	Pipeline Income	Royalty & Production Payments	Total
	(Millions of Dollars)		
1977	0	$ 28.28	$ 28.28
1978	0	29.33	29.33
1979	0	139.10	139.10
1980	0	145.99	145.99
1981	0	141.87	141.87
1983	0	147.33	147.33
1988	0	356.11	356.11

Estimated Income to State
Public Ownership
Chart III



AGO 530665

Case I - Base Case
7% Dividend

Year	Pipeline Income	Royalty & Production Payments	Total
	(Millions of Dollars)		
1977	$230.86	$ 15.70	$246.56
1978	228.00	17.28	245.28
1979	227.47	123.47	350.94
1980	224.60	122.26	346.86
1981	243.56	112.35	355.91
1983	234.69	117.53	352.22
1988	183.01	297.92	480.93

Case II
5.5% Dividend

Year	Pipeline Income	Royalty & Production Payments	Total
	(Millions of Dollars)		
1977	$181.39	$ 25.00	$206.39
1978	179.14	26.47	205.61
1979	178.72	132.64	311.36
1980	176.47	131.31	307.78
1981	191.37	122.16	313.53
1983	184.40	126.98	311.38
1988	143.79	305.29	449.08

Case III
4% Dividend

Year	Pipeline Income	Royalty & Production Payments	Total
	(Millions of Dollars)		
1977	$131.92	$ 34.30	$166.22
1978	130.28	35.65	165.93
1979	129.98	141.80	271.78
1980	128.34	140.36	268.70
1981	139.18	131.97	271.15
1983	134.11	136.44	270.55
1988	104.58	312.66	417.24

Private ownership, 15 year projection with .07 dividend, low throughput option, .10 equity, no income tax option and no Ad Valorem tax. Total cost is $3.5 billion at .08 for 30 years, two periods per year.

Year:	4	5	6	7	8	10	15
INCOME ($ millions)							
Gross Income	523.36	522.72	532.25	507.05	551.62	544.75	523.28
Operating Expenses	21.99	22.85	30.89	31.82	32.78	34.77	64.99
Depreciation	89.25	89.25	89.25	89.25	98.03	98.03	98.03
Interest on Bonds	242.28	241.80	240.87	214.91	234.27	227.30	204.26
Income before Taxes	169.84	189.27	171.24	171.06	186.54	184.64	156.00
State Income Tax	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Federal Income Tax	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Income after Taxes	169.84	169.27	171.24	171.06	186.54	184.64	156.00
ICC ROFV (%)	12.50	12.61	12.68	12.03	12.09	12.29	13.78
CASH FLOW ($ millions)							
Income after Taxes	169.84	169.27	171.24	171.06	186.54	184.64	156.00
Depreciation	89.25	89.25	89.25	89.25	98.03	98.03	98.03
Bond Amortization	28.22	30.53	33.02	35.71	41.02	47.99	71.03
Net Cash Flow	230.86	228.00	227.47	224.60	243.56	234.69	183.01
Tariff (cents)	281.15	280.84	142.96	136.19	148.17	146.32	84.33
Flow/Day	.51	.51	1.02	1.02	1.02	1.02	1.70
ROCF (%)	7.00	7.00	7.00	7.00	7.00	7.00	7.00
Pipeline Valuation ($ billions)	3.298	3.257	3.250	3.209	3.479	3.353	2.614
Wellhead Price ($)	.18	.22	1.63	1.74	1.65	1.74	2.56
($ millions)							
Wellhead Value (oil)	34.39	41.18	608.21	646.09	614.32	647.14	1586.37
Wellhead Value (gas)	20.10	20.10	40.21	40.21	42.22	42.22	73.72
Total Wellhead Value	54.48	61.28	648.42	686.30	656.53	689.36	1660.08
Total Royalty & Severance (oil)	6.47	7.74	114.34	121.46	115.49	121.66	298.24
Total Royalty & Severance (gas)	9.68	10.96	120.78	127.90	122.25	128.42	310.03

Private ownership, 15 year projection with .07 dividend, low throughput option, .10 equity, .30 income tax option and no Ad Valorem tax. Total cost is $3.5 billion at .08 for 30 years, two periods per year.

Year:	4	5	6	7	8	10	15
INCOME ($ millions)							
Gross Income	596.15	595.32	605.63	580.36	631.57	623.89	590.14
Operating Expenses	21.99	22.65	30.89	31.82	32.78	34.77	64.99
Depreciation	89.25	89.25	89.25	89.25	98.03	98.03	98.03
Interest on Bonds	242.28	241.60	240.87	214.91	234.27	227.30	204.26
Income before Taxes	242.63	241.82	244.62	244.38	266.49	263.78	222.86
State Income Tax	12.88	12.84	12.99	12.98	14.15	14.01	11.83
Federal Income Tax	59.90	59.70	60.40	60.33	65.79	65.12	55.02
Income after Taxes	169.84	169.28	171.24	171.07	186.54	184.65	156.01
ICC ROFV (%)	12.50	12.61	12.68	12.03	12.09	12.29	13.78
CASH FLOW ($ millions)							
Income after Taxes	169.84	169.28	171.24	171.07	186.54	184.65	156.01
Depreciation	89.25	89.25	89.25	89.25	98.03	98.03	98.03
Bond Amortization	28.22	30.53	33.02	35.71	41.02	47.99	71.03
Net Cash Flow	230.87	228.00	227.47	224.60	243.56	234.69	183.01
Tariff (cents)	320.25	319.81	162.67	155.89	169.64	167.58	95.11
Flow/Day	.51	.51	1.02	1.02	1.02	1.02	1.70
ROCF (%)	7.00	7.00	7.00	7.00	7.00	7.00	7.00
Pipeline Valuation ($ billions)	3.298	3.257	3.25	3.209	3.479	3.353	2.614
Wellhead Price ($)	(.21)	(.17)	1.44	1.54	1.44	1.53	2.45
($ millions)							
Wellhead Value (oil)	(38.40)	(31.37)	534.83	572.78	534.37	568.00	1519.51
Wellhead Value (gas)	20.10	20.10	40.21	40.21	42.22	42.22	73.72
Total Wellhead Value	(18.29)	(11.26)	575.03	612.98	576.59	610.22	1593.22
Total Royalty & Severance (oil)	(7.22)	(5.90)	100.55	107.68	100.46	106.78	285.67
Total Royalty & Severance (gas)	3.22	3.22	6.43	6.43	6.76	6.76	11.79
Grand Total Royalty & Severance	(4.00)	(2.68)	106.98	114.12	107.22	113.54	297.46

Private ownership, 15 year projection with .055 dividend, low throughput option, .10 equity, .30 income tax option and no Ad Valorem tax. Total cost is $3.5 billion at .08 for 30 years, two periods per year.

Year:	4	5	6	7	8	10	15
INCOME ($ millions)							
Gross Income	525.48	525.53	536.00	511.60	557.01	552.04	534.12
Operating Expenses	21.99	22.65	30.89	31.82	32.78	34.77	64.99
Depreciation	89.25	89.25	89.25	89.25	98.03	98.03	98.03
Interest on Bonds	242.28	241.60	240.87	214.91	234.27	227.30	204.26
Income before Taxes	171.95	172.03	174.99	175.62	191.93	191.93	166.84
State Income Tax	9.13	9.13	9.29	9.33	10.19	10.19	8.86
Federal Income Tax	42.45	42.47	43.20	43.36	47.39	47.39	41.19
Income after Taxes	120.37	120.42	122.50	122.94	134.35	134.36	116.79
ICC ROFV (%)	11.00	11.11	11.18	10.53	10.59	10.79	12.28
CASH FLOW ($ millions)							
Income after Taxes	120.37	120.42	122.50	122.94	134.35	134.36	116.79
Depreciation	89.25	89.25	89.25	89.25	98.03	98.03	98.03
Bond Amortization	28.22	30.53	33.02	35.71	41.02	47.99	71.03
Net Cash Flow	181.39	179.14	178.73	176.47	191.37	184.40	143.79
Tariff (cents)	282.29	282.32	143.97	137.42	149.61	148.28	86.08
Flow/Day	.51	.51	1.02	1.02	1.02	1.02	1.70
ROCF (%)	5.50	5.50	5.50	5.50	5.50	5.50	5.50
Pipeline Valuation ($ billions)	3.298	3.257	3.25	3.209	3.479	3.353	2.614
Wellhead Price ($)	.17	.21	1.62	1.72	1.64	1.72	2.54
($ millions)							
Wellhead Value (oil)	32.27	38.43	604.46	641.53	608.93	639.85	1575.53
Wellhead Value (gas)	20.10	20.10	40.21	40.21	42.22	42.22	73.72
Total Wellhead Value	52.38	58.53	644.67	681.74	651.15	682.07	1049.25
Total Royalty & Severance (oil)	6.07	7.22	113.64	120.61	114.48	120.29	296.20
Total Royalty & Severance (gas)	3.22	3.22	6.43	6.43	6.76	6.76	11.79
Grand Total Royalty & Severance	9.28	10.44	120.07	127.04	121.23	127.05	307.99

Private ownership, 15 year projection wit[illegible]o dividend, low throughput option, .10 equity, r[illegible]ncome tax option and no Ad Valorem tax. Total cost is $3.5 billion at .08 for 30 years, two periods per year.

Year:	4	5	6	7	8	10	15
INCOME ($ millions)							
Gross Income	292.50	294.78	304.78	282.45	308.07	310.06	340.28
Operating Expenses	21.99	22.65	30.89	31.82	32.78	34.77	64.99
Depreciation	89.25	89.25	89.25	89.25	98.03	98.03	98.03
Interest on Bonds	242.28	241.60	240.87	214.91	234.27	227.30	204.26
Income before Taxes	(61.03)	(58.72)	(56.23)	(53.54)	(57.01)	(50.05)	(27.00)
State Income Tax	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Federal Income Tax	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Income after Taxes	(61.03)	(58.72)	(58.23)	(53.54)	(57.01)	(50.05)	(27.00)
ICC ROFV (%)	5.50	5.61	5.68	5.03	5.09	5.29	6.78
CASH FLOW ($ millions)							
Income after Taxes	(61.03)	(58.72)	(56.23)	(53.54)	(57.01)	(50.05)	(27.00)
Depreciation	89.25	89.25	89.25	89.25	98.03	98.03	98.03
Bond Amortization	28.22	30.53	33.02	35.71	41.02	47.99	71.03
Net Cash Flow	.00	.00	.00	.00	.00	.00	.00
Tariff (cents)	157.13	158.36	81.86	75.87	82.75	83.28	54.84
Flow/Day	.51	.51	1.02	1.02	1.02	1.02	1.70
ROCF (%)	.00	.00	.00	.00	.00	.00	.00
Pipeline Valuation ($ billions)	3.298	3.257	3.250	3.209	3.470	3.353	2.614
Wellhead Price ($)	1.42	1.45	2.24	2.34	2.30	2.37	2.85
($ millions)							
Wellhead Value (oil)	265.25	269.17	835.68	876.69	857.87	881.83	1769.37
Wellhead Value (gas)	20.10	20.10	40.21	40.21	42.22	42.22	73.72
Total Wellhead Value	285.36	289.28	875.89	910.90	900.09	924.05	1843.09
Total Royalty & Severance (oil)	49.87	50.00	157.11	163.69	161.28	165.78	332.64
Total Royalty & Severance (gas)	3.22	3.22	6.43	6.43	6.76	6.76	11.79
Grand Total Royalty & Severance	53.08	53.82	163.54	170.12	168.03	172.54	344.44

Public ownership, 15 year projection with .04 dividend, low throughput option, no equity, no income tax option and no Ad Valorem tax. Total cost is $3.5 billion at .08 for 30 years, two periods per year.

Year:	4	5	6	7	8	10	15
INCOME ($ millions)							
Gross Income	392.41	391.44	420.42	440.76	499.90	502.09	509.29
Operating Expenses	21.99	22.65	30.89	31.82	32.78	34.77	64.99
Depreciation	89.25	89.25	89.25	89.25	98.03	98.03	98.03
Interest on Bonds	238.50	238.50	238.08	235.91	256.69	244.81	203.79
Income before Taxes	42.67	41.03	62.20	83.78	112.39	124.47	142.48
State Income Tax	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Federal Income Tax	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Income after Taxes	42.67	41.03	62.20	83.78	112.39	124.47	142.48
ICC ROFV (%)	8.53	8.58	9.24	9.96	10.61	11.01	13.24
CASH FLOW ($ millions)							
Income after Taxes	42.67	41.03	62.20	83.78	112.39	124.47	142.48
Depreciation	89.25	89.25	89.25	89.25	98.03	98.03	98.03
Bond Amortization	-0-	-0-	21.47	44.69	71.25	88.39	135.94
Net Cash Flow	131.92	130.28	129.98	128.34	139.18	134.11	104.58
Tariff (cents)	210.81	210.28	112.93	118.39	134.27	134.86	82.08
Flow/Day	.51	.51	1.02	1.02	1.02	1.02	1.70
ROCF (%)	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Pipeline Valuation ($ billions)	3.298	3.257	3.250	3.209	3.479	3.353	2.614
Wellhead Price ($)	.89	.93	1.93	1.91	1.79	1.85	2.58
($ millions)							
Wellhead Value (oil)	165.34	172.52	720.04	712.38	666.04	689.80	1600.36
Wellhead Value (gas)	20.10	20.10	40.21	40.21	42.22	42.22	73.72
Total Wellhead Value	185.44	192.62	760.24	752.59	708.26	732.02	1674.07
Total Royalty & Severance (oil)	31.08	32.43	135.37	133.93	125.22	129.68	300.87
Total Royalty & Severance (gas)	3.22	3.22	6.43	6.43	6.76	6.76	11.79
Grand Total Royalty & Severance	34.30	35.65	141.80	140.36	131.97	136.44	312.60

Private ownership, 15 year projectio[illegible]ith .04 dividend, low throughput option, .10 equ[illegible], no income tax option and no Ad Valorem tax. Total cost is $3.5 billion at .08 for 30 years, two periods per year.

Year:	4	5	6	7	8	10	15
INCOME ($ millions)							
Gross Income	424.42	425.07	434.76	410.79	447.24	444.17	444.85
Operating Expenses	21.99	22.65	30.89	31.82	32.78	34.77	64.99
Depreciation	89.25	89.25	89.25	89.25	98.03	98.03	98.03
Interest on Bonds	242.28	241.60	240.87	214.91	234.27	227.30	204.26
Income before Taxes	70.90	71.56	73.75	74.81	82.16	84.06	77.57
State Income Tax	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Federal Income Tax	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Income after Taxes	70.90	71.56	73.75	74.81	82.16	84.06	77.57
ICC ROFV (%)	9.50	9.61	9.68	9.03	9.09	9.29	10.78
CASH FLOW ($ millions)							
Income after Taxes	70.90	71.56	73.75	74.81	82.16	84.06	77.57
Depreciation	89.25	89.25	89.25	89.25	98.03	98.03	98.03
Bond Amortization	28.22	30.[illegible]	33.02	35.71	41.02	47.99	71.03
Net Cash Flow	131.92	130.28	129.98	128.34	139.18	134.11	104.58
Tariff (cents)	228.00	228.35	116.78	110.34	120.13	119.30	71.69
Flow/Day	.51	.51	1.02	1.02	1.02	1.02	1.70
ROCF (%)	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Pipeline Valuation ($ billions)	3.298	3.257	3.250	3.209	3.479	3.353	2.614
Wellhead Price ($)	.72	.75	1.90	1.99	1.93	2.01	2.68
($ millions)							
Wellhead Value (oil)	133.33	138.89	705.70	742.35	718.70	747.72	1664.80
Wellhead Value (gas)	20.10	20.10	40.21	40.21	42.22	42.22	73.72
Total Wellhead Value	153.43	158.99	745.91	782.55	760.92	789.94	1738.51
Total Royalty & Severance (oil)	25.07	26.11	132.67	139.56	135.11	140.57	312.98
Total Royalty & Severance (gas)	3.22	3.22	6.43	6.43	6.76	6.76	11.79
Grand Total Royalty & Severance	28.28	29.33	139.10	145.99	141.87	147.33	324.78

AGD 530671

Public ownership, 15 year projection with .055 dividend, low throughput option, no equity, no income tax option and no Ad Valorem tax. Total cost is $3.5 billion at .08 for 30 years, two periods per year.

Year:	4	5	6	7	8	10	15
INCOME ($ millions)							
Gross Income	441.88	440.29	469.17	488.89	552.09	552.38	548.51
Operating Expenses	21.99	22.65	30.89	31.82	32.78	34.77	64.99
Depreciation	89.25	89.25	89.25	89.25	98.03	98.03	98.03
Interest on Bonds	238.50	238.50	238.08	235.91	256.69	244.81	203.79
Income before Taxes	92.14	89.89	110.94	131.91	164.58	174.76	181.69
State Income Tax	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Federal Income Tax	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Income after Taxes	92.14	89.89	110.94	131.91	164.58	174.66	181.69
ICC ROFV (%)	10.03	10.08	10.74	11.46	12.11	12.51	14.74
CASH FLOW ($ millions)							
Income after Taxes	92.14	89.89	110.94	131.91	164.58	174.76	181.69
Depreciation	89.25	89.25	89.25	89.25	98.03	98.03	98.03
Bond Amortization	-0-	-0-	21.47	44.69	71.25	88.39	135.94
Net Cash Flow	181.39	179.14	178.72	176.47	191.37	184.40	143.79
Tariff (cents)	237.38	236.53	126.02	131.32	148.29	148.37	88.40
Flow/Day	.51	.51	1.02	1.02	1.02	1.02	1.70
ROCF (%)	5.50	5.50	5.50	5.50	5.50	5.50	5.50
Pipeline Valuation ($ billions)	3.298	3.257	3.250	3.209	3.479	3.353	2.614
Wellhead Price ($)	.62	.66	1.80	1.78	1.65	1.72	2.52
($ millions)							
Wellhead Value (oil)	115.87	123.66	671.29	664.25	613.85	639.51	1561.14
Wellhead Value (gas)	20.10	20.10	40.21	40.21	42.22	42.22	73.72
Total Wellhead Value	135.97	143.77	711.50	704.46	650.07	681.73	1634.86
Total Royalty & Severance (oil)	21.78	23.25	126.20	124.88	115.40	120.23	293.49
Total Royalty & Severance (gas)	3.22	3.22	6.43	6.43	6.70	6.70	11.79
Grand Total Royalty & Severance	25.00	26.47	132.64	131.31	122.16	126.98	305.29

AGD 530672

Public ownership, 15 year projection with .07 dividend, low throughput option, no equity, no income tax option and no Ad Valorem tax. Total cost is $3.5 billion at .08 for 30 years, two periods per year.

Year:	4	5	6	7	8	10	15
INCOME ($ millions)							
Gross Income	491.36	489.15	517.91	537.02	604.28	602.67	587.73
Operating Expenses	21.99	22.65	30.89	31.82	32.78	34.77	64.99
Depreciation	89.25	89.25	89.25	89.25	98.03	98.03	98.03
Interest on Bonds	238.50	238.50	238.08	235.91	256.69	244.81	203.79
Income before Taxes	141.61	138.75	159.69	180.04	216.77	225.05	220.91
State Income Tax	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Federal Income Tax	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Income after Taxes	141.61	138.75	159.69	180.04	216.77	225.05	220.91
ICC ROFV (%)	11.53	11.58	12.24	12.96	13.61	14.01	16.24
CASH FLOW ($ millions)							
Income after Taxes	141.61	138.75	159.69	180.04	216.77	225.05	220.91
Depreciation	89.25	89.25	89.25	89.25	98.03	98.03	98.03
Bond Amortization	-0-	-0-	21.47	44.69	71.25	88.39	135.94
Net Cash Flow	230.86	228.00	227.47	224.60	243.56	234.69	183.01
Tariff (cents)	263.96	262.77	139.11	144.24	162.31	161.88	94.72
Flow/Day	.51	.51	1.02	1.02	1.02	1.02	1.70
ROCF (%)	7.00	7.00	7.00	7.00	7.00	7.00	7.00
Pipeline Valuation ($ billion)	3.298	3.257	3.250	3.209	3.479	3.353	2.614
Wellhead Price ($)	.36	.40	1.67	1.65	1.51	1.58	2.45
($ millions)							
Wellhead Value (oil)	66.40	74.81	622.55	616.12	561.66	589.22	1521.95
Wellhead Value (gas)	20.10	20.10	40.21	40.21	42.22	42.22	73.72
Total Wellhead Value	86.50	94.91	662.66	656.33	603.88	631.44	1595.64
Total Royalty & Severance (oil)	12.48	14.06	117.04	115.83	105.59	110.77	286.12
Total Royalty & Severance (gas)	3.22	3.22	6.43	6.43	6.76	6.76	11.79
Grand Total Royalty & Severance	15.70	17.28	123.47	122.26	112.35	117.53	297.92

AGO 530673

Private ownership, 15 year projection with .07 dividend, low throughput option, .[illegible] equity, full income tax option and no Ad Valorem tax. Total cost is $3.5 billion at .08 for 30 years, two periods per year.

Year:	4	5	6	7	8	10	15
INCOME ($ millions)							
Gross Income	713.89	712.67	724.34	698.95	760.88	751.89	698.29
Operating Expenses	21.99	22.65	30.89	31.82	32.78	34.77	64.99
Depreciation	89.25	89.25	89.25	89.25	98.03	98.03	98.03
Interest on Bonds	242.28	241.60	240.87	214.91	234.27	227.30	204.26
Income before Taxes	360.36	359.17	363.33	362.96	395.80	391.78	331.01
State Income Tax	33.73	33.62	34.01	33.97	37.05	36.67	30.98
Federal Income Tax	156.79	156.27	158.08	157.93	172.21	170.46	144.02
Income after Taxes	169.84	169.27	171.24	171.06	186.54	184.64	156.00
ICC ROFV (%)	12.50	12.61	12.68	12.03	12.09	12.29	13.78
CASH FLOW ($ millions)							
Income after Taxes	169.84	169.27	171.24	171.06	186.54	184.64	156.00
Depreciation	89.25	89.25	89.25	89.25	98.03	98.03	98.03
Bond Amortization	28.22	30.53	33.02	35.71	41.02	47.99	71.03
Net Cash Flow	230.86	228.00	227.47	224.60	243.56	234.69	183.01
Tariff (cents)	383.50	382.85	194.56	187.74	204.37	201.96	112.54
Flow/Day	.51	.51	1.02	1.02	1.02	1.02	1.70
ROCF (%)	7.00	7.00	7.00	7.00	7.00	7.00	7.00
Pipeline Valuation ($ billions)	3.298	3.257	3.250	3.209	3.479	3.353	2.614
Wellhead Price ($)	(.84)	(.80)	1.12	1.22	1.09	1.18	2.27
($ millions)							
Wellhead Value (oil)	(156.13)	(148.71)	416.12	454.19	405.05	440.00	1411.36
Wellhead Value (gas)	20.10	20.10	40.21	40.21	42.22	42.22	73.72
Total Wellhead Value	(136.03)	(128.61)	456.33	494.40	447.27	482.22	1485.08
Total Royalty & Severance (oil)	(29.35)	(27.96)	78.23	85.39	76.15	82.72	265.34
Total Royalty & Severance (gas)	3.22	3.22	6.43	6.43	6.76	6.76	11.79
Grand Total Royalty & Severance	(26.14)	(24.74)	84.66	91.82	82.91	89.48	277.13

Private ownership, 15 year projection wi[illegible].07 dividend, low throughput option, .10 equity, [illegible]1 income tax option and no Ad Valorem tax. Total cost is $3.5 billion at .08 for 30 years, two periods per year.

Year:	4	5	6	7	8	10	15
INCOME ($ millions)							
Gross Income	613.16	610.54	620.70	602.05	653.78	642.18	579.97
Operating Expenses	21.99	22.65	30.89	31.82	32.78	34.77	64.99
Depreciation	89.25	89.25	89.25	89.25	98.03	98.03	98.03
Interest on Bonds	161.52	161.07	160.58	143.27	156.18	151.54	136.17
Income before Taxes	340.40	337.57	339.98	337.70	366.79	357.84	280.77
State Income Tax	31.86	31.60	31.82	31.61	34.33	33.49	26.28
Federal Income Tax	148.11	146.88	147.92	146.94	159.59	155.70	122.16
Income after Taxes	160.43	159.10	160.23	159.16	172.87	168.65	132.33
ICC ROFV (%)	9.76	9.83	9.87	9.43	9.46	9.55	10.27
CASH FLOW ($ millions)							
Income after Taxes	160.43	159.10	160.23	159.16	172.87	168.65	132.33
Depreciation	89.25	89.25	89.25	89.25	98.03	98.03	98.03
Bond Amortization	18.82	20.35	22.01	23.81	27.35	31.99	47.35
Net Cash Flow	230.86	228.00	227.47	224.60	243.56	234.69	183.01
Tariff (cents)	329.39	327.99	166.72	161.71	175.61	172.49	93.47
Flow/Day	.51	.51	1.02	1.02	1.02	1.02	1.70
ROCF (%)	7.00	7.00	7.00	7.00	7.00	7.00	7.00
Pipeline Valuation ($ billions)	3.298	3.257	3.250	3.209	3.479	3.353	2.614
Wellhead Price ($)	(.30)	(.25)	1.40	1.48	1.38	1.48	2.47
($ millions)							
Wellhead Value (oil)	(55.41)	(46.59)	519.76	551.09	512.16	549.71	1529.69
Wellhead Value (gas)	20.10	20.10	40.21	40.21	42.22	42.22	73.72
Total Wellhead Value	(35.31)	(26.48)	559.97	591.29	554.37	591.93	1603.40
Total Royalty & Severance (oil)	(10.42)	(8.76)	97.72	103.60	96.29	103.35	287.58
Total Royalty & Severance (gas)	3.22	3.22	6.43	6.43	6.76	6.76	11.79
Grand Total Royalty & Severance	(7.20)	(5.54)	104.15	110.04	103.04	110.10	299.38

AGD 530675

SCOMM

#12:2

(1)

12440 Recess

end tape # 1

5:00 TAPE 2 3/9/72

0001.5 Reconvened (McVeigh Chairing)

0002.0 Questions of Markham ~~McVeigh Chairing~~

0002.5 Radar / Markham

0006.3 Donaldson to Markham

0014.3 Rettig / Donaldson

0018.0 McVeigh / Donaldson

0020.5 Holm / Markham #86

0028.3 Donaldson

0031.5 Coletta / Donaldson

0038.3 Markham

0039.0 Croft / Donaldson

0041.8 McVeigh / Croft / Donaldson

0043.0 McVeigh

0044.3 McVeigh / Donaldson

0050.0 Thomas / Donaldson

0051.4 Markham

0052.8 Dubert / Markham

0055.0 McVeigh

0055.4 Dubert / Markham

0061.0 Donaldson

360
1.25
1800
720
360
450.00

4/545 AGO 530676

(2)

McVeigh Claiming

0063.0 Rettig / Markham
0064.8 Donaldson
0067.0 Rettig / Markham
0070.8 Young / Markham / Donaldson
0076.0 Rose / Markham
0088.3 Donaldson / Rose
0090.5 Barber / Donaldson
0096.8 McVeigh / Donaldson
0097.5 Palmer / Donaldson
0100.0 Ten minute break
0100.3 Reconvened · McVeigh
0104.5 Donaldson intro Seymour
0110.5 Hulbert
0123.6 Croft / Seymour
0125.0 End of testimony
0125.3 Donaldson intro Patton
0150.0 Hulbert / ~~Seymour~~ Patton
0153.3 Miller / ~~Seymour~~ Patton
0155.0 McVeigh / Patton
0157.8 Mendes / Patton
0161.0 Barber / Patton
0167.0 Colletta / Patton
0168.0 Radar / Patton
0169.5 Colletta / Patton

0173.5 Galletta
0175.3 End of Patton
0176.- Miller
0178.0 Donaldson intro Cortese
0179.0 Cortese statement
0249.0 Rose / Cortese
0252.8 Harris / Cortese
0254.8 Barber / Cortese
0257.8 McVeigh / Cortese
0258.0 Groh / Cortese
0243.8 Holm / Cortese
0268.8 Recess until 3:00
0270.0 Reconvened
0271.0 Donaldson intro Gary
0272.5 Gary statement
0333.5 Kelly / Gary
0343.3 Groh / Gary
0353.0 Holm / Gary
0360 Gary: "Yes, I think it does."
0372.3 Kelly / ~~Gary~~
0374.3 McVeigh / Gary
0383.8 Rose / Gary
0397.0 McVeigh
0398.0 Ten Minute Recess

0400 - 1.00

0398.0 Reconvened. - (Retting Chasing)
0400.5 Wahlfarth / Gary
0413.0 Retting / Wahlfarth
0415.0 Croft / Gary
0418.5 Retting / Gary / Croft
0420.5 Retting / Gary
0422.0 Hulbert / Gary
0427.0 Retting Adjourn
0427.8 Josephson / Gary / Retting
0430.0 Josephson / Gary
0432.5 Donaldson intro Broussard
0455.5 End of Statement
0456.0 Holm / Broussard
0461.0 Retting
0462.5 Wahlfarth (Recite)
0463.3 Barber / Broussard
0484.8 Radar / Broussard
0466.5 Donaldson intro Seymour
0486.0 Barber / Seymour
0490.5 Retting / Seymour
0492.0 Croft / Seymour
0497.0 Rose / Seymour
0508.5 Radar / Seymour
0504.8 Barber / Seymour

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0505.5 End of Seymour
0506.0 Donaldson intro Cortese
0507.0 Cortese spoke
0548.0 Croft / Cortese
0560.0 Retting / Croft / Cortese
0568.0 Retting / Croft
0569.3 Cortese / Croft
0573.5 Retting
0575.5 Recess until 8:00
0576.5 Reconvened 8:03/10/72
0576.8 Retting / Herring
0577.8 Hulbert / Cortese
0591.3 McVeigh / Cortese
0599.0 Retting
0601.0 Croft / Cortese
0605.0 Donaldson
0615.0 End of Statement
0615.5 Hulbert
0617.3 Mrs Fischer / Donaldson
0620.8 Mr. Sandusky Statement
0648.8 End of Statement
0649.3 Phil Halsworth statement
0666.0 End of Statement
0666.3 Groh / Halsworth

106
62
168

216
181
35

(6)

0669.5 Mrs. Fischer / Halsworth
0671.5 Mike Miller /
0674.0 10 min break
0674.3 Recompend
0676.5 Wm. Hopkins statement
0681.0 End of statement
0681.5 Havelock
0690.5 Havelock intro Allen
0694.0 Mr. Allen's statement
0725.3 End of statement
0727.0 Barber / Allen
0732.3 McVeigh / Allen
0734.0 Calletta / Allen
0737.8 Rettig
0744.5 McVeigh / Allen
0748.3 Calletta / Allen
0750.8 Calletta / Havelock
0753.5 Croft / Allen
0760.0 Rettig / Donaldson
0761.3 Donaldson / Cabanas
0763.0 Cabanas
0788.3 Donaldson
0790.0 Barber / Cabanas
0793.5 Donaldson

0795.8 10 Min. recess.
0796.0 Reconvened.
0800. Havelock
0802.5 Havelock intro. Wohlforth
0803.0 Wohlforth intro Jamison
0812.0 Jamison statement
0833.8 Holm / Jamison
0837.3 Palmer / Jamison
0840.3 Gilletta / Jamison / Wohlforth
0844.8 Fischer / Jamison
0846.0 Noland / Jamison
0847.5 Wohlforth
0848.0 Jamison
0849.8 Palmer / ~~Jamison~~ / Wohlforth
0855.5 Eppenbach
0856.8 Palmer / Wohlforth
0857.0 Jamison
0857.3 Kelly / Jamison
0859.0 Wohlforth
0859.5 Jamison
0860.0 Gilletta / Jamison
0862.0 Kelly / Jamison
0864.8 ~~Havelock~~ Palmer / Havelock
0865.0 Kelly Recess until 1:30

1060
895
165
55
3)165
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0866.0 Reconvened. Rettig chairing
0870.0 Listen for gavel / Rettig chairing
0870.8 Havelock summarize
0904.5 Rettig joke
0906.5 Halm / Havelock
0909 - about Halm / Havelock / Wohlforth
0915.0 Miller / Wohlforth
0919.8 Harris / Havelock
0922.8 Wohlforth / Rettig
0925.0 Harris / Havelock
0926.0 Barber / Havelock
0928.3 Palmer / Allen / Palmer
0934.0 Havelock / Kades
0945.5 Palmer / Havelock
0949.0 Halm / Havelock
0950.5 Galletta / Kades
0954.5 Galletta / Havelock
0956.3 McVeigh / Kades
0963.0 Rettig / Havelock
0966.0 Wohlforth / Rettig
0973.3 Rope / Havelock
0977.0 Nuhert / Havelock
0981.0 Wohlforth
0983.0 Havelock

0983.5 Colletta / Wohlfarth / Havelock
0985.0 Rose / Havelock
0985.5 Havelock
0986.8 Recess 10 min
0987.0 Reconvened.
0987.8 Rettig intro Croft
1014.3 End of statement
1015.5 Hulbert statement
1017.5 Barber statement
1023.0 Harris statement
1026.8 Rose statement
1029.8 Miller statement
1034.0 Holm statement
1034.5 Fischer statement
1038.8 KEITH SPECKING
~~KAY POLAND~~
~~1045.0 JAY HAMMOND~~
1041.5 MIKE COLLETTA
1045.0 Jay Hammond statement
1049.0 Thomas statement
1053.8 Kay Poland statement
1055.0 McVeigh statement
1058.8 Rettig statement
1064.3 End

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Culetta: 187 for State acquiring money, your testimony, or my interpretation, is that this money is the problem that we face and, if I interpret your testimony correctly, one of the alternatives was the State ownership proposal. With supplementary income from severence and royalties we were going to make up the deficit in monies that we need through the profit that is allowed on the pipeline. Have you looked into any other alternatives?

Henri: Well, Representative Culetta, when you mean alternatives do you mean other natural resource development or just what is the general thrust of this.

Culetta: Yes, either in that field or coupled to the Prudhoe Bay. Is consideration being given to, recently we read in the paper where gas research not taken out of the ground. Have we considered selling our pre-owned, you know approximately 20%?

Henri: Well, right, I think that should be the essence of it is Commissioner Herbert's. But, I would say in general that I have looked at every conceivable possibility for getting income for the State, more or less, I don't mean to tell you that we spent several hundred thousand dollars on each conceivable possibility. We certainly have tried to imagine any income source. There isn't anything, including gas, that is anywhere near like oil. That is the problem. I mean the oil is so far and above the great yielder of revenue to the Treasury that there just isn't anything else remotely comparable to it.

Culetta: Mr. Chairman. Again, I was apparently misinformed but it seems that I recall from the news article that between two and five hundred million dollars in one gas sale had been negotiated.

Henri: Well, I don't doubt, Mr. Culetta, that if they sold all the oil in the Prudhoe Slope right today that they could get a figure quite a bit higher than that, obviously, but that is the total figure over many years. My concern, of course, is to funding the budget in 1978 and 1979, not that I am representing to you that I'm going to be the one who's doing it then, but at least we have

to fund the budget then and those are the years, particularly the late seventies, that are so critical to our State.

Culetta: Mr. Chairman. Commissioner, what I am driving at is until the line is on full capacity we seen to be facing the problem . It seems conceivable to me that we should sell some of the future production now to make up the deficit until the line is on stream so that we could solve our problem.

Havelock: If I may answer that for the Commissioner. I have discussed this with a number of people as a prospect, but the effect is, and it is a strategy the State may wish to use at the appropriate point, but the strategy does not change basic lines of the projection. What you can do through the advance sale, lets take sale of oil and gas futures, is to nip off the bottom of the deep part of the V when you hit bottom. You can't sell anything, or you can't sell for any kind of advantageous price until you have the assurance that the product is going to be marketed, otherwise, you are going to be selling a highly discounted comodity. Even if you do sell it, you are selling something that otherwise you would count on in the future. So, the effect is that you can round off the bottom of the V in the bottom of the dip but you don't change the basic trend of the decade by that kind of strategy. As far as other alternatives go, I do call to your attention one of the measures the Legislature may wish to consider, one of measures we had introduced does call for a twenty mill property tax on the pipeline and related oil property as a method of raising revenue and, of course, the legislature may wish to consider the utilization of the property tax as one of the various tax tools that is available to the State in meeting its fical problems.

Rettig: In several different ways the question has been posed, why can't we not increase severence taxes to make up for what, otherwise, would be pipeline profit. Perhaps Mr. Wohlforth could explain where most of this pipeline profit really comes from under State ownership. Would you care to do that Eric?

Wohlforth: Yes I would be glad to. The pipeline profit is shown under pipeline income

in the years 1977, 78, and 1979 to some extent, comes from pipeline income, that is to say, in the amount of the charge which the State is entitled to make as the owner of the pipeline.

Rettig: Perhaps I didn't make myself clear. For example,

Wohlforth: as well as the fact that we are not taxable as a pipeline owner.

Rettig: That is the point I was trying make. Out of perhaps four hundred million dollars of pipeline income, perhaps two hundred fifteen million of that mearly is money that would otherwise go to Uncle Sam for taxes.

Rose: My curiousity is getting the best of me, what is a ?

Henri: It is an example of figures.

Groth: Joe this is the last question and I realize that I am probably being argumentative but I don't mean it. If you refuse to put anything in the budget on the value of the 1.5 million acres on the slope or the seventy seven million acres that the State otherwise has, would you sell it to me for a hundred million dollars? Of course you wouldn't, so you do have a figure on it someplace and it seems to me that that figure has to be put in your revenue projections someplace.

Henri: Senator, you're referring to lands that the State has?

Groth: Yes sir.

Henri: Of course, the lands, whether they are oil bearing lands is question number one. Again, I would have to ask whether Chuck Herbert thinks they are, but even Chuck has missed one or two acres in Alaska as to whether they have oil under them or not. So that in itself seems to be problematical, and then the question of when the oil companies would be interested in taking the oil is the thing that clenches us up. All we are talking about is a ten year period. I think that over the long run of time that we can get through the next ten years probably, our future is particularly bright in this State.

Adjournment until 2 p.m.

McVay: This is a continuation of the hearings on the pipeline proposals of the administration. Our schedule calls for us to go straight through until 6:00 this afternoon and we'll have breaks approximately every hour and fifteen minutes. Mr. Attorney General do you have the next witness?

Havelock: Mr. Co-Chairman and members of the committee, at this time the State would like to call Mr. Charles Kades of Barker, Stella, Field and Wood, special council of the State on public financing. He will discuss the statutory framework of State ownership. In connection with Mr. Kades testimony I have a distribution in line with the previous comments that I have made and other witnesses have made regarding a proposed introduction of the proposed amendment to the constitution of Alaska and with the Chairs permission I would like to distribute that now for your perusal and, in addition, we have to the amendment bill already committed to the committee we have two other proposed amendments to HB 569 which the committee may wish to consider.

McVay: Mr. Kades, when you are ready to begin would you give us a little bit of your background for the records.

Kades: Mr. Co-Chairman, my name is Charles L. Kades. I am a partner in the firm of Barker, Field, Stella and Wood of New York City. I have been a partner for some twenty some odd years. Prior to that I was overseas during WW II until about 1942. In an earlier period I had been Assistant General Council of the United States Treasury in Washington from 1933 or 1934 until 1940. After we were retained to advise the Attorney General and other members of the administration in connection with the ownership of the, or possible ownership of the pipeline by the State, we conferred at length and concluded that the device that was best adapted to providing the State ownership of the pipeline would be public authority. The authority device is not a new device. It is not untried and, at its best, under competent members, it has advantages of full private and public management. It must pay its way and usually it has no access to the public treasury. It has no stock; it is operated under Government and after its debt is paid it properly belongs to the State and to the people. Although there

has not been any project of which I am aware of comparable size to the pipeline under consideration here, there have been authority financings amounting to billions of dollars. For example, the Port of New York Authority now has outstanding about one and a half billion dollars worth of bonds and it has retired about an equivalent of that amount of bonds. The Los Angeles Power and Light Authority has outstanding about a billion dollars worth of bonds. The Power Authority of the State of New York has outstanding a billion and a half of bonds. The New York State Throughway has a billion in principle amount of bonds outstanding. The New Jersey Turnpike Authority has approximately three quarters of a billion; Illinois Turnpike Authority has over six hundred million; and the Nebraska Public Power Agency has a half a billion dollars in bonds outstanding. All of these projects have been financed without any recourse whatever to tax revenue. These projects have been self-liquidating, self-supporting, and are managed by the authority as an autonomous, independent, separate corporate legal entity. That is the purport of HB number 569 which creates the Trans-Alaska Authority as an independent corporate entity. Its membership is appointed by the Governor with the confirmation of both houses in joint session of the Legislature. It has all the general powers of a private corporation as well as a public corporation. It has specific powers to issue bonds or notes and to make agreements with the bond holders and note holders for the financing of the project and it can make rates and charges and revise them from time to time without the surveillance of any other regulatory agency sufficient to pay the interest and principal on the bonds as well as its debt service as well as the operating and maintenance expenses. It has the power to acquire the property of any other pipeline company, either by purchase of stocks or by purchase of property, or by physical property or, if necessary, by exercising the right of eminent domain upon payment, of course, of just compensation. The Act is not mandatory. The Act is purely permisive. All it does is set up the framework from which the State can then determine its next move. It is purely enabling legislation. It might never be used or it might be used in part or in whole, but it is indispensible some legal framework if the proposals that there may be State

ownership is to move forward. The hearings, I think, became confused at one point in regard to pledge of credit of the State. An independent public authority such as should be self-supporting. All of the authorities that I have mentioned are self-supporting. Sometimes it has been desirable, although I only know of one case, to guarantee the bonds, although no recourse has ever been had to that guarantee. That is in the case of the New York State Throughway, where some bonds were issued guaranteed by the State, after a constitutional amendment was adopted authorizing the guarantee, but the project has been completely self-liquidating and there had never been any of payment of any of the interest or principals out of the revenues. Did one of the amendments that the Attorney General introduced or offered to the committee at the opening of this session eliminates from this act the recittal or from this bill, the recittal in the legislative findings that it is clear to be in public interest for the State to guarantee the principal and interest on bonds issued to finance the facility. The other amendment eliminates the section which provided to the extent that the constitution permitted the bonds might be guaranteed. Now, that section was pure surplus and really doesn't belong in the bill because the constitutional amendment provides that, if it is adopted by the people, then the Legislature is authorized by an act to guarantee the bonds but, first of all, the constitutional amendment is required to pass the people and, secondly, another Legislature must act to pass a law before any of the bonds are guaranteed. So there (Its redundant) for anything of that character to be in this bill, thats why it has been eliminated. As it stands, the bill authorizes an authority to make plans and to proceed with the project but doesn't require the authority to do anything, and doesn't in any way pledge directly, or indirectly, the credit of the State or the taxing power of the State. I may say of this connection that the project, as defined in the Act, is much broader than the pipeline. There are many other things that are required to be built which would be revenue producing. For example, port facilities, airports, docks, wards, storage

facilities, electric energy facilities, pollution controls, possibly recreation areas. The authority would have broad powers to consider construction of those undertakings incidental to, and along with, the pipeline. That, in broad, outlines what is the proposed authority which would be the framework for State ownership of the pipeline. I would be glad to answer any questions.

McVay: Do we have any questions from members of the Senate group or the Senate Commerce Committee?

Groth: It appears to me that under the proposed constitutional amendment the question of incurring of debt is not put to the vote of the people under this proposal whereas under existing law, any bonds that have a guarantee by the State would be put to a good vote of the people. Is my analysis correct?

Kades: Your analysis is correct. The purpose of this constituticnal amendment is to delegate, is for the people to delegate to the Legislature and vest in the Legislature the power to guarantee the bonds if the Legislature should want to guarantee the bonds of the authority which simply is a delegation of power to the Legislature so that it wouldn't be necessary to come back to the people again. Of course, there is no reason to suppose at this time that it will ever be necessary or desirable to guarantee the bonds, but this would put the Legislature in a position where, if the Legislature in its wisdom decided that the bonds of the Trans-Alaska Authority should be guaranteed in whole or in part, then the Legislature would be able to make that decision rather than mean it must be, there would be a further delay to go back to the people, but nothing can happen without a subsequent vote of another Legislature which would meet after this Legislature. It would meet after the election at which the constitutional amendment would be considered.

Groth: One other quick question. Generally, if we were to catagorize between general obligation and revenue bond, these would be considered revenue bonds I suppose?

Kades: Yes, although all the funds of the authority would be placed to their payments so technically they would be general obligation bonds of the authority, but, in fact, they would be revenue bonds because they would be payable solely out of revenues of

the authority and the authority would have no revenues except from the project because the authority has no tax account.

Groth: Generally, again the interest rate on revenue bonds is slightly higher than those on general obligation bonds.

Kades: I am really not in a position to answer that, but I think it depends on the project and the issue. I don't know whether there is a general rule on that or not. Mr. Macy, who is following is a financial man who probably could answer that.

Christenson: Mr. Chairman, sorry I was late, I didn't get the first part of this. Is this the resolution that you are talking about? Does this go to a vote of the people?

Kades: The House joint resolution?

Christenson: Yes. Here again I would say, suppose it didn't pass?

Kades: If it didn't pass it would not effect the Trans-Alaska Authority Act because the Trans-Alaska Authority Act does not contain any powers to pledge the credit of the State, or pledge the severence taxes, whatever. In other words, the Trans-Alaska Authority stands or falls on its own feet. Well, lets assume that it didn't pass the Legislature, it was never submitted to the people. It wouldn't effect the enabling Legislature. This enabling Legislature is necessary for a number of reasons if the State is to proceed at all. For example, we have the problem on tax exemption. Only one way we will have an answer, final answer, on that, is to secure a ruling from the United States Treasury. We can't go through a ruling because there is no authority to go through a ruling. There is no State agency with the statutory power to request a ruling. The Treasury won't rule on purely hypothetical cases, they want a specific case. Where is the law, where is the plan, then we can get a ruling. The meaningful discussions can't hardly be held on a plan with the oil companies or even with the investment bankers without knowing how the plan can be implemented. It is indispensible as a matter of statute that there be some law on the books under which the officials of the State can proceed in our case.

Rettig: Thank you Mr. McVay. I believe you referred to the possible guarantee by the Legislature, as authorized in this amendment, would not this in effect add a general obligational feature to the bond?

Kades: If the bonds are guaranteed, Mr. Chairman, then it would. It would then be general obligation bonds to the State in a contingent section. If the revenues were insufficient then the [illegible] would pull on the taxing power of the State.

Rettig: It would generally have a G. O. feature supplemented by a revenue pledge of some sort?

Kades: That is correct in substance, but the primose security would be the revenue. If the constitutional amendment is not acceptable to the Legislature or, is not acceptable to the people, then the bonds would be exclusively revenue bonds payable solely from the revenues of the project and, as I stated earlier, the authorities which I mentioned which are just typical of authorities throughout the United States, are all cases where the projects are completely self-supporting without a guarantee. With the one exception on the part of Throughway. For example, lets suppose that three billion dollars worth of bonds were issued by the authority that were purely revenue bonds payable solely from the revenues of the project. The bankers and said, well for the last half a billion it might be desirable if the State pledged its credit, especially since these are going to be not just pipeline facilities but they are going to be parks and recreational facilities, one or the other subsidiary projects. Then this would put the State in a position where it could, if the Legislature, in its discretion, determined it was a good idea to guarantee the bonds, but all it does is give a flexible mechanism, it doesn't bind the Legislature in any way. The bonds of the authority would not be a debt of the State in any sense of the word.

Rettig: As I understand it, the whole constitutional amendment would remove from our constitution the prohibition against the dedication of tax revenue and, in effect, would permit the dedication of tax revenues for a particular purpose?

Kades: Would permit the Legislature to dedicate the tax revenues.

Rettig: Now, recognizing that the severence taxes involved from possible pipeline operation may be relatively minor with

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...Kades:... by the State then the entire tax power of the State would be available to pay bonds.

Rettig: I understand that. But Short of a formal guarantee by the legislature they could still pledge particular tax revenues could they not, which would not be a general guarantee, but would be limited to those particular revenues pledged.

Kades: Well, this amendment was drawn with the severance tax only in mind. Now whether there are other taxes that could be pledged, I haven't considered it because it was only the severance tax that was under consideration. I think it's probably broad enough to cover other tax.

Rettig: I believe it does in effect remove the prohibition against the dedication of taxes in toto, does it not?

Kades: Yes. For this purpose, the purposes of the is limited for the purpose of securing the payment of bonds and notes of a public enterprise or a public corporation of the State.

Rettig: Thank you. Mr. Kades I am familar with your firm and have great respect for it, as experience bond counsel, in your opinion would a dedication limited to severance taxes only, satisfy the requirements of bond underwriters in this type of deal.

Kades: I think, Mr. Macy is better equipped to answer to answer this question, but I think based upon our experience with authority bonds that it may be you wouldn't need to pledge even the severance. I'm just not sure. It depends on the investment bankers and what they underwrite. For example they might say well, we don't need more than the royalties. It would be sufficient if royalties were pledged. Or they might say that revenues were so good we don't need even royalties, or they might say in view of the delays which have been placed, we'd better have severance tax as well. I'm really...

Rettig: Thank you very much. We will perhaps take this up a little further with Mr. Macy. Thank you.

Young: Mr. Kades, the examples you gave of the other authorities have been were public ~~conveniences~~ authorities in New York primarily, were they not? These authorities were strictly public convenience. I just wonder if there has been any authorities, like private conveniences, since private ~~conveniences~~ own that oil as well as the State.

Kades: Well I did give you examples of the power authority in New York in the example which, and also the Los Angeles power and Nebraska power which generate and transmit power.

Young: I understand that, but they ~~don't buy the use~~, the authority and generated delivered by the authority, and it would be another party in the State, such things as belong to private industry. And I just wanted another example where possibly an oil line or coal field or something else, curiosity curiosity...

Kades: I don't know of a case where the natural resources is owned by the State except again the power authority owns the water rights in New York. The situation as far as the power authority is concerned in your situation is not too different but when Charles Evans Hughes was the Governor in New York in 1910 he decided to send a message to the legislature that the water resources of New York were just too essential to New York to permit the development by private/public utility companies which were subject to the regulation of course of the public service commission and the federal power commission and as a result of that the power authority of New York was established which

developed the water resource of New York in complete cooperation with the private utilities. They sell the private utilities and they also transmit the private power which is produced by the private utilities. It is a joint cooperative arrangement. It is handled by contracts between the private utility and the power authority. It didn't come about over a few months, it took some time before there was mutual confidence. That's the current situation.

Young: Thank you. You mentioned also that the authority would have the right to raise the tariff on the pipeline, the usage of the pipeline if necessary to raise funds, obligation funds.

Kades: Yes, the Act provides that the authority must fix rates and charge its tariffs sufficient to pay the interest and principle on the bonds, the maintenance of reserves, operation of maintenance expenses and also to yield a reasonable return to the state on its capital or on its investment.

Young: Do you foresee any way this might [illegible] the powers of the legislature as far as the increase in the severance tax they so desire, their form of taxation, limit the form of taxation on the oil.

Kades: I don't think it would, it simply is an agreement for the protection of the bond holders, that the tariffs will be fixed sufficient to pay the bonds.

Young: And they couldn't raise the tariff beyond the point where they would be paying the bond back from capital investment. They couldn't use the money they had been given as far as the authority.

Kades: I am not clear on the question.

Young: What I am saying is they have the authority to raise the tariff, use could they use this for the State, the authority has a great deal of power, use

it for generating money rather than to pay back just on the bonds.

Kades: So long as the tariffs were reasonable, I think that the Act is broad enough to permit a yield of excess revenues to the State.

Young: It would be under this bill there would be the power to, that is what I am asking. There would be that authority.

Kades; THere is that authority, yes. In other words, I want to be sure I understand. The , there is not a maximum rate in , ~~that~~ the sense that only ~~them~~ enough to pay back the market, and only enough for operation and maintenance, that is a minimum rate. There is room and it is anticipated in the Act that the rates will be sufficient to provide a reasonable return to the State. But the rates would still have to be reasonable.

Young: Whose term is reasonable. I'm always worried about the ~~term~~ [illegible] reasonable. It is a catch all. What I'm worried about is the authority superceding with the authority of the Legislature. If we grant this act will they end up being the super power as far as raising money through the oil lines and other taxations?

Kades: No because they are always a creature of the legislature. The authority is , would be subject to the control of the legislature in the event it ~~were to~~ [illegible] raise the rates to a point where it was imparing severance tax? I don't think it would be able to do that under the act.

Havelock: Mr. Kades, so the committee may be fully informed , I wonder if [illegible] you might talk for a moment or two about the , how you would arrange for, or what the principles which would apply to tax exemptions of the bonds which the authority might issue for this purpose.

Kades: Well the , first of all , there are a number of these projects where there

is no problem about tax exemption . For example, only of for example on a minor nature, there is no problem in regard to applying of bonds the proceeds of which would go for roads, court facilities, airports, docks, ; there is some problem in regard to electric energy, the question being whether or not it is local furnishing of electrical energy. It's a very technical problem, but the real problem comes insofar as the interest on the bonds is concerned is, as distinguished from profits of the pipeline itself, profits of the authority, it was those two cases that have to be distinguished. If the volume of oil the pipeline companies can put through the pipeline is subject in some way to reduction on reasonable notice by the authority in order to make capacity available for use by other companies and the obligation of the oil companies to pay, is not opposed by any so called take or pay or hell or high water contract which means in effect a guarantee by the oil companies, that the interest & and principle of the bonds will be paid, then it is our opinion that more likely than not we can secure a favorable ruling from the treasury. The cardinal point is, that if the benefits and the burden of the ownership of the pipeline is transferred to the oil companies by imposing with all the rights, all the burdens on the oil companies such as guaranteeing the debt service that would be incurred by the authority and if the oil companies have all the rights in the pipeline, then the chances are unfavorable that we would be able to secure a favorable ruling on the bonds. In other words, if, what the statute provides if the proceeds of the bonds are issued by the authority are going to be used in the trader business not of the authority but in the trader business of the oil company the interest on the bonds is taxable, it's simply the oil companies using the credit of the authority in order to finance the project. But if the benefits of the States and the burdens are

are the States also, with adequate protection of course, for the bond holder, then the interest on the bonds should be exempt. Now on that we would, because this is a grey area, it would be necessary for us to secure a ruling from the Commissioner of Internal Revenue. In Last November, when the Attorney General first raised this point with us, we prepared an opinion to Governor Egan that was agreeable to the Attorney General, I think it is complicated.. In so far as the profits of the pipeline are concerned, it is our opinion that they will not be subject to taxation, in other words any excess revenues that the authority derives for use by the State for general purposes, this rule is not in the grey area, such as the question of the interest on the bonds, it has been well settled for a hundred years that the State or an agency of the State is not subject to the internal revenue code, it is not a person within the meaning of the code, it is not a corporation within the meaning of the code. This is decided by the Supreme Court of The United States in 1872 in a case involving the Civil War income tax case and it has been consistently followed by the treasury. Robert Jackson, Justice of the Supreme Court when he was the chief counsel for the Bureau of Internal Revenue gave an opinion in 1933 which reiterated the fact the revenues of the State for State agencies were not subject to Federal Income Tax in connection with Ohio liquor stores who had a tidy profit. Since then, other state instrumentalities have secured rulings that their profits were not subject to taxation and as recently as last year the rationale of the decisions was reiterated in a published ruling. The same thing is true of all these other authorities that engage in what one might call business activities. All make some money and they're not subject to taxation and if that were the only point

involved, we wouldn't think it was necessary to ask for a ruling, but because of the fact that we don't have any regulations, so this law which troubles us passed in 1969, the regulations have not yet been issued. Under the proposed regulations there are several examples given and without being too technical at this point, we mention that in ~~this~~ opinion, this case falls in the middle, between two examples, one of which says that the interest is exempt and the other which says that the interest is not exempt. Depending upon the contract between the authority and the ~~companies~~. That's, as I think I mentioned before, a reason why it's important to have enabling legislation because we can't get this question settled and it's a very important question, until there's some enabling authority on the statute books.

McVay: Mr. Barber.

Barber: I have a question, Mr. McVay. Say that the Trans-Alaska Authority Act was passed, HB 569, as amended, would subsequent legislators have the authority and right to change that authority, that authorizing legislation?

Kades: Subject to one provision, they would have plenty of power to change it, for there is a provision in the bill which states that the legislature will not do anything to impair the rights of the bond holders, or diminish the powers of the authority which would adversely affect the bond holders. It might be well if I mentioned it because ---- this is on page 23, this section 44.58.340, and the subject of this provision, the legislature could at will change and in this stage, if it's inaccurate. The State pledges to, and agrees with the holders of notes, bonds or other obligations of the authority that the State will not limit or alter the rights by this chapter vested in the authority to possess and use property acquired by it or for its use, so long as its corporate existence continues; and to establish and collect tariffs, tolls, rates and charges as may be convenient or necessary to produce sufficient revenue to meet the expenses of maintenance

and operation , and to fulfill the terms of any agreements made with the holders of notes, bonds or other obligations of the authority. And further pledges it will not, in any way, impair the rights and remedies of the holders until the notes, bonds and other obligations, together with interest thereon, and interest on unpaid installments of interest are fully met and discharged. That's the only limitation on the power of the legislature to control the activities of the authority and that's understandable because the bond holders, especially if they're relying solely on revenues of the authority, will be taking the risk that the revenues will be raised and if the legislature withdrew the power from the authority to charge tariffs sufficient to pay the bonds, the bond holders would not have any recourse against the State. Their recourse would be only against the authority under the revenue type - bond type of obligation which the authority would be authorized to issue. Thank you.

McVay: Are you through Mr. Barber? Mr. Rose.

Mr Rose: Mr. Kades, you have indicated that these revenue bonds would not in anyway obligate the credit of the State. As a practical matter though, isn't the credit of the State behind the revenue bonds in the event the project is not as successful as anticipated?

Kades: With all due respect I don't think so. The bonds will say on their face, the offering circular will carry language to the effect that the State is not liable on the notes or bonds, or the interest on the notes or bonds, and no one will be misled - the bond holders will be looking solely to the revenues of the project. Some revenue bonds have gone into the [illegible], one, an authority of the State of Virginia and I daresay, although I rather, again I'm not a financial expert, have Mr. Macy or Mr. Guildhouse testify to this, but I doubt if that's in any way hurt the credit of the State of Virginia. There's an authority in California [illegible] but no one thinks that California should pay

those bonds. Here and there, some authorities have gone into the [pool] without adverse affects, I believe, so far as the credit of the state is concerned. And everyone is put on complete notice and there's no misrepresentation or anything to cause anyone to seek recourse against the State, and in those instances where an authority or a project was bonded by a revenue basis [bond] the state in question, or the municipality in question, had not come through and back it up with its own credit. At the present time, there are a hundred million dollars of bonds of the Cheasepeake Bay Bridge and Tunnel Authority in float in the state of Virginia, has nothing whatever and they have been under [pool] for two or three years. I don't even think a bill has ever been introduced to do anything about the bonds. Ultimately, I suppose the reason is, I'm out of my field now, but I suppose the reason is the bond holders will ultimately get paid. There are tolls coming in but they're not coming in as fast as was anticipated so they're getting, I think, two-thirds of the interest. Eventually they'll be paid off, but there's no move against the state, or by the state, to - that's been one of the - in fact, that's [one] of the basic reasons for the authorities being created in the first instance was to take the burden off the taxing power and put it on the revenues of enterprises that were revenue producing. If you take the Port of New York Authority with three billion dollars worth of bonds, of which half are now outstanding, it would be a terrific debt even for states like New York or New Jersey. One of the reasons for setting up that authority was so there would be no recourse against the states and that was also the reason for setting up the Power Authority of New York, and the Power Authority of Los Angeles.

Rose: I do see that as far as the people of Alaska are concerned, they wouldn't have to worry about their children and grandchildren being obligated in anyway

Kades: That's ~~true~~ correct.

Rose: Thank you.

Kades: Mr. Holm

: Mr. Kades, as I get it then there are three stages going to be passed: 569, is that right? 569, and then the people will vote on a change of constitution so that we can dedicate the funds and thirdly, the legislature will have to act to dedicate the funds. Now, in your judgement, will it be necessary for us to go through all these stages in order to optimize the interest rate on these bonds, especially a bonding of this size?

Kades: I don't really know. I am an attorney and I think perhaps I'll let that question be answered by Mr. Macy and Mr. Guilderhouse. I don't mind giving you my private opinion, but it's not an expert opinion---

[illegible] field now

I would think that anybody, I was just thinking to myself now as if I were going to buy the bonds, I would rely on the revenues of the pipeline, not the taxing power of the state of Alaska, my feeling it would be that the security is the oil that would be flowing through the pipelines, not what real estate or income taxes Alaska can extract from its limited population.

Holm: Now you people are bond counsels?

Kades: It's attorneys, a bond counsel is, we're lawyers. We're not financial experts such as are going to follow me, that's why I say-I say I'm out of my--

Holm: Now, if we do go the route, bonding ourselves for three and one-half billion dollars, then you people will also act to advise the State, or someone will act to advise the State, involving this bonding, in addition to the broker house or whoever is going to sell the bonds?

Kades: The underwriting group have their own counsel, we've been acting as counsel to the State. The -- I just might say because we've had many meetings ~~with~~ where the

underwriting group's counsel who are much _____in New York, agree with, generally agrees with what I've testified. But we would represent the State to be sure that, for example: to be sure that there wasn't anything in the circulars or in the offering prospectus or in the resolutions which indicated, that directly or indirectly, there was any obligation on the State to resort to its taxing power in the absence of the guarantee, of the state.

Holm: Could you tell us what it costs the State to enlist services like yours in case we went to sale of the bonds?

Kades: No, we have never charged a fee without first consulting with our client and being sure that he, or the public body, felt that it was reasonable because we're - we're - we live in a fish bowl and our fees are a matter of public record. So, I think we probably have to be more cautious than many private corporate lawyers.

Holm: Well, we kinda live in a fish bown too and we'd kinda like to know what it's going to cost us if we're going to sell three and one-half billion dollars worth of bonds.

Kades: Well, I think it's a very fair question, but I may say that so far, it hasn't cost the State anything.

Holm: Are there other questions by any other members of the legislature?

Holm: Mr. Rettig has another question.

Rettig: Just one ~~more~~ question Mr. Kades. In the proposed constitutional amendment, I suspect there may be some reluctance on the part of the legislature, and perhaps the public, to open wide only momentarily, this prohibition against the dedication of tax revenues for a particular purpose. In your opinion, if this- in your opinion, if this dedication were limited to the tax revenues arising from a particular enterprise, such as the pipeline, if it were restricted to those particular taxes, would this in any way adversely affect the non-tax status of,

the possible non-taxable status, of the bond?

Kades: No, I think it would be a good idea, and I think your suggestion is well taken, to insert the language that's in Section 8 and Section 7, where it's limited to public enterprises or public corporations created or empowered to construct the pipeline, so that it would be more limited than it is.

Rettig: Now, I believe that what I really meant was to restrict the dedication to the taxes arising from that poperation of that, for example, the pipeline.

Kades: Such as the severance tax.

Rettig: Correct

Kades: Well, that really depends on how much of the purchasers of the bonds feel they can rely on the revenues of the pipeline plus the severance tax.

Rettig: Now I'm not speaking of the security to the bond holders but the tax status of the bond interest, only. If it were tied directly and restricted to the tax revenue

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

The log I've kept is strictly the name of the people who are talking. There is one bad part of the hearing and you'll have to rely on the Department of Revenue transcript which is enclosed.

The Department of Revenue has kept a transcript of the hearing. The equipment that I've recorded on is much superior to theirs but think the ideal way to transcribe this is for someone to edit their transcript and let someone else type. This seems the most expeditious to me. Just glancing at their transcript I notice that the names are spelled very poorly. I think that most of the people who testified have their names listed on one of the enclosed sheets. You can get the spellings from there. The people who did the questioning not on the committee were either Senators or Representatives and you can get their spelling. There is enclosed for your convenience the statment copies that were provided to the members of the committee. I'll try enclose anything that I think might help you in transcribing.

Jim Bryson

March 6, 1972

0003.5 Called to order by Rettig

0005.3 Introduction of committees

0010.0 McVeigh

0011.0 Rettig

0012.5 John Havelock introduction

0014.0 Boucher makes statement

0038.0 End of Boucher

0038.3 Rettig intro. Havelock

0042.0 Herbert makes statement

0052.0 Herbert returns to seat from across room

0055.0 Herbert returns to seat

0064.8 End of Herbert statement.

0066.5 Havelock's statement (Rettig introduced)

0084.3 Havelock intro. Temple

0084.3 Rettig's "fine"

0085.0 Temple statement (no copy)

0141.0 End of statement

0141.0 McVeigh

0142.5 Groh

0143.3 Temple

0144.0 Groh/Temple

0145.0 Groh/Temple

0146.0 Groh/Temple

0150.3 Young/Temple

0154.3 Meland/Temple (just tell Joe Blow on the street)

0157.0 Holm/Temple

0166.0 Hubert/Temple (McVeigh chairing during question and answer period)

0169.0 Rose/Temple

0175.0 Barber/Temple

0179.0 Miller/Temple

0182.5 Rose/Temple

0185.3 Radar/Temple

0187.5 Bowman/Temple

0188.5 Josephson/Temple

0191.5 Swanson/Temple

0193.5 Mike Colletta/Temple

0196.5 Farrow/Temple

0198.0 McVeigh/Temple

0198.3 Rettig/Temple

0203.0 Temple - End of statement

0203.8 Recess -- reconvened

0204.0 Bruce Campbell statement

0212.3 End of Campbell statement/Rettig

0213.3 Holm/Campbell

0214.3 Rose/Campbell

0218.0 Christiansen/Campbell/Havelock

0220.5 Rettig

0221.8 Havelock

0222.3 Recessed until 8:00 a.m. tomorrow.

March 7, 1972

0224.0 Reconvened

0224.3 Rettig intro. Wohlforth.

0225.0 Rettig

0226.0 Wohlforth statement

0269.5 End of Wohlforth to Havelock

0271.0 McVeigh "can everyone hear...."

0273.0 Larry Eppenbach statement

0284.0 McVeigh

0284.3 Groh

0285.8 Wohlforth

0287.5 Groh/Wohlforth (McVeigh "speak up, etc.")

0288.3 Christiansen

0289.0 Havelock

0290.5 Holm/Eppenbach

0294.0 Wohlforth answers

0299.0 Havelock "May I comment." Holm

0297.8 Havelock

0306.5 Christiansen (McVeigh chairing during question and answers)

0307.5 Wohlforth

0308.5 Havelock

0309.0 Young/McVeigh

0310.8 Rettig/Wohlforth

0312.8 Eppenbach

0315.0 Palmer

0316.3 Wohlforth

0317.5 Eppenbach

0318.5 Wohlforth

0319.0 Rettig

0320.3 Havelock

0322.0 Recess for ten minutes

(From this point to the noon recess is a bad tape and you will have to go to the Department of Revenue transcript to take your transcript. I will givewhat I have down on my log anyway.)

0322.0 McVeigh

0324.5 Havelock intro Henri

03226.3 Henri

0368.0 End of Henri statement

0368.3 McVeigh chairs - Groh/Henri

0378.0 Young/Henri

0380.0 Wohlforth

0386.8 Eppenbach

0388.3 Holm/Henri

0394.0 Hubert/Henri

0396.0 Barber/Henri

0398.0 Thomas/Henri

0401.5 McVeigh/Josephson/Henri

0404.0 Palmer/Henri

0407.8 Rettig

0408.5 Eppenbach/Palmer

0411.5 Palmer/Havelock

0414.8 McVeigh

0415.8 Colletta/Henri

0420.0 Havelock

0422.8 McVeigh/Rettig/Wohlforth

0425.3 Groh/Henri

0429.3 McVeigh - recess.

(End of bad tape)

0428.5 Reconvened McVeigh

0430.5 Havelock intro Kades

0433.0 McVeigh

0433.5 Kades statement

0450.8 End of statement

0451.0 Groh/Kades

0455.0 Christiansen/Kades

0468.5 Young/Kades

0478.0 Havelock/Kades

0489.8 Barber/Kades

0494.8 Rose/Kades

0501.0 Holm/Kades

0507.3 Rettig/Kades

0519.8 McVeigh/Havelock

0520.5 Kades

0521.3 McVeigh/Havelock

0522.0 Kades

0523.0 Rose/Kades

0525.5 Recess until 3:15

0527.8 Reconvened

0532.5 McVeigh

0532.8 Havelock/Wohlforth

0535.3 Havelock intro Gildehaus

0536.0 Gildehaus statement

0568.0 End of statement

0568.5 Groh/Gildehause

0572.3 Rose/Gildehaus

0575.8 Wohlforth

0578.3 Rettig/Gildehaus

0589.5 Havelock/Gildehaus-Rettig

0594.0 McVeigh/Gildehaus

0600.8 Eppenbach/McVeigh

0604.3 Gildehaus

0611.0 Rettig/Gildehaus

0612.0 Eppenbach

0612.5 Wohlforth

0684.8 Havelock

0686.0 Groh/Rettig

0687.5 Havelock intro

0687.5 Havelock introduced Hellen

0688.8 Hellen statement

0704.0 End of statement

0704.5 Rettig/Hellen

0713.0 Holm/Hellen

0714.0 Holm/Havelock

0717.3 McVeigh/Hellen

0774.3 Groh/Hellen

0726.3 Havelock/Groh

0727.3 Rose/Hellen

0734.8 Hubert/Hellen

0738.8 Rettig/Havelock

0741.0 Holm

0741.5 Christiansen/Rettig

0743.5 Wohlforth

0743.8 Rettig - adjourn until 8:00

March 8, 1972

0745.0 Reconvened

0746.0 Sen. Croft statement

0778.3 End of statement

0779.0 Groh/Croft (Rettig chairing)

0786.5 Radar/Croft

0789.0 Rose/Croft

0792.0 Hubert/Croft

0797.5 Barber/Croft

0802.5 Croft statement

0805.0 Rettig/Croft

0807.3 Rose/Croft

0810.0 Hubert/Croft

0813.0 Croft finish

0813.3 Rettig statement

0817.8 Recess until 9:15

0818.0 Reconvened

0821.0 Rettig introduction of Spahr

0876.8 End of statement

0876.3 Holm/Spahr

0897.3 Miller/Spahr

0910.0 Groh/Spahr

0916.5 Radar/Spahr

0921.0 Croft/Spahr

0925.3 Thomas/Spahr

0930.0 Josephson/Spahr

0938.0 Merdes/Spahr

0949.0 Recess until 1:30

0950.3 Reconvened at 2:00

0952.0 Rettig/Donaldson

0953.0 Donaldson intro Williamson

1005.8 End of statement

1006.0 Groh/Williamson (Rettig chairing)

1008.0 Donaldson

1009.3 Holm/Williamson

1012.0 Donaldson

1013.5 Rose/Williamson

1015.3 Donaldson/Rose

1017.5 Williamson

1019.3 Donaldson/Rose

1022.3 Williamson

1025.0 Rettig

1025.5 Donaldson

1028.3 Radar/Williamson

1032.5 Donaldson/Radar

1036.3 Hubert/Rettig/Donaldson

1041.3 Croft/Williamson

1047.0 Barber/Williamson

1048.0 McVeigh

1052.8 Palmer/Williamson

1056.5 Croft/Williamson

1058.0 Radar/Williamson

1060.0 Donaldson

1061.3 Thomas/Donaldson

1068.5 Donaldson

1063.0 Recess for 10 min. - Reconvened

1066.0 Donaldson intro net three witnesses.

1068.0 Harry Jones statement

1097.5 End of Statement

1098.0 Rose/Jones

1100.3 Miller/Jones

1106.3 McVeigh/Jones (Rettig chairing)

1112.5 Groh/Jones

1116.5 Hubert/Jones

1124.5 Holm/Jones

1130.5 Donaldson intro Markham

1131.5 Markham statement

1196.5 End of Statement--recess

1197.00 Reconvened - Rettig

1200.0 Holm/Spahr

1200.8 Groh/Spahr

1206.3 Palmer/Spahr

1210.3 Donaldson/Palmer

1213.8 Hubert/Spahr

1222.5 McVeigh/Spahr

1229.5 Rose/Spahr/Donaldson (we'll try to get an answer...)

1242.8 Mr. Spahr left.

1244.0 Recess

End of Tape #1

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

OUTLINE OF PROPOSED TESTIMONY
BEFORE
THE SENATE COMMERCE COMMITTEE
HON. RON L. RETTIG, CHAIRMAN
AND
THE HOUSE LOCAL AFFAIRS COMMITTEE
HON. RICHARD C. McVEIGH, CHAIRMAN
3:00 p.m., March 6

1.	The Concerns of State Policy Statement of Governor	(Lt. Gov. Red Boucher)
2.	Alaska's Stake in North Slope Oil leases, royalty, severance and rollback	(Charles Herbich, Commissioner of Natural Resources)
3.	The Federal Role in North Slope Oil I.C.C. regulation - how it works, federal pre-emption	(John E. Havelock, Attorney General, Pipeline Coordinator)
4.	The Cost of Building the Trans-Alaska Pipeline System	(Bruce Campbell, Commissioner of Revenue)
5.	The Impact of Costs on Revenue	(Dale E. Woldfeath, Commissioner of Revenue)
	Methodology - Comparison of State and Private Ownership Cases	(Barry Eggebach, Department of Revenue)
6.	Impact of State Revenues on the State Budget	(Joseph R. Bond, Commissioner of Administration)
7.	The Advantages of State Ownership Issues and Answers	(H. M. Temple III, Temple, Bardeen & Stonne)
8.	The Statutory Framework for State Ownership	(Charles Kuder, Hawkins, Delafield & Wood)
9.	Arrangements for the Public Financing of Pipelines	(Tom Gildehaus, Temple, Bardeen & Stonne)
10.	The Marketing of Public Pipeline Issues	(Robert Macy, Kuhn, Loeb & Co.)

AGO 530717

Page No. 6

Mr. Rettig: Now at this time we will proceed with the administration witnesses, Attorney General John Havelock.

Mr. Havelock: Thank you Mr. Chairman. The opening witness we present for the Committee here today is the Honorable Eric E. Wohlforth, Commissioner of Revenue, who will speak generally to the impact of pipeline costs on revenue. Commissioner Wohlforth.

(Mr. Rettig)
Before Mr. Wohlforth commences his testimony, I would like to point out just a slight kink in our plans. We are going to commence questioning from committee members and legsilators immediately following testimony of all out-of-town witnesses. It would be helpful if you do have questions concerning the administration staff and others who reside in Juneau to save your question, certainly make notesof them so that you can ask those questions at a later time at the individual committee meetings when these measures are being considered.

(Mr. Wohlforth)
Thank you, Mr. Chairman, members of the committee, let me first point out one of those uphappy events which happens in the course of preparing documents and that is for these two years 1980 and 1981 some typist made a reversal of some of the figures. The figure 3397 should be under state taxes, the figure 3705 should be under state taxes, thats Conversely taxes should be in the other column. I think that we see readily from the sequence of figures that that typing reversal did occur and I'm very much indebeted to the unidentified gentlemen who called it to my attention at 7 o'clock this morning.

The figures which are, although done graphically, are hard to see from, by any of those who are sitting in back of the room or any person who doesn't happen to be farsighted, are depicted in a hand-out entitled, Exhibits to support Testimony before these Committees, with yesterday's date. Committee members have those exhibits now and they will see little tick marks after the two places where the unfortunate figure reserval occurred. My job this morning is to summarize past projections of North Slope revenues and those presented today based upon private ownership and to contrast the effect of private ownership case with the case of the pipeline owned by the State of Alaska. The most recent public North Slope oil revenue projections before those which

Governor referred to last week were made by the Division of Oil and Gas in cooperation with the Department of Revenue as part of the State's contribution to the Federal impact statement which was released by Governor Egan in July of 1971. These projections were developed from a computer model which was based on the information then available to the State of Alaska and showed various and numerous economic cases on differing assumptions again, based on facts then assumed to be ascertainable. The July 30 report which is contained in the State's contribution to the impact statement states, on page 166, that "the originally estimated $900,000,000 cost of the pipeline has already increased considerably, present cost estimates range from one million to 2.1 billion, that will occur I am sure, frequently, to 1 billion to 2.3 billion dollars. These revenue projections use the assumption of one billion dollars, as the lowest installed cost of the pipeline and 2.5 billion as the highest estimate. A footnote to this statement gives backup for the State's then cost estimates. This footnote notes that as late as July 19, 1971, Aleyeska furnished the State Department of Revenue an estimate of $969 million dollars as the cost of the entire contract and the footnote concludes with a reference to a statement from Interior Secretary Rogers C. Morton, in the late spring of 1971 that environmental regulations and environmental precautions are contributing to a higher price tag of about 2.3 billion dollars. So it was this figure of 2.3 billion dollars which was used on the State's most likely estimate of North Slope revenues. ~~The revenue estimates included in the State's report developed from this estimates of total cost, the revenue estimates most likely estimate of North Slope revenue.~~ The revenue estimates included in the State's report developed from this estimate of total cost assumed refinery value in the year, fiscal year 1975, which was the then estimated start-up year, that is refinery value on the West coast of $3.37 a barrel, marine transportation costs of 44¢ and pipeline tarrif initially of 80¢ per barrel, giving a wellhead value of $2.12 per barrel. From these figures it was estimated that total royalties and taxes would amount to $164,000,000 a year in fiscal year 1976. The first year, then assumed, of pipeline operations. In the second year of operations fiscal 1977, the total revenue was estimated at 278,000,000, the third year,

$282,000,000, in the fourth year $311,000,000. In the then-estimated, and I repeat then-estimated, fifth year of operatinn, fiscal year 1980, pipeline tariff was calculated at $ .47 a barrel with marine transportation costs of $ .52 leaving a wellhead value of ~~$~~ 2.56 per barrel. In that year, fiscal 1980, we showed then, a total of $348,000,000 in total royalties and severance taxes from the pipeline. And we didn't stop with one set of assumptions. Other assumptions were run with different assumptions. Estimates were run with different assumptions. For example, one set the pipeline cost $1 billion again with the initial production year 1976. A wellhead value of $2.75 with lower marine transportation and tariff, ~~showed~~ produced $212,000,000 in revenues the first year of production and the ~~second~~ fifth year of production on this optimistic, optimistic ~~on~~ from the point of view of the billion cost of the pipeline, was assumed to capture, ~~I say~~ the State was assumed to capture in that year $412,000,000 in pipeline revenues. A then pessimistic case which assumed a pipeline cost of 2.5 billion showed a wellhead value of $1.76 in the initial year of 1976 and royalties and taxes of $136 million in that year. In 1980, however, at a wellhead value/of $2.20 a barrel, royalties and severance taxes reached the figure of $297,000,000. Incidentally, and obviously, in all these case, one of the main reasons wellhead value increases over the years is that transportation costs go down as the volume of oil shipped/increases. Now several important events have come to light which have required the State to revise downward drastically its revenue estimates. The first indication of the fact that the State was incorrect in assuming as it did, in July, 1971, for its contribution to the Impact Statement, the first indication that the State was incorrect at that time in making an assumption that a production flow/starting at 600 barrels per day would reach 1.7 million barrels per day in the second year of ptoduction was disclosed in the summary description ~~projection~~ of the transalaskan pipeline system received by the State this fall. On page 55 of that ~~the~~ document it is stated the pipeline will be brought to full capacity in ~~three~~ stages. In the initial phase of operation the system will have the ability to transport 600,000

barrels a day, and I'm paraphrasing page 55 of the summary impact statement. The reports goes on to state that the second phase is tentatively scheduled to be completed approximately 2 years after initial start-up. In this phase the report states the system will have the designed capacity of 1.2 million barrels per day. The final phase so says the report, is expected to be completed approximately seven years after initial start up, that is a pumpage flow at which time the pipeline will reach its ultimate capacity of 2.0 million barrels per day according to the description in the statement. In other words, ~~it~~ there willbe, according to the statement, at least five hundred thousand barrels per day less production in the second year of operations and each year thereafter for the initial seven years. The next shock to the State was ~~XXX~~ disclosed by the S.E.C. Registration Statement filed by British Petroleum Company Ltd. ~~submitted~~ on October 12, 1971. In the offering circular accompanying that registration statement the following statement is made on page 24, "the initial construction phase of the pipeline is expected to provide a minimum aggregate throughput capacity upon completion of 600,000 barrels per day. This capacity is designed to be expanded in two stages. The first stage resulting in a total capacity of 1.2 million barrels per day, and the second a total capacity of 2.0 million barrels per day. Parenthetically, no reference to the time of build-up. It is presently estimated that the cost of the pipeline upon completion to the 600,000 barrels per day capacity would be approximately 2.3 billion and that increasing the capacity to 2 million barrels per day would increase the cost by $400,000,000. On November 10, 1971 Atlantic Richfield, together with the City Service Company, filed a registration statement with the Security and Exchange Commission stating that "the cost of the system upon completion ~~TX~~ the 600,000 barrel per day capacity is presently estimated to be approximately 2.4 billion of which the company will be responsible for approximately $675,000,000. The additional costs to all particpants of increasing the capacity to 2 million barrels per day is estimated to be at least $400,000,000. Thus by mid-November, 1971, the total pipeline costs ~~were~~ had escalated to 2.8 billion, or $500,000,000 over the average case assumed in July when the State made its revenue estimates. In fact, it increased $100,000,000

in less than one month between two SEC filings by companies involved in the North Slope pipeline. This dramatic increase in pipeline costs, revealed in official documents at the time of Governor Egan's first announcement on State ownership, made it urgently necessary that the State finally determine independently the likely magnitude of the pipeline costs. Commissioner Campbell has already indicated the independence study which the State has made through its consulting engineers, Tibbets, Evan, McCarthy and Stratton, and the foundation for the present estimate of 3.5 billion. These figures have been recently developed, along with an independent evaluation of operating costs, so that for the first time the State can make a reasonable projection ofthe probable amount it can expect to capture from North Slope revenue. And incidentally, in the hand-out of exhibits there is a breakdown in addition to the comparison of public and private ownership of the construction costs table which Mr. Campbell referred to yesterday. We will make additional copies of those available if they are in short supply, for other senators, representatives or members of the public desire to see them. The base case shown today in graphic form assumes the total pipeline cost of 3.5 billion financed 90% by debt, at an interest rate of 8%. It conforms to the Aleyska throughput assumption of full production only in the 7th year of pipeline operation. It shows the same ICC permitted rate of return as shown in the State's projection in July. In the fourth year from the beginning of construction or thefirst year of operation, for 1977 we now show a negative well-head value or no state revenues. This was the year comparable to that in which it was earlier shown that the state would capture at least $164,000,000 in total revenues consisting of royalties and severance fees. The fifth year, 1978, the second assumed year of operation we earlier estimated $278,000,000 in State revenues. In these two years alone the net revenue loss to the State over earlier estimates amount to $442,000,000. By the sixth year, or 1979, the new projection shows $84.6 million in oil severance and royalties revenues. Earlier we estimated $282,000,000 for that year. The net loss by that year over earlier estimates is $640,000,000. Not until the 15th year of pipeline operation do royalties and severance taxes amount to near the amount shown in our previously made estimate before the second calculated year

In that 15th year we show severance and royalty revenues of $?77 million. Now the question ~~is~~ it has been asked, and not only has/been asked, it has been asserted that this is the most pessimistic of all/cases possible which can be produced by the State for its revenue picture in the late 1970's and 1980's. I'd say that the answer to that is clearly no, for three reasons. In the first place the revenue loss figure mentioned above is no effect to our expectations now of first pipeline operation in the year 1977 whereas in July we assumed the full year of revenues starting on July 1, 1975. That is to say we show a $640,000,000 loss comparing three years of operation regardless of start. In the second place we show state taxes in each year of operation of approximately $33,000,000. For these first three years of operation ~~the~~ state income taxes are estimated to total approximately $100,000,000 or 3 times the $33,000,000 a year. This assumes full state ~~impacts~~ income tax on pipeline profits. Experts have indicated that this itself may not be/a realistic assumption. Even, however, with the most optimistic income tax estimate, net revenue loss from earlier projections amounts to $540,000,000 during the critical first three years of operation. Thirdly, calculation of the 7% permitted rate of return on valuation may err on the low side. This was alluded to yesterday by Mr. Temple as the legalities of the possibilities were discussed by Attorney General Havelock. I can only say that the leading text on the ~~XXXXX~~ subject which is Petroleum Pipelines and Public Policy by Arthur Johnson, cites numerous instances of the slowness of the ICC to actually evaluate pipeline costs and its heavy reqliance on figures supplied by industry. And its well known to the Committe and/to the public at large that the Cook Inlet pipeline valuation itself took nearly three years to complete. The 7% figure again is not high when it is remembered that there are seven separate proposed pipeline owners, each of whom may aggregate earnings of each of its other pipelines when the 7% rate is considered. We will hear further expert testimony on this later. The point here is that is entirely possible that higher return rates ~~will~~ may be permitted at least until the valuation of the pipeline is complete and possibly there after when earnings of other pipeline companies are aggregated to arrive at a total rate of return for a particular pipeline company. The next case shown on the chart and to some, seeable on the wall, assumes the case

of the economic effect of State ownership of the pipeline. Financing is assumed in the amount of $1 billion dollars in each of the first two years of construction at 8%. $900,000,000 in the third year of construction at 6.5%, $215,000,000 at 8% in the first year of operation and $310,000,000 in the second year of operation, and I may say that Mr. Eppenbach who will follow me will give you some more precise detail on the assumptions that went into the assumed case of public ownership I'm now discussing. This case also assumes the same ICC permitted rate of dividend payoff as assumed for the private case. The 7% percent which is a cash dividend payout limitation in each year of the projection. In arriving at the State's net cash flow which is indicated at the top of the chart assuming public ownership, pipeline income, royalty and production payments, in arriving at the State's net cash flow operating expenses, amoritazation and interest on bonds, are deducted from gross income. During the first year of operation net cash flow to the state through tariff is, as you can see from the chart, $230,000,000 and royalty and severance taxes amount to $15.7 million for a total of $245,000,000. Obviously, in State ownership no Federal or State income taxes are calculated on pipeline income. Mr. Kades will speak to this later today, explaining in detail the assumption legal rationale for that statement. In the fifth year from the beginning of construction, or the second year of operation, net cash flow is $228,000,000 which together with royalty and severance taxes of $17,000,000 produce a total of $245,000,000 for the State. In the sixth year from the beginning of construction and the third year of operation, net cash flow amounts to $227,000,000 through the tariff and total royalties and severance taxes amount to $123,000,000 for a total $350,000,000 or for those who are farsighted, $350.94 million as shown on the chart. In the 15th year cash flow is reduced to $183,000,000 by reason of the fact that the pipeline has depreciated but total royalties and severance taxes amount to $297,000,000 for a total to the State Treasury of $480,000,000. Now let me emphasize that this case makes almost identical assumptions to the private case described before. It should be

emphasized that net income to the State is computed after debt service on State bonds. To avoid a speculative argument on the possible differential between interest rates on the State's debt, which may be tax exempt, versus taxable interest on private borrowing, we show all but $900,000,000 in state bonds at the same 8% rate as shown in the private case. I think the 8% can be, we could spend the day arguing 8%, 7% or 9%, we all know the trend of interest rates in recent years, the fact that double AA corporate ~~XXX~~ bonds are selling today at about an interest rate level of 7.23 gives me comfort that 8% is as good an estimate of interest on both state and public borrowing and indeed conservative on state borrowing as which can be arrived at today. The main differences between the assumptions lie of course as I have stated before, in the fact that the State is not subject to Federal income tax and obviously will receive no State income taxes from the pipeline since it is assumed to be the owner. The timing of the bond issues for both the public and the private cases is the same, although the term of the public bond issue is ~~short~~ shorter, 25 years, indicating heavier debt service loads and the state of course is assumed to finance the pipeline 100% ~~and~~ on a step basis. Now we ~~can~~ could make numerous additional assumptions, and we have made additional assumptions, on the question of the matter of public financing, the manner of private of private financing, the assumed debt equity ratio of private financing, the rate of return permitted either to the State or to private pipeline owners, interest rates payable by the State and private pipeline owners, the effective tax rate in private ownership, to mention only a few. We know and the Committee knows, and I believe ~~that~~ each Senator and Representative in this room knows, that estimating the effect of a project of this size and magnitude based on events three to seven years away, must rest on ~~an~~ assumptions which are to a degree speculative and you will hear testimony that our assumptions are probably incorrect. The point is that no one can say with absolute certainty what our revenue picture will be with the pipeline in private ownership. We have now, however, tested prior ~~XXXXX~~ assumptions based on new and in two instances, official information before us. I refer to the Aleyeska Impact Statement and the more recent SEC

filings of ~~the~~ two of the member companies. This effort and this information has convinced the administration thatit must attempt to do now what it can to remove the uncertainty of the revenue picture in the late 1970's and the late 1980's and this attempt to remove the speculation and to give the State the tool to move forward in this regard is the thrust of the billsthat are here before ~~XXX~~ you today. The details of the bills, the theory and rationality ~~XXXXXXXXXXXX will be~~ addressed by other members to come before you, but I see it in the context of State's effort to remove the degree of speculation about which we are in when the pipeline ~~is~~ starts to flow and when State revenue's can, to some degree begin to be hoped for.

Mr. Larry Eppenbach, L. E. Eppenbach, will explain to you now how our projections were made ~~and~~ in some additional details, and some of the detail on the chart before you. Thank you.

Thank you Commissioner.

Mr. Havelock. A little comments, perhaps, about now to explain the methodology used in discussing with Commissioner Wohlforth, Mr. Chairman, he acknowleged recognition that there is considerable complexity to the testimony as presented by himself and Mr. Eppenbach and if the Chairman wishes that...so that details are not lost in the minds of those

END TAPE 6

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

Date of meeting: March 7, 1972

MR. EPPENBACH: Mr. Chairman, Committee Members: In testimony already presented, you have heard a great deal about revenues, talks of pipelines, calculations of royalties and production taxes, and permitted dividends. Rather than to add more numbers, more formulas, more calculations, I think it would be prudent now to pause and develop perspective on the numbers already given to you about the many charts. To do this I should like to talk first about how the State brought all of its [eline information together, to calculate what is the most important piece of information thus far--that is, the new estimates of total annual income from the North Slope. As has already been indicated, we employed a computer model which simulated each year the economic operation of the pipeline, the various conditions regarding ownership, financing, taxes, and earnings limitations. In a sense, an income statement was prepared each year for the owner of the line. This income statement does not appear so very different, at least in terms of these expressions, from that of any other income statement. Gross revenues to the pipeline are derived from its tariff charge in barrels of oil transported through the line. That gross revenue less the cost of operating and maintaining the line less depreciation less interest cost of financing the line will produce the net income figure. From that we deducted any Federal or State income taxes paid to calculate a net-after-taxes income. Similarly, the cash flows to a pipeline company is much like that of any other business, is equal to the net-after-tax income plus any additional cash flows which may be generated because the depreciation chargethat is provided for in the income statement happens to be greater than the volume of bond retirements made by the company. The only place the pipeline operation appears different economically to that of the ordinary company is in the dividend payout allowed each year by the pipeline company to its owners. Again, as was discussed yesterday and this morning, that dividend is not some percentage of equity or some rate of return on capital investment,

but is a percentage dividend allowed on the valuation of the pipeline as determined by the ICC. The ICC valuation approach takes into account many issues: original cost of the line, depreciation, percentage increases for going concern value, and additional percentage increases for inflation. Our computer model had to also simulate this ICC valuation. In very general terms, during the first year of operation we calculated ICC valuation to be about $3.25 billion. In the following years it decreased and increases slightly as additional phases of operation were under way providing for a higher throughput and eventually decreased in value as the line began to depreciated.

The dividend limitation on ICC valuation is a critical variable in the economics of pipeline ownership. Our model, given a dividend rate calculated back up the income statement to find out what kind of tariff would have to be placed on the pipeline any year to provide gross revenue required to generate the appropriate cash flow for the dividend. During the first year of operation of the trans-Alaska pipeline, the 7 per cent dividend limitation provides for a dividend to the parent company of over $230 million, a legal dividend provided only to the owner or owners of the pipeline.

If I may turn your attention now to the large chart located up there, which is also the first chart on the Committee Members' chart portfolio here, it is that very dividend that accounts for the vast difference in estimated income to the State of Alaska under conditions of public ownership on the top line, shown in red on the large chart, versus conditions of private ownership, the bottom line. You will note that both lines slope upward as the throughput of oil through the line increases, clearly shown as a step increase between operation of the line in Phase One, a capacity of 600,000 barrels a day up to Phase Two, a design capacity of 1,200,000 barrels per day. But the graph does not display all of the information which is in the tables alongside of it.

First, in public ownership, the major part of revenue during the early years is derived from dividends with positive and growing amounts of revenue coming from wellhead value royalty and production taxes. You will note that there are no State income taxes included here as a revenue source to the State under conditions of public ownership of the line.

Under conditions of private ownership, a very different case develops. Here in the initial year a total of about $37 million should accrue to the State. Where does it come from? Three million two hundred thousand dollars of it only comes from the North Slope in the form of gas royalty and production tax payments. This is gas that is assumed to be shipped in a trans-Canadian gas pipeline. The remaining $34 million comes from State income taxes. In the 7 per cent dividend case displayed here there is no positive wellhead value for oil during the first two years of operation under private ownership. In this case, for there to begin to be some positive wellhead for oil during those first two years, the dividend payments must be no greater than 4.75 per cent, and even if the dividend was lowered to zero during those two years, the State's income of approximately $53 million under those conditions would be, of course, less than one-third of that estimated as recently as last year.

I shall present at the close of the testimony this afternoon a series of cases for the Committee to study that explore this question of taxation and dividend limition. For the present, however, let us return to these two cases that we have displayed before you. Again, they provide a legal 7 per cent ICC dividend. In the private case, even though a negative wellhead value is indicated for the first two years, it is quite possible that the oil companies would still pump oil as their true cost of shipping their own oil through their own pipeline may be different from their calculated cost of shipping the State's oil through their own pipeline. Not only is the dividend permitted legal, but together with the

costs and throughput capacity limitations as stated in the Impact Statement, this case of private ownership of the line appears quite possible. So are the revenues it generates.

That finishes my testimony. I believe now questions are in order.

CHAIRMAN: We'll take questions from the Committee, Senate group, Senate Commerce Committe; Senator Groth?

SENATOR GROTH: At one time when the legislative oil consultant testified before the Legislature he indicated that it would be possible that the oil companies may hasten the date on which the 2-million-barrels-per-day capacity goes into the line. Assumptions here, as I understand you, are based on the premise that throughput 2 million basrels per day will not be achieved for a period of seven years. My question is: Have you inquired of the companies as to whether they intend to hasten that throughput arrangement to sometime earlier than seven years?

WOHLFORTH: We plan to answer that, Senator ~~Groth~~. The official document which came to the State is dated August 1971, and received and analyzed about in the September-October time frame. We made reference as recently as Friday directly to the main Impact Statement itself to determine where that seven-year throughput date was in the official Impact Statement. Commissioner Brewer called the several officials in Washington who could make that determination, and he has assured us that that is the figure that's there. I feel it's a figure we have to live with, and we may hear testimony from oil companies later that indeed that is not the correct assumption, but I really think that's a matter for them to ~~see~~ to and perhaps Mr. Sparr, himself, whom I understand is the lead-off and direct witness.

GROTH: Eric, I understand that if you've looked at the Statement, but insofar

as a direct inquiry then, gentlemen, do you intend to do this sooner than seven years? That discussion, I gather, has not taken place.

WOHLFORTH: We've had discussions. I, personally, have not discussed it with any oil company official. Others have, may have, discussed it. I do not know what their direct answers may have been to that statement.

GROTH: Thank you.

CHAIRMAN: Thank you. Are you through? Senator Christiansen. Please stand up and speak up as loud as you can, please, so they can hear in the back.

CHRISTIANSEN: Mr. Chairman, yesterday just before we left I asked a question and I believe Mr. Havelock said that I would be answered later on. As a matter of fact I think you answered part of it when I asked the question came out where this bond, in case it didn't pass, then what would happen? Would we still have the pipeline or what would we do?

HAVELOCK: I think I indicated, Senator, that we are not now proposing that a bond issue be proposed to the people, but we do have a constitutional amendment to propose that will allow State guarantee. That question would be an academic one. There is always the question of whether the people or the Legislature of the State of Alaska wants to do something, and if the Legislature does not wish to do something, then ~~something~~ nothing will happen. The wishes of the people, the wishes of the Legislature are binding on the State.

CHAIRMAN: Are there any other questions? Senator Meland? Members of the, Senator Holm.

HOLM: Perhaps you can tell me why you only made it a ten-year projection or an eleven-year projection on this chart. What happens if project it to maybe 20 years?

EPPENBACH: For reasons of room and also time here, and having our computer results transmitted from Massachusetts to here in Alaska, we confined the analysis to specific years--first five years and then the eighth, tenth, and fifteenth year of operation. We have the ability to make a longer term estimate. We have analyzed ten years of operation with fifteen years of time periods overall. A more direct answer to your question--~~we tried to~~ in trend establish in a graph to about 1988 within stock since you would be in Phase Three Operation at that point. They would tend to level off a bit. There may be some marginal increases but on the whole we would expect the effects of inflation to just about equal both in costs and in higher refining prices of oil.

HOLM: So then you expect the next ten years the distance would level--would start to narrow.

EPPENBACH: That's right. The capacity of the pipeline, as we understand it now, will not be increased ~~in another~~ during these ten years. It would take an increase in capacity to have those charts continue to move up right off the paper.

HOLM: Then one further question. If I were the Alyeska Pipeline Company and knew I wasn't going to get any additional profit from ownership and operation of the pipeline, I doubt if I'd contract with you to build at the same price that I would build if I were building for my own use. Now, are you assuming that they will build at the same price for you as they would build for themselves?

WOHLFORTH: Well, I think we try to achieve comparability in the suit cases. I indicated in my testimony (I hope I sufficiently indicated) that we had now achieved something which we felt was a great deal firmer in concept than we had certainly last July. To achieve comparability in the one case versus the other the $3.5 billion total landed cost of the figure was assumed. It may be, indeed, that that is not the ultimate price. It may be, indeed, that some of the $3.5 billion cost is not an allocable, ascertainable cost of the State or some slight

amount may be more, but as a gross, and I should say perform an economic projection, we thought it would do the Committee a service to stay with the basic landed at stall cost figures.

HOLM: I also assume that you have not considered any other contractor for the construction of this pipeline becuase they are already the owners of all this pipe and a lot of construction so far.

WOHLFORTH: Mr. Campbell is far better--is he here this morning?

CHAIRMAN: Yes, he's here.

WOHLFORTH: Far better to speak to the composites of the $3.5 million ($3.5 billion --I guess I'll do that every five minutes for the next couple of days) which are set forth in the chart which is here before you and indeed there is a figure here which shows costs to date before start of construction and makes component references to costs thereafter. I defer anything further on that to Commissioner Henri.

? With your permission, may I comment first?

HOLM: I just wanted to assume (1) that Alyeska is the only party that you considered as being the contractor for this, and that they then will probably build in a little bit extra [illegible] to the pipeline because they are almost a captive contractor.

HAVELOCK: First of all, Mr. Holm, the State ownership of the pipeline does not mean that there is no interest or profit available to the industry. Their interests and our interests basically identical in one respect--that we all expect to enjoy a substantial benefit to getting that pipe, that oil underground, and moving it to market, and the fact that the incidence of their benefit shifts from the profits obtained from the pipeline to other aspects of the chain of commerce

doesn't seem to me reduces their incentive. As to the particular incentives in operation, if the pipeline is owned by the State of Alaska and they are a contractor to build that pipeline, they have a particular incentive to operate with maximum efficiency in that construction because under the ICC rule the contractural costs will become the valuation base which we will in turn charge back to the shipping companies for the cost of transportation. So they would then have an incentive which in fact does not exist now to keep costs down. Thirdly, you touch upon a question, or applied in a question which I believe Senator ~~Groth~~ Gross commented on yesterday or addressed you yesterday, which is: What if the pipeline owner/company just don't cooperate? And I think there are three responses to that. First of all, the first response that comes to my mind is: What if the sovereign State of Alaska doesn't cooperate? This is not exactly a situation where the State is without bargaining position. Not only do we have bargaining position, but we also have a substantial interest. This is a situation where the private interest involved vastly exceeds the interests of the public of the State of Alaska.

I may say that in our discussions with the industry we have given some consideration to alternative contractors, but in our discussions have mainly assumed with the industry that in the event that public ownership was deemed to be in the public interest that in fact they would be willing and agreeable to contract. Once they get by the hurdle of public ownership in the first place, as a question of State public policy, I don't believe that we would expect their non-cooperation. There has been no sign in the hundreds of man hours we had in talking with various representatives of the industry that they that they in any ultimate sense, that ~~they~~ the industry would refuse to cooperate. They approach our negotiations with the most--we have had occasional confrontations-type of meetings where tempers where tempers have got up, which is expectable under the circumstances, but they have approached it by and large as a gentleman and

responsible businessman. I have not heard anybody speak in the terms used as to noncooperation. Which reminds me of Commodore Vanderbilt's famous line: "The public be damned--ain't it my railroad?" Nobody has said to us: "The public of Alaska be damned--ain't it our pipeline?" So in the discussions we had, rather than and the people of the State of Alaska, our discussions have pretty well worked themselves out based upon feasibility and the desirability from the point of view of the public policy of the State, and the extent of the commitment or sacrifice that we might be calling upon the industry to make in adjusting these new arrangements. And it is not only a question of sacrifice, of course, but of benfit to the industry. We have not asked them to give up, without compensatory advantages, which we can see for the industry in these arrangements.

The last point I might make on it is that we aren't really going to find out where we are until we have the tools, that is, the permissive legislation which would enable us to go forward and talk with them and move into the next stage of negotiation with the industry based upon an authority bill that the Legislature might adopt. I think it is first for the Legislature of the State of Alaska to decide whether it is the public policy of the State, or should be the public policy of the State, to have public ownership of the line and then to ask questions as to what the attitude of the industry is and whether they are willing to go along rather than the other way around.

Sorry to have talked at such length, but that does meet some of your points.

CHAIRMAN: Are there any other questions on State affairs? Senator Christiansen.

CHRISTIANSEN: Mr. Chairman, I hate to keep asking this question, but talking about $3.5 billion, and if we don't bond outself, where are we going to get that $3.5 billion to build the pipeline? Then if we do build it, are we going to use

this first revenue to pay it back, or?

WOHLFORTH: I may just point out that the pipeline income here is shown under public ownership. This income is after debt service, Senator. Debt service is off before you get to this , that's been calculated. On the assumptions we've made so far, the debt service is shown as a deduction from gross income and this is net income, and I think that may answer a tiny portion of your question. It is assumed that the money would be borrowed in all events.

CHAIRMAN: The next three witnesses will be addressing themselves to the question you raised as to the market situation. Senator Young.

YOUNG: Will we be allowed to call any of these witnesses back again?

CHAIRMAN: That's the plan. The reason we're departing from the regular procedure is that because this witness will probably not be available at that time. Address questions to the administrative or administration officers. Mr. Rose.

ROSE: Only one question, Mr. That's on the difficulty on our payment during the initial payment period until revenue starts going in. Now, I assume that the bonds require a yearly net interest payment, and how would that be met?

WOHLFORTH: Again, we'll address more specifically the area of authority bond issue by Mr. Kades. As with other public authority issues, interest is borrowed or capitalized during the construction period.

CHAIRMAN: Any other questions, members of the State Affairs Committee? Senator Rettig.

RETTIG: Question to Mr. Wohlforth. You referred to the first table in the income from the pipeline under "Private and State Ownership." In the year 1988 you called our attention to the sharp drop in pipeline income from $235 million

in 1983 to $183 million in 1988, and I believe you attributed that to the impact of depreciation that had then taken place. Recalling Mr. Temple's testimony of yesterday, it indicated that pipeline valuation, which is the base ICC permitted profit, you stated, I believe that this valuation was based on replacement costs. Well, what effect would this depreciation have then, if that be the case?

WOHLFORTH: First, let me say, Mr. Chairman, I'm going to turn this over to Mr. Eppenbach who will have the full text of Mr. Temple's testimony before you hopefully within an hour or so, and you take it away on that basis, Larry.

EPPENBACH: Senator, replacement cost is clearly a function of replacement from original cost. The higher the value of the line, then, the larger the dividend, assuming a constant rate of dividend, whether it be 5.5 or 7 per cent, or higher. Now, ~~Herbert~~ Temple did testify that replacement cost was a significant component of the ICC valuation formula. In developing this model to simulate what ICC valuations would be in any particular year, we did include a percentage inflation factor to estimate replacement costs. We found, however, that the formula was quite complex, and in later years it was also [illegible] of the formula, we'll call that depreciation, so that the net effect was yes, inflation was there [illegible] up the value of the pipeline for a period of time, but then eventually using the ICC's own table for depreciation. The value of the pipeline fell off. Now, I can't tell you more than that right now other to say what we did--what will happen--how the ICC will value the pipeline. As far as I'm concerned, it is a matter of great uncertainty right now. Thank you.

RETTIG: That's all I have.

CHAIRMAN: Are there any questions now from other members of either the House or the Senate? Senator Palmer.

PALMER: Yes, Mr. Chairman. Perhaps this information has already been given

and, if so, please forgive me, but I do have four questions--they are all related. We will all hope, of course, that there will be many more structures found on the North Slope that will use the pipeline. On the other hand, we have to assume that there may not be. Therefore, what figures do you ~~have~~ use for ~~First of all for total~~ Prudhoe Bay Reservoirs and then the amounts recoverable? We did think of that yesterday, I think, but I would like to know what figures you used.

WOHLFORTH: Really, Mr. Herbert is the expert witness on this subject. We know, Senator Palmer, that 9.4, which is the de ~~Gaulle~~ Galle, or 9.6 billion, which is the de ~~Gaulle~~ Galle-McNaughton proven reserve estimate, has been variously assumed to have been increased to $14 billion, and in a Canadian magazine referred to as 50 billion in the total field and adjoining field. The figures that we used, very frankly, showed enough oil to flow for 25 years to amortize at the rates of, amortize a $3.5 billion bond issue.

PALMER: Do you have that figure?

[illegible]

EPPENBACH: No sir. We made that assumption that given the 9.6 billion barrels proven today that there would be additional (cough) [illegible] by the time (cough) the last bond issue was issued to support a 25 year debt. They contrasted that on private financing, that is, ownership of the line by private industry. We calculated 30-year debt, assuming they would also [illegible] their credit on their bonds.

PALMER: You are basing the debt service on the assumption that there will be a reserve found? The pipeline will be utilizing those reserves in addition to the Prudhoe reserve?

WOHLFORTH: That's correct.

[illegible]: That concluded my group of questions.

CHAIRMAN: Are there any further questions? Senator Rettig.

RETTIG: Just one item of clarification to Mr. Havelock. Perhaps in your

in reference to your comments that the State does have a certain amount of bargaining power because its, ah

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

TAPE # 8

Senator Rettig: The oil that we are speaking about, have we not already sold the 7/8th interest in that oil and is not that now a right to the 7/8ths of the oil invested in the oil companies, doesn't this perhaps give them some sort of a weighted vote in these matters:

Havelock: Well I think that certainly in our discussions Senator, we have attempted to weigh and recognize the private rights that are involved, and I don't mean by any means to suggest that the private rights of the industry should not be given all the considerations appropriate. While the oil is in the ground, my understanding is that it is the oil of the people of Alaska and if the leases are not exploited it will revert to the people of Alaska, but certainly you are quite correct that 7/8ths that one, as the oil comes out of the ground, it's theirs and it is entitled to be given recognition as we recognize any body else's right to private property in the State.

Senator Rettig: Are there any other questions now? (Ten minute break)
The State of Alaska would like to call the Honorable Joseph Henri, Commissioner of Administration who will testify as to the impact of State revenues on the State budget and related issues. I may state as Mr. Henri has found, that in discussion with him he has indicated that he would like to have the opportunity to get full presentation before the committee in advance and that if he has no objections to questions relating to his testimony when he concludes his remarks. I would like further to say with regards to, I said the later witnesses would be answering Senator Christianson's questions, I was really referring to Mr Kades, Mr. Gilderhouse, and Mr. Macy who are the witnesses that follow Commissioner Henri.

Joseph Henri: Written Testimony

TESTIMONY OF JOSEPH R. HENRI
Commissioner of Administration, State of Alaska,
Before the Senate Commerce Committee
And the House State Affairs Committee
At Juneau, Alaska, 6 March 1972,
Regarding Income From North Slope Oil and Gas,
And How it Affects the State Budget

Mr. Chairman and Members:

I am Joseph Henri, Commissioner of Administration. This part of the State's presentation deals with budget expenditures vis-a-vis income to be derived from North Slope oil and gas extraction. The essential questions are:

1. Will we be able to maintain our current level of services, adjusted for population growth and inflation?

2. Will we be able to increase our level of service to meet compelling needs recognized by this administration, the legislature and the citizens of Alaska?

3. Will we have to reduce our level of service, and if so, what are the activities affected?

The answers to these questions rest in the amount of dollars the State can expect as its share of the Prudhoe Bay oil basin. Once upon a time, the Department of Administration felt much more certain about future State income than it does today. When will the

pipeline begin? What extraordinary man-caused interruptions will delay its completion? What will be the first year capacity of the line? The second year? The third? What is the maximum extraction rate the basin structure will prudently allow? What volumes of oil can be expected in any of the first seven years of the pipeline? What will be its final cost?

All of these variable factors, well known to each of us in this room, make budget planning extremely difficult, because the major part of Alaska's State revenue has come and will come from ~~the~~ North Slope resources. In the budget now pending before the legislature, we have recommended a total general fund expenditure of $311.7 million; those are state dollars of this sum, $97 million will have to come directly from the Prudhoe Bay bonus money, the principal, and $52 million more from interest earnings on the investment. As we dip heavily into the corpus - invade the principal - interest earnings diminish, compounding the revenue problem. Our present or anticipated re-curring revenues are simply too low to fund our present and anticipated expenditures. We are depleting our savings account. As the following year's budget figure increases, more of the principal will have to be spent; the interest yield will dwindle further. Obviously, we will soon hit the bottom of the barrel. Only large and new revenues from the North Slope can allow us to continue our present budget growth rates.

What is the growth rate we have recommended for Fiscal Year 1973? For the general fund, it is 3.5%; for the total budget, 4.6%. We have had to slash so dramatically the rate of increase because pipeline delays and cost escalations have darkly influenced

our future revenue projections. With ~~such~~ a small increase in the budget, a number of programs have already felt the chill winds of dollar scarcity. The proposed Fiscal Year 1973 budget contains such unpalatable things as holding school foundation funding to the current year's level, regardless of enlarged student population; keeping the University's of Alaska increase to $800,000 in the face of a claimed need for an addition of over $5 million just to maintain current activities; a limitation of nursing home care and general medical relief; foregoing general obligation bonds for lengthening two more ferry boats, and for a larger program of airport construction. There are many more "pinches" in the budget, besides that I have mentioned. Nonetheless, so far we have not jeopardized any State activity essential to health and safety. These painful adjustments herein noted were recommended in spite of the fact oil was projected on stream in July 1976; now another year's delay - or more - seems probable. The consequences are obvious.

Our budget book for Fiscal Year 1973 projects a growth rate of 6% compounded annually through 1976, and 8% thereafter through Fiscal Year 1977 1981, covering a ten-year period. Further, it envisions capital improvement bond authorizations of $60 million in 1974, and $100 million in the next biennial election, and each one thereafter. I can only characterize these projected budgets as "modest." They are very little more than maintenance figures. Program dollars will still be limited. Careful budgeting and allocation will still be required. New starts and new programs will be exceedingly selective. The 6 and 8% growth rates most likely mean a shortage of funding for the school foundation plan, and for the revenue sharing program with local governments. Yet, I express to you the gravest concern that actual receipts in the State treasury during the next ten years may be pitifully shy of the sums needed even to maintain our austerity.

Previously, in the testimony of Commissioner Wohlforth and the Department of Revenue, test cases have been articulated regarding revenue to be derived under (A) private ownership and (B) State ownership of the crude oil pipeline. All of us realize that a multitude of variations in revenues and expenditures are possible under each heading, that is under private ownership or public ownership. Nevertheless, for purposes of comparison we have presented two likely cases and their dollar results: Both examples entail the seven-year oil volume build up delineated in the Department of the Interior Environmental Impact Statement submission by Alyeska, a 7% dividend to the owner, a line cost of $3.5 billion, and oil on stream in July 1977.

Exhibits A and B, attached at the conclusion of these remarks, protray the figures - and the story - for the decade 1972 - 1982.

We might just pause, Mr. Chairman, and refer the committee to those for a second if I may. Exhibit A is the computer run on private ownership, and you can see the assumptions that go into these calculations, the debt service for each year on these bonds, the growth rates of the budget for each year, and so forth. Then Exhibit B, are the same assumptions, identical assumptions based on private ownership. I beg your pardon, Mr. Chairman, Exhibit A is the private ownership and Exhibit B is the public ownership. As you can see the bottom column of the right hand side in exhibit A that is the general fund at the end of the fiscal year 1982, has a deficit of $1,135,000,000 under the private ownership case, whereas in exhibt B, the general fund in the lower right hand column at the same year at the end of fiscal 1982, has a surplus in it of $450,000,000. Those runs of course need to be carefully studied and I shan't take up your time this morning with them.

Under the private ownership case, Exhibit A, were Alaska to continue to increase its budget expenditures at the 6 and 8% rates, mentioned earlier, the first year of

deficit would be Fiscal Year 1978, wherein we would experience a shortfall of over $156 million. This shortage would increase so that by Fiscal Year 1982 the deficit would be $1,135,000,000. Of course, deficits for operating expenditures are in fact impossible under our State constitution; instead of experiencing a billion dollar deficit ten years from now, we would in actuality have to reduce State expenditures radically.

Under the private ownership case the State could have in its treasury at the end of Fiscal Year 1982 the sum of $45 million if, and only if, its operating expenditures in every year of the planning decade rose annually by only 1%. Now an increase of 1% equals in fact a huge cut in all programs, and the elimination of many. And what the figures look like in that case are protrayed in Exhibit C which is the computer run showing budget increases of 1% annually over that period. And, the assumptions there are the same, the assumptions as of the first two exhibits; when the line will start and through what volume and so forth.

The dollar crunch is graphically portrayed by the following paradigm. Under the private ownership operating budget column, increasing annually at 1%, the available dollars, are, recorded. And there, Mr. Chairman, if I may direct the committee's attention to the following page of my testimony, page 6, to the paradigm which is also available, I thought they were in big figures, they are when you try to see them on the wall over Mr. Weiner's head. In the charts called "Comparison of Funds Available, Private vs Public Ownership, and I might say all these figures are in thousands so that actually the figures on the paradigm are in millions of dollars. It addresses itself only to our operating budget. Now this year for a base of reference in our budget book is $276 million. This figure is referenced in my testimony under fiscal year 1973. So getting into the 1974 budget, which is the one the legislature will be considering just next year, you already begin to see a difference in available dollars under public and private ownership, whereas under public ownership in 1974 we would have available to spend approximately $293

million, under the private ownership plan there would only be available $279 million. And so forth on up where you get into very dramatic areas. Let's compare, for instance, fiscal year 1978 which isn't too many years away, under State ownership of the pipeline in the example we furnished you here, the state would have to spend on operations, that's not the total budget, just the operating portion, $384 million whereas under private ownership the state would have to spend in the same year for operations, $290 million. Almost $100 million difference in that year. And as we say at the end of the column of figures the difference over the planning decade, in operating expenditure the State would have available to it would be $925 million. The difference in debt authorizations, that is capital improvements, what the legislature and the people would authorize, is a difference of $365 million.

Returning, then, to my testimony, Mr. Chairman at the top of page 5.

In contrast these with the operating budget under public ownership, the first column on the left. The figure shows that if the State of Alaska owned the pipeline there would be sufficient dollars in each of the next ten years to meet our planned 6 and 8% annual increases. In fact, the revenue would be sufficient to raise the budget from these maintenance or austerity levels so that expansion of present services and the addition of new ones could be handily realized. Were the oil line privately owned the State would have almost a billion less dollars to spend over the next ten years. We would be able to authorize 365 million fewer dollars for capital improvements.

I might say, Mr. Chairman that the 6% and 8% increase in the budget which is portrayed in our budget books presented to you in January, those increases were projected on the State Revenue Projections figures which Commissioner Wohlforth and Mr. Eppenbach have discussed in great detail this morning. Now the projections are not valid because the revenues will not materialize at the dollar amounts portrayed to you in the revenue book. Going on to page 7.

You might want to really look at these Mrs. Chairman.

The attached graphs, Exhibits D and E, portray what I have been saying. Exhibit D is on the front of the room behind the co-chairman - behind Miss Bracken and it shows in graphic form what we have just testified to, that if the budget went up at the 6 and 8% rates under the private ownership example here, the general fund would be depleted, completely depleted in January of 1978, in the middle of fiscal year 1977, that is the blue line on the left of the chart. Whereas under public ownership, State ownership of the pipeline, the State general fund would dip to a low of $231 million in the fiscal year 1976 and go up at the end of the decade we're speaking of, 1982, to about $450 million in the Treasury. That's exhibit D, Exhibit E is the graph portrayal of Exhibits B and C. In other words Exhibit B is the public ownership case raising the budget at 6 and 8% and Exhibit C is the private ownership case, you might say the subsistence case, whereby the State budget would go up 1% annually. And if the State budget were to go up only 1% annually under the factors given in our private ownership example here the State treasury would have $45 million dollars by 1982. But as I say, all of the programs we have believed in would have been decimated thoroughly.

In Exhibit D, under private ownership of the oil pipeline, the general fund would be depleted around January of 1978. On the contrary, under State ownership of the line, the precipitate dive to insolvency would stop in 1976 at a general fund balance of $231 million, and rise to a plateau of $450 million in the general fund by 1982. Furthermore, as Exhibit B shows, the total expenditure for that year would be approximately $605 million, and the total revenue $602 million; a parity between income and expenditure would have been achieved, and a surplus of almost half a billion dollars enjoyed. In actuality, no doubt, were the funds from State ownership available, the administration and the legislature would have expanded the budget faster than the 8% increase portrayed for the years 1977 and beyond so that no such surplus would likely exist at the end of fiscal year 1982.

The private ownership case I have presented to the Committeees, Mrs. Chairman,

necessitates an abrupt and drastic reduction in State services and activities. I cannot tell you with certainty where the administration or the legislature would cut, but I can cite a few startling and likely areas of impingement in each of our program categories:

The State pays approximately 90% of local ~~xx~~ school district costs, constituting roughly 30% of annual State dollar expenditures. That State aid would be materially reduced; it would be impossible for the local areas to maintain present educational standards through increased property taxes. State Operated Schools and the University of Alaska would have to radically abate their present service levels.

The welfare or social services activities of the State would experience vast curtailment in the number of eleigible cases and the amount of benefit dollars; many people would be compelled to leave Alaska; distress or even starvation would haunt many who decided to stay. Public health and mental health retrenchments could force the closing of the Alaska Psychiatric Institute, and a diminution or abolishment of the State's work in drug abuse, alcoholism, tuberculosis testing and venereal disease control. The necessitated nullifications of State expenditure in these areas will in turn lose large amounts of federal dollars now enjoyed. Our ability to operate and maintain an effective Pioneers' Homes program will be materially impaired.

No new fish hatcheries would be built. No hunter safety program would be initiated. Salmon yields in Southeast Alaska would remain significantly below maximum sustained yield. Land use planning and the inventorying of our natural wealth would be jeopardized, thus making management of the State's surface and subsurface resources haphazard at best. Added park and recreational sites would be forgotten, and the maintenance of existing facilities lessened. Many Alaska communities would remain without sewage treatment facilities. Programs for coastal zone management, environmental engineering, permafrost and soils engineering would likely be abolished.

In the category of Public Protection, disaster planning, the Public Utilities Commission, the Alaska Transportation Commission, and most consumer protection programs would be impaired or fatally weakened.

The State police would experience a great shrinkage in manpower, and the courts and their ancillary agencies could not cope with their workloads.

Tourist promotion would have to be seriously curtailed and our work in research, in community improvements and grant assistance, and conventions and trade shows would most likely fall by the board. The work of the agricultural loan fund and the small grain incentive program would be enfeebled or eliminated. The Division of Planning and Research and the State Economic Opportunity Office would be crippled or possibly dropped.

Our program of revenue sharing with the local governments, around $7 million in the current year, would no doubt go out the window. The Marine Transporation System for Southwest Alaska would likely be eliminated, and service in Southeast materially contracted. Airport maintenance in rural Alaska would be severely curtailed, likely forcing the winter closure of those ports, thus isolating a large part of Alaska for five months of the year, denying medical and other critical services. Likewise, winter maintenance of many of our highways would be only a pale reflection of the excellent job being performed today.

The various boards and commissions whereby Alaskan citizens take a direct and active part in the work of the State government would be minimally funded, or in some cases, unfunded. I am speaking of activities like the Western Interstate Conference on Higher Education, the Athletic Commission, the Status of Women Commission, the International Development Commission, the Pioneers' Advisory Board, the Yukon Taiya Commission, the Rural Affairs Commission, the International North Pacific Fisheries

Commission. Our Youth in Government program, recently instituted with such great success, would likely be abandoned.

I might say, Mr. Chairman, that I notice a certain aura of disbelief when I recite these cuts here, but I can tell you from my own experience as chairman of the budget review committee, that each one of these representations I have made, is made with a lot of insight and forethought, and I am absolutely confident that if the revenues materialize as projected under the private ownership case, very many of the exact programs I have mentioned will have to be severely cut or even abolished. There is no other way to do it, our State does not have the ability to, as you know, _____ with huge annual deficits. We have to make our budget balance. I do not represent to you as the view of this administration, that each of these reductions suggested above, would come to pass under the private ownership case, where trade in Exhibits A and C. Nevertheless, no one can say that many of the above dire consequences would not eventuate under that case. Undoubtedly some would. The ~~as~~ economic and social dislocation would be grievous indeed.

The purport of my remarks is that this State has a vital interest in an adequate share of North Slope riches. If we do not realize that share, State expenditures over the next decade will be woefully inadequate to do the job Alaskans expect from their government. The solution we propose to sufficiently fund the budget is the ownership of the crude oil pipeline by the State of Alaska.

I thank you for your attention.

MR. HAYES

Groh: May we have questions now from the members of the Senate.

COMPARISON OF FUNDS AVAILABLE

PRIVATE VS PUBLIC OWNERSHIP

(ALL FIGURES IN 1000)

FISCAL YEAR	PUBLIC OWNERSHIP OPERATING BUDGET *	PUBLIC OWNERSHIP DEBT AUTHORIZED	PRIVATE OWNERSHIP OPERATING BUDGET *	PRIVATE OWNERSHIP DEBT AUTHORIZED
1972	260186.5	71000.0	260186.5	71000.0
1973	276232.7		276232.7	
1974	292910.7	60000.0	278994.8	15000.0
1975	310485.1		281784.3	
1976	329114.1	100000.0	284601.8	20000.0
1977	355443.1		287447.4	
1978	383878.5	100000.0	290321.5	20000.0
1979	414588.8		293224.3	
1980	447755.8	100000.0	296156.1	20000.0
1981	483576.2		299117.3	
1982	522262.2	100000.0	302108.1	20000.0
TOTAL	4075433.7	531000.0	3150174.8	166000.0

* All figures refer to expenditure from general fund only

Difference in Operating Expenditure is over $925,000,000

Difference in Capital Debt Authorization = $365,000,000

Exhibit A

STATE OF ALASKA
DIVISION OF BUDGET AND MANAGEMENT

BUDGET PLANNING MODEL

Private

RUN ID RUN 3

DATE MARCH 3, 1972

COMMENTS
PRIVATE OWNERSHIP
7% TARIFF
BASE CASE
OIL IN 77

ASSUMPTIONS

ANNUAL RATE OF INTEREST ON GENERAL FUND = 6.00%

ANNUAL RATE OF INTEREST ON NEW BONDS = 6.00%

MATURITY PERIOD ON NEW BONDS IN YEARS = 20.

% ABOVE G.F.UNENCUMBERED BAL. UNEXPENDED = 0.0 %

GROWTH RATES FOR OPERATING EXPENDITURE FROM PRIOR YEAR

1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
6.2	6.00	6.00	6.00	8.00	8.00	8.00	8.00	8.00	8.00

NEW BOND AUTHORIZATIONS IN EACH YEAR

1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
710 .0	0.0	60000.0	0.0	100000.0	0.0	100000.0	0.0	100000.0	0.0

FISCAL YEAR	NON INVESTMENT REVENUE	INVESTMENT INTEREST	TOTAL REVENUE	OPERATING EXPENDITURE	DEBT SERVICE	MISC EXP SHD TAXES OF CAP EX	TOTAL EXPENDITURE	SURPLUS OR DEFICIT	GENERAL FUND END OF YEAR
1972									761266.2
1973	162284.1	42456.7	204730.7	276331.0	24020.8	11358.6	311710.3	-106979.6	654288.4
1974	182367.0	35772.1	218139.0	292910.7	29646.2	11756.5	334313.4	-116174.4	538114.0
1975	190047.0	28146.4	218193.4	310485.1	3297315	12749.8	356208.4	-138015.0	400099.0
1976	136752.0	18960.8	207712.8	329114.1	33479.2	13230.6	375843.8	-168131.1	231927.9
1977	220569.0	8673.9	229242.8	355443.1	35373.3	13153.0	403969.4	-174726.6	57201.4
1978	225994.9	-2988.6	222966.3	383878.5	39390.5	13719.0	436988.0	-214021.8	-156820.4
1979	314776.0	-14823.9	299952.1	414508.8	42674.9	23358.3	480541.8	-180489.8	-337310.1
1980	329299.9	-26743.6	302556.3	447755.8	46929.0	25105.1	519389.9	-216833.6	-554143.8
1981	332012.4	-41230.4	290811.9	483576.2	47129.4	25167.5	555873.0	-265061.1	-819204.8
1982	344154.7	-59641.5	285513.1	522262.2	52863.3	8.5	601826.0	-316312.9	-1135515.0
	2490194.0	-10379.5	2479814.0	3814342.0	383809.9	175496.8	4373647.0	-1893782.0	

AGO 530752

Exhibit B

STATE OF ALASKA
DIVISION OF BUDGET AND MANAGEMENT

BUDGET PLANNING MODEL

RUN ID RUN 4

DATE MARCH 3, 1972

COMMENTS
PUBLIC OWNERSHIP
7% TARIFF
BASE CASE
OIL IN 77

ASSUMPTIONS

ANNUAL RATE OF INTEREST ON GENERAL FUND = 6.00%

ANNUAL RATE OF INTEREST ON NEW BONDS = 6.00%

MATURITY PERIOD ON NEW BONDS IN YEARS = 20.

% ABOVE G.F.UNENCUMBERED BAL. UNEXPENDED = 0.0 %

GROWTH RATES FOR OPERATING EXPENDITURE FROM PRIOR YEAR

1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
6.2	6.00	6.00	6.00	8.00	8.00	8.00	8.00	8.00	8.00

NEW BOND AUTHORIZATIONS IN EACH YEAR

1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
71[illegible].0	0.0	60000.0	0.0	100000.0	0.0	100000.0	0.0	100000.0	0.0

FISCAL YEAR	NON INVESTMENT REVENUE	INVESTMENT INTEREST	TOTAL REVENUE	OPERATING EXPENDITURE	DEBT SERVICE	MISC EXP SHD TAXES GF CAP EX	TOTAL EXPENDITURE	SURPLUS OR DEFICIT	GENERAL FUND END OF YEAR
1972									761268.2
1973	162264.1	42466.7	204730.7	276331.0	24020.8	11358.6	311710.3	-106979.6	654288.4
1974	162367.0	35772.1	218139.0	292910.7	29646.2	11756.5	334313.4	-116174.4	538114.0
1975	190047.0	28146.4	218193.4	310485.1	32973.5	12749.8	356208.4	-138015.0	400099.0
1976	188752.0	18960.8	207712.8	329114.1	33479.2	13279.6	375883.8	-168171.1	231927.9
1977	436209.0	15116.4	645325.4	355443.1	35373.3	14482.8	405299.1	40026.3	271954.3
1978	434394.9	16695.3	451090.2	383878.5	39390.5	15217.0	438486.0	12604.2	284558.4
1979	547046.0	19533.7	566579.7	414588.8	42494.9	27486.9	484570.4	82009.3	366567.7
1980	550369.9	23532.2	573902.1	447755.8	46529.0	28343.7	522628.5	51273.6	417841.3
1981	567[illegible]2.4	26121.0	594083.3	483576.2	47129.4	28359.7	559065.2	35018.1	452859.4
1982	575119.7	27090.4	602210.1	522262.2	52[illegible].3	27747.4	604912.9	-2707.8	450156.6
	3328529.0	253434.8	4031965.0	3916342.0	383899.9	19[illegible].9	4393075.0	-311111.4	

AGO 530753

Exhibit C

STATE OF ALASKA
DIVISION OF BUDGET AND MANAGEMENT

BUDGET PLANNING MODEL

Budget Increases Annual

RUN ID RUN 3

DATE MARCH 3, 1972

COMMENTS
PRIVATE OWNERSHIP
7% TARIFF
1% GROWTH
GREATLY REDUCED CAPITAL EXPENDITURES

ASSUMPTIONS

ANNUAL RATE OF INTEREST ON GENERAL FUND = 6.00%

ANNUAL RATE OF INTEREST ON NEW BONDS = 6.00%

MATURITY PERIOD ON NEW BONDS IN YEARS = 20.

% ABOVE G.F. UNENCUMBERED BAL. UNEXPENDED = 0.0 %

ANN OPER EXPEND GROWTH RATE AFTER 1ST YR = 1.00%

NEW BOND AUTHORIZATIONS IN EACH YEAR

1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
71[illegible].0	0.0	15000.0	0.0	20000.0	0.0	20000.0	0.0	20000.0	0.0

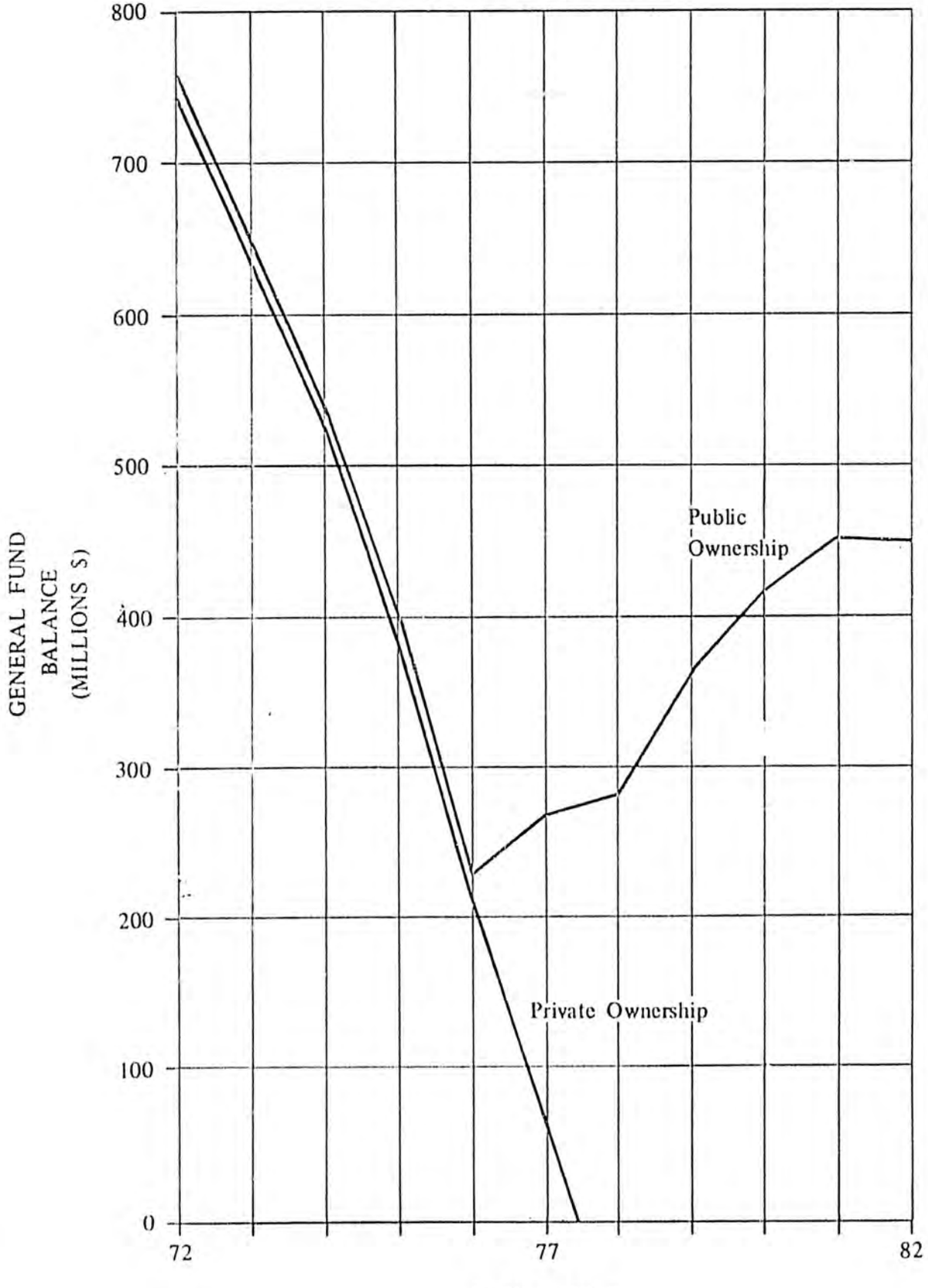
FISCAL YEAR	NON INVESTMENT REVENUE	INVESTMENT INTEREST	TOTAL REVENUE	OPERATING EXPENDITURE	DEBT SERVICE	MISC EXP SHD TAXES GF CAP EX	TOTAL EXPENDITURE	SURPLUS OR DEFICIT	GENERAL FUND END OF YEAR
1972									761268.2
1973	162264.1	42469.7	204733.8	276232.7	24020.8	11358.6	311612.0	-106878.3	654389.8
1974	182367.0	36208.7	218575.7	278994.8	29646.2	11756.5	320397.5	-101821.8	552567.9
1975	190047.0	29928.1	219975.1	281784.3	32973.5	12749.8	327507.6	-107532.5	445035.4
1976	188752.0	23147.4	211899.3	284601.6	32478.4	13290.6	330390.6	-118491.3	326544.1
1977	220569.0	16705.2	237274.2	287447.4	32921.2	13153.0	333521.5	-96247.3	230296.8
1978	225954.9	10787.1	236741.9	290321.5	33723.5	13719.0	337764.0	-101022.1	129274.8
1979	314776.0	6802.4	321658.3	293224.3	34212.3	23358.3	350794.8	-29136.4	100138.3
1980	329299.9	5394.7	334694.5	296156.1	33887.2	25105.1	355148.3	-20453.8	79684.5
1981	332012.4	4182.2	336194.5	299117.3	31872.0	25167.5	356156.8	-19962.3	59722.2
1982	344194.7	3140.6	347295.2	302108.1	33246.7	26698.5	362053.3	-14758.1	44964.1
	2493194.3	178845.6	2667040.0	2849986.3	312031.6	17[illegible].8	3385343.0	-716303.9	

AGO 530754

Exhibit D

ENDING GENERAL FUND BALANCE

Private vs Public Ownership
Budget Book Expenditure Plan

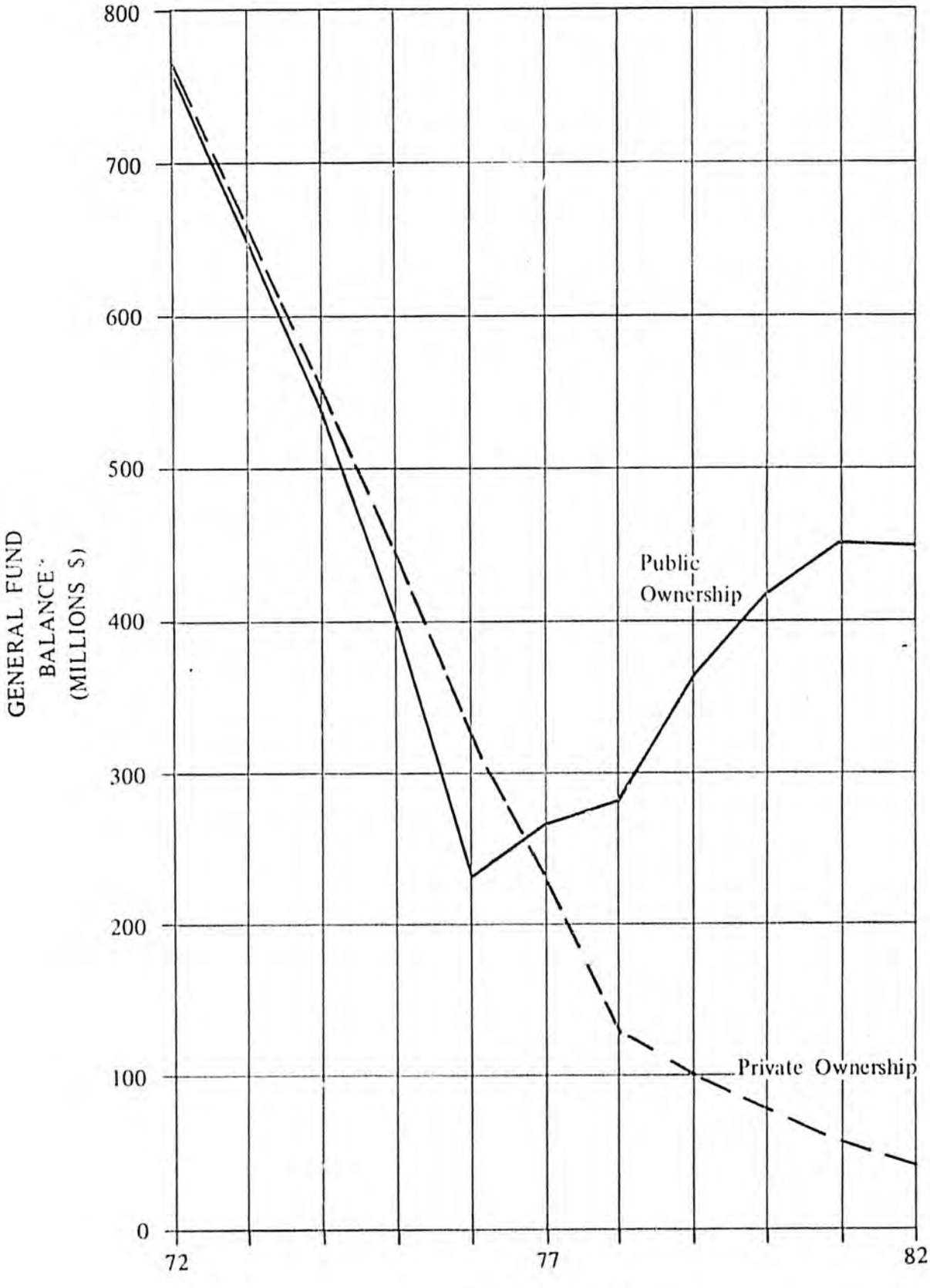


AGO 530755

Exhibit E

ENDING GENERAL FUND BALANCE

Public Ownership Budget Book Expenditure Plan
vs
Private Ownership Subsistence Expenditure Plan



AGO 530756

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TAPE # 9

...Groth:...selected land less valid federal leases, and just the other day here within the last couple of months we have selected another 77 million acres. You anticipate no revenues from any of these places?

Henri: Senator, the examples I have given you, Exhibits A and C on the private case do not contain any private ownership, any further income of the Private ownership case but I'd like to fortify or expand on that observation by saying the amount we are spending over income right now is about $150,000,000 over income this year and as the budget increases, the dollars over income will expand rather dramatically and so except for the Prudhoe Bay oil in those huge volumes there would be no way in my estimation to lift further bonus sales ~~from~~ income other economic development to make up the dollars we need to increase the budget even by 6% to say 8%, so let me say that just by general allusions of possible sales and possible income we analyze those possibilities the dollar volume is not there.

Groth: It still remains inconceivable to me if you can make $900,000,000 out of 400,000 acres which is what we did, you have a million and a half acres right there in round figures, I don't know what the correct figure is, but that is what Chuck testified to, and if you've got 77 million acres of additional land or at least in that portion of it which we're going to get out under the Statehood act, whether that's 77 million acres is it or not, I don't know how you can conceiveably say that that is going to produce zero money. And in the case of the public versus private ownership of the pipeline you say that that is going to produce zero money in order to argue for the public ownership, it just doesn't seem reasonable. I can't conceive that nothing is going to come out of that.

Henri: Senator, I am addressing my remarks for the next planning decade not presume for the next 50 years and I ~~assume~~ that once the environmental business is settled satisfactorily for this country, that leases will be valuable again, but I am very doubtful that any oil company is going to go up and lease further land until they are pretty sure about whether they know what the government is going to do about their present holdings. So I don't believe that it is prudent at all to anticipate income up there ~~is~~ in the ~~recent~~ reasonably near future. And further on the amount of dollars if we were to find a taker for our future lease offering, you will notice that Commissioner Herbert's testimony covered, I think it was almost a million dollars sold before the September, 1969 sale which brought in hardly a tenth of that. In other words, there may be a ~~lease~~ value.

Groth: Mr. Chairman, I understand Joe, my problem is that i can't conceive that in these projections that you have, did not feed anything in on these estimates on the basis that all of the other lands that the State owns, and all of the other interests/ the State has, and the ~~it~~ the boom and doom here is to what is going to happen to get into public ownership of the pipeline is the inevitable result without putting in any bucks at all for all of these other assets. And that is where I have the problem.

Not to be aggressive, believe me I am not going to be aggressive trying to be

HENRI: My references from a budget point of view, now there is an underlying conviction that we have here from the Governor on down, and that is that the budgets of the state should be increasing steadily and systematically, in other words you shouldn/t have a budget that high rise then next year cut off a lot of people who have been depending on these expenditures, so unless we can pretty clearly say that out there somewhere ~~at~~ at the end of the ten year period that there is going to be some more money coming in, if we can't ~~some~~

say that with some certainty then we have to adjust this years spending and next years spending as if there wern't that money there because it is too speculative, ~~it~~ too remote, and that, what I am addressing myself to is the budget and if we can't reasonably calculate some money out there then I think the budget has to be adjusted each year now as if ~~we are~~ we weren't going to get the money. Now that's based on one thing that is different since 1970, and that is that we are spending beyond our income in this State for the first time. We have no trouble would like that if our expenditures were anywhere near equivalent to our ~~income~~ income, but it is not, as I say we are spending almost twice as much as we are taking in which means that our savings account will be depleated, and then where are we if these new revenues do not materialize.

Groth: Without being argumentative Joe, you presume those to sign in zero value to all that other land and that 77 million acres and I respectively suggest to you that it may have some value greater than zero, and if you feed that into the projections then all of the _____ athletic commissions and youth commissions might still continue.

Senator Young: Mr. Chairman, first let me say that some of the proposed testimony taken place at the present place _____ right now.

But one thing bothers me, Mr. Henri and this is if we build this pipeline we have to go into debt or a guaranteed debt of 3-1/2 billion dollars, what effect is this going to have on proposed bond issues already before the legislature, for instance 6 million for highways, sewers and waters, etc. According to my latest figures it will be so far in debt for guarantees that there will be no market for the bonds

they are putting before the legislature now.

Henri: Senator, I would like to refer the answer to that if I may to Mr. Macy, who is here from Kuhn, Loeb and also Commissioner Wohlforth who I think can do a better job.

Wohlforth: I think the basic answer to that question is that, as I represented in New York as I stated about a month ago, a North Slope bond issue of necessity would have to be so well secured and so able to stand on its own feet that it would not jeopardize ordinary State bonding programs, that the essential security of state general obligation bonds are recurring revenues of the State's ultimate power to tax on an ad valorem basis its 2.7 million assessed evaluation. What we are talking about here and what will be described in detail by Mr. Gilderhouse and Mr. Macy is a bond issue which is essentially self liquidating and does not reflect adversely and therefore would not reflect adversely on the States general obligation bonding power. It would be I believe a separate sustaining utility type bond issue, as compared to our general obligation bond issues each of which do encumber our States credit and each of which are assessed in the bond rating communities on a per capita debt basis, on the basis of assessed valuation to total bonded indebtedness. In addition it is pointed out to me that as said previously that we, the bond issue of this size can have a positive effect on Alaska bonds of necessity it would reach a broad market of new investors and create interests in Alaska, those, a range of investors in Alaska that are growing now but who have not yet nearly reached the number we had hoped for, and of course the net income which we show available after debt service in the public case, is income to the State

treasury.

Young: O. K. Let's carry this thing a little further. Lets say the pipeline to build, if the state builds the pipeline, we're dealing with a world energy here and if they find that other oil companies or companies find a cheaper source of power for world energy, now true they have to produce a certain amount, but what if they are not competitive ~~with~~ where does that leave the the State. In paying their bond issues off.

Wohlforth: To a certain extent I have ~~xkx~~ analagized this with the question which was posed yesterday, there was a replacement found for ~~possibkx~~ Fossil Fuels, we expect a replacement from Fossil Fuels maybe in the year 2010. The existing indications are that there is a need for North Slope oil and that will continue. The refinery price on the west cost has escalated and indeed it is much higher on the east coast, so that there are projections underlying projections that are used, just as there are in other financings based on utility type self liquidating financing which give , it seems to me, the degree of confidence necessary to finance the pipeline itself. And indeed no bond investor is going to put monies at debt, and at risk unless he ~~similarily~~ similarly is assured the State that the oil will flow in the estimated quantities. It to a certain extent has to be and will be a test of the market.

Young: Commissioner Henri, another thing , Senator Groth hit upon , that you geared our whole income into the ownership of the pipeline of the North Slope Oil . Entering the projections of the other testimonies given today is there any thought given to the possibility of revenues generated by the ~~gap~~ gas field that is on the North Slope, the monies that will be generated to the mid west states , that the pipeline will possibily go through Canada?

Wohlforth: I think Mr. Eppenbach can answer that.

Eppenbach: Yes sir. They are fully included in our estimates. We assume that in 1977 the price of gas at the wellhead will be about 20 cents. Obviously the production of gas is the function of the production of oil. We've made those consistent and we assume the price of gas at the wellhead will increase about 1 cent every five years, assuming that gas will be transported through Canada through a Trans Canadian pipeline into the mid western markets in the U.S.

Holm: Commissioner Henri, as I read the figures, the first chart up to the left there, and I added them up, if my arithmetic is correct, we are saying that State ownership will total a billion and one half dollars net increase to the State over the next 10 or 11 years. That is if everything goes right. Presuming that the States bargining position is good now and might be a little bit worse in the coming years without _____ by the State, after all any oil company worth its salt can see that we are going to desparately need money due to the testimony that has been given. What is going to happen to our future oil lease sales and the net income to the state; have you built this in; what is going to happen as the oil companies see this localization or parallel to nationalization of the oil industry in the State of Alaska and as they contemplate this couldn't we lose more money that way by investments in the State in the oil leases, by investments in the State in the oil industry than we would gain theoretically by taking over the pipeline ownership.

Henri: Representative Holm, Senator Groth referred to additional oil lands in the North, I would like to speak a little bit further on that later, but, there are more as we all know than 7 oil companies. Now if there were other oil companies that wanted to get these future oil lease lands I think that State ownership of the

lines would enhance the desirability of those leases because they would know the State, as a public agency would allow them to use the line , whereas if the line were dominated by the _____ who had the existing discovery it may not be that way. So I think the ownership would not be a hendrance, it would be a help.

Holm: Well, aren't we presuming, at least this has been my understanding it is going to be a public carrier either way?

Henri: Yes, but I will defer to Mr. Hellen and others about how that concept works under ICC regulations of private ownership. My impression is, simply saying ~~it is~~ a public carrier does not give all the answers. Furthermore in the State's case of private ownership Mr. Temple clearly brought out yesterday that there is going to have to be a voluntariness, what ever you want to call it, between the oil companies and the ~~State~~ State if the State is ever going to own the pipeline, at least under the sale of bonds, municipal bonds and I would think that if the package were not fairly palatable to the oil companies that somehow they are not going to do it anyway.

Holm: Well then you are presuming in all of your figures , projections, that the State take over the pipeline, will not depress the market for our future sale of oil leases?

Henri: I think that would be something that we tend to guard against very carefully. We obviously would not want to do that. I think we all agree with Senator Rettigs' remarks that we want the state to be a favorable place for investment. But nevertheless we have a great stake of getting something out of our resources to?

Huber: Mr. Chairman, Commissioner Henri, on Page 3 of your testimon v

Joe, you project about, rounded off, $50,000,000 a year general obligation bonding programs for State capital programs. Now what ~~in~~ retirement term is anticipated on those bonds, and ~~can~~ the interest from principal payments ~~thx~~ been included in the public ownership draft line on exhibit E?

Henri: The term, Mr. Chairman, Mr. Huber, is 20 years, and debt service has been included in the run and if I may Mr. Huber, refer ~~t~~ you to exhibit B where it that information is given there. Exhibit B in the computer run/gives the interest assumptions, the annual rate of ~~interest~~ in the general fund, in other words what we have earned in the Bank of America funds of 6% and so forth, is all spelled out, and your answer is the debt service was included for 20 year payoff.

Huber: Well what concerned me was the debt service in the initial bonding.

Barber: Mr. Henri, through the Chairman, the Committee it ~~sh~~ has always been my assumption that we are currently using up our North Slope $900,000,000 to the extent of the State ~~h~~ sharing in local government and in other efforts. In other words of our normal budget is running somewhere between 220 and 240 million dollars and we're using up somewhere between 60 and 80 million dollars a year out of our North Slope fund. Now are those figures approximately correct?

Henri: I think the, we are using this year, Mr. Huber, the Governor's budget proposed ~~in~~ taking 97 million of the principal of the North Slope Fund and of that almost entirely used for local government.

Barber: That was my understanding. Thank you.

Senator Thomas: Mr. Chairman, I have the impression that they haven't really explored all of the alternatives, and I would like to ask, since we may not have a chance to ask later on, if they have looked into the alternative of increasing

the severance tax or / and at the same time possibly substituting the cents per barrel for the severance tax; if it is so to what extent would each of those have to be changed to forestall this down the road based upon your 3.5 billion dollar figure.

Henri: Mr. Chairman I will defer a full rounded explanation of that, Senator Thomas, I do have two observations if I may. One, the severance tax as it exists, is as you know a percentage of the value of the oil per barrel of the wellhead. Obviously, under the private case that he's giving you the wellhead has no value the first few years, so would produce no severance income. If the severance tax were amended to instead of an ad valorem item, to be a cents per barrel item, there is no magic to making up the deficiency in our budgetary income because no government is allowed to tax to confiscation. I haven't actually calculated that out , I would say that the , to equal the throwoff of ownership of the pipeline which is a legal, valid receipt of money, to equal that to heist up the severance portion would probably be confiscatory, I don't know. I suspect it would be a God awful amount of cents per barrel.

Thomas: Mr. Chairman, could I just ask would it be possible by using the cent barrel arrangement to persuade industry not to take such great profits out of the operation of the pipeline.

Henri: I couldn't answer that. They own their line and I presume they like to take a dividend from it.

McVay: Mr. Chairman, one more, when we have a chance to hear their response during these hearings, the pipeline committees have proposed a lease sale arrangement.

Josephson: Someone mentioned that the most alarming thing about

your three r's is Joe, that we might be able even to increase legislative salary.

Henri: I carefully avoided that.

Josephson: Commissioner, have you predicated the impact of the Native Land Claim Settlement in your revenue projections , how do they fit into your revenue projections?

Henri: Yes sir, they are in there, I am going to ask Larry Eppenbach to tell you exactly how they are in there, but the impact of the native 2% over-rise is in the figures.

Josephson: No I meant the additional economy or impact , favorable impact of the economy generated by economic activities.

Henri: Again I'd like to get Larry... My impression is that we haven't tried to estimate what the ~~funny~~ money of these native corporations will mean to the States economy. There again it is so speculative, and I'd just like to re-emphasize Mr. Chairman, my point of view in these hearings, it comes as chairman of the budget review committee and from a convention which is probably shared by many in the room, that the budget shouldn't be at a certain level one year then come into a cleft so to speak and fall off. I think you have to calculate your budget increases or decreases if they are necessitated gradually over a period of years. In other words at least , while we have now given to you, the legislature, a 5 year planning projection and we have tried to avoid the very speculative incomes in the future so as to keep our budget ~~study~~ reliable.

Palmer: Mr. Henri, you have mentioned this matter of ~~the~~ items of the budget several times, this was a responce, as I understand it, as Senator Rivers mentioned,

additional land sales, plugged into future revenue projections because it was to speculate, a few weeks ago, before the Senate Finance Committee and then later that week before the resource committee we had the same type of commentary testimony from the people in charge of the Division of Oil and Gas, Mr. Burrill and Mr. Gilbreath. When it was pointed out that the revenue projections for North Slope Oil would decrease in the 1980's because of the 9.6 million recoverable barrels, or billions rather, and that this would be decreasing in the mid 80's, I believe it is ~~rated~~ 2 billion barrels a day and in about 14 years those reserves would be ~~xxxxxxxxxx~~ exhausted. Now in response to the question of , Mr. Burrel said that it was too speculative as far as any other reserves up there to slug any other values into revenues. That they could not because they had to be prudent, come up with any other figures for production through that pipeline and therefore revenues would decrease in the 1980's. And yet you are saying, as I understand it, that it will require 25 years of production rather than 12 or 13 years of production, to amortize the cost of the construction of the pipeline. If the State builds it, it is our gamble, if the company builds it, it is their gamble. I don't understand how we cannot afford to ~~xxx~~ be speculative in one instance and we can in the other.

Henri: Well Senator, you have spoken to two sides of the budget, income versus expenditures. My remarks on speculation were primarily about the level of expenditure and as to the ingredients of the revenue side of the budget I defer that it to Mr. Eppenbach who has those computer runs and why he thinks they are valid.

Rettig: Mr. Henri just to verify Senator Palmer's question , his question was a very good one, he did refer to the speculative nature of the possible lease sales, on

the other hand the State ~~has~~ in suggesting State ownership and the 3-1/2 billion dollar debt is speculating that there is a lot more oil than we now know is in the Prudhoe Bay field. Is that your point Senator?

Palmer: Yes sir.

Eppenbach: Senator, when revenue estimates were prepared and discussed with you by Mr. Burrell and Mr. Gilbreath they were referring to 9.6 bilion barrels of Prudhoe Bay reserves. We based our reserve figures here for purposes of financing State ownership of the pipeline from the total of the resvoirs on the North Slope already leased. And I would defer further questions on this to Commissioner Herbert. Now Have I... In terms of State financing of the lines we were not speculating on it, future reserves, we were planning that additional resvoirs would come onto line, those resvoirs already located in the lease area. Their timing may be characterized as a form of intuitive judgement, but nevertheless we expect over the 10-20 years that there would be additional reserves of oil coming from new resvoirs that have not yet been estimated to contain reserves but are nevertheless there, that would provide oil to the Trans Alaska pipeline. That is oil in addition to the 9.6 billion barrels that Mr. Burrell talked about.

Palmer: Would we have the assurance of these reserves that will be recoverable from the Division of oil and gas, ~~Mr existing~~.

Eppenbach: Commissioner Herbert already testified on that point, that there are no assurances to date, he did imply that right now it would take perhaps ~~xx~~ another year to get those assurances but he did ~~communicate~~ indicate about 100 million barrels of oil were available at least in one of the pools. I for one would like to hear the

oil companies respond to this question in some detail.

Palmer: A second question if I may then, it was stated that an increase in severance tax , this is a response to Senator Thomas' question questions, in order to reach the income required by the State it might reach the confiscatory level and therefore be impossible, but it seems to me that there is a given amount of money to come from this resourse regardless whether it from the pipeline or whether it is severance tax or regardless of where it comes from , that there is still X number of dollars that will be available. I don't understand how it would be confiscatory if we take it through severance tax and it would not be if we take it through a pipeline profit.

Havelock: If I may comment at this point Senator, I think that a cent per barrel tax is one of the alternatives that the legislature can consider among other tax possibilities. I don't think it is our intent to say that it is not an appropriate tax. There are a number of reasons why it has economic disadvantages, and the man who should probably testify most on this would be Walter Levy. The cents per barrel tax is a little bit like a lot of complaints we've heard about the gross receipts tax , apply to the cents per barrel tax, that is it does not necessarily relate to economic realities in the oil industry. But it certainly is a possibility as providing a floor shall we say to revenue, I think the industry, the economics they've made to us about it, is they would rather pay taxes in other _____ through the cents per barrel formula. That is my impression. But it certainly is one of the tax avenues that the legislature can consider.

Palmer I might add that Walter Levy

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Tape #12

Mr. Kades: It is not due to the failure to pledge credit or any special tax of the State. The reason is due to a prevailing view in the Internal Revenue Service, that if you have bonds issued for a project, companies (private companies) or non-exempt persons have a right to the use of that project for a long-term period and that isn't defined, but twenty-five years or say would be undoubtedly a long time. And they agree that they will pay for the right to put oil into the pipeline or take power even though the pipeline or the transmission line isn't available. For example, there's a forced _____ _____ which impedes the operation of the pipeline. But nevertheless, they must continue to pay f[illegible] it so that they have the risk of loss. And also they have all the rights of ownership; then there is doubt about the interest or the bonds being exempt. But it really isn't directly related to the purging of the taxes, because even though the bonds were general obligation bonds of the State such as the bill which was withdrawn provided, that would still be true in that case - that if private companies have the unrestricted right to the use of a project and they're bound over a long-term period to pay for the project even though they don't get reuse of the project; then it's considered that the bonds have been issued for the trade of business of the non-exempt persons. Now, I don't think that situation exists here, because we have a common carrier, and if other oil companies come to Alaska to explore and decide to utilize the pipeline, under my understanding of the law, ways and means must be found whereby they're served. The pipeline must open up, in other words, the rights or withdrawals. They're not firmament. It's not like the pipeline was leased to one or two or seven oil companies and no other oil companies could untilize it, so I have reasonable hopes of being able to secure a favorable ruling once we're in a position to make an application

Tape #12 (continued)

for the ruling, but we've discussed this with counsel for the oil companies since last November and there's simply no answer to this question without going to the Commissioner of Internal Revenue, and as I stated we're hand strung. We're not in a position to move because all we have is a hypothetical proposition to put to the Treasury and the Treasury won't rule on that type of a proposition. But long before any bond is ever issued, long before the authority makes any firm commitment, with any oil company, we'll know what the answer is to this point and we ought to know pretty soon so that plans can be made and so there's no delay.

(Mr. Rettig)
LET ME APPROACH THIS JUST IN A SLIGHTLY DIFFERENT MANNER FOR CLARIFICATION. I THINK WE HEARD TESTIMONY AT SOME LENGTH EARLIER THAT PROBABLY AND CERTAINLY IN THE FIRST TWO YEARS OF THE OPERATION OF THE PIPELINE THERE WOULD BE NO WELL HEAD VALUE AND PERHAPS EVEN LONGER AND AS A CONSEQUENCE THERE WOULD BE NO SEVERANCE TAX REVENUE. AND RECOGNIZING THIS PLEDGING OF THAT TYPE OF SEVERANCE TAX REVENUE MAY NOT SATISFY BOND HOLDERS. COULD THEY THEN OR WOULD YOU RECCOMEND THEN THAT WE LEAVE THIS DEDICATION OPEN TO PERMIT THE POSSIBLE SUPPLEMENTAL DEDICATION OF FOR EXAMPLE INCOME TAX INCREASES TO THESE [illegible] SERVICE? WOULD THIS BE WHAT IS CONTEMPLATED IN THIS GENERAL OPENING UP OF THE DEDICATION FEATURE?

Mr. Kades: I'm not quite ready to answer the question. It wasn't intended to open it up so that you could pledge the income taxes. On the other hand, it may be an excellent idea. It might be just exactly what the doctor ordered as far as the prospective concourses are concerned and I think again I'll have to . . . I don't like to knock squarely into the question but I think Mr. Macy _____ has poor confidence in _____.

Tape #12 (continued)

Mr. McVay: I just have one brief question. If an authority (State) were created, would ICC control it the same way as if it were in title ownership?

Mr. Havelock: May I respond to that?

Mr. Rettig: Please do.

Mr. Havelock: The answer is that to the extent, the ICC would control the pipeline and if they would control the pipeline, they would also control it if it were publicly owned..

Mr. Kades: I suppose that's another answer to your question, sir, as to perhaps it wasn't yours but a question that was asked me about reasonableness of the rates.

Mr. Havelock: That would also be subject to the ultimate jurisdiction of the ICC so that the rates would necessarily have to be [illegible] reasons.

Mr. McVay: Is there a problem of a Federal regulatory agency, namely the ICC, controlling a State entity? Is there a constitutional problem there?

Mr. Havelock: I don't believe so, Mr. McVay. The common example would be the various court authorities which are controlled by which are municipally or State owned which are regulated by the United States. There is precedence among these for Federal regulation of State owned

_____.

Mr. Kades: The power authorities which are rather analogous are all subject to the supervision of the Federal Power Commission and the Automic Energy Commission if they struck nuclear plans. They spend a great deal of time in Washington.

Mr. Rose: I have one additional question for Mr. Kades. Mr. Kades, the question I had before but it isn't quite clear in my mind as to what you provided by way of an answer. As I read this House Joint Resolution

for the constitutional amendment, Section 7 permits the dedication of funds but Section 8 which was the guaranty would open up the State credit to the full extent as well as permit specific funds such as rural needs or whatever. That way you have the alternative of going either way, is that right?

Mr. Kades: That's right. It was intended for flexibility to go either way or both ways.

Mr. Rose: But it could be the whole budget of the State on one hand or a specific fund.

Mr. Kades: That's right. Or both or it could be to one part of the bond issue and not to all of it.

Mr. Rose: Thank you

Mr. Havelock: Mr. Co-Chairman of the _____ chair of the committee, we forgot to enter an exhibit that should have been entered with Mr. Wohlforth's testimony. Could we have 90 seconds allowed Mr. Wohlforth to insert this for the record. Would that be permissible?

Mr. McVay: Well let's . . we were going to take a ten minute break in a little while from now, but let's go ahead and take it now, and then we'll come back . . .

Commissioner Wohlforth: The assumptions upon which the analysis is based are contained in the first four pages and there are charts showing various assumptions of estimated incomes to State and private ownership at dividend varying dividend and tax levels showing estimated income to State under private ownership with a 5-1/2% dividend and the industry wide average facts, a 4% dividend and zero income tax, estimated income with State public ownership and a 7% dividend, a 5-1/2% dividend and a4% dividend. And we will be submitting to the committee, very shortly, further more detailed income statements. I think you will want a moment

Tape #12 (continued)

to reflect and read these documents, and, therefore, request that questioning be held until after the committee members have an opportunity to read. Thank you very much.

Mr. Havelock: Mr. Chairman, Members of the Committee, at this time we would like to call Mr. Tom Guilderhouse of the firm Temple, Parker & Slone, Economic Consultants to the State. Mr. Guilderhouse. . . . He will speak about the arrangements for public financing, various alternatives for public financing available to the State, public financing and pipeline. Mr. Guilderhouse . . . .

Mr. Guilderhouse: Thank you very much Mr. Chairman, Ladies and Gentlemen of the Committee. I am pleased to have this opportunity to discuss with you this afternoon a plan to accomplish the public financing of the State ownership of the Trans-Alaska Pipeline. Before discussing the plan, however, I would like to make the following observations. _____to understand the plan that I will discuss and answer questions on today is a plan prepared by Temple, Parker & Slone. Although the plan has been reviewed by the State, it has been reviewed by the investment banking group, it has been reviewed by at least some of the oil companies. It has not been particularly approved by any of them. It has been looked at and discussed. The second point I would like to make is that this is a preliminary plan and is in no way intended to be definitive in nature. The definitive plan for financing an operation of this size and nature takes weeks and even months of intensive negotiations between the interested parties. One of the issues under consideration in these hearings is the creation of such an authority and such a party to negotiate on the State's behalf. Related to this point is that I'm going to refrain from trying to be terribly specific in my testimony. I will be happy to answer and respond to any questions. Financing of

this nature has a tremendous number of details, and I hope to be able to avoid my testimony getting down to the nitty gritties so to speak. As I say though, I will be most happy to answer to the best of my ability any and all questions. With that understanding, I would like to preface the plan and point out that there are essentially eight (8) general assumptions that outline our approach to try to find a reasonable and feasible financing program. The first is the assumption that the operation of a pipeline is a sound business and that the operation of the Trans-Alaska Pipeline is a sound business. The testimony that you heard today, the charts on the wall show that either set of circumstances, public or private, the pipeline itself is expected to generate revenues in excess of costs over the long run. I don't think that we would be trying to recommend State ownership if it was felt that the pipeline ownership was a bad business. Secondly, I have the greatest respect for the oil companies, These men have sound business judgment and they are very interested in getting into the pipeline business, and I think that is just a further indication of the fact that it's a good business. The second assumption is that the cost would approximate $3.5 billion dollars. The third assumption, and most important, is that bond holders obviously need adequate guarantees in order to lend money to the State's authority to undertake this project. They need guarantees in essentially two areas--the guarantee that the project will be built and secondly that it will be utilized to the extent to provide payment of interest, amortization and operating costs. The fourth assumption is that the State of Alaska's credit, of and by itself, this associated from the oil, or this associated from this particular activity, is not an adequate to raise ourself $3.5 billion dollars worth of debt. I don't think barely any state's general obligation powers from one issue are that good, but Alaska's are not [illegible]. The fifth assumption is that the oil companies, as has been

Tape #12 (continued)

stated many times in these areas, cannot be reasonably expected to lend their full faith and credit to secure the financing of a State-owned pipeline. It's just simply, fair is fair and it doesn't make a great deal of sense to ask them to go on the bottom line for $3.5 billion dollars and not own the pipeline. The fifth assumption is, and this is a critical assumption, There exists both a proven supply of oil on the North Slope of Alaska in existing reserves and reserves beyond that and that there exists a demand in the lower 48 to take at least 2 million barrels of oil a day for the next twenty-five years. That's a very important assumption. We have to bear that in mind. The next assumption is that if the financing of State ownership can be achieved without the encumbrance of the oil companies credit, that this might be attractive to the oil companies who would then be relieved of having to utilize $3.5 billion dollars in this particular project whereas there are other places in other areas where they might be able to invest that same amount of money in the construction of new refineries, further exploration or other activities. To the extent that this could be achieved, we felt that it might be actractive and the oil companies might be interested. So....those particular assumptions in mind, I would like at this point to outline the essentials of a plan, a plan that we have suggested is worthy of consideration and which has not been deemed completely unacceptable in its totality by anybody. Certain parts of it obviously are not well received by some people. The essence of the plan for financing State ownership of the Trans-Alaska Pipeline is contained within the following four major items. The first is that the oil companies enter into an agreement with the State's authority whereby the oil companies or the users, the original users and any new users to come on stream in the future years, would agree to 1.) shipped through

Tape #12 (continued)

the Trans-Alaska Pipeline taps a minimum number of barrels of oil on a quarterly or annual basis. For arguments sake, one might imagine that enter into an agreement lets say to ship a million barrels of oil a day when the pipeline is up to its capacity of 2 million barrels. The second part of this agreement would be that the oil companies would agree to use the Trans-Alaska Pipeline until its capacity was full before using any other source of shipment or transportation for North Slope oil. This is to assure before other means of transportation are used that the pipeline is full and there is not enough capacity to meet demand. The third issue, and I will try to elaborate alittle bit on these in my testimony, is that the oil companies would agree to sell or otherwise assign at the well head or in the field to another member of the consortium or the unit or to the State should no other member of the unit or the consortium want the oil enough oil so that the State could assume the responsibility of shipping the oil through the pipeline to market. This is obviously relying on the oil as a "black gold" if you will to secure the interest of the bond holders. The second major part of this proposed financing plan is that the authority of the State of Alaska will provide the user oil companies with reasonable assurance on rates based on cost and volumes for as long as the minimum shipping agreement remains in force. This is a quick _____. You really can't ask or expect someone to make a deal with you unless you make a deal with him, and give him some protection for his responsibilities. The third major portion of this plan is that the Alyeska Pipeline Service Company would construct the pipeline for the State under contract to the State with full conformance and completion guarantees. Fourth - that the authority obviously would provide the appropriate and necessary

Tape #12 (continued)

guarantees to the bond holders through pledges of all surplus revenues and pipeline operations and provide a general reserve fund adequate to provide for one year to eighteen months of operating cost, interest and amortization. The basic premise in this plan, there's three basic premises, is 1.) that the oil companies in this case are only being asked to do something they are surely planning to do already, mainly ship the oil as quick as possible. It's inconceivable to me, or I think alot of people that the oil companies would have invested the amount of money they have today anticipating investing an additional $3.5 billion dollars unless they were expecting to ship oil to market just as fast as they could possibly get it out of the ground and down to wherever its going, somewhere in the lower 48. All the State is asking the oil companies to do is to promise to ship at a minimum rate probably far less than they are anticipating shipping at the moment within a guaranteed price range again based on cost of volume of movement for a period of say twenty (20) years or twenty-five (25) years depending on the negotiation or until the approximate exhaustion are put in reserves. The second basic premise is that this minimum shipping agreement and the fact that the State is ultimately taking the responsibility to move the oil to market allows for a pledge of revenues by the State's authority. For with this minimum pumping and shipping contract the State will have guaranteed income to pledge. The third major premise is concerning the risk of completion which is to address one of the other bond holder needs that the performance and completion be guaranteed to the State under a contractual basis, a negotiated contract basis, unless the bond holders will have sufficient guarantees that the project will be completed once undertaken. I would like now to

Tape #12 (continued)

go back and address in limited detail some of the terms conditions and major portions of this plan. The first one with respect to the minimum shipping agreement. The first question that will obviously arise is that isn't this really a hell or high water or take or pay or an agreement of some sort, we're just calling it by another name and it's really just the same thing as people have discarded already. This is just a Rube Goldberg invention to get around to some of the problems. Though, I don't think it is. What we're doing here is guaranteeing and pledging essentially to the bond holders the oil which is in the ground, and we're not really pledging the credit of the oil companies. We have talked with commercial bankers, bond rating agencies, accounting firms and investment bankers with respect to their attitudes and thoughts as to whether an agreement of this nature would infact really encumber the credits of the participating oil companies. It's their unanimous opinion that it probably wouldn't. Now everyone always has to wait and see how things are and you never want to make a 100% opinion on anything as nebulous as this particular proposal is at this particular time, but to the extent that some of the oil companies would be relieved of this burden that's looking over their shoulders at the moment of $900,000,000, $600,000,000 to them. (I keep forgetting zeroes) in this project. It would be helpful. With respect to the minimum number of barrels of oil, I think this has to be negotiated. You obviously have two factors going - you've got the depending on how few barrels that ultimately you agree with on a minimum shipment depends on the height of the tariff that you'll have to charge in order to be able to break even if you will and provide interest, amortization and operating costs. The lower the absolute guarantee you would have to assume the higher the tariff and consequently on the other side of the coin the higher the minimum guarantee the lower the tariff associated with that.

Tape #12 (continued)

With respect to using only the pipeline, I don't think it's unreasonable to request that the pipeline be used to its capacity and the State provide the facilities to its capacity before other types of transportation were used. With respect to the assignment of oil and the sale of oil at the well head, I believe and I don't think I'm incorrect that there is a considerable amount of buying and selling of oil in fields and at well heads that goes on in the industry today. It's not an entirely unusual thing for one oil company to sell to another oil company its production out of a producing field and sell it at the well head at the posted price in the field. So this is not an unusal or Rube Goldberg agreement. It's something that's done all the time. With respect to the reasonable assurance on rates, this again has to be negotiated. We are intermediaries here for the State and there is no real way that you can come to rest. We have some ideas how it might be negotiated, but it certainly is impossible at this particular point in time to say how it could be negotiated. Certainly there is an area I think of agreement where reasonable guarantees could be provided to both the authority and to the oil companies to make a workable plan. With respect to the construction contract with Alyeska, there was a question I think earlier as to would it might not be possible that the Alyeska would spend more money building the pipeline under contract to the State than they would if they built the pipeline for themselves. I suggest that this is not a probable case. Ultimately, I think that this is a very good incentive contract, because the tariffs of the pipeline will ultimately be based in some degree on the cost of the pipeline. So to that extent that Alyeska builds the pipeline for the State, they are infact controlling to a large part their future tariffs because the tariffs the State will charge for movement of oil will be based on the cost of the pipeline which they're

Tape #12 (continued)

responsible for bidding for and building. So they infact, under this arrangement would be controllers of their own destiny so to speak with respect to what the tariffs would have to be. The fourth item with respect to the necessary pledges, it's difficult at this point to say exactly, I think in Mr. Kades's testimony the range of full faith and credit down to a particular pledge, down to a pledge of severance or perhaps a pledge of royalty or perhaps no pledge depending on what things look like twelve (12) months from now or eighteen (18) months from now if indeed we're able to get full cooperation and interchange of information and people working together. Perhaps the revenues in the market projections will be such that a revenue bond alone could be sold, but I think the only thing you can say at this particular point in time is that there would have to be some pledges by the authority. The minimum one would be the revenues of the authority would first be pledged to the bond holders and any surpluses from pipeline operations would have to be first pledged to the bond holders to make sure all the demands of the interest, amortization and operating costs were met and there would have to be established a general reserve fund to also further protect the bond holders interest. I'd now just like to sum up this part and respond to questions on what I think are basic rationale for acceptance of this proposal by the three really interested parties - the State on the one hand, the oil companies on the other, the investment community of prospective bond holders on the third. With respect to the oil companies, it seems to me that their acceptance of a proposal of this nature or concept of State ownership and their cooperation with it is first in that they are in no way required to guarantee monies or otherwise assume

Tape #12 (continued)

contingent liability through a monetary sense with respect to this program. Their commitments are only to pump and ship at a minimum rate which they intend to do already under reasonable and negotiated tariff guarantees. Should they fail to meet that commitment, the only sanction against them is they must transfer their pumping rights; first to another person in the field, for whatever negotiated price he can get, and then to the extent that another fellow in the field doesn't want it, the State will come in and insure the movement of the oil to market. As I said before, their acceptance and cooperation is further encouraged by the fact that they're only being asked to do something they are already planning to do. From the bond holders point of view, we feel that he will be more than adequately protected by the following: 1.) the minimum shipping _____from the oil companies and the State's obligation to step in and move the oil to market in the event that they chose not to. 2.)

Guilderhouse: The domestic oil, the crude oil in the lower forty-eight, and the proven and expected to be realized reserves on the north slope oil. As far as the State is concerned, it seems to me that the State is accomplishing a great many of its objectives in this case. It is positioning itself in the middle of, on an equal basis or more equal basis with the very few economic entities. It becomes a part of the total development and movement to market of Alaska's natural resources. It does it in a fashion which promotes, I think, cooperation with the oil companies, and I think it gives the State a position to protect what it is seeking to protect, either through regulation or ownership, the projected income to the State from its royalties and revenues. In closing I want to point out that it is our opinion that in a hostile atmosphere with the oil companies the public financing of the pipeline is probably impossible. It is our feeling that unless there is agreement and cooperation and unity it would be really impossible to sell this many bonds to the public so we have to (1) establish a climate in which the oil companies and the State can work together around a program of this or any other program to address the issues as they have been stated and I do think that we can then proceed to go to market with a negotiated security and competitive security. Now I will be happy to respond to any questions.

?: We'll use the same sheet for Senator Groth.

?: Is this on?

?: Yes sir.

Groth: You said one thing that I wonder about Mr. Guilderhouse, and I'm not sure you amplified it. You said would enter into a construction contract with Alyeska and then you said, how do we guarentee, who takes the risk of completion on that construction contract?

Guilderhouse: The way I would foresee it is that it would be a, let's take a little example any contract the State lets. The State lets a contract and it's a contract with specifications and let's say it's a fixed price contract. Let's just first take the fixed price contract, obviously there is some problems with the

fixed price contract in this case, but let's say that it was a fixed price contract well, it has been freely negotiated, openly arrived at fixed price contract and the obligation of the contractor is to finish that project. Now I suggest there is ~~suficient~~ sufficient financial strength within the oil companies who are the owners of the ~~Aleyeska~~ Alyeska Pipeline Service Company to guarantee any contract ~~the State openly or~~ that they freely negotiated and I would look to the performance and completion of the contract from the ~~Aleyeska~~ Alyeska Pipeline Service Company as they provide their own guarantees or their own bonds that they will complete a contract that they freely entered into.

~~Groth:~~ Groth: In other words, we would ask them to guarantee the construction of the contract and take the risk of completion on this project.

Guilderhouse: The risk is included in the price, right. They're acting as general contractors like any other general contractor would operate.

~~Groth:~~ Groth: And do they make a profit here?

Guilderhouse: I would assume so, yes, just like any other contractor in their price and in their bid they would receive a mark-up on their labor, certainly.

~~Groth~~: Groth: Do they put up bonds in the event of a noncompletion?

Guilderhouse: Well I don't think that it is necessary for Humble Oil or ARCO or these oil companies to go to the bonding market to receive bonds. I think that the assets and the strength of the oil companies are probably greater than most of the bonding companies so I do not think it would be a requirement to post bonds.

~~Groth~~: Groth: To that extent isn't ~~there~~ their credit seriously impaired to the tune of three and a half billion dollars?

Guilderhouse: No I don't think so because they have negotiated a contract and they are going to get paid 3.5 billion dollars. Let's say we negotiated a contract of ~~of~~ 3.5 billion dollars. Their only liability is to the fact that they don't meet the terms of the contract

~~Groth~~: Groth: Okay, thank you. I have no other questions, Mr. Chairman, thank you.

McVeigh: Senator

Rose: Mr. Whelan

_____: Questions from members of the house panel. Mr. Rose.

Mr. Rose: What do you want Mr. ~~Kevin~~ CHAIRMAN that is ~~a~~ AT PAGE phase four of the study that was made. I see that you ~~was willing to face~~ GO ON THE BASIS OF five ISSUES of bonds and first two ~~ones~~ have an eight per cent each interest and the third one on a tax exempt rate of 6 1/2 per cent. Now why is it that if we can qualify for the 6 1/2 PERCENT tax exempt rate that we wouldn't find that in the first two?

Guilderhouse: I'm not quite sure what, okay. Well, I would say what the study shows here is just a variety of possible interest rates because until you go to market and the underwriters finally bid on your INSTRUMENT you really don't know what the interest rate is going to be. I think that one, I'm not familiar with this particular study here, but I would say that if the interest rate is judged to be higher in the early issues than it is in the later issues the assumption is that the risk is greater and it would be a harder sell on the first issues of the bonds when people are more accustomed to the flow of the bonds and they just won't have to pay as much money to get the money.

Rose: Say if you have to _____ which would be the last one and the smallest, not the smallest, but almost the smallest one, second smallest ~~one~~ is also indicated at eight per cent but the thing that I don't understand if we were to qualify for tax exempt status which would appear to be the case on the assumption of issue number three then why would not that assumption hold as well on the other four issues?

Guilderhouse: I hate to duck questions, I'll have to REFER IT report to the fellow who made this document, I'm not clear why issue three is at a lower interest rate than issues one and two and four and five.

Wohlforth: Issue three is a gross assumption of those facilities which would be conventionally tax exempt without question, gross etc., and or would qualify under the environmental exceptions to Section 1085 of the Internal Revenue

Code about which Mr. Cady spoke at such great length. That is the rational behind the 6 1/2 per cent 900 million portion of the total issue.

Rose: Do we expect then that if tax exempt status is obtainable on the others that the interest rate would also be likely to be lower.

Wohlforth: It might be, although we gotten no affirmative reading from the bankers, no banker has put himself on the line and said yes, it will absolutely be a hundred ~~bases~~ points lower because of the size of hundred bases point one per cent because of the size of the issue. We have bearing indications from time to time of a hundred twenty-five ~~bases~~ points to seventy-five bases points 1 1/4 per cent to 3/4 of one per cent but we have tried to portray the conservative case of of interest rate on the State and the private case excluding only giving ourselves credit if you will only for the environmental protection portion of the gross 3.5 billion dollar bond issue.

McVay: The Senator Rettig has a question?

Rettig: Mr. Guilderhouse, I believe that in the early part of your remarks that you characterize your financing plan as one in which the oil companies would not be asked to do anything that they have not already planning to do; is that their statement?

Guilderhouse: Well, I guess that it would not with respect to the shipment of oil.

Rettig: And I believe in that you referred as one of the elements, an agreement to ship a minimum quantity of oil, you cited as an example, I believe, a million barrels a day. That may not be the one or not, but would it be reasonable to expect that this might be something that the oil companies were not planning to do if the vaguries of the market are such that they may not plan to ship that minimum under circumstances?

Guilderhouse: Yes, I guess that I have to say one can't postulate circumstances one would not be planning to ship the oil. That is the reason we have the State

entering in under those circumstances and shipping the oil. For example, I can, lets take for example Arco who has a refinery down Seattle way. Lets say that that refinery burned up, or blew up, for some reason or another, and a hundred thousand barrels a day of Arco's oil would not have its normal place to flow, and it might be given away at unit rates, I am not quite sure how they can stop their percentage of the unit from flowing downstream to the market anyway. But, on the assumption that there was some way that they could, we would then have them reobligate it to offer that one hundred thousand barrels first to another member of the consortium, which I think they probably do under any circumstances as it is, but if, for some reason or another, another member of the consortium didn't want the oil either, then we would expect the State to step in and move the oil to market for the bond holders' welfare.

Rettig: Your further condition being to secure an agreement that the oil companies, failing to ship the minimum, would agree then to sell to the State, presumably as a back-up to the guarantee this minimum. Is that correct?

Guilderhouse: If it was first offered to another oil company.

Rettig: Failing in that, the State would have the option to purchase?

Guilderhouse: Yes sir.

Rettig: What would the State do with this?

Guilderhouse: Well, I said that the premise is that there exists, and will exist, continue to exist, a demand in the "lower 48" for Alaskan crude and that the assumption is that Alaskan crude will be competitive with other sources of domestic crude ~~crude~~ oil over the long run. On that assumption, I assume that the State could find a buyer for the oil. Now, I understand ~~that~~ there are great amounts of complexity involving oil companies make their plans ~~lease~~ time six months. They know where their oil is coming for any particular refinery. So it is entirely possible to suggest that the State could not market or sell the oil. That nobody would buy it, I think it highly unlikely and I think you can get testimony more expert than I, to suggest that Alaskan oil will be marketable somewhere in the United States over the long run. I would suggest that is the

reason the oil companies are willing to spend six billion dollars in the long run to bring that oil to market. They believe that over the next 25 years, they'll have a place to sell it.

Rettig: Wouldn't it be reasonable to assume that if the minimum under the contract fails its probably because of failure of the market. Those who are in the business of marketing if their market fails, would you suggest a place that the state might find a market for this oil.

Guilderhouse: I would say that if the market for Alaskan crude oil is non-existent, the State will not be able to sell oil. I also say that I don't think the market for Alaskan crude will be nonexistent. I do not think the State will probably ever have to sell a barrel of oil because I think the oil companies will sell the oil over the next 25 years and the circumstance for which we are providing in this case is highly unlikely ever to occur. And I would also say that if there was no market for Alaskan oil, the State could not sell it and ~~that would be a risk~~ that we'd be asking the bond-holder to take is that the market for Alaskan oil evaporates because we're providing to move the oil to a market that is assumed to exist. If the market is not there--

Rettig: Just one additional point--I believe you referred to this minimum guarantee requirement as in effect a mere pledge of the oil in the ground. Is that?

Guilderhouse: Yes sir.

Rettig: I don't think that term is quite clear to me. In relating it to your initial statement that we're not asking the oil companies to guarantee any credit, now this is their oil, is it not? At least seven-eights of it is.

Guilderhouse: I think the oil belongs to the people of the State of Alaska

~~And they have~~ AND THEY have paid to develop the oil and bring it to market. The oil belongs to the people of the State of Alaska and the oil companies have a lease to develop and bring to market that oil. But maybe I'm wrong on that. Is that correct?

Rettig: You were telling me that this oil that we have in effect sold to the oil companies still belongs to the people of the State?

Guilderhouse: Well, I'm not--it was my understanding that a lease--the oil companies have leased the land under which the oil exists--they haven't bought the oil.

Rettig: Do they not have a right to 7/8ths of that oil?

Guilderhouse : Yes sir.

Rettig: Then....isn't that title to it, if they have full right to it?

Guilderhouse: I'm not a lawyer, and I'm not going to ---[illegible]

Rettig: I fail to see how we can regard that oil as ours when we have sold it.....

Guilderhouse: Well, I

Rettig: .....and have received the money.

Guilderhouse: I'm going to have to deal with the lawyer addressing the legality of the lease, in terms of what it means.

Rettig: All right, that will be fine.

Chairman Stevens: We touched on this before and I think ownership as we have discovered, such items as the Native Land Claims, is a divisible interest and certainly we recognize that there are private rights of ownership in this oil that are the property of the bidder that bid on the oil; there are also interests the State of Alaska has which might also be described as being ownership rights in general, diversionary rights, belonging to an ownership

....right of ownership. Title is an intangible subject.

_____: I don't think this is really the thrust of my question, in any event, but the fact that we are pledging, asking the oil companies to pledge this minimal amount of oil to secure this bond service - something/~~xexxxe~~ not otherwise planning to do.

_____: Well, if you ~~figure~~ the pieces.....we are asking them as part of a mutually beneficial arrangement, and not forcing them because I have stated that there is a hostile atmosphere and we can't work this out, this does not make sense with all the parties concerned, nothing will ever happen in terms of public financing. If this doesn't make any sense, ~~xnd~~ there is no way that anybody is going to make them do it, now I would suggest.... now I'm talking about encumbering their credit, or encumbering the ability of the oil company, lets say to go to a commercial banker, and the commercial banker will say "you have such a large _____ liability with that pipeline arrangement you have with the State of Alaska, I won't lend you any more money because I am concerned about that liability." Or to the extend that a bond rating agency would reduce the bond rating of a particular oil company because he entered into an arrangement of this sort. I am suggesting, and I think it is substantiated, that such/would not encumber the credit of oil companies in this attitude. With respect to their being a footnote perhaps in their balance sheet, because this is a material commitment on their part, a significant commitment that needs to be brought to the attention of the share holders and other people that certainly would be missing, but when I say encumber their credit, ~~xxxxxxxxxxxxxxxxxx~~ its not like you take a play where they say "if you don't ship you have to pay money", or in this case we say "if you don't ship we'll come in and ship the oil for you and pay you".

_____: Thank you.

_____: I have a couple of questions . Going to your point that any agreements should be made between the two partners....must be between the two partners, and must benefit both partners, it would seem to me and I ....this is pretty basic but I am having a little trouble, it would seem to me that as cheap as we can build the line is the most desirable thing both for the State and for the oil companies. Now if the State would build it, perhaps they would sell the bonds at ...if they were revenue or tax free bonds...would sell them at an interest rate less than what normal bonds could be sold for. Is that right?

_____: Yes, sir.

_____: We would figure the point spread from ..I think anywhere from 1.5 to 2 points. Is that correct?

_____: [illegible]

_____: So this is very general. So that would result in substantial savings, insofar as far as debt service is concerned.

_____: It depends on how much of the pipeline is going to be financed by equity on the part of the oil companies, and how much of the pipeline is going to be openly financed by debt on the part of the oil companies. Because if the State would go out and lets say borrow, (or, million?) 3.5 billion dollars, then the State would be paying, lets say 7% interest on that, for arguments sake. It is possible that the oil companies will not be able to borrow 3.5 million dollars, they will only be able to borrow say half of that, and for the rest they will have to sell shares of stock to the public and also use their own cash flow of retained earnings, to finance this. Well there is a cost associated with that capital which I think with the oil companies is higher than 7%, and there is also a cost associated with the debt which I think the oil companies, for this magnitude, will be higher than 7%. So in a long-winded way, yes, it would be cheaper for the State to finance it in terms of tax exempt bonds.

_____: And we're talking about maybe 1 or 1.5 per cent?

_____: Now, in the other area, as far as the Federal government is concerned, if the State owned the pipeline, then the State would be entitled as a private company to make the suggested 7% ... the ICC allowance, then a 7% profit would be taxable if the line were held in private ownership by the Federal government. The 7% profit would not be taxable by the Federal government if held under State ownership. Now, in millions of dollars, estimate what that saving would be. It seems to me that there would be a substantial piece of money and that that would eventually inure to the benefit of the shipper - the oil companies - as well as the State.

_____: Yes sir, I think you are right on it.

_____: Can you estimate what that figure.....

_____: Should have a run..... more specifically

_____: Lets do it, it can be done somewhere, but lets say that it costs three billion dollars, and the State lets say in the first year will pay ...well in the first year the whole debt issue,...in the State, would pay 7% interest on that, so you are talking 210 million dollars in interest, and if the oil companies lets say had 100% financing, you said that they had a cost associated with it, of lets just say for argument's sake 9% which I think is lower than the oil companies would like it, they earn on their assets, you've got 2% difference there, thats essentially 60 million right there, I guess. And of the income tax, thats a year, ...

_____: Let me continue with Federal and State taxes that we calculated, that would be paid by private ownership, in our private ownership base case.

They are, the first year, 33.73 million dollars in State income taxes; BUT 158.8 million dollars Federal income taxes.

In the second year, a similar amount 33 plus million dollars IN STATE TAXES, and again 150 and a quarter million dollars in Federal income tax.

Moving on to the third year of operation, the Federal income tax and State income tax remain roughly the same - 34 million in State, 158 million dollars in Federal.

_____: Thats third year?

_____: Third year. Yes sir.

_____: Well, I can have all these figures.....

_____: No, thats not necessary....as my rough fig ures show thats about 200 million dollars a year in tax savings if the State would own it. Am I right?

_____: You are right.

_____: Now, that/200 million dollars,/which is a substantial piece of money going to be distributed?Wouldn't the oil companies benefit in part because, say for example if it takes 75¢ to ship a barrel of oil from Prudhoe to Valdez, but you don't have to pay tax on it, you could say, then in rough figures, say then it only cost them 50¢ a barrel.....is that right?

_____: Correct, I am not sure of your numbers.....actual tax savings are definitely a part of the tariff calculation, the lower the taxes the lower the tariff.

_____: All right, now let me ask you another question: would the tax savings anywhere compare to the 7% profits they would make if they held the title under private? You see what I mean?

_____: Yes.

_____: In other words they would save a quarter a barrel if its

in State ownership, but are they going to make profit at a quarter a barrel if they hold it in their own hands? Is there any way to equate that?

_____: The situation you just described, yes, you certainly can't equate it .....it looks like a mess. The profit that ....theoretically the profit that of 7% - if we're going to use the 7% number, with a 3 billion dollar pip eline, the profit is 210 million dollars. Thats how much profit they can make. Its that simple a calculation, 7% of 3 billion dollars. Now the profit - if you're going to use the 7%, is 210 million dollars. Equate... and use these numbers and we come up to around 200 million dollars. So Well, in terms of the cash position of the oil companies, its a good foot. But I could say something....I'll make it quite clear that this is a [illegible] sort of an opinion and nobody else really has anything to do with it, its strictly ours. That there might be a way to make this concept more feasible and engender the environment in which cooperation might take place, by Suggesting to the oil companies that under state ownership it might not chose to build its tariff structure around a 7% return. Say perhaps the State not only would provide this type of savings but could conceivably develop its tariff structure on a basis something less than the maximum. Again I want to emphasize that this is [illegible] Sloan speaking. As a suggestion for consideration, if you ever reach the point where you are driving [illegible] this favorable climate [illegible]

_____: Right, that was sort of what I was thinking, in terms of each having a be nefit, not one at the expense of the other.

_____: I heartily recommend that.

_____: Only one other thing that bothers me - the oil companies of course would have the right to depreciate the pipeline as an asset, I assume.

_____: Yes sir.

_____: And that would be a tax of paper transaction because we assume the pipeline is going to be there and carry all the oil out and I suppose _____ zero. But The State wouldn't have that....the State, since it doesn't get doesn't pay taxes, it ~~xxxxxxxxxxxx~~ the depreciation quite obviously. Now, how does that gear into that?

_____: Well, the _____ of oil company financing and accounting, ~~is~~ exactly an art unto itself. And I'm not really qualified to say how much the depreciation of the pipeline is worth to a particular oil company, or in the undivided interest structure what value ~~xxx~~ a particular member of the consortium would place to that depreciation. With respect....lets say that it was a separate entity, and not an undivided interest structure, the depreciation would really not make a whole lot of difference to the private ownership on the basis of 7% consent decree limitation. Because that's a cash dividend figure, and what they're working on on that basis, they can just take 7% cash out of the dividends and that ...and then the depreciation within the structure would not be a significant item at all.

_____: ~~xxxxxxxxxxxxxxxxxxxx~~ Okey.

_____: But thats not in the same place with the undivided interest, because that is all folded back within the parent corporation, the depreciation may well have some values beyond the.....

_____: All right, now in just the painting with the broad brush, we've got 200 million dollars here that can be saved in taxes.

_____: Yes, sir.

_____: Isn't that....and if the oil companies are going to share in some of the savings, right now isn't that going to....not withstanding the

arrangement between the State and the oil companies, isn't that going to result in the oil companies being more competitive in their own area of marketing? I would think that would follow.

_____: You mean to the extent that their costs are lower, that they are more competitive in the market? Yes sir.

_____: So they'd get a substantial advance, I would think.

_____: I THINK SO, YES SIR, UNDER

~~Under~~ the right circumstances I think there are tremendous advantages to the oil companies, both in reduced costs and in reduced financing burdens. (?)

_____: Mr. Rettig is a banker... ~~I'm going to~~ continue, as I'm getting a cold in my head.

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Guilderhouse: _____referred to establishing the tariffs, and I would suggest it should be a factor in establishing the tariffs. In order to recover the costs.

Rettig: Yes sir, I'm sorry, I just wanted to clarify a point. When I performed an analysis on the income statements of an owner of the pipeline, be it the state or a private secrete, I did in fact include straight line depreciation over a 30 year line for 15% _____VALUE, in either case.

Guilderhouse: Thank you, I had thought it was important to make it clearer that we all understood ~~XXXXXXXXX~~ the treatment of depreciation in either case.

Eppenback: If I may add _____Mr. Chairman, the cases showing estimated income to state public ownership which Chairman McVay was eluding to way. and shown on chart ~~exhibit~~ 3 and reduce dividen levels 7, 5.5, and 4, so that the committee has this information before us and again to perhaps being a little oversensative to refute any imputation of the state had shown only the worse case or that the governor has made it the only ~~the~~ worse case, these charts are before the committee and we'll be ready to respond to them at your pleasure.

Rettig: thank you.

Wohlforth: Senator Raider has a question,

Raider: I have a question for Mr. Guilderhouse , under the various proposals here how would the issues of 3 ½ million involve or would it effect our abilities to issue bonds for normal governmental purposes? That question was asked this morning, but I'd like to have your opinion.

Guilderhouse: Well, mines just an opinion, I happen to believe that ownership of the pipeline will enhance the states ability to issue general revenue bonds. I think that ownership of the pipeline increases the security of the states total income package. I think, first of all, I think the pipeline is a good business, and because its a good business , or a sound business, and lets say it would be operated in a sound fashion. The abillty to protect the states well head and protect the states royalities and severences, generate lets say a moderate surplus or even a large surplus, however

if we're at doubt from pipeline operations to develope other activities in the state, would enhanse the states abilitating the state would be in a stronger financial XXXXXXXXX position rather than a weaker, financial position.

Holm: Mr. Guilderhouse, haven't you assumed that the price per barral for transportation to the line is the same ~~weather~~ whether its state ownership or private ownership?

Guilderhouse: No sir, I would say in line with the discussions we have there, that there would be some costs savings, ah, in state ownership because of the reduced cost of financing the reduced cost of taxation. That the actual cost of moving under state ownership would be less than the actual costs of moving under private ownership, given equal efficiency in operations.

Holm: Than what relationship doXX these charges have, or these charts upon the wall have to a diferential between the rate charged and thus the competive position of the state operating the pipeline, the oil that passes through that, on the world market as compared with that under private ownership?

Guilderhouse: Could you rephrase it sir, I'm sorry.

Holm: Well, under private ownership they will have a certain value on the world market, because it will be certain costs, ah, is state ownership going to put the oil on the market at a better competive price to compete with Venezuelian Oil, East Indian Oil, any other oil? Or have we built in basically the same end price in Bellingham?

Guilderhouse: I'm not really qualified to testify on the world market prices, I had some discussion with a Mr. Whelley, several long discussions, and he states that ~~Alaskan~~ Alaskan oil, I hope I'm not misphrasing him, as I understood him, stated that ~~Alaskan~~ Alaskan oil will probable be a price taker and not a price maker for a long time. So, I can't talk aboun Indonesian Oil, or Venezuelian Oil, but I am saying the cost associated with the transportation move of the oil to the market is probable given equally efficient operation of the pipeline to be some magnatude less on the public ownership, than private. The actual cost _____ _____the cost of plans.

Holm: Now these figures predicated thou upon a specific figure, now I thought they were the same, I thought you were using the same figures, weather under private ownership or the other. If you want to let someone else answer that I can ask that later. May I ask you one other question? You stated earlier major risks of the bond holder was maybe lack of market, ah, isn't it a major risk of the bond holder, to contemplate strike, to contemplate injunctions because of a, a maybe the ~~bitterman~~ Bigherman getting all worked up over some oil spills and so forth, how will this relate to the cost of our bond?

Guilderhouse: To the cost of the bonds? ah,

Holm: What happens, for example if these things occur and the state is in an impossible position of delivering?

Guilderhouse: Well, that is the reason you would establish a general reserve fund. If you remember one of the things I talked about, was that, it would have to be established under conditions of state ownership, A substantial reserve fund that was equal to, lets for discussion sakes, say one year or 18 months of the total operation costs of an interest in amunization costs associated with the pipeline, to provide sufficient income to meet the authorities obligations in the event of a situation such as you described.

Holm: You don't think that will have a depressing effect on the cost of our bond?

Guilderhouse: Well, it depends on how vague, in terms of the interest costs, it depends on how vague you ultimately decide to make the general reserve, I you made it for a 10 year period or a 5 year period which is _____ of course, but it, it depends on how big a general reserve fund you make, and how the market proceedes and risks, you have described occur. I would say that, yea, there are, this is not going to be the cheepest bond that was ever issued. I would say that, given one the size, you have to attract a lot of people,

Farrow: In answer to Representative McVay, You, on one question indicated that this was a darn good business to be in, ah, with that in mind, do you think its necessary for the

state legislature to put the full faith and credit of the of the state on the line to guarantee anything?

Guilderhouse: No sir, I don't think its necessary to put the full faith and credit of the state on the line.

Farrow: Thank you

Guilderhouse. Mr. Farrow,

Farrow: The point you brought up in response to this

1. What representation can you make with respect to the duration the _____ duration Such a fund _____ would have to be established for, how would you establish it in terms of the senate of revenue? and secondly, how would this enhance the states ability to _____ obligation box? Or would it decrease the states ability to establish a ah, 20% ah, revenue,

Guilderhouse: May I restate the question to make sure I understood? You're asking essentially 3 questions, How would you go about establishing the size of the general reserve fund? and how much it should be, and then how it would effect the ability to sell the bond.

1) How you go about establishing, it is first, ah, you figure out what the cost, for lets say 1 year cause thats a convenient term, what the interest costs are, what the amortization costs are , and what the operating costs to the pipeline are. Fortunately pipeline is you can get a pretty good fix to what costs are because its not labour intensive, you know, you can really figure out after awhile pretty close to what it cost to operate a pipeline. You know your interest in your amortization, so you say that if, for some reason or another we have a force XXXXXX or the injunction to the strike that the senator mentioned, ah, how long is this liable to last, what is the biggest exposure and how long do we have to pledge to the investment bankers who are representing the investment comunity _____, How much do they say that you've got to give us before we can sell you bonds? And its negotiated and is sometimes an excruciatingly agonizing process

to come to drifts with how long this is, with the state or the seller of the bonds saying, "well it only needs to be 18 months," and the investment banker saying,"well gee, I can't sell it unless its 3 years," and then you say, "well I'll give you 20 months," for if he can say, I can sell in 2 and 1.5 years. Its this process of evaulation of risks, ah, and the likelyhood and the probability of risks as well as what the actual costs are that ultimately come in to whats necessary to sell the bond, and its generally some multiple of what the costs are to operate the line in case its shut down. Or operate the facilities in case its shut down, and with respect to its impact on the states ability to sell other bonds, I don't see how it would have an adverse effect on it. The ensistance of the general reserve fund will send the context of the pipeline. I don't believe it would have an adverse effect.

McVay: Excuse me, Mr Farrow, are you through? Just one more point, it would seem to me that if ~~and~~ the state pays off this bond, it aquires an etquity position in terms of a very expensive asset. That would seem to me, to help the general obligation situation. directly or indirectly,would it not? In a concrete way, at the end of five years if you've got 100 million dollar equity that you didn't have five years before, or an asset, or equity unit asset, then that would be helpful for the general balance sheet, would it not?

Guilderhouse: Yes sir, in my opinion it would.

McVay: Would that be an _____? as to how this would improve the G.O. picture.

Guilderhouse: I don't see how the existance of the general reserve funds would _____ contract to the overall financeing of the pipeling. It would be damageing to the G.O.

Havelock: Ah, I'm going to have a ten minute break.

McVay: _____ Like to call Robert Macy, _____ Company of N.Y. who will discuss the marketing of public pipeline issues. Mr. Macy. Mr. Macy, would you' ~~XXXXX~~ please, before you start, ~~XXXXXXXXXXXXXXXX~~ just for the record, give us just a brief backgroung of your experience.

Macy: I am Vice Pres. _____ of N.Y., i have been a student over the past 3 years. I have had 4 years of economic investment consulting, for Va Trust Company in Washington Prior to that time _____ for approximately the previous 4 years I was with _____ Company, which I was responsible for annalysing various investment projects.

McVay: Thank you. (Macy) Mr. Chairman, members of the committee: As a representative of _____ I wish to note that we are pleased to be here to express our views as members of the investment banking group, which is consisting to state in evaulating the fesability of state financing of the oil pipeline project. A project of this unpresedented magnitude obviously poses many unusual considerations, in analyzing various approached to the financial market. The first and most important group of consideration is the identification of the major risk factors involved. In this category we would include the following major investors concern, 1st) Are there sufficient oil reserves on the north slope to establish an economic justification for long term finance 2nd) Are there adequate assurances that the pipeline can be constructed within reasonable time and cost estimates. 3rd) Once built, can the pipeling be operated and maintained on a satisfactorally economic basis. 4th) are there adequate assurances that once built, sufficient revenue will be generated, , to cover operating maintanience in debt serviceing requirements _____ that issue. 5th) assuming the financeing would have to be accomplished in stages, what ~~XX~~ assurance do the investors in the earlier stages have that market conditions will continue to sustain the timely injection of funds needed to complete the project. 6th) Are there back-up alturnatives that the state finds that it cannot finance, build, or operate the pipeline on an economic basis. 7th) Does the status of domestic and world oil markets as projected, give satisfactory promise oil ~~from~~ Our this source over the life of the issue and at what maximum price? 8th) What additional finance over reserves are there incorporated in the financing plans, to cover unforseen problems in the future? Few if any of the above

XXXXX

risks can be satisfied by absolute guarantees to the investor. Each, however must be addressed to some degree in the financing plan, and the relative degree to which these risks are secured. We'll determine not only the fesability of the financing, but also the cost. We understand that entensive, economic and engineering studies are available as background data and _____some investors concern. The sizeable investment already made by the oil companies is undoubtably as physiological plus. In addition the state could, in theory, take certain steps to provide additional financial reserve to cushion the impact on death serviceing of temporary unforseen problems related to the afore major risks, However, these assurances alone, we believe, are insufficient to ficilitate the market, the successful marketing of an issue of thes magnatude. Furthermore, from all the suggestions which our group has considered, we know of no feasible plan which does not involve to some degree the cooperation of the oil ~~copanies~~ with the state, in arriving at a feasible financing plan. The question is what form of co-operation is necessary and desirable? The first and most obvious to an investor, is to have both the full faith and guarantee of the state and the oil ~~copanies~~ behind the issue, however we understand while the oil companies imparticuliar may not wish to pledge their credit in this fashion. An alturnative, and one we must recognize as a significant jump, interms of the risk, as viwed by the investor. Is to restrict the liability or financial exposure of the oil companies in any financing , to the state which they have in the AKN oil venture. We have heard several possibilities suggested along each lines including those expeessed earlier in these proceedings. Upon consideration, we believe that subject to the conclusion of satisfactory, contractual agreements with the oil company and others pertaining to the construction and utalization of the pipeling, that it is possible that these agreements coupled with satisfactory guarantees by the state, could make such an issue feasible. In conclusion, we believe that if as there appears to be in earlier testimony, there are sound , economic, and social reasons for the state

and the oil companies to coperate in the financing of this project. Also the establishment of a legislative and organizational framwork as presentely under consideration by the legislature, should facilitate discussions between the stateand the oil companies. The output of such discussions could greately assist us as well, in providing a more definitive judgement as to weather we believe a state finance oil pipeling is feasible at this time. Thank you

McVay: We'll take, ah, questions in the usual order.

Groth: Mr. Macy, you say that subject to the conclusion of satisfactory contracts it is possible , couples with satisfactory guarantees by the state that it might work., ah, what kind of state guarantees are we talking about?

Macy: Senator Groth, One of the difficulties I think we all encounter in answering questions like this and one of the reasons why I really outlined what we considered the major risk to the investors in such an issue, is that to satisfy any one of these risks theres a whole varity of different guarantees, different methods, that could be used to satisfy the risk element to the investor. I think that perhaps it would be, I think it is pre-mature, if I may say so, to try to disect one risk, or one method. And say well if we provided this then this would make is feasible, because frankly, I think until the legislation has been passed to set frame. And some feasible plan, or some mode of cooperation has been established with the oil company. That you cannot come up with sufficient pieces of a plan to satisfy, to really make any meaningful judgement,

Groth: Mr. Chairman, Thats one of the things that troubles me, and has troubled my since this discussion first arose.. Because, ah, seems to me, wether we have a bill or don't have a bill, somebody should go to oil companies and make an enquire, gentlemen, are you prepared to sell what you already have, and are you prepared to enter into meaningful negotiations with us presumming we have the power to do so. And it becomes a purchase and sale arrangement that troubles me very greatly. The first inquiry seems to me

I mean we all talk about establishing, buying meaningful negotiations, and opportunities for cooperation, but I'm troubled by the fact that maybe the first inquiry hasen't been made.

McVay: May I recognise that your not the XXXXX person for me to ask that question. I haven't had any other questions. Thank you

Barber: Mr. Macy, I would like to ask you if you _____that the passage of this house bill 569, The Trans Alaskan Authority, is a matter which should be determined prior to negotiations with the oil industry, as to their reseption, of stateXXX ownership of the pipeline.

Macy: I believe it is.

Barber: The prime factor in initial negotiation.

Macy: Well I think that it, if I can try to expand a little bit _____. I think that, _____ perhaps a healthly indication in our system for private companies to exhibit considerable reserve in entering openly in cooperative agreements with public organizations. I think it's possibly, partly due to communication, it's partly due to some misgivings concerning motivations, objectives, goals _____of interest and what have you. I think the variety of such motivation, on the part of public organizations, is certainly, probably greater than the variety on the corporate side. I think to the extent the state can exhibit through legislation their willingness to cut down and to focus what their motivations and interests are. It's really not only the legislation it's even the hearings and the testimony that we have here that exhibit what the goals and objectives of the state are and this is crystallized, I believe, in this legislation. I think this is very helpful to the corporations in better focusing on in what is involved in this, this very broad term of cooperation of the State in such a project of this magnitude.

Barber; The saving in corporate tax determination would also very possibly, would it not, be a prime consideration to the oil industry.

Macy: In other words, you're saying if, if we

Barber: Won before I.R.S., and got a favorable decision, ~~it~~ that would enhance this Trans-Alaska Authority.

Macy: I believe this is the case. I think there is perhaps one additional factor that has to be brought to bear. Let us assume that you have a basic security. All things being equal, what might be the difference in interest costs between a tax. if it were taxable, or if it were non-taxable? The question here also involves one other factor. An issue of this size is going to ~~be~~ have to be marketed very broadly. Some of the institutions which would have to be included in the market, such as life insurance companies, do not have the same tax structures as other institutions to which tax exempt securities might you might say, might normally be, to which they might normally be marketed. Therefore, I think you would probably because of the sheer size of this issue and the marketing problem, have to give up a portion of that differential between a, the normal differential, between a taxable and a non-taxable issue.

Barber: Senator Rettig

Rettig: Mr. Macy, in your studies of this situation, this proposition so far, are you and you as representing your associates and the companies that perhaps you're associated with in this study together this proposal, are you in a position to suggest that we should pass this, in other words, do you feel the chances are favorable that once it is passed that these bonds and various contracts could be worked out? Would you, in other words, recommend that we act favorable on this?

Macy: I would recommend that you act favorable on this. There is an urge to be somewhat flip in saying that you will never know, or you may never know, if such a financing were feasible until you provide a framework which would allow, I think, for what I consider a more cooperative exchange between the State and the oil companies.

Rettig: You're saying we can't do this unless we do have the vehicle.

Macy: Well, I say I find it highly doubtful that you could do that without the vehicle.

Rettig: Thank you.

Macy: I'm not guaranteeing that you'll be successful.

Rettig: I understand.

McVay: Any other questions - Mr. Farrow

Farrow: Thank you, Mr. Chairman. Assuming that the State goes ahead Mr. Macy, and starts to build the pipeline, despite an outstanding agreement with the oil companies, will this _____, or not?

It seems to me that we'd be able to save the time _____ at this time, There must be some area that you can say how the State has to guarantee its own _____. What areas are we talking about?

Macy: I'm afraid I have to come back to the same answer that I gave to Senator Groh earlier, that frankly, mind you, one of the

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TAPE 15:

page 1

such as satisfactory, reasonable, sufficient ~~[illegible]~~ if ~~[illegible]~~ Aside from the risks which I have listed here, there are undoubtedly others I could list, throw in another dozen; anyone of these risks can be met in a number of ways. To get focused on one ~~[illegible]~~ way to attenuate part of the problem of this risk by looking to the State for certain guarantees, is really misleading.

I think that if you want a ~~broad~~-- broader statement, which is highly generalized, the State and the oil companies, if such a plan, vaguely along these lines, were developed, have a stake in the development, exploitation, shipment of oil to (??) North Slope. When you put together a prospectus to market this issue, and assuming that you're not counting on external guarantees by the oil companies, I give full credit to the oil companies, you're going to have to focus on the economics of the North Slope, its oil and its future market, and cost of getting it there. You're going to be focused on what the state has invested there. I think perhaps that to the degree the revenues and stake that the State has, and that the oil companies have, that these are areas in which you will undoubtedly be exploring for certain assurances, guarantees, agreements. I am sorry, I don't think it is meaningful to be more explicit than that.

RITTIG: ~~I believe~~ Mr. Macey, you have indicated that you feel the chances of working out a suitable arrangement with the oil companies are sufficiently good that you would recommend the passage of HB 569, and would you also agree that up to that we should proceed with passing the ~~bond~~ authorization measure at the same time? Is that a necessary part of the...at this stage of the game?

MACEY: I think this is very useful. The acceptance of these levels of financing to which the State to some degree is going to have its name

attached, because the legislature is going to go along with this, I think this is very important.

We have, perhaps as you are no doubt aware, one of the highest per capita bonded indebtednesses of any state at this time, and I am aware that many of the bond underwriters look at it as it is on the books already to be authorized.

With the many, many still unanswered questions in connection with the three and one half billion dollar issue, would the very fact that that is on the books, have any effect upon our other general obligation bonds that we may have to market immediately or in the near future?

MACY: I don't believe so, not, as I understand from Mr. Cady's interpretation.....what is really involved in the issue here, as I understand it, before any obligation of this type could occur, it requires so many plans enabling .....enabling legislation...I cannot really see where this would have effect on it at all.

Thank you.

Any further questions? Mr. Fisher?

Mrs. Fisher: Mr. MACY (Meisdig???) If HB 569 is passed, if everything went right, what time would you estimate the first bonds could be sold? This could be a guessistimate.

MACY: I would say the first bonds might be sold.....the time factor, point of departure, the time after this cooperative agreement is reached with the oil companies so it becomes given that that is reached, and that with suitable inputs from the investment community, that this agreement can be brought up to.....the investment bankers judge to be a satisfactory level of investment grade, I would assume that within three

to six months after that, the bonds ~~could~~ you could ..... ~~would~~ begin to sell the bonds. (~~???~~)

Now we also have conditions over which none of us have co ntrol. It is not only as I understand it

it ~~is~~ not only a question of whether you can sell the bonds. As how much you can ~~you might be able to~~ sell the bonds, how much of the bonds you can sell ~~the bonds for~~, and at what cost. And these are subject to market conditions, which we have relatively little control over.

MCVAE:
Other questions? Mr. ~~Grohs~~? ~~(??)~~ Grohs~~?~~

GROH: :One quick one - in the broadest gener al terms, Mr. Macy, what are potential underwriting counsel fees, in connection with the three and a half billion dollar issue? HA HA .....No, just as.....I think the people of Alaska ~~would like to~~ ought to know. I'd like to know.

MACY: I think that This again is something that I would always ~~would~~ say is subject to existing market conditions highly graded issue and so forth I would say that you have to accep t that the initial issues are going to have a larger underwriting spread, which is investment banking fee I think you are referring to, than the later issues because it is a sheer educational effort that is going to have to go into the market. I think that various comments that we have discussed ~~with~~ among the members of the group, I think that the underwriting discount here would be ...somewhere between 1-1/2 and 2-1/2 %. Now admittedly I have heard of rumors in the newspapers that somebody is willing to bid slightly higher than that for the underwriters service , but I think that this is perhaps a realistic realm in today's market.

GROH:
You deal in these figures all the time - would you translate that for me?

MACY: Yes, that is the principal ~~(???)~~ amount of the issue.

TAPE 15:

page 4

McVAE: I would like ~~verification~~ CLARIFICATION on that...are .....are you.... are you saying 1-1/2 to 2 % of the entire issue, or would that 1-1/2 to 2% say of the first hundred million?

MACY: No, each series, as it comes. Theoretically, at the end of the total issue, the/underwriting spreads.....should total 1-1/2 to 2-1/2 % of the total principal amount of the bonds - in this case 3-1/2 billion dollars.

McVAE: you say seventy million.....2% ~~is~~ would be 70 million?.....

(much hilarity)

HOLM: Mr. Macy, I just want to follow that up - would this be the same, whether it was sold by private industry or not?

MACY: Now in general, the underwriting spread for a private issue here, on this particular case - I think the alternative you are referring to would be the oil companies (yes) financing - would be less.

HOLM: Approximately how much less?

MACY: This gets very subjective: I'd say that it might run a half percent lower.

HOLM: So we pay a half per cent premium? Why do we pay a half per cent premium?

MACY: I think it is because of the differences in which corporate municipal or issues are marketed, and the way ~~in which~~/public issues are marketed, the relationship between the sale ---- IF YOU WILL, THE SELLERS the underwriters and the institution, THEN IT WOULD BE --

HOLM: Well, ~~anyway~~, doesn't that narrow that 1-1/2 % spread that was talked about, a little bit earlier - I suppose you were here - this narrow that down to one, and some of the other questions that were raised - took another half per cent ~~out~~ off,

TAPE 15:

page 5

MACY : Well, ~~we~~ you have to understand....you have two things here.... IF you will in an underwriting discount, our spread, if you will, which is a one time cost at the front end... ~~It~~ THIS comes out and is deducted from the net proceeds ~~that~~ OF ~~are~~ The offering.

HOLM : So it is just the first year, MACY: Its not an annual thing?

HOLM : No. I UNDERSTAND, BUT ITS

: ~~I understand, the~~.....

MACY : I think the spread that you're referring to was the spread in the interest cost, for the life of the issues. ~~(27)~~

HOLM : For the first year there would be ....the spread wouldn't be nearly as great?

MACY : That is correct.

HOLM : Thank you.

RETTIG : Mr. Macy, would you be willing to pay the bond counsels fee out of that?

RETTIG (laughter) you don't have to answer that.

Mr. Rose?

Mr. Rose : My question, Mr. Chairman, was along the same line that you were just asking.....the answer to Senator ~~Rowe's~~ GROH (~~27~~) question. I am interested in the underwriting fee, but Senator Groh asked about the counsel fee - what kind of a spread does that represent?

MACY : I am afraid I couldn't GUESS MYSELF.

Mr. Rose : You have no idea? There is no DOOR OPEN FOR THIS KIND OF THING.

MACY : There may be - ~~I believe Mr.~~ TO RESPOND TO

RETTIG : I believe Mr. Macy has indicated he is not prepared ~~for~~ that, ~~xxxxxxxxxxxxxxxxxxxx~~ not being bond counseler.

RETTIG : Are there any other questions?

CHRISTENSON M.: Yes.....where can we get this figure?

RETTIG: Mr. Wohlforth, would you care to volunteer this information?

Wohlforth: ~~I am afraid I am not any improvement as unfortunately I was~~ there some ~~in~~ conversation at my table.

~~[illegible]~~: ~~Can you rephrase it?~~

ROSE: Senator Groh ~~[illegible]~~ asked earlier about what the normal liquidation bond fee counsel/would be [RETTIG:] .....what would be the bond counsel's fee for representing the State in this issue?

WOHLFORTH: Well, again since I didn't hear the question, I imprudently came to the table .....

RETTIG: Are there any other questions?

WOHLFORTH: ~~It~~ Is the Largest or Not? would be the largest PROJECT ~~This would~~ certainly, ~~be the largest project~~ in the Western Hemisphere and I THINK .....the second largest in the world, to be perhaps "smart alecky" negotiable AGAIN, an arms length transaction between those public officials responsible for the public purse, or those people who are performing services. And again, I ~~think~~ its of the magnitude on which unfortunately I ~~where~~ don't think the committee can begin on meanginful information.

MCVEE: Its not on a minimum fee schedule?

RETTIG: Mr. Macy, do I understand that you have to leave town tomorrow? Tonight, there'll be a few minutes perhaps shortly, that any members who want to consult with Mr. Macy, may do so later.

[illegible]: Thank you very much, Mr. Macy, for appearing.

RETTIG: In this hearing we've considered only the various aspects ~~in~~ of possible State ownership of the pipeline. There are other majors introduced by the administration ..sponsored by the administration....namely SB 313, 14 and 15 concerning rights of ways, safety standards and pipeline regulations. Mr. Havelock,

are you ready to proceed?

Mr. Havelock: Senator, the....if I may be allowed a moment of digression to answer ~~the~~ A NON- question of Senator Groh earlier - he asked ...he made an inquiry about .....he couldn't understand why we hadn't approached the oil companies ~~about~~ TO FIND OUT this preliminary question of whether they were willing to.....if I may answer this in sort of an analogy.....I suppose if possible that I could get up from this table and go and ask the attractive girl at the end of the table whether she's willing , and I'm sure she'd tell me to go jump in the lake. IF I DID SO. On the other hand, if I invited her out TO DINNER, I might get a good deal more information whether she was willing.....start looking in store windows, AT FURS & DIAMONDS, I would probably get a good deal more information! An old negotiator like Senator ~~Grothe~~ GROH is probably quite aware of the answer to this. (laughter) This is Attorney General OLAF HELLIN who will discuss the bills YOU REFERRED TO.

GROH: Mr. Ch airman, I have a comment....my question is, have you ever called them?

HAVELOCK: We've talked to them hundreds of hours,

GROH: Did you ever ask them "are you willing to sell?"

BETTIG: ~~According to the papers, quite willing. (???)~~ IT'S BEEN CARRIED IN THE PAPERS QUITE FULLY.

BETTIG: The answer was"no."

GROH: Then, what are we doing here?

BETTIG: He is still taking them out to dinner!

GROH: I SEE. Havelock! Before MR. Hellin starts with his ~~as part of the~~ testimony, Mr. Chairman, I would just like to comment that there is a bill that is not before this committee, BUT which will relate to the subject matter generally which will be testified TO before other committees, which is the so-called 20 mill property tax ~~law~~ on ~~the oil~~ pipeline, OIL transportation EQUIPMENT, which is very much related to the subject

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

Testimony of Eric E. Wohlforth
Commissioner of Revenue

March 6, 1972

I am Eric Wohlforth, Commissioner of Revenue. I will summarize past projections of North Slope revenues and those presented today based on private ownership and contrast the revenue effect of private ownership case with the case of a pipeline owned by the State.

The most recent public North Slope oil revenue projections, before those referred to the Governor last week, were made by the Division of Oil and Gas in cooperation with the Department of Revenue as part of the State's contribution to the federal pipeline Impact Statement released by Governor Egan on July 30, 1971. These projections were developed from a computer model which was based on the information then available to the State and showed numerous economic cases on differing assumptions again based on facts then assumed to be ascertainable.

The July 30 report states on page 166 that, "the originally estimated $900 million cost of the pipeline has already increased considerably. Present cost estimates range from about $1.0 to $2.3 billion." The revenue projections used the assumption of $1 billion as the lowest installed cost and $2.5 billion

as the highest estimate. The footnote to this statement gives the backup for the State's cost estimates. It notes that as late as June 19, 1971 Alyeska furnished the State Department of Revenue an estimate of $969 million as the cost of the entire contract and concludes with reference to a statement from Interior Secretary Rogers C. B. Morton in late spring of 1971 that environmental precautions are contributing to a higher price tag of around $2.3 billion. This figure of $2.3 billion total cost was used in the State's "most likely" estimate of North Slope revenues. The revenue estimates included in the State's Report developed from this estimate of total cost, assumed refinery values in fiscal year 1976, the then estimated start up year, of $3.37, marine transportation costs of 44 cents, a pipeline tariff initially of 80 cents per barrel, giving a wellhead value of $2.12. From these figures it was estimated that total royalties and taxes would amount to $164 million a year in fiscal year 1976, the first year of pipeline operation. In the second year of operation, fiscal 1977, total revenue was estimated at $278 million, the third year $282 million, and the fourth year $311 million. In the then estimated fifth year of production, fiscal 1980, the pipeline tariff was calculated at 47 cents a barrel with the marine transportation costing 52 cents leaving a wellhead value of $2.56. In that year we showed a total of $348 million in total royalties and severance taxes from the pipeline.

Other estimates were also run with different assumptions. For example, one set the pipeline cost at $1 billion with again the initial production year assumed in fiscal 1976. A wellhead value of $2.75, with lower marine transportation and tariffs produced $212 million in revenues in the first year of production and the fifth year of production on this optimistic projection the State was assumed to capture $412 million in oil pipeline revenues. A then pessimistic case which assumed a pipeline cost of $2.5 billion shows a wellhead value of $1.76 in the initial year of 1976 and royalties and taxes of $136 million in that year. In 1980, however, at a wellhead value of $2.20 a barrel, royalties and severance taxes reached a figure of $297 million. Incidently, in all of these cases, one of the main reasons wellhead value increases over the years is that transportation costs go down as the volume of oil shipped increases.

Several important events have now come to light which have required the State to revise downwards drastically its revenue estimates. The first indication of the fact that the State was incorrect in assuming as it did in the Impact Statement that a production flow starting at 600,000 barrels per day would reach 1.7 million barrels per day in the second year of production was disclosed in the summary project description of the trans-Alaska pipeline system received by the State this fall. On page 55 of that document it is stated that

the pipeline system will be brought to its full capacity in stages. In the initial phase of operation the system will have the ability to transport 600,000 barrels per day. The report goes on to state that the second phase is tentatively scheduled to be completed approximately two years after initial start up. In this phase the system will have a design capacity of 1,200,000 barrels per day. The final phase is expected to be completed approximately seven years after initial start up at which time the pipeline will reach its ultimate capacity of 2,000,000 barrels per day according to the project description. In other words, there will be at least 500,000 barrels per day less production in the second year of operation and each year thereafter for the initial seven years.

The next shock to the State was disclosed by the SEC Registration Statement filed by British Petroleum Co., Ltd., on October 12, 1971. In the offering circular accompanying the registration statement the following statement is made at page 24:

> ... "The initial construction phase of the pipeline is expected to provide a minimum aggregate throughput capacity upon completion of 600,000 barrels per day. This capacity is designed to be expanded in two stages, the first stage resulting in a total capacity of 1,200,000 barrels per day, and the second in a total capacity of 2,000,000 barrels

per day. It is presently estimated that the cost of the pipeline upon completion to the 600,000 barrels per day capacity would be approximately $2.3 billion, and that increasing the capacity to 2,000,000 barrels per day would increase the cost by approximately $400 million." (Emphasis added.)

On November 10, 1971, Atlantic Richfield filed a Registration Statement with the SEC stating that:

... "The cost of the system upon completion to the 600,000 barrel per day capacity is presently estimated to be approximately $2.4 billion, of which the Company will be responsible for approximately $675 million. The additional cost to all participants of increasing the capacity to 2,000,000 barrels per day is estimated to be at least $400 million." (Emphasis added.)

Thus, by mid November, the total pipeline cost had escalated to $2.8 billion or $500 million over the average case assumed in July when the State made its revenue estimates. In fact it increased $100 million in less than one month

between SEC filings. This dramatic increase in pipeline costs revealed in official documents at the time of Governor Egan's first announcement on State ownership made it urgently necessary that the State finally determine the likely magnitude of pipeline costs. Commissioner Campbell has already indicated the independent study which the State has made through its consulting engineers, Tibbets, Abbott, McCarthy and Stratton, and the foundation for the present estimate of $3.5 billion. These figures have been recently developed along with an independent evaluation of operating costs so that for the first time the State can make a reasonable projection of the probable amount it can expect to capture from North Slope oil revenues.

The base case shown to you today in graphic form assumes the total pipeline cost of $3.5 billion financed 90% by debt at an interest rate of 8%. It conforms to the Alyeska throughput assumptions of full production only in the seventh year of pipeline operation. It shows the same ICC permitted rate of return as shown in the State's projection in July. In the fourth year from the beginning of construction or the first year of production, or 1977, we now show a negative wellhead or no State oil revenues. This was the year comparable to that in which it was earlier shown that the State would capture at least $164 million in revenues. The fifth year, 1978, the second assumed year of operation,

we earlier estimated $278 million in State revenues. In these two years alone the net revenue loss to the State over earlier estimates amounts to $442 million. By the sixth year or 1979 the new projection shows $84.6 million in oil severance and royalty revenues. Earlier we estimated $282 million for that year. The net loss by that year over earlier estimates is $640 million. Not until the 15th year of the pipeline operation do royalties and severance taxes amount to near the amount shown to our previously calculated second year. In the 15th year we show severance and royalty revenues of $277 million.

The question may be asked whether this is most pessimistic of cases which can be produced. The answer is clearly no for three reasons. In the first place the revenue loss figure mentioned above gives no effect to our expectation now of first pipeline operation in the year 1977, whereas in July we estimated a full year of revenues starting on July 1, 1975.

In the second place we show State taxes in each year of operation of approximately $33 million. For the first three years of operation State income taxes are estimated to total approximately $100 million or $33 million a year. This assumes the full State income tax rate on pipeline profits. Experts have indicated that this may not be a realistic assumption. Even, however, with the most optimistic income tax estimate net revenue loss from earlier projections amounts to $540 million during the critical first three years of operation.

Thirdly, calculation of the 7% permitted rate of return on valuation may err on the low side. The leading text on the subject "Petroleum Pipelines and Public Policy" by Arthur Johnson cites numerous instances of the slowness of the ICC to actually evaluate pipeline costs and its heavy reliance on industry figures. The Cook Inlet pipeline valuation itself took three years to complete.

The 7% figure is not high also when it is remembered there are seven separate proposed pipeline owners, each of which may aggregate earnings of other pipelines when the 7% rate is considered. It is entirely possible that higher return rates may be permitted until the valuation of the line is complete and even thereafter when earnings of other pipeline companies are aggregated to arrive at a total rate of return.

The next case presented shows the possible economic effect of State ownership of the pipeline. Financing is assumed in the amount of $1 billion in each of the first two years of construction at 8%, $900,000,000 in the third year of construction at 6-1/2%, $250,000,000 at 8% in the first year of operation, and $310,000,000 in the second year of operation. This case also assumes the same ICC permitted rate of dividend payout as assumed for the private case, namely, 7% which is a cash dividend payout limitation in each year of the projection. In arriving at the State's net cash flow, operating expenses, amortization, and interest on bonds are deducted from the gross income. During the

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first year of operation net cash flow to the State through its tariff on the pipeline is $230 million and royalty and severance taxes of $15.7 million for a total of $245 million. Obviously, in State ownership no federal or state income taxes are calculated on pipeline income. In the fifth year from beginning of construction or the second year of operation net cash flow is $228 million which together with royalty and severance taxes of $17 million produce a total of $245 million. In the sixth year from the beginning of construction and the third year of operation net cash flow amounts to $227 million through the tariff and total royalties and severance taxes amount to $123 for a total of $350 million. In the 15th year cash flow is reduced to $183 million by reason of the fact that the pipeline has depreciated but total royalties and severance taxes amount to $297 million for a total to the State treasury of $480 million.

It is emphasized that this case makes almost identical assumptions to that for the private case described above. It should be emphasized that the net income shown to the State is computed after debt service on State bonds. To avoid a speculative argument on the possible differential between interest rates on the State's debt which may be tax exempt versus taxable interest on the private borrowing we show all but $900,000,000 in State bonds at the same 8% rate. The main differences, of course, lie in the fact that the State is not subject to federal income tax and will receive no state income tax from pipeline operations

since it is the owner. The timing of the bond issues for both private and public ownership is the same although the term of the public bond issue is shorter indicating heavier debt service loads and the State of course is financing the pipeline 100% on a debt basis.

Numerous additional assumptions can be made on the question of the manner of public financing, the rate of return permitted either to the State or to private pipeline owners, interest rates payable by the State and private owners, the effective tax rate in private ownership, to mention only a few. We know that estimating the effect of economic projects based on events three to seven years away must rest on assumptions which are to a degree speculative. You will hear testimony that our assumptions are incorrect. The point is that no one can say with positive certainty what our revenue picture will be with the pipeline in private ownership. We have, however, tested prior assumptions based on official information now before us. This effort has convinced the administration that it must do what it can now to remove the uncertainty of the revenue picture in the late 1970's and in the 1980's. Mr. Eppenbach will explain how our projections were made and some of the detail on the charts before you.

JOINT HEARINGS ON PROPOSED PIPELINE LEGI TION

MARCH 6 THROUGH MARCH 9, 1972

WITNESS REGISTER

	NAME	AFFILIATION	REPRESENTING
1.	H. A. Boucher	Lt. Governor	Administration
2.	Charles Herbert	Commissioner, Nat. Resources	Administration
3.	John E. Havelock	Attorney General	Administration
4.	Bruce Campbell	Commissioner of Highways	Administration
5.	Eric E. Wohlforth	Commissioner of Revenue	Administration
6.	Larry Epperbach	Department of Revenue	Administration
7.	Joseph R. Henri	Commissioner of Administration	Administration
8.	H. M. Temple III	Temple, Barker & Sloane	Administration
9.	Charles Kales	Hawkins, Delafield & Wood	Administration
10.	Tom Gildehaus	Temple, Barker & Sloane	Administration
11.	L. E. Crowley	Salomon Brothers	Administration
12.	Robert Macy	Kuhn, Loeb & Company	Administration
13.	John E. Havelock	Attorney General	Administration
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JOINT HEARINGS ON PROPOSED PIPELINE LEGISLATION

MARCH 6 THROUGH MARCH 9, 1972

WITNESS REGISTER

	NAME	AFFILIATION	REPRESENTING
1.	Charles E. Spahr	Aleyeska Pipeline	Standard Oil of Ohio (SOHIO)
2.	W.J. Williamson	Aleyeska Pipeline	Law Professor U. of Houston
3.	Harry R. Jones	Aleyeska Pipeline	Attorney specializing in State & Interstate commerce. Houston, Texas
4.	Donald W. Markham	Aleyeska Pipeline	Washington, D.C. Attorney
5.	Edward L. Patton	Aleyeska Pipeline	President of Aleyeska Pipeline
6.	Joseph R. Cortese	Aleyeska Pipeline	Attorney Ohio, specialistin law re Powers of State & localgovt
7.	Raymond B. Gary	Aleyeska Pipeline	Investment Banking, Underwriting & distrib of securities.
8.	George A. Seymour	Aleyeska Pipeline	Mobil Pipe Line Company.
9.	Thomas R. Broussard	Aleyeska Pipeline	Atty. Spec in taxation, Legal Dept. ARCO
10.	Edward L. Patton	Aleyeska Pipeline	Aleyeska President. See 5 above
11.	Joseph R. Cortese	Aleyeska Pipeline	Same as 6 above.
12.	Richard M. Donaldson	Aleyeska Pipeline	V-Pres & Gen Counsel of SOHIO
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JOINT HEARINGS ON PROPOSED PIPELINE LEGISLATION

MARCH 6 THROUGH MARCH 9, 1972

WITNESS REGISTER

	NAME	AFFILIATION	REPRESENTING
1.	S. C. SANDUSKY	DIVISIONAL MANAGER	MARATHON OIL COMPANY
2.	DON DICKEY	GENERAL MANAGER	STATE CHAMBER OF COMMERCE
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IN THE HOUSE

BY THE RULES COMMITTEE BY REQUEST OF THE GOVERNOR

HOUSE JOINT RESOLUTION NO.

IN THE LEGISLATURE OF THE STATE OF ALASKA

SEVENTH LEGISLATURE - SECOND SESSION

Proposing an amendment to the Constitution of the State of Alaska provisions regarding the use of state funds for the debt of public corporations.

BE IT RESOLVED BY THE LEGISLATURE OF THE STATE OF ALASKA:

* Section 1. Sec. 7, art. IX of the Constitution of the State of Alaska is amended to read:

SECTION 7. DEDICATED FUNDS. The proceeds of any state tax or license shall not be dedicated to any special purpose, except when required by the federal government for state participation in federal programs, or when dedication is provided by law, for the purpose of securing the payment of bonds and notes of a public enterprise or public corporation of the state or a political subdivision of the state. This provision shall not prohibit the continuance of any dedication for special purposes existing upon the date of ratification of this constitution by the people of Alaska.

* Sec. 2. Sec. 8, art. IX of the Constitution of the State of Alaska is amended to read:

SECTION 8. STATE DEBT. No state debt shall be contracted unless authorized by law for capital improvements and ratified by a majority of the qualified voters of the State who vote on the question except that the State may guarantee by law bonds and notes of a public enterprise or a public corporation of the State created or empowered to construct pipelines for the transportation of oil or gas or both and may by law authorize such public enterprise or public corporation to mortgage any State lands or properties

and royalties or rents, issues and profits therefrom as additional security for its bonds or notes, whether or not guaranteed by the State. The State may, as provided by law and without ratification, contract debt for the purpose of repelling invasion, suppressing insurrection, defending the State in war, meeting natural disasters, or redeeming indebtedness outstanding at the time the constitution becomes effective.

* Sec. 3. The amendment proposed by this resolution shall be placed before the voters of the state at the next statewide election in conformity with sec. 1, art. XIII of the Constitution of the State of Alaska and the state election laws.

PROPOSED AMENDMENTS TO HOUSE BILL NO. 569

Page 2, line 26:

After the word "interest." strike the words "It is also declared to be in the public interest for the state to guarantee the principal and interest on bonds issued to finance the facility."

Page 19, line 12:

Delete all of AS 44.58.260.

Statement of Charles F. Herbert
Commissioner of Natural Resources

In 1964 the State of Alaska selected 1,593,705 acres on the North Slope, between Naval Petroleum Reserve No. 4 and the Arctic Wildlife Range. The land selected was considered to have good potential for petroleum but none suspected that it would contain the largest oil pool ever found in North America. On the map, the lands north of the heavy green line are those selected in 1964 and the orange-shaded area covers the Prudhoe Bay oil field. I want to emphasize that not all of the land within the shaded area will be productive of oil or gas--in fact, there are a number of dry holes within the area shown as the oil field.

Although millions of dollars had been spent in an unsuccessful search for oil on Federal lands southwest of State lands, the first lease sale of North Slope lands by the State was moderately successful and provided revenue at a time when it was needed badly. Greater interest was shown in subsequent lease sales even though drilling on State lands had been disappointing. Finally, on what was said to be a "last try" for oil on the North Slope, ARCO announced a major discovery in July, 1968. The State then selected an additional 2,852,880 acres south of the original North Slope selection. This later selection, for which tentative approval by the Bureau of Land Management has not been received, lies between

the green and brown lines on the map. Note that over half of the area in the later selection is covered by leases. These are Federal noncompetitive leases which had been issued prior to State selection. Some have expired recently and many are due to expire within the next few years, unless oil or gas is found in productive quantities.

With oil interest at fever pitch, the State sold much of remaining tentatively approved North Slope lands at a lease sale on September 10, 1969. The total of bonus bids received at that sale is the largest ever recorded anywhere.

Bonuses received from the sale of State leases on the North Slope:

Date of Sale	Acres Leased	Bonus/Acre	Total Bonus
Dec. 8, 1964	476,147	$ 9.20	$ 4,379,729.91
July 15, 1965	403,000	15.25	6,145,472.59
Jan. 24, 1967	42,397	34.87	1,478,777.23
Sept. 10, 1969	412,548	2,181.66	900,041,605.34
	1,334,092*	$ 683.65	$912,045,585.07

* This figure includes some offshore lands and some duplication caused by forfeiture of leases and subsequent re-leasing.

Bonuses on future sales of leases on the North Slope are most difficult to estimate. Certainly, there is little incentive to purchase leases in the area until such time as construction of a pipeline is assured. About all we know is that the State does own, or will own, land that can be offered for competitive oil and gas leasing.

We estimate that the following land may be offered at some future date:

Unleased land on which the State now has tentative approval	200,000 acres
Selected land, less valid Federal leases - at least	1,000,000 acres
Offshore lands between Pet. 4 and and the Arctic Wildlife Range	300,000 acres

Since Alaska now ranks second among the states in proven oil reserves, and will probably outrank the leading state, Texas, when more active drilling is resumed, Alaska can look forward for very many years to substantial income from oil and gas royalties and severance taxes.

The Prudhoe Bay field alone has a proven reserve of 9.6 billion barrels of oil and 26 trillion cubic feet of natural gas. To the west of Prudhoe Bay, the Ugnu field has oil but there has not been enough drilling to permit a reliable estimate of reserves. Wells in the Ugnu field are much less productive than those in the Prudhoe Bay field but they should add materially to North Slope production. Other potentially productive structures are known so we think that an estimate of 20 billion barrels of oil from State lands on the North Slope is justified.

In addition to production from State lands and offshore lands on the North Slope, oil and gas will be produced from lands that may be selected by Native Regional Corporations and from Federal lands that are or may be leased. We expect that someday Petroleum Reserve No. 4 will be developed, and there is some possibility that the very attractive Marsh Creek anticline in the northwesterly portion of the Arctic Wildlife

Range may be drilled. The highly regarded Canadian publication, OILWEEK, estimates that the Alaskan North Slope will produce 50 billion barrels of oil and many trillions of cubic feet of natural gas. Most certainly, oil and gas pipelines from the North Slope will be busy for many years.

In all existing leases on the North Slope, royalty is fixed at 12-1/2% of the wellhead value. However, leases issued prior to 1969 provide for a royalty of 5% of the production from a lease on which a discovery of a new field is made. Only one lease in the Prudhoe Bay field is entitled to the reduced royalty and that privilege expires in 1978, ten years after the date of discovery.

All existing North Slope leases have a term of ten years, or as long as production is maintained. Leases may also be extended if committed to an approved unit agreement. Unit agreements, which are formed by pooling of interests of all lessees on a geologic structure capable of, or believed to be capable of, producing oil or gas, carry specific drilling requirements which must be approved by the Department of Natural Resources if on State land, or by the U.S. Geological Survey if on Federal land. Prior to 1969, leases on lands to which the State had only received tentative approval were issued as conditional leases and the lease term did not begin to run until the State received patent to the land. With the exception of the leases sold in the September, 1969 sale, North Slope leases are conditional and the term of lease has

not begun to run.

The wellhead price of oil or gas, on which royalty and severance taxes are based, is stated in each lease as the highest of (1) the price actually paid by a purchaser at the well, (2) the posted price by the Lessee in the oil or gas field, or (3) the prevailing price paid to other producers. Since nearly all Alaskan oil is sold on the West Coast of the United States, the wellhead price is determined by the field price at the point of delivery on the West Coast, less transportation charges. Since these charges are variable among producing companies there has been enough confusion in the Cook Inlet Basin to cause a lawsuit between the State and one of the producers. Since this matter is now before the court I cannot comment further, other than to hope that clear guidelines for the determination of wellhead price are established either by directive from the court or by general agreement.

All oil and gas produced from State lands on the North Slope, other than offshore lands, is subject to a payment of 2% of the gross value (i.e., wellhead price) to the Alaska Native Fund, until such time as $500 million has been paid into that fund from all sources of State income subject to such payment. Although provision for payment to the Alaska Native Fund effectively reduces State royalty on a standard oil and gas lease to 10-1/2%, the payment is treated in State accounts as an obligation against the State treasury and so does not enter into estimates of State income from minerals.

After deduction of royalty from wellhead price, the remaining value is subject to a State severance tax based on the rate of production from each producing well. The tax on oil is:

3% on the first 300 barrels per day

5% on the next 700 barrels per day

6% on the next 1,500 barrels per day

8% on all production over 2,500 barrels per day

The severance tax on natural gas is 4% of the wellhead price, regardless of the rate of production.

Derivation of State income from royalty and severance tax is:

Assumed wellhead price of oil	$ 2.00
State royalty @12-1/2%	0.25
Taxable value of oil	1.75
Severance tax @ 7% (best estimate)	0.12

Total State income then would be $0.37, or 18-1/2% of the wellhead price, a percentage that is probably applicable to oil production from the North Slope, regardless of wellhead price. For natural gas, State income is 16% of the wellhead price.

INTRODUCTORY STATEMENT BY LIEUTENANT GOVERNOR MARCH 6, 1972

I HAVE BEEN ASKED BY GOVERNOR EGAN TO DELIVER HIS MESSAGE TO THE PEOPLE OF THE STATE OF ALASKA IN HIS ABSENCE.....AS LIEUTENANT GOVERNOR I HAVE HAD THE OPPORTUNITY TO WATCH OUR CHIEF EXECUTIVE DEAL WITH THE AGONIZING REALITIES THAT DELAY IN PIPELINE CONSTRUCTION AND SPIRILING COSTS HAVE RESULTED IN.... AND WHILE APPRAISALS THAT DO NOT VIEW A PORTION OF OUR FUTURE TOTALLY THROUGH ROSE COLORED GLASSES ARE DISTASTEFUL TO SOME.... I HAVE NEVER SEEN OUR CHIEF EXECUTIVE SWERVE FROM HIS DUTY TO OUR STOCKHOLDERS.....THE PEOPLE OF THE STATE OF ALASKA

THE FUTURE OF OUR STATE IS A BRILLIANT ONE....NO ONE KNOWS THIS BETTER THAN OUR GOVERNOR WHO HAS DEVOTED OVER THIRTY YEARS OF HIS LIFE IN SERVICE TO ALASKA AND HER PEOPLE....THERE HAVE BEEN ROCKY SHOALS BEFORE AND OUR SHIP OF STATE HAS NAVIGATED THEM.... THEY WERE NOT OVERCOME BY WISHFUL THINKING...WE NEED NOT BE AT ODDS WITH OUR PARTNERS IN THE FUTURE...THE OIL INDUSTRY...WE RECOGNIZE YOUR CORPORATE RESPONSIBILITIES....I AM SURE YOU WILL RECOGNIZE AS GOOD CITIZENS OUR RESPONSIBILITIES...AND IT IS IN THIS SPIRIT THAT GOVERNOE EGAN HAS ASKED THAT I READ THIS MESSAGE INTO THE RECORD.....

SCHEDULE OF JOINT HEARINGS ON PROPOSED PIPELINE LEGISLATION

COMMITTEES:

SENATE COMMERCE COMMITTEE, RON L. RETTIG, CHAIRMAN.

HOUSE STATE AFFAIRS COMMITTEE, RICHARD L. MCVEIGH, CHAIRMAN.

LOCATION: GOLD ROOM, BARANOF HOTEL

BILLS TO BE CONSIDERED:

SB 313 - Relating to lease of rights-of-way.

SB 314 - Relating to safety standard for oil and gas transportation.

SB 315 - Creating Alaska Oil and Gas Transportation Commission.

SB 294 - Creating Alaska Leasing Board.

HB 569 - Establishing Trans-Alaska Authority.

HB 570 - G. O. bonds, $3,500,000,000.

MEETING SCHEDULE:

Monday, March 6, 1972	2:00 p.m. to 6:00 p.m.
Tuesday, March 7, 1972	8:00 a.m. to 11:00 p.m. 2:00 p.m. to 6:00 p.m.
Wednesday, March 8, 1972	8:00 a.m. to 12:00 p.m. 1:30 p.m. to 6:00 p.m.
Thursday, March 9, 1972	8:00 a.m. to Completion

A special section will be reserved for other Members of the Legislature.

Testimony of Lawrence Eppenbach
State Investment Officer

March 6, 1972

Mr. Chairman, Committee Members. In testimony already presented you have heard a great deal about revenues, costs of pipelines, calculations of royalties and severance taxes and permitted dividends. Rather than to add more numbers, more formulas, more calculations, I think it would be prudent now to pause and develop perspective on the numbers already giver to you and about the many charts. To do this, I should like to talk first about how the State brought all of its pipeline information together to calculate what is really the most important piece of information thus far and that is an estimate of total revenue from the North Slope.

We employed a computer model which simulated each year, economic operation of the pipeline under varying conditions regarding ownership, financing, taxes, and earnings limitations. In a sense, an income statement was prepared each year for the owner of the line. This income statement does not appear so very different, at least in terms of its expressions, from that of any other income statement. Gross revenues to the pipeline are derived from its tariff charge on barrels of oil transported through the line. That gross revenue less the cost of operating and maintaining the line, less depreciation, and less interest costs for financing

the line, will produce a net income figure. From that we deducted any federal or state income taxes paid to yield a net after taxes income.

Similarly, the cash flow to a pipeline company is much like that of any other business. The net after tax income plus any additional cash flows which may be generated because the depreciation charge that is provided for in the income statement happens to be greater than the bond retirement actually made by the company. The only place that pipeline operation appears different, economically, to that of the ordinary company, is in the dividend payout allowed each year by the pipeline company to its owners.

That dividend is not some percentage of equity or some rate of return of capital investment, it is a percentage dividend allowed on the valuation of the pipeline as determined by the ICC. The ICC valuation approach takes into account many issues: original cost of the line, depreciation, percentage increases for going concern value, and additional percentage increases for inflation. Our computer model had to also simulate this ICC valuation. In general terms, during the first year of operation ICC valuation was about $3-1/4 billion. In the following years it increases slightly as additional phases of operation were under way providing for higher throughput and then decreased in value as the line began to depreciate.

The dividend limitation on ICC valuation is a critical variable in the

economics of pipeline ownership. Our model, given a dividend rate calculated back up the income statement to find out what kind of tariff would have to be placed upon the pipeline in any year to provide gross revenue required to generate the appropriate cash flow for the dividend. During the first year of operation of the trans-Alaska pipeline, the 7% dividend limitation provides for a dividend to the parent company of over $230 million, a legal dividend provided only to the owner of the pipeline.

If I may turn your attention now to the large chart, it is that very dividend that accounts for the vast difference between estimated income to the State of Alaska under conditions of public ownership on the top line, versus conditions of private ownership, the bottom line. You will note that both lines slope upward as the throughput of oil through the line increases, clearly shown as a step increase between operation of the line in phase one, a capacity of 600,000 barrels a day up to phase 2, a design capacity of 1,200,000 barrels per day. But the graph does not display all of the information which is in the tables alongside of it.

First, in public ownership, the major part of revenue during the early years is derived from dividends with positive and growing amounts of revenue coming from wellhead value royalty and production taxation. You will note that there are no state income taxes included here as a revenue source to the State

under conditions of public ownership.[1]

Under conditions of private ownership, a very different case develops. Here in the initial year a total of about $37 million should accrue to the State. Where does it come from? $3.2 million of it only comes from the North Slope in the form of gas royalty and production tax payments. This is gas that is assumed to be shipped in a trans-Canadian gas pipeline. The remaining $34 million comes from state income taxes. In the 7% dividend case displayed here there is no positive wellhead value for oil during the first two years of operation under private ownership. In this case, for there to begin to be some positive wellhead for oil during the first two years, the dividend payments must be no greater than 4.75% and even if the dividend were lowered to zero the State's income from royalty and severance tax of approximately $53 million would be less than one third of that estimated as recently as last year.

I shall present at the close of the testimony this afternoon a series of cases for the committee to study that explore this question of taxation and dividend limitation. For the present, however, let us return to these two cases that we have displayed before you. Again, they provide a legal 7% ICC dividend. In the private case even though a negative wellhead value is indicated for the first two years it is quite possible that the oil companies would still pump oil

as their true cost of shipping their own oil through their own pipeline may be different than their calculated cost of shipping the State's oil through their own pipeline. Not only is the dividend permitted legal, but together with the costs and throughput capacity limitations as stated in the Impact Statement, this case of private ownership of the line appears quite possible. So are the revenues it generates. Speaking next to the very important question of what these revenues will mean to the State will be the Commissioner of Administration, Joseph Henri.

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

TESTIMONY OF JOSEPH R. HENRI
Commissioner of Administration, State of Alaska,
Before the Senate Commerce Committee
And the House State Affairs Committee
At Juneau, Alaska, 6 March 1972,
Regarding Income From North Slope Oil and Gas,
And How it Affects the State Budget

Mr. Chairman and Members:

I am Joseph Henri, Commissioner of Administration. This part of the State's presentation deals with budget expenditures vis-a-vis income to be derived from North Slope oil and gas extraction. The essential questions are:

1. Will we be able to maintain our current level of services, adjusted for population growth and inflation?

2. Will we be able to increase our level of service to meet compelling needs recognized by this administration, the legislature and the citizens of Alaska?

3. Will we have to reduce our level of service, and if so, what are the activities affected?

The answers to these questions rest in the amount of dollars the State can expect as its share of the Prudhoe Bay oil basin. Once upon a time, the Department of Administration felt much more certain about future State income than it does today. When will the

pipeline begin? What extraordinary man-caused interruptions will delay its completion? What will be the first year capacity of the line? The second year? The third? What is the maximum extraction rate the basin structure will prudently allow? What volumes of oil can be expected in any of the first seven years of the pipeline? What will be its final cost?

All of these variable factors, well known to each of us in this room, make budget planning extremely difficult, because the major part of Alaska's State revenue has come and will come from the North Slope resources. In the budget now pending before the legislature, we have recommended a total general fund expenditure of $311.7 million; those are State $ of this sum, $97 million will have to come directly from the Prudhoe Bay bonus money, the principal, and $52 million more from interest earnings on the investment. As we dip heavily into the corpus - invade the principal - interest earnings diminish, compounding the revenue problem. Our present or anticipated recurring revenues are simply too low to fund our present and anticipated expenditures. We are depleting our savings account. As the following year's budget figure increases, more of the principal will have to be spent; the interest yield will dwindle further. Obviously, we will soon hit the bottom of the barrel. Only large and new revenues from the North Slope can allow us to continue our present budget growth rates.

What is the growth rate we have recommended for Fiscal Year 1973? For the general fund, it is 3.5%; for the total budget, 4.6%. We have had to slash so dramatically the rate of increase because pipeline delays and cost escalations have darkly influenced

our future revenue projections. With ~~such~~ a small increase in the budget, a number of programs have already felt the chill winds of dollar scarcity. The proposed Fiscal Year 1973 budget contains such unpalatable ~~things~~ items as holding school foundation funding to the current year's level, regardless of enlarged student population; keeping the University's 19 Alaska increase to $800,000 in the face of a claimed need for an addition of over $5 million just to maintain current activities; a limitation of nursing home care and general medical relief; foregoing general obligation bonds for lengthening two more ferry boats, and for a larger program of airport construction. There are many more "pinches" in the budget, besides those I mention. Nonetheless, so far we have not jeopardized any State activity essential to health and safety. These painful adjustments herein noted were recommended in spite of the fact oil was projected on stream in July 1976; now another year's delay - or more - seems probable. The consequences are obvious.

Our budget book for Fiscal Year 1973 projects a growth rate of 6% compounded annually through 1976, and 8% thereafter through Fiscal Year 1981, covering a ten-year period. Further, it envisions capital improvement bond authorizations of $60 million in 1974, and $100 million in the next biennial election, and each one thereafter. I can only characterize these projected budgets as "modest." They are very little more than maintenance figures. Program dollars will still be limited. Careful budgeting and allocation will still be required. New starts and new programs will be exceedingly selective. The 6 and 8% growth rates most likely mean a shortage of funding for the school foundation plan, and for the revenue sharing program with local governments. Yet, I express to you the fervent hope that actual receipts in the State treasury during the next ten years may be pitifully shy of the sums needed even to maintain our austerity.

Previously, in the testimony Commissioner Wohlforth and the Department of Revenue, test cases have been articulated regarding revenue to be derived under (A) private ownership and (B) State ownership of the crude oil pipeline. All of us realize that a multitude of variations in revenues and expenditures are possible under each heading. Nevertheless, for purposes of comparison we have presented two likely cases and their dollar results: Both examples entail the seven-year oil volume build up delineated in the Department of the Interior Environmental Impact Statement submission by Alyeska, a 7% dividend to the owner, a line cost of $3.5 billion, and oil on stream in July 1977.

Exhibits A and B, attached at the conclusion of these remarks, portray the figures - and the story - for the decade 1972-1982. Under the private ownership case, Exhibit A, were Alaska to continue to increase its budget expenditures at the 6 and 8% rates, mentioned earlier, the first year of deficit would be Fiscal Year 1978, wherein we would experience a shortfall of over $156 million. This shortage would increase so that by Fiscal Year 1982 the deficit would be $1,135,000,000. Of course, deficits for operating expenditures are in fact impossible under our State constitution; instead of experiencing a billion dollar deficit ten years from now, we would in actuality have to reduce State expenditures radically.

Under the private ownership case the State could have in its treasury at the end of Fiscal Year 1982 the sum of $45 million if, and only if, its operating expenditures in every year of the planning decade rose annually by only 1% (see Exhibit C). Now an increase of 1% equals a huge cut in all programs, and the elimination of many.

The dollar crunch is graphically portrayed in the following paradigm. Under the private ownership operating budget column, increasing annually at 1%, the available dollars are recorded. Contrast these with the operating budget under public ownership, the first column on the left. The figure shows that if the State of Alaska owned the pipeline there would be sufficient dollars in each of the next ten years to meet our planned 6 and 8% annual increases. In fact, the revenue would be sufficient to raise the budget from these maintenance or austerity levels so that expansion of present services and the addition of new ones could be handily realized. Were the oil line privately owned the State would have almost billion less dollars to spend over the next ten years. We would be able to authorize 365 million fewer dollars for capital improvements.

(Graph on following page)

COMPARISON OF FUNDS AVAILABLE

PRIVATE VS PUBLIC OWNERSHIP

(ALL FIGURES IN 1000)

FISCAL YEAR	PUBLIC OWNERSHIP OPERATING BUDGET *	PUBLIC OWNERSHIP DEBT AUTHORIZED	PRIVATE OWNERSHIP OPERATING BUDGET *	PRIVATE OWNERSHIP DEBT AUTHORIZED
1972	260186.5	71000.0	260186.5	71000.0
1973	276232.7		276232.7	
1974	292910.7	60000.0	278994.8	15000.0
1975	310485.1		281784.3	
1976	329114.1	100000.0	284601.8	20000.0
1977	355443.1		287447.4	
1978	383878.5	100000.0	290321.5	20000.0
1979	414588.8		293224.3	
1980	447755.8	100000.0	296156.1	20000.0
1981	483576.2		299117.3	
1982	522262.2	100000.0	302108.1	20000.0
TOTAL	4075433.7	531000.0	3150174.8	166000.0

* All figures refer to expenditure from general fund only

Difference in Operating Expenditure is over $925,000,000

Difference in Capital Debt Authorization = $365,000,000

The attached graphs, Exhibits D and E, portrary what I have been saying./ In Exhibit D, under private ownership of the oil pipeline, the general fund would be depleted around January of 1978. On the contrary, under State ownership of the line, the precipitate dive to insolvency would stop in 1976 at a general fund balance of $231 million, and rise to a plateau of $450 million in the general fund by 1982. Furthermore, as Exhibit B shows, the total expenditure for that year would be approximately $605 million, and the total revenue $602 million; a parity between income and expenditure would have been achieved, and a surplus of almost half a billion dollars enjoyed. In actuality, no doubt, were the funds from State ownership available, the administration and the legislature would have expanded the budget faster than the 8% increase portrayed for the years 1977 and beyond so that no such surplus would likely exist at the end of Fiscal 1982.

The private ownership case I have presented to the Committees, Mr. Chairman, necessitates an abrupt and drastic reduction in State services and activities. I cannot tell you with certainty where the administration or the legislature would cut, but I can cite a few startling and likely areas of impingement in each of our program categories:

The State pays approximately 90% of local school district costs, constituting roughly 30% of annual State dollar expenditure. That State aid would be materially reduced; it would be impossible for the local areas to maintain present educational standards through increased property taxes. State Operated Schools and the University

of Alaska would have to radically abate their present service levels.

The welfare or social services activities of the State would experience vast curtailment in the number of eligible cases and the amount of benefits; many people would be compelled to leave Alaska; distress or even starvation would haunt many who decided to stay. Public health and mental health retrenchments could force the closing of the Alaska Psychiatric Institute, and a diminution or abolishment of the State's work in drug abuse, alcoholism, tuberculosis testing and venereal disease control. The necessitated nullifications of State expenditure in these areas will in turn lose large amounts of federal dollars now enjoyed. Our ability to operate and maintain an effective Pioneers' Homes program will be materially impaired.

No new fish hatcheries would be built. No hunter safety program would be initiated. Salmon yields in Southeast Alaska would remain significantly below maximum sustained yield. Land use planning and the inventorying of our natural wealth would be jeopardized, thus making management of the State's surface and subsurface resources haphazard at best. Added park and recreation sites would be forgotten, and the maintenance of existing facilities lessened. Many Alaska communities would remain without sewage treatment facilities. Programs for coastal zone management, environmental engineering, permafrost and soils engineering would likely be abolished.

In the category of Public Protection, disaster planning, the Public Utilities Commission, the Alaska Transportation Commission,

The State police would experience a great shrinkage in manpower, and the courts and their ancillary agencies could not cope with their workloads.

Tourist promotion would have to be seriously curtailed and our work in research, in community improvement and grant assistance, and at conventions and trade shows would most likely fall by the board. The work of the agricultural loan fund and the small grain incentive program would be enfeebled or eliminated. The Division of Planning and Research and the State Economic Opportunity Office would be crippled or possibly dropped.

Our program of revenue sharing with the local governments, around $7 million in the current year, would no doubt go out the window. The Marine Transportation System for Southwest Alaska would likely be eliminated, and service in Southeast materially contracted. Airport maintenance in rural Alaska would be severly curtailed, likely forcing the winter closure of those ports, thus isolating a large part of Alaska for five months of the year, denying medical and other critical services. Likewise, winter maintenance of many of our highways would be only a pale reflection of the excellent job being performed today.

The various boards and commissions whereby Alaskan citizens take a direct and active part in the work of the State government would be minimally funded, or in some cases, unfunded. I am speaking of activities like the Western Interstate Conference on Higher Education, the Athletic Commission, the Status of Women Commission, the International Development Commission, the Pioneers'

Advisory Board, the Yukon Taiya Commission, the Rural Affairs Commission, the International North Pacific Fisheries Commission. Our Youth in Government program, recently instituted with such great success, would likely be abandoned.

I do not represent to you, as the view of this administration, that each of these reductions suggested above would come to pass under the private ownership case portrayed in Exhibits A and C. Nevertheless, no one can say that many of the above dire consequences would not eventuate under that case; undoubtedly some would. The economic and social dislocation would be grievous indeed.

The purport of my remarks is that this State has a vital interest in an adequate share of North Slope riches. If we do not realize that share, State expenditures over the next decade will be woefully inadequate to do the job Alaskans expect from their government. The solution we propose to sufficiently fund the budget is the ownership of the crude oil pipeline by the State of Alaska.

Exhibit A

STATE OF ALASKA
DIVISION OF BUDGET AND MANAGEMENT

BUDGET PLANNING MODEL

RUN ID RUN 3

DATE MARCH 3, 1972

COMMENTS
PRIVATE OWNERSHIP
7% TARIFF
BASE CASE
OIL IN 77

ASSUMPTIONS

ANNUAL RATE OF INTEREST ON GENERAL FUND = 6.00%

ANNUAL RATE OF INTEREST ON NEW BONDS = 6.00%

MATURITY PERIOD ON NEW BONDS IN YEARS = 20.

% ABOVE G.F.UNENCUMBERED BAL. UNEXPENDED = 0.0 %

GROWTH RATES FOR OPERATING EXPENDITURE FROM PRIOR YEAR

197	1974	1975	1976	1977	1978	1979	1980	1981	1982
6.[illegible]	6.00	6.00	6.00	8.00	8.00	8.00	8.00	8.00	8.00

NEW BOND AUTHORIZATIONS IN EACH YEAR

197[illegible]	1974	1975	1976	1977	1978	1979	1980	1981	1982
71[illegible].0	0.0	60000.0	0.0	100000.0	0.0	100000.0	0.0	100000.0	0.0

FISCAL YEAR	NON INVESTMENT REVENUE	INVESTMENT INTEREST	TOTAL REVENUE	OPERATING EXPENDITURE	DEBT SERVICE	MISC EXP SHD TAXES OR CAP EX	TOTAL EXPENDITURE	SURPLUS OR DEFICIT	GENERAL FUND END OF YEAR
1972									761268.2
1973	162264.1	42466.7	204730.7	276331.0	24020.8	11358.6	311710.3	-106979.6	654288.4
1974	182367.0	35772.1	218139.0	292910.7	29646.2	11756.5	334313.4	-116174.4	538114.0
1975	190047.0	28146.4	218193.4	310485.1	32973.5	12749.8	356208.4	-138015.0	400099.0
1976	136752.0	18960.8	207712.8	329114.1	33479.2	13230.6	375823.8	-168171.1	231927.9
1977	220969.0	8673.9	229242.8	355443.1	35373.3	13153.0	403969.4	-174726.6	57201.4
1978	225954.9	-2988.6	222966.3	383878.5	39390.5	13719.0	436988.0	-214021.8	-156820.4
1979	314776.0	-14823.9	299952.1	414588.8	42494.9	23358.3	480441.8	-180489.8	-337310.1
1980	329299.9	-26743.6	302556.3	447755.8	46529.0	25105.1	519389.9	-216833.6	-554143.8
1981	332012.4	-41200.4	290811.9	483576.2	47129.4	25167.5	555873.0	-265061.1	-819204.8
1982	344154.7	-58641.5	285513.1	522262.2	52863.3	26698.5	601824.0	-316310.9	-1135515.0
	2490194.0	-10378.5	2479816.0	3816342.0	383899.9	176356.8	4376599.0	-1896782.0	

AGO 530854

Exhibit B

STATE OF ALASKA
DIVISION OF BUDGET AND MANAGEMENT

BUDGET PLANNING MODEL

RUN ID RUN 5

DATE MARCH 3, 1972

COMMENTS
PUBLIC OWNERSHIP
7% TARIFF
BASE CASE
OIL IN 77

ASSUMPTIONS

ANNUAL RATE OF INTEREST ON GENERAL FUND = 6.00%

ANNUAL RATE OF INTEREST ON NEW BONDS = 6.00%

MATURITY PERIOD ON NEW BONDS IN YEARS = 20.

% ABOVE G.F.UNENCUMBERED BAL. UNEXPENDED = 0.0 %

GROWTH RATES FOR OPERATING EXPENDITURE FROM PRIOR YEAR

1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
6.20	6.00	6.00	6.00	8.00	8.00	8.00	8.00	8.00	8.00

NEW BOND AUTHORIZATIONS IN EACH YEAR

1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
71000.0	0.0	60000.0	0.0	100000.0	0.0	100000.0	0.0	100000.0	0.0

FISCAL YEAR	NON INVESTMENT REVENUE	INVESTMENT INTEREST	TOTAL REVENUE	OPERATING EXPENDITURE	DEBT SERVICE	MISC EXP SHD TAXES OF CAP EX	TOTAL EXPENDITURE	SURPLUS OR DEFICIT	GENERAL FUND END OF YEAR
1972									761268.2
1973	162264.1	42466.7	204730.7	276331.0	24020.8	11358.6	311710.3	-106979.6	654288.4
1974	182367.0	35772.1	218139.0	292910.7	29646.2	11756.5	334313.4	-116174.4	538114.0
1975	190047.0	28146.4	218193.4	310485.1	32973.5	12749.8	356208.4	-138015.0	400099.0
1976	188752.0	18960.8	207712.8	329114.1	33479.2	13220.6	375883.8	-168171.1	231927.9
1977	430209.0	15116.4	445325.4	355443.1	35373.3	14482.8	405299.1	40026.3	271954.3
1978	434396.9	16695.3	451090.2	383878.5	39390.5	15217.0	438486.0	12604.2	284558.4
1979	547046.0	19533.7	566579.7	414588.8	42494.9	27486.9	484570.4	82009.3	366567.7
1980	550369.9	23532.2	573902.1	447755.8	46529.0	28343.7	522628.5	51273.6	417841.3
1981	567962.4	26121.0	594083.3	483576.2	47129.4	28359.7	559065.2	35018.1	452859.4
1982	575119.7	27093.4	602210.1	522262.2	52863.3	29787.4	604912.9	-2702.8	450156.6
	3428529.0	253434.8	4081965.0	3816342.0	383899.9	192832.9	4393075.0	-311111.4	

AGO 530855

Exhibit C

STATE OF ALASKA
DIVISION OF BUDGET AND MANAGEMENT

BUDGET PLANNING MODEL

RUN ID RUN 3

DATE MARCH 3, 1972

COMMENTS
PRIVATE OWNERSHIP
7% TARIFF
1% GROWTH
GREATLY REDUCED CAPITAL EXPENDITURES

ASSUMPTIONS

ANNUAL RATE OF INTEREST ON GENERAL FUND = 6.00%

ANNUAL RATE OF INTEREST ON NEW BONDS = 6.00%

MATURITY PERIOD ON NEW BONDS IN YEARS = 20.

% ABOVE G.F.UNENCUMBERED BAL. UNEXPENDED = 0.0 %

ANN OPER EXPEND GROWTH RATE AFTER 1ST YR = 1.00%

NEW BOND AUTHORIZATIONS IN EACH YEAR

1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
71000.0	0.0	15000.0	0.0	20000.0	0.0	20000.0	0.0	20000.0	0.0

FISCAL YEAR	NON INVESTMENT REVENUE	INVESTMENT INTEREST	TOTAL REVENUE	OPERATING EXPENDITURE	DEBT SERVICE	MISC EXP SHD TAXES OF CAP EX	TOTAL EXPENDITURE	SURPLUS OR DEFICIT	GENERAL FUND END OF YEAR
1972									761268.2
1973	162264.1	42469.7	204733.8	276232.7	24020.8	11358.6	311612.0	-106878.3	654389.8
1974	182367.0	36208.7	218575.7	278994.8	29646.2	11756.5	320397.5	-101821.8	552567.9
1975	170047.0	29928.1	219975.1	281784.3	32973.5	12749.8	327507.6	-107532.5	445035.4
1976	138752.0	23147.4	211899.3	284601.8	32478.4	13290.6	330390.6	-118491.3	326544.1
1977	220569.0	16705.2	237274.2	287447.4	32921.2	13153.0	333521.5	-96247.3	230296.8
1978	229954.9	10787.1	236741.9	290321.5	33723.5	13719.0	337764.0	-101022.1	129274.8
1979	314776.0	6882.4	321658.3	293224.3	34212.3	23358.3	350794.8	-29136.4	100138.3
1980	329299.9	5394.7	334694.5	296156.1	33837.2	25105.1	355148.3	-20453.8	79684.5
1981	332012.4	4182.2	336194.5	299117.3	31872.0	25167.5	356156.8	-19962.3	59722.2
1982	344154.7	3140.6	347295.2	302108.1	33246.7	26698.5	362053.3	-14758.1	44964.1
	2490194.0	178845.6	2669040.0	2889986.0	319001.6	176356.8	3385343.0	-716303.9	

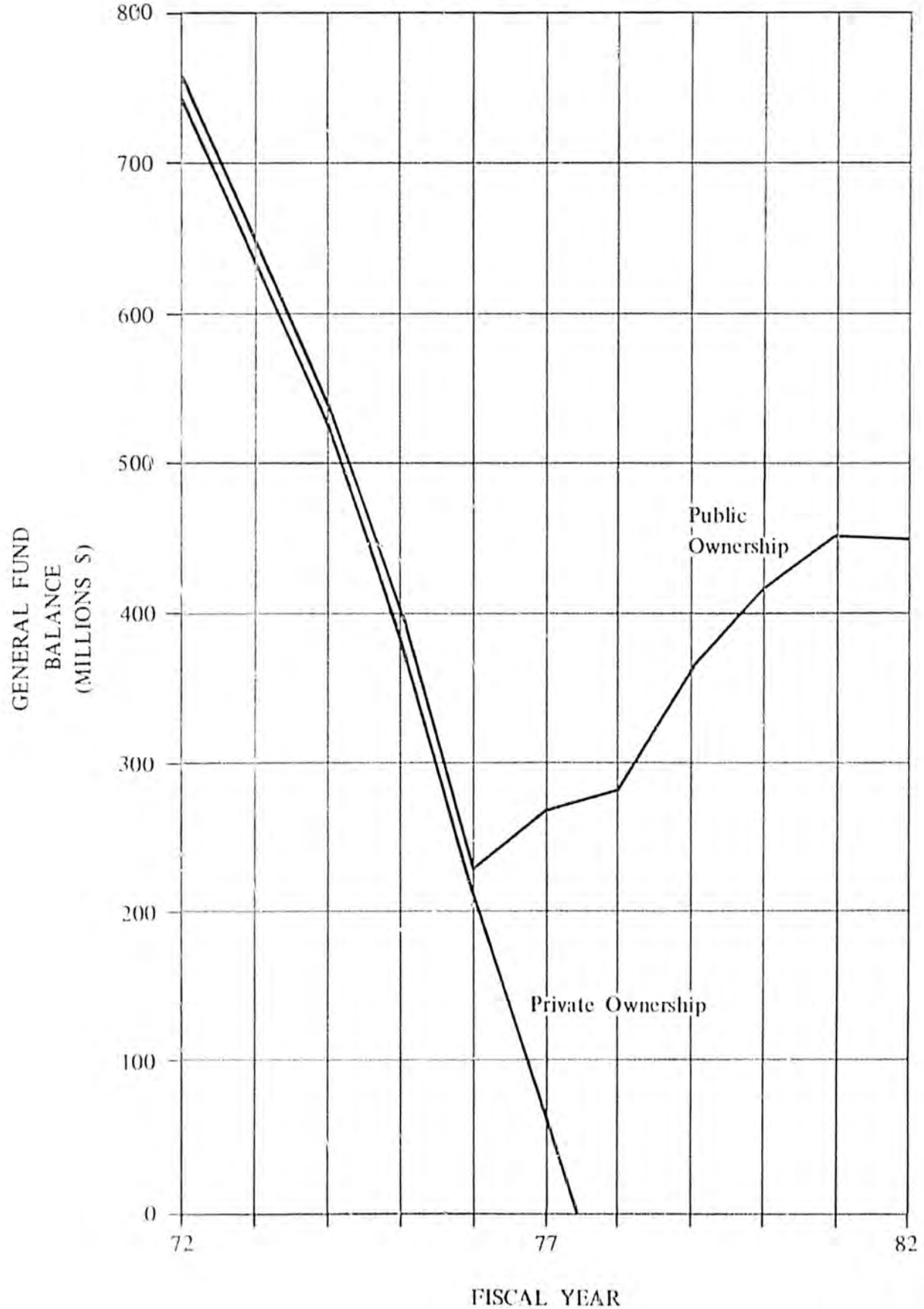
AGO 530856

Exhibit D

ENDING GENERAL FUND BALANCE

Private vs Public Ownership

Budget Book Expenditure Plan



AGO 530857

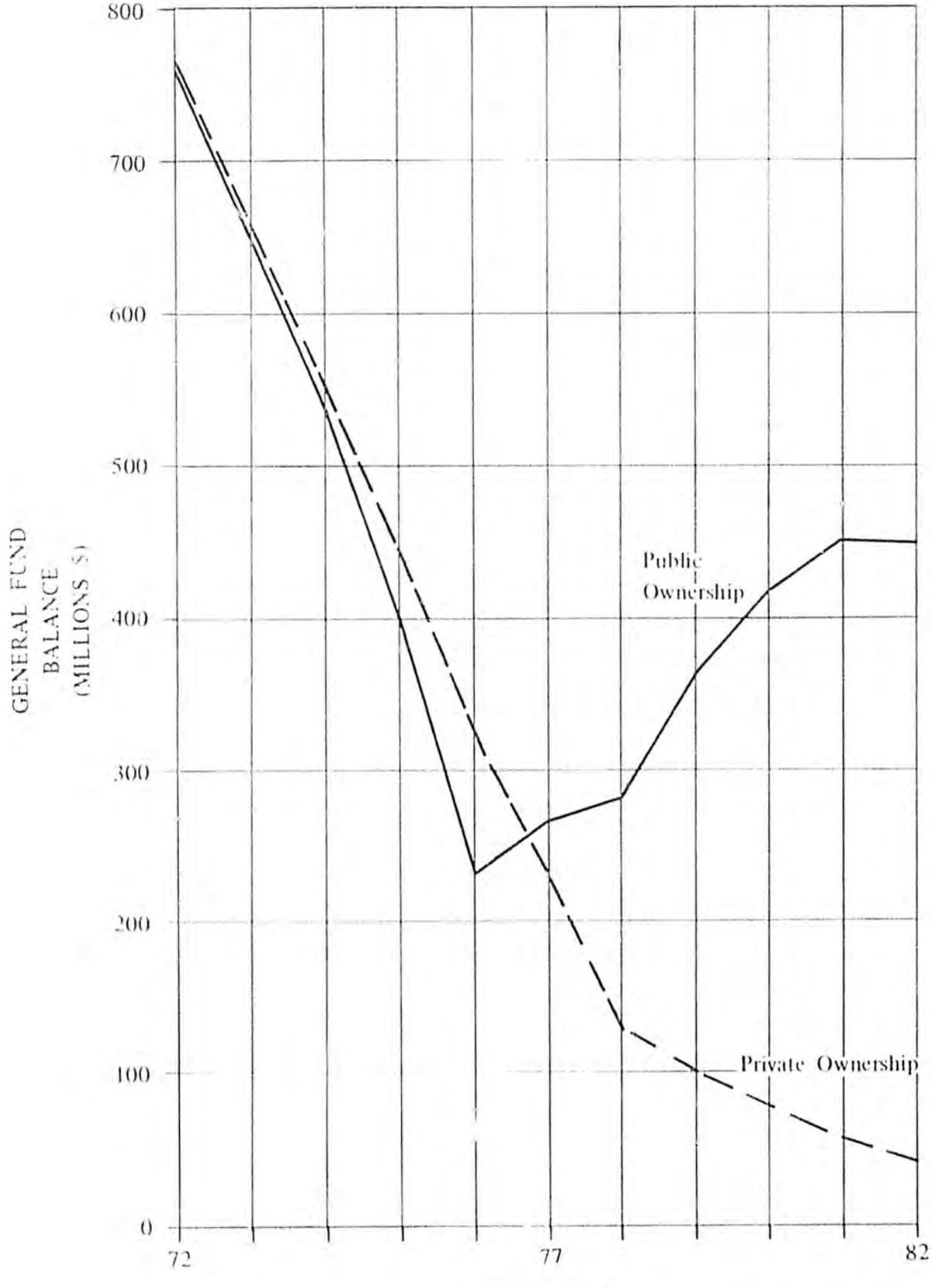
Exhibit E

ENDING GENERAL FUND BALANCE

Public Ownership Budget Book Expenditure Plan

vs

Private Ownership Subsistence Expenditure Plan



AGO 530858

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

Culetta: for State acquiring money, your testimony, or my interpretation, is that this money is the problem that we face and, if I interpret your testimony correctly, one of the alternatives was the State ownership proposal. With supplementary income from severence and royalties we were going to make up the deficit in monies that we need through the profit that is allowed on the pipeline. Have you looked into any other alternatives?

Henri: Well, Representative Culetta, when you mean alternatives do you mean other natural resource development or just what is the general thrust of this.

Culetta: Yes, either in that field or coupled to the Prudhoe Bay. Is consideration being given to, recently we read in the paper where gas research not taken out of the ground. Have we considered selling our pre-owned, you know approximately 20%?

Henri: Well, right, I think that should be the essence of it is Commissioner Herbert's. But, I would say in general that I have looked at every conceivable possibility for getting income for the State, more or less, I don't mean to tell you that we spent several hundred thousand dollars on each conceivable possibility. We certainly have tried to imagine any income source. There isn't anything, including gas, that is anywhere near like oil. That is the problem. I mean the oil is so far and above the great yielder of revenue to the Treasury that there just isn't anything else remotely comparable to it.

Culetta: Mr. Chairman. Again, I was apparently misinformed but it seems that I recall from the news article that between two and five hundred million dollars in one gas sale had been negotiated.

Henri: Well, I don't doubt, Mr. Culetta, that if they sold all the oil in the Prudhoe Slope right today that they could get a figure quite a bit higher than that, obviously, but that is the total figure over many years. My concern, of course, is to funding the budget in 1978 and 1979, not that I am representing to you that I'm going to be the one who's doing it then, but at least we have

to fund the budget then and those are the years, particularly the late seventies, that are so critical to our State.

Culetta: Mr. Chairman. Commissioner, what I am driving at is until the line is on full capacity we seen to be facing the problem . It seems conceivable to me that we should sell some of the future production now to make up the deficit until the line is on stream so that we could solve our problem.

Havelock: If I may answer that for the Commissioner. I have discussed this with a number of people as a prospect, but the effect is, and it is a strategy the State may wish to use at the appropriate point, but the strategy does not change basic lines of the projection. What you can do through the advance sale, lets take sale of oil and gas futures, is to nip off the bottom of the deep part of the V when you hit bottom. You can't sell anything, or you can't sell for any kind of advantageous price until you have the assurance that the product is going to be marketed, otherwise, you are going to be selling a highly discounted comodity. Even if you do sell it, you are selling something that otherwise you would count on in the future. So, the effect is that you can round off the bottom of the V in the bottom of the dip but you don't change the basic trend of the decade by that kind of strategy. As far as other alternatives go, I do call to your attention one of the measures the Legislature may wish to consider, one of measures we had introduced does call for a twenty mill property tax on the pipeline and related oil property as a method of raising revenue and, of course, the legislature may wish to consider the utilization of the property tax as one of the various tax tools that is available to the State in meeting its fical problems.

Rettig: In several different ways the question has been posed, why can't we not increase severence taxes to make up for what, otherwise, would be pipeline profit. Perhaps Mr. Wohlforth could explain where most of this pipeline profit really comes from under State ownership. Would you care to do that Eric?

Wohlforth: Yes I would be glad to. The pipeline profit is shown under pipeline income

in the years 1977, 78, and 1979 to some extent, comes from pipeline income, that is to say, in the amount of the charge which the State is entitled to make as the owner of the pipeline.

Rettig: Perhaps I didn't make myself clear. For example,

Wohlforth: as well as the fact that we are not taxable as a pipeline owner.

Rettig: That is the point I was trying make. Out of perhaps four hundred million dollars of pipeline income, perhaps two hundred fifteen million of that mearly is money that would otherwise go to Uncle Sam for taxes.

Rose: My curiousity is getting the best of me, what is a ?

Henri: It is an example of figures.

Groth: Joe this is the last question and I realize that I am probably being argumentative but I don't mean it. If you refuse to put anything in the budget on the value of the 1.5 million acres on the slope or the seventy seven million acres that the State otherwise has, would you sell it to me for a hundred million dollars? Of course you wouldn't, so you do have a figure on it someplace and it seems to me that that figure has to be put in your revenue projections someplace.

Henri: Senator, you're referring to lands that the State has?

Groth: Yes sir.

Henri: Of course, the lands, whether they are oil bearing lands is question number one. Again, I would have to ask whether Chuck Herbert thinks they are, but even Chuck has missed one or two acres in Alaska as to whether they have oil under them or not. So that in itself seems to be problematical, and then the question of when the oil companies would be interested in taking the oil is the thing that clenches us up. All we are talking about is a ten year period. I think that over the long run of time that we can get through the next ten years probably, our future is particularly bright in this State.

Adjournment until 2 p.m.

McVay: This is a continuation of the hearings on the pipeline proposals of the administration. Our schedule calls for us to go straight through until 6:00 this afternoon and we'll have breaks approximately every hour and fifteen minutes. Mr. Attorney General do you have the next witness?

Havelock: Mr. Co-Chairman and members of the committee, at this time the State would like to call Mr. Charles Kades of Barker, Stella, Field and Wood, special council of the State on public financing. He will discuss the statutory framework of State ownership. In connection with Mr. Kades testimony I have a distribution in line with the previous comments that I have made and other witnesses have made regarding a proposed introduction of the proposed amendment to the constitution of Alaska and with the Chairs permission I would like to distribute that now for your perusal and, in addition, we have to the amendment bill already committed to the committee we have two other proposed amendments to HB 569 which the committee may wish to consider.

McVay: Mr. Kades, when you are ready to begin would you give us a little bit of your background for the records.

Kades: Mr. Co-Chairman, my name is Charles L. Kades. I am a partner in the firm of Barker, Field, Stella and Wood of New York City. I have been a partner for some twenty some odd years. Prior to that I was overseas during WW II until about 1942. In an earlier period I had been Assistant General Council of the United States Treasury in Washington from 1933 or 1934 until 1940. After we were retained to advise the Attorney General and other members of the administration in connection with the ownership of the, or possible ownership of the pipeline by the State, we conferred at length and concluded that the device that was best adapted to providing the State ownership of the pipeline would be public authority. The authority device is not a new device. It is not untried and, at its best, under competent members, it has advantages of full private and public management. It must pay its way and usually it has no access to the public treasury. It has no stock; it is operated under Government and after its debt is paid it properly belongs to the State and to the people. Although there

has not been any project of which I am aware of comparable size to the pipeline under consideration here, there have been authority financings amounting to billions of dollars. For example, the Port of New York Authority now has outstanding about one and a half billion dollars worth of bonds and it has retired about an equivalent of that amount of bonds. The Los Angeles Power and Light Authority has outstanding about a billion dollars worth of bonds. The Power Authority of the State of New York has outstanding a billion and a half of bonds. The New York State Throughway has a billion in principle amount of bonds outstanding. The New Jersey Turnpike Authority has approximately three quarters of a billion; Illinois Turnpike Authority has over six hundred million; and the Nebraska Public Power Agency has a half a billion dollars in bonds outstanding. All of these projects have been financed without any recourse whatever to tax revenue. These projects have been self-liquidating, self-supporting, and are managed by the authority as an autonomous, independent, separate corporate legal entity. That is the purport of HB number 569 which creates the Trans-Alaska Authority as an independent corporate entity. Its membership is appointed by the Governor with the confirmation of both houses in joint session of the Legislature. It has all the general powers of a private corporation as well as a public corporation. It has specific powers to issue bonds or notes and to make agreements with the bond holders and note holders for the financing of the project and it can make rates and charges and revise them from time to time without the surveillance of any other regulatory agency sufficient to pay the interest and principal on the bonds as well as its debt service as well as the operating and maintenance expenses. It has the power to acquire the property of any other pipeline company, either by purchase of stocks or by purchase of property, or by physical property or, if necessary, by exercising the right of eminent domain upon payment, of course, of just compensation. The Act is not mandatory. The Act is purely permisive. All it does is set up the framework from which the State can then determine its next move. It is purely enabling legislation. It might never be used or it might be used in part or in whole, but it is indispensiible some legal framework if the proposals that there may be State

ownership is to move forward. The hearings, I think, became confused at one point in regard to pledge of credit of the State. An independent public authority such as should be self-supporting. All of the authorities that I have mentioned are self-supporting. Sometimes it has been desirable, although I only know of one case, to guarantee the bonds, although no recourse has ever been had to that guarantee. That is in the case of the New York State Throughway, where some bonds were issued guaranteed by the State, after a constitutional amendment was adopted authorizing the guarantee, but the project has been completely self-liquidating and there had never been any of payment of any of the interest or principals out of the revenues. Did one of the amendments that the Attorney General introduced or offered to the committee at the opening of this session eliminates from this act the recittal or from this bill, the recittal in the legislative findings that it is clear to be in public interest for the State to guarantee the principal and interest on bonds issued to finance the facility. The other amendment eliminates the section which provided to the extent that the constitution permitted the bonds might be guaranteed. Now, that section was pure surplus and really doesn't belong in the bill because the constitutional amendment provides that, if it is adopted by the people, then the Legislature is authorized by an act to guarantee the bonds but, first of all, the constitutional amendment is required to pass the people and, secondly, another Legislature must act to pass a law before any of the bonds are guaranteed. So there (Its redundant) for anything of that character to be in this bill, thats why it has been eliminated. As it stands, the bill authorizes an authority to make plans and to proceed with the project but doesn't require the authority to do anything, and doesn't in any way pledge directly, or indirectly, the credit of the State or the taxing power of the State. I may say of this connection that the project, as defined in the Act, is much broader than the pipeline. There are many other things that are required to be built which would be revenue producing. For example, port facilities, airports, docks, wards, storage

facilities, electric energy facilities, pollution controls, possibly recreation areas. The authority would have broad powers to consider construction of those undertakings incidental to, and along with, the pipeline. That, in broad, outlines what is the proposed authority which would be the framework for State ownership of the pipeline. I would be glad to answer any questions.

McVay: Do we have any questions from members of the Senate group or the Senate Commerce Committee?

Groth: It appears to me that under the proposed constitutional amendment the question of incurring of debt is not put to the vote of the people under this proposal whereas under existing law, any bonds that have a guarantee by the State would be put to a good vote of the people. Is my analysis correct?

Kades: Your analysis is correct. The purpose of this constitutional amendment is to delegate, is for the people to delegate to the Legislature and vest in the Legislature the power to guarantee the bonds if the Legislature should want to guarantee the bonds of the authority which simply is a delegation of power to the Legislature so that it wouldn't be necessary to come back to the people again. Of course, there is no reason to suppose at this time that it will ever be necessary or desirable to guarantee the bonds, but this would put the Legislature in a position where, if the Legislature in its wisdom decided that the bonds of the Trans-Alaska Authority should be guaranteed in whole or in part, then the Legislature would be able to make that decision rather than mean it must be, there would be a further delay to go back to the people, but nothing can happen without a subsequent vote of another Legislature which would meet after this Legislature. It would meet after the election at which the constitutional amendment would be considered.

Groth: One other quick question. Generally, if we were to catagorize between general obligation and revenue bond, these would be considered revenue bonds I suppose?

Kades: Yes, although all the funds of the authority would be placed to their payments so technically they would be general obligation bonds of the authority, but, in fact, they would be revenue bonds because they would be payable solely out of revenues of

the authority and the authority would have no revenues except from the project because the authority has no tax account.

Gro[illegible]: Generally, again the interest rate on revenue bonds is slightly higher than those on general obligation bonds.

Kades: I am really not in a position to answer that, but I think it depends on the project and the issue. I don't know whether there is a general rule on that or not. Mr. Macy, who is following is a financial man who probably could answer that.

Christenson: Mr. Chairman, sorry I was late, I didn't get the first part of this. Is this the resolution that you are talking about? Does this go to a vote of the people?

Kades: The House joint resolution?

Christenson: Yes. Here again I would say, suppose it didn't pass?

Kades: If it didn't pass it would not effect the Trans-Alaska Authority Act because the Trans-Alaska Authority Act does not contain any powers to pledge the credit of the State, or pledge the severence taxes, whatever. In other words, the Trans-Alaska Authority stands or falls on its own feet. Well, lets assume that it didn't pass the Legislature, it was never submitted to the people. It wouldn't effect the enabling Legislature. This enabling Legislature is necessary for a number of reasons if the State is to proceed at all. For example, we have the problem on tax exemption. Only one way we will have an answer, final answer, on that, is to secure a ruling from the United States Treasury. We can't go through a ruling because there is no authority to go through a ruling. There is no State agency with the statutory power to request a ruling. The Treasury won't rule on purely hypothetical cases, they want a specific case. Where is the law, where is the plan, then we can get a ruling. The meaningful discussions can't hardly be held on a plan with the oil companies or even with the investment bankers without knowing how the plan can be implemented. It is indispensible as a matter of statute that there be some law on the books under which the officials of the State can proceed in our case.

Rettig: Thank you Mr. McVay. I believe you referred to the possible guarantee by the Legislature, as authorized in this amendment, would not this in effect add a general obligational feature to the bond?

Kades: If the bonds are guaranteed, Mr. Chairman, then it would. It would then be general obligation bonds to the State in a contingent section. If the revenues were insufficient then the bonds would pull on the taxing power of the State.

Rettig: It would generally have a G. O. feature supplemented by a revenue pledge of some sort?

Kades: That is correct in substance, but the primose security would be the revenue. If the constitutional amendment is not acceptable to the Legislature or, is not acceptable to the people, then the bonds would be exclusively revenue bonds payable solely from the revenues of the project and, as I stated earlier, the authorities which I mentioned which are just typical of authorities throughout the United States, are all cases where the projects are completely self-supporting without a guarantee. With the one exception on the part of the Throughway. For example, lets suppose that three billion dollars worth of bonds were issued by the authority that were purely revenue bonds payable solely from the revenues of the project. The bankers and said, well for the last half a billion it might be desirable if the State pledged its credit, especially since these are going to be not just pipeline facilities but they are going to be parks and recreational facilities, one or the other subsidiary projects. Then this would put the State in a position where it could, if the Legislature, in its discretion, determined it was a good idea to guarantee the bonds, but all it does is give a flexible mechanism, it doesn't bind the Legislature in any way. The bonds of the authority would not be a debt of the State in any sense of the word.

Rettig: As I understand it, the whole constitutional amendment would remove from our constitution the prohibition against the dedication of tax revenue and, in effect, would permit the dedication of tax revenues for a particular purpose?

Kades: Would permit the Legislature to dedicate the tax revenues.

Rettig: Now, recognizing that the severence taxes involved from possible pipeline operation may be relatively minor with

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...Kades:... by the State then the entire tax power of the State would be available to pay bonds.

Rettig: I understand that. But Short of a formal guarantee by the legislature they could still pledge particular tax revenues could they not, which would not be a general guarantee, but would be limited to those particular revenues pledged.

Kades: Well, this amendment was drawn with the severance tax only in mind. Now whether there are other taxes that could be pledged, I haven't considered it because it was only the severance tax that was under consideration. I think it's probably broad enough to cover other tax.

Rettig: I believe it does in effect remove the prohibition against the dedication of taxes in toto, does it not?

Kades: Yes. For this purpose, the purpose of securing the payment of bonds and notes of a public enterprise or a public corporation of the State.

Rettig: Thank you. Mr. Kades I am familar with your firm and have great respect for it, as experience bond counsel, in your opinion would a dedication limited to severance taxes only, satisfy the requirements of bond underwriters in this type of deal.

Kades: I think, Mr. Macy is better equipped to answer to answer this question, but I think based upon our experience with authority bonds that it may be you wouldn't need to pledge even the severance I'm just not sure. It depends on the investment bankers and what they underwrite. For example they might say well, we don't need more than the royalties. It would be sufficient if royalties were pledged. Or they might say that revenues were so good we don't need even royalties, or they might say in view of the delays which have been placed, we'd better have severance tax as well. I'm really...

Rettig: Thank you very much. We will perhaps take this up a little further with Mr. Macy. Thank you.

Young: Mr. Kades, the examples you gave of the other authorities have been were public authorities in New York primarily, were they not? These authorities were strictly public convenience. I just wonder if there has been any authorities, like private conveniences, since private ~~conveniences~~ own that oil as well as the State.

Kades: Well I did give you examples of the power authority in New York in the example which, and also the Los Angeles power and Nebraska power which generate and transmit power.

Young: I understand that, but they ~~don't buy the use~~, the authority and generated delivered by the authority, and it would be another party in the State, such things ~~as~~ belong to private industry. And I just wanted another example where possibly ~~xxxxxx~~ an oil line or coal field or something else, ~~xxxxxxxx~~ curiosity...

Kades: I don't know of a case where the natural resources is owned by the State except again the power authority owns the water rights in New York. The situation as far as the power authority is concerned in your situation is not too different but when ~~xxx~~ Charles Evans Hughes was the ~~xxxxxx~~ Governor in New York in 1910 he decided to send a message to the legislature that the water resources of New York were just too essential to New York to permit the development by private/public utility companies which were subject to the regulation of course of the public service commission and the federal power commission and as a result of that the power authority of New York was established which

developed the water resource of New York in complete cooperation with the private utilities. They sell the private utilities and they also transmit the private power which is produced by the private utilities. It is a joint cooperative arrangement. It is handled by contracts between the private utility and the power authority. It didn't come about over a few months, it took some time before there was mutual confidence. That's the current situation.

Young: Thank you. You mentioned also that the authority would have the right to raise the tariff on the pipeline, the usage of the pipeline if necessary to raise funds, additional funds.

Kades: Yes, the Act provides that the authority must fix rates and charge its tariffs sufficient to pay the interest and principle on the bonds, the maintenance of reserves, operation of maintenance expenses and also to yield a reasonable return to the state on its capital or on its investment.

Young: Do you foresee any way this might serve to prevent the powers of the legislature as far as the increase in the severance tax they so desire , their form of taxation , limit the form of taxation on the oil.

Kades: I don't think it would. It simply is an agreement for the protection of the bond holders, that the tariffs will be fixed sufficient to pay the bonds.

Young: And they couldn't raise the tariff beyond the point where they would be paying the bond back from capital investment , They couldn't use the money they had been given as far as the authority.

Kades: I am not clear on the question.

Young: What I am saying is they have the authority to raise the tariff, use could they use this for the State, the authority has a great deal of power, use

it for generating money rather than to pay back just on the bonds.

Kades: So long as the tariffs were reasonable, I think that the Act is broad enough to permit a yield of excess revenues to the State.

Young: It would be under this bill there would be the power to, that is what I am asking. There would be that authority.

Kades; THere is that authority, yes. In other words, I want to be sure I understand. The , there is not a maximum rate in , ~~that~~ the sense that only ~~them~~ enough to pay back the market, and only enough for operation and maintenance, that is a minimum rate. There is room and it is anticipated in the Act that the rates will be sufficient to provide a reasonable return to the State. But the rates would still have to be reasonable.

Young: Whose term is reasonable. I'm always worried about the ~~term~~ word reasonable. It is a catch all. What I'm worried about is the authority superceding with the authority of the Legislature. If we grant this act will they end up being the super power as far as raising money through the oil lines and other taxations?

Kades: No because they are always a creature of the legislature. The authority is , would be subject to the control of the legislature in the event it ~~were to~~ raise the rates to a point where it was imparing severance tax? I don't think it would be able to do that under the act.

Havelock: Mr. Kades, so the committee may be fully informed , I wonder if you might talk for a moment or two about the , how you would arrange for, or what the principles which would apply to tax exemptions of the bonds which the authority might issue for this purpose.

Kades: Well the , first of all , there are a number of these projects where there

is no problem about tax exemption . For example, only of for example on a minor nature, there is no problem in regard to applying of bonds, the proceeds of which would go for roads, court facilities, airports, docks, ; there is some problem in regard to electric energy, the question being whether or not it is local furnishing of electrical energy. It's a very technical problem, but the real problem comes insofar as the interest on the bonds is concerned is, as distinguished from profits of the pipeline itself, profits of the authority, it was those two cases that have to be distinguished. if the volume of oil the pipeline companies can put through the pipeline is subject in some way to reduction on reasonable notice by the authority in order to make capacity available for use by other companies and the obligation of the oil companies to pay, is not opposed by any so called take or pay or hell or high water contract which means in effect a guarantee by the oil companies, that the interest and principle of the bonds will be paid, then it is our opinion that more likely than not we can secure a favorable ruling from the treasury. The cardinal point is, that if the benefits and the burden of the ownership of the pipeline is transferred to the oil companies by imposing all the rights, all the burdens on the oil companies such as guaranteeing the debt service that would be incurred by the authority and if the oil companies have all the rights in the pipeline, then the chances are unfavorable that we would be able to secure a favorable ruling on the bonds. In other words, if, what the statute provides if the proceeds of the bonds issued by the authority are going to be used in the trader business not of the authority but in the trader business of the oil company than the interest on the bonds is taxable, it's simply the oil companies using the credit of the authority in order to finance the project. But if the benefits are of the States and the burdens

are the States also, with adequate protection of course, for the bond holder, then the interest on the bonds should be exempt. Now on that we would, because this is a grey area, it would be necessary for us to secure a ruling from the Commissioner of Internal Revenue. In Last November, when the Attorney General first raised this point with us, we prepared an opinion to Governor Egan that was agreeable to the Attorney General, I think it is complicated.. perhaps ... In so far as the profits of the pipeline are concerned, it is our opinion that they will not be subject to taxation, in other words any excess revenues that the authority derives for use by the State for general purposes, this rule is not in the grey area, such as the question of the interest on the bonds, it has been well settled for a hundred years that the State or an agency of the State is not subject to the internal revenue code, it is not a person within the meaning of the code, it is not a corporation within the meaning of the code. This is decided by the Supreme Court of The United States in 1872 in a case involving the Civil War income tax case and it has been consistently followed by the treasury. Robert Jackson, Justice of the Supreme Court when he was the chief counsel for the Bureau of Internal Revenue gave an opinion in 1933 which reiterated the fact the revenues of the State for State agencies were not subject to Federal Income Tax in connection with Ohio liquor stores who had a tidy profit. Since then, other state instrumentalities have secured rulings that their profits were not subject to taxation and as recently as last year the rationale of the decisions was reiterated in a published ruling. The same thing is true of all these other authorities that engage in what one might call business activities. All make some money and they're not subject to taxation and if that were the only point

involved, we wouldn't think it was necessary to ask for a ruling, but because of the fact that we don't have any regulations, so this law which troubles us passed in 1969, the regulations have not yet been issued. Under the proposed regulations there are several examples given and without being too technical at this point, we mention that in ~~this~~ this opinion, this case falls in the middle, between two examples, one of which says that the interest is exempt and the other which says that the interest is not exempt. Depending upon the contract between the authority and the ~~companies~~. That's, as I think I mentioned before, a reason why it's important to have enabling legislation because we can't get this question settled and it's a very important question, until there's some enabling authority on the statute books.

McVay: Mr. Barber.

Barber: I have a question, Mr. McVay. Say that the Trans-Alaska Authority Act was passed, HB 569, as amended, would subsequent legislators have the authority and right to change that authority, that authorizing legislation?

Kades: Subject to one provision, they would have plenty of power to change it, for there is a provision in the bill which states that the legislature will not do anything to impair the rights of the bond holders, or diminish the powers of the authority which would adversely affect the bond holders. It might be well if I mentioned it because ---- this is on page 23, this section 44.58.340, and the subject of this provision, the legislature could at will change and in this stage, if it's inaccurate. The State pledges to, and agrees with the holders of notes, bonds or other obligations of the authority that the State will not limit or alter the rights by this chapter vested in the authority to possess and use property acquired by it or for its use, so long as its corporate existence continues; and to establish and collect tariffs, tolls, rates and charges as may be convenient or necessary to produce sufficient revenue to meet the expenses of maintenance

and operation , and to fulfill the terms of any agreements made with the holders of notes, bonds or other obligations of the authority. And further pledges it will not, in any way, impair the rights and remedies of the holders until the notes, bonds and other obligations, together with interest thereon, and interest on unpaid installments of interest are fully met and discharged. That's the only limitation on the power of the legislature to control the activities of the authority and that's understandable because the bond holders, especially if they're relying solely on revenues of the authority, will be taking the risk that the revenues will be raised and if the legislature withdrew the power from the authority to charge tariffs sufficient to pay the bonds, the bond holders would not have any recourse against the State. Their recourse would be only against the authority under the revenue type - bond type of obligation which the authority would be authorized to issue. Thank you.

McVay: Are you through Mr. Barber? Mr. Rose.

Mr Rose: Mr. Kades, you have indicated that these revenue bonds would not in anyway obligate the credit of the State. As a practical matter though, isn't the credit of the State behind the revenue bonds in the event the project is not as successful as anticipated?

Kades: With all due respect I don't think so. The bonds will say on their face, the offering circular will carry language to the effect that the State is not liable on the notes or bonds, or the interest on the notes or bonds, and no one will be misled - the bond holders will be looking solely to the revenues of the project. Some revenue bonds have gone into the [illegible], one, an authority of the State of Virginia and I daresay, although I rather, again I'm not a financial expert, have Mr. Macy or Mr. Guildhouse testify to this, but I doubt if that's in any way hurt the credit of the State of Virginia. There's an authority in California [illegible] but no one thinks that California should pay

those bonds. Here and there, some authorities have gone into the pool without adverse affects, I believe, so far as the credit of the state is concerned. And everyone is put on complete notice and there's no misrepresentation or anything to cause anyone to seek recourse against the State, and in those instances where an authority or a project was bonded by a revenue basis failed the state in question, or the municipality in question, had not come through and back it up with its own credit. At the present time, there are a hundred million dollars of bonds of the Cheasepeake Bay Bridge and Tunnel Authority in float in the state of Virginia, has nothing whatever and they have been under pool for two or three years. I don't even think a bill has ever been introduced to do anything about the bonds. Ultimately, I suppose the reason is, I'm out of my field now, but I suppose the reason is the bond holders will ultimately get paid. There are tolls coming in but they're not coming in as fast as was anticipated so they're getting, I think, two-thirds of the interest. Eventually they'll be paid off, but there's no move against the state, or by the state, to - that's been one of the - in fact, that's been one of the basic reasons for the authorities being created in the first instance was to take the burden off the taxing power and put it on the revenues of enterprises that were revenue producing. If you take the Port of New York Authority with three billion dollars worth of bonds, of which half are now outstanding, it would be a terrific debt even for states like New York or New Jersey. One of the reasons for setting up that authority was so there would be no recourse against the states and that was also the reason for setting up the Power Authority of New York, and the Power Authority of Los Angeles.

Rose: I do see that as far as the people of Alaska are concerned, they wouldn't have to worry about their children and grandchildren being obligated in anyway in the event that this does not [illegible] as hoped for.

Kades: That's ~~true~~ correct.

Rose: Thank you.

Kades: Mr. Holm

: Mr. Kades, as I get it then there are three stages going to be passed: 569, is that right? 569, and then the people will vote on a change of constitution so that we can dedicate the funds and thirdly, the legislature will have to act to dedicate the funds. Now, in your judgement, will it be necessary for us to go through all these stages in order to optimize the interest rate on these bonds, especially a bonding of this size?

Kades: I don't really know. I am an attorney and I think perhaps I'll let that question be answered by Mr. Macy and Mr. Guilderhouse. I don't mind giving you my private opinion, but it's not an expert opinion---

How I would know if this was field now

I would think that anybody, I was just thinking to myself now as if I were going to buy the bonds, I would rely on the revenues of the pipeline, not the taxing power of the state of Alaska, my feeling it would be that the security is the oil that would be flowing through the pipelines, not what real estate or income taxes Alaska can extract from its limited population.

Holm: Now you people are bond counsels?

Kades: It's attorneys, a bond counsel is, we're lawyers. We're not financial experts such as are going to follow me, that's why I say-I say I'm out of my--

Holm: Now, if we do go the route, bonding ourselves for three and one-half billion dollars, then you people will also act to advise the State, or someone will act to advise the State, involving this bonding, in addition to the broker house or whoever is going to sell the bonds?

Kades: The underwriting group have their own counsel, we've been acting as counsel to the State. The -- I just might say because we've had many meetings ~~with~~ the

underwriting group's counsel who are much _____in New York, agree with, generally agrees with what I've testified. But we would represent the State to be sure that, for example: to be sure that there wasn't anything in the circulars or in the offering prospectus or in the resolutions which indicated, directly or indirectly, that there was any obligation on the State to resort to its taxing power in the absence of the guarantee, of the state.

Holm: Could you tell us what it costs the State to enlist services like yours in case we went to sale of the bonds?

Kades: No, we have never charged a fee without first consulting with our client and being sure that he, or the public body, felt that it was reasonable because we're - we're - we live in a fish bowl and our fees are a matter of public record. So, I think we probably have to be more cautious than many private corporate lawyers.

Holm: Well, we kinda live in a fish bown too and we'd kinda like to know what it's going to cost us if we're going to sell three and one-half billion dollars worth of bonds.

Kades: Well, I think it's a very fair question, but I may say that so far, it hasn't cost the State anything.

Holm: Are there other questions by any other members of the legislature?

Holm: Mr. Rettig has another question.

Rettig: Just one ~~more~~ short question Mr. Kades. In the proposed constitutional amendment, I suspect there may be some reluctance on the part of the legislature, and perhaps the public, to open wide ~~only momentarily~~ even momentarily, this prohibition against the dedication of tax revenues for a particular purpose. In your opinion, if this- in your opinion, if this dedication were limited to the tax revenues arising from a particular enterprise, such as the pipeline, if it were restricted to those particular taxes, would this in any way adversely affect the non-tax status of,

the possible non-taxable status, of the bond?

Kades: No, I think it would be a good idea, and I think your suggestion is well taken, to insert the language that's in Section 8 and Section 7, where it's limited to public enterprises or public corporations created or empowered to construct the pipeline, so that it would be more limited than it is.

Rettig: Now, I believe that what I really meant was to restrict the dedication to the taxes arising from that poperation of that, for example, the pipeline.

Kades: Such as the severance tax.

Rettig: Correct

Kades: Well, that really depends on how much of the purchasers of the bonds feel they can rely on the revenues of the pipeline plus the severance tax.

Rettig: Now I'm not speaking of the security to the bond holders but the tax status of the bond interest, only. If it were tied directly and restricted to the tax revenue

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

The log I've kept is strictly the name of the people who are talking. There is one bad part of the hearing and you'll have to rely on the Department of Revenue transcript which is enclosed.

The Department of Revenue has kept a transcript of the hearing. The equipment that I've recorded on is much superior to theirs but think the ideal way to transcribe this is for someone to edit their transcript and let someone else type. This seems the most expeditious to me. Just glancing at their transcript I notice that the names are spelled very poorly. I think that most of the people who testified have their names listed on one of the enclosed sheets. You can get the spellings from there. The people who did the questioning not on the committee were either Senators or Representatives and you can get their spelling. There is enclosed for your convenience the statment copies that were provided to the members of the committee. I'll try enclose anything that I think might help you in transcribing.

Jim Bryson

March 6, 1972

0003.5 Called to order by Rettig

0005.3 Introduction of committees

0010.0 McVeigh

0011.0 Rettig

0012.5 John Havelock introduction

0014.0 Boucher makes statement

0038.0 End of Boucher

0038.3 Rettig intro. Havelock

0042.0 Herbert makes statement

0052.0 Herbert returns to seat from across room

0055.0 Herbert returns to seat

0064.8 End of Herbert statement.

0066.5 Havelock's statement (Rettig introduced)

0084.3 Havelock intro. Temple

0084.3 Rettig's "fine"

0085.0 Temple statement (no copy)

0141.0 End of statement

0141.0 McVeigh

0142.5 Groh

0143.3 Temple

0144.0 Groh/Temple

0145.0 Groh/Temple

0146.0 Groh/Temple

0150.3 Young/Temple

0154.3 Meland/Temple (just tell Joe Blow on the street)

0157.0 Holm/Temple

0166.0 Hubert/Temple (McVeigh chairing during question and answer period)

0169.0 Rose/Temple

0175.0 Barber/Temple

0179.0 Miller/Temple

0182.5 Rose/Temple

0185.3 Radar/Temple

0187.5 Bowman/Temple

0188.5 Josephson/Temple

0191.5 Swanson/Temple

0193.5 Mike Colletta/Temple

0196.5 Farrow/Temple

0198.0 McVeigh/Temple

0198.3 Rettig/Temple

0203.0 Temple - End of statement

0203.8 Recess -- reconvened

0204.0 Bruce Campbell statement

0212.3 End of Campbell statement/Rettig

0213.3 Holm/Campbell

0214.3 Rose/Campbell

0218.0 Christiansen/Campbell/Havelock

0220.5 Rettig

0221.8 Havelock

0222.3 Recessed until 8:00 a.m. tomorrow.

March 7, 1972

0224.0 Reconvened

0224.3 Rettig intro. Wohlforth.

0225.0 Rettig

0226.0 Wohlforth statement

0269.5 End of Wohlforth to Havelock

0271.0 McVeigh "can everyone hear...."

0273.0 Larry Eppenbach statement

0284.0 McVeigh

0284.3 Groh

0285.8 Wohlforth

0287.5 Groh/Wohlforth (McVeigh "speak up, etc.")

0288.3 Christiansen

0289.0 Havelock

0290.5 Holm/Eppenbach

0294.0 Wohlforth answers

0299.0 Havelock "May I comment." Holm

0297.8 Havelock

0306.5 Christiansen (McVeigh chairing during question and answers)

0307.5 Wohlforth

0308.5 Havelock

0309.0 Young/McVeigh

0310.8 Rettig/Wohlforth

0312.8 Eppenbach

0315.0 Palmer

0316.3 Wohlforth

0317.5 Eppenbach

0318.5 Wohlforth

0319.0 Rettig

0320.3 Havelock

0322.0 Recess for ten minutes

(From this point to the noon recess is a bad tape and you will have to go to the Department of Revenue transcript to take your transcript. I will givewhat I have down on my log anyway.)

0322.0 McVeigh

0324.5 Havelock intro Henri

03226.3 Henri

0368.0 End of Henri statement

0368.3 McVeigh chairs - Groh/Henri

0378.0 Young/Henri

0380.0 Wohlforth

0386.8 Eppenbach

0388.3 Holm/Henri

0394.0 Hubert/Henri

0396.0 Barber/Henri

0398.0 Thomas/Henri

0401.5 McVeigh/Josephson/Henri

0404.0 Palmer/Henri

0407.8 Rettig

0408.5 Eppenbach/Palmer

0411.5 Palmer/Havelock

0414.8 McVeigh

0415.8 Colletta/Henri

0420.0 Havelock

0422.8 McVeigh/Rettig/Wohlforth

0425.3 Groh/Henri

0429.3 McVeigh - recess.

(End of bad tape)

0428.5 Reconvened McVeigh

0430.5 Havelock intro Kades

0433.0 McVeigh

0433.5 Kades statement

0450.8 End of statement

0451.0 Groh/Kades

0455.0 Christiansen/Kades

0468.5 Young/Kades

0478.0 Havelock/Kades

0489.8 Barber/Kades

0494.8 Rose/Kades

0501.0 Holm/Kades

0507.3 Rettig/Kades

0519.8 McVeigh/Havelock

0520.5 Kades

0521.3 McVeigh/Havelock

0522.0 Kades

0523.0 Rose/Kades

0525.5 Recess until 3:15

0527.8 Reconvened

0532.5 McVeigh

0532.8 Havelock/Wohlforth

0535.3 Havelock intro Gildehaus

0536.0 Gildehaus statement

0568.0 End of statement

0568.5 Groh/Gildehause

0572.3 Rose/Gildehaus

0575.8 Wohlforth

0578.3 Rettig/Gildehaus

0589.5 Havelock/Gildehaus-Rettig

0594.0 McVeigh/Gildehaus

0600.8 Eppenbach/McVeigh

0604.3 Gildehaus

0611.0 Rettig/Gildehaus

0612.0 Eppenbach

0612.5 Wohlforth

0684.8 Havelock

0686.0 Groh/Rettig

0687.5 Havelock intro

0687.5 Havelock introduced Hellen

0688.8 Hellen statement

0704.0 End of statement

0704.5 Rettig/Hellen

0713.0 Holm/Hellen

0714.0 Holm/Havelock

0717.3 McVeigh/Hellen

0774.3 Groh/Hellen

0726.3 Havelock/Groh

0727.3 Rose/Hellen

0734.8 Hubert/Hellen

0738.8 Rettig/Havelock

0741.0 Holm

0741.5 Christiansen/Rettig

0743.5 Wohlforth

0743.8 Rettig - adjourn until 8:00

March 8, 1972

0745.0 Reconvened

0746.0 Sen. Croft statement

0778.3 End of statement

0779.0 Groh/Croft (Rettig chairing)

0786.5 Radar/Croft

0789.0 Rose/Croft

0792.0 Hubert/Croft

0797.5 Barber/Croft

0802.5 Croft statement

0805.0 Rettig/Croft

0807.3 Rose/Croft

0810.0 Hubert/Croft

1028.3 Radar/Williamson

1032.5 Donaldson/Radar

1036.3 Hubert/Rettig/Donaldson

1041.3 Croft/Williamson

1047.0 Barber/Williamson

1048.0 McVeigh

1052.8 Palmer/Williamson

1056.5 Croft/Williamson

1058.0 Radar/Williamson

1060.0 Donaldson

1061.3 Thomas/Donaldson

1068.5 Donaldson

1063.0 Recess for 10 min. - Reconvened

1066.0 Donaldson intro net three witnesses.

1068.0 Harry Jones statement

1097.5 End of Statement

1098.0 Rose/Jones

1100.3 Miller/Jones

1106.3 McVeigh/Jones (Rettig chairing)

1112.5 Groh/Jones

1116.5 Hubert/Jones

1124.5 Holm/Jones

1130.5 Donaldson intro Markham

1131.5 Markham statement

1196.5 End of Statement--recess

1197.00 Reconvened - Rettig

1200.0 Holm/Spahr

1200.8 Groh/Spahr

1206.3 Palmer/Spahr

1210.3 Donaldson/Palmer

1213.8 Hubert/Spahr

1222.5 McVeigh/Spahr

1229.5 Rose/Spahr/Donaldson (we'll try to get an answer...)

1242.8 Mr. Spahr left.

1244.0 Recess

End of Tape #1

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

OUTLINE OF PROPOSED TESTIMONY
BEFORE
THE SENATE COMMERCE COMMITTEE
HON. RON L. RETTIG, CHAIRMAN
AND
THE HOUSE LOCAL AFFAIRS COMMITTEE
HON. RICHARD C. McVEIGH, CHAIRMAN
3:00 p.m., March 6

1.	The Concerns of State Policy Statement of Governor	(Lt. Gov. Red Boucher)
2.	Alaska's Stake in North Slope Oil leases, royalty, severance and netback	(Charles Herbert, Commissioner of Natural Resources)
3.	The Federal Role in North Slope Oil I.C.C. regulation - how it works, federal pre-emption	(John E. Havelock, Attorney General, Pipeline Coordinator)
4.	The Cost of Building the Trans-Alaska Pipeline System	(Bruce Campbell, Commissioner of Highways)
5.	The Impact of Costs on Revenue	(Eric E. Wohlforth, Commissioner of Revenue)
	Methodology - Comparison of State and Private Ownership Cases	(Larry Eppenbach, Department of Revenue)
6.	Impact of State Revenues on the State Budget	(Joseph R. Henri, Commissioner of Administration)
7.	The Advantages of State Ownership Issues and Answers	(H. M. Temple III, Temple, Barker & Sloane)
8.	The Statutory Framework for State Ownership	(Charles Kades, Hawkins, Delafield & Wood)
9.	Arrangements for the Public Financing of Pipelines	(Tom Gildehaus, Temple, Barker & Sloane)
10.	The Marketing of Public Pipeline Issues	(Robert Macy, Kuhn, Loeb & Co.)

Page No. 6

Mr. Rettig: Now at this time we will proceed with the administration witnesses, Attorney General John Havelock.

Mr. Havelock: Thank you Mr. Chairman. The opening witness we present for the Committee here today is the Honorable Eric E. Wohlforth, Commissioner of Revenue, who will speak generally to the impact of pipeline costs on revenue. Commissioner Wohlforth.

(Mr. Rettig)
Before Mr. Wohlforth commences his testimony, I would like to point out just a slight kink in our plans. We are going to commence questioning from committee members and legsilators immediately following testimony of all out-of-town witnesses. It would be helpful if you do have questions, concerning the administration staff and others who reside in Juneau to save your question, certainly make notesof them so that you can ask those questions at a later time at the individual committee meetings when these measures are being considered.

(Mr. Wohlforth)
Thank you, Mr. Chairman, members of the committee, let me first point out one of those uphappy events which happens in the course of preparing documents and that is for these two years 1980 and 1981 some typist made a reversal of some of the figures. The figure 3397 should be under state taxes, the figure 3705 should be under state taxes, thats Conversely taxes should be in the other column. I think that we see readily from the sequence of figures that that typing reversal did occur and I'm very much indebeted to the unidentified gentlemen who called it to my attention at 7 o'clock this morning.

The figures which are, although done graphically, are hard to see from, by any of those who are sitting in back of the room or any person who doesn't happen to be fair sighted, are depicted in a hand-out entitled, Exhibits to support Testimony before these Committees, with yesterday's date. Committee members have those exhibits now and they will see little tick marks after the two places where the unfortunate figure is reserval occurred. My job this morning to summarize past projections of North Slope revenues and those presented today based upon private ownership and to contrast the effect of private ownership case with the case of the pipeline owned by the State of Alaska. The most recent public North Slope oil revenue projections before those which

Governor referred to last week were made by the Division of Oil and Gas in cooperation with the Department of Revenue as part of the State's contribution to the Federal impact statement which was released by Governor Egan in July of 1971. These projections were developed from a computer model which was based on the information then available to the State of Alaska and showed various and numerous economic cases on differing assumptions again, based on facts then assumed to be ascertainable. The July 30 report which is contained in the State's contribution to the impact statement states, on page 166, that "the originally estimated $900,000,000 cost of the pipeline has already increased considerably, present cost estimates range from one million to 2.1 billion, that will occur I am sure, frequently, to 1 billion to 2.3 billion dollars. These revenue projections use the assumption of one billion dollars, as the lowest installed cost of the pipeline and 2.5 billion as the highest estimate. A footnote to this statement gives backup for the State's then cost estimates. This footnote notes that as late as July 19, 1971, Alyeska furnished the State Department of Revenue an estimate of $969 million dollars as the cost of the entire contract, and the footnote concludes with a reference to a statement from Interior Secretary Rogers C. Morton, in the late spring of 1971, that (environmental regulations and) environmental precautions are contributing to a higher price tag of about 2.3 billion dollars. So it was this figure of 2.3 billion dollars which was used on the State's most likely estimate of North Slope revenues. ~~The revenue estimates included in the State's report developed from this estimates of total cost, the revenue estimates most likely estimate of North Slope revenue.~~ The revenue estimates included in the State's report developed from this estimate of total cost assumed refinery value in the year, fiscal year 1975, which was the then estimated start-up year, that is refinery value on the West coast of $3.37 a barrel, marine transportation costs of 44¢ and pipeline tarrif initially of 80¢ per barrel, giving a wellhead value of $2.12 per barrel. From these figures it was estimated that total royalties and taxes would amount to $164,000,000 a year in fiscal year 1976. The first year, then assumed, of pipeline operations. In the second year of operations fiscal 1977, the total revenue was estimated at 278,000,000, the third year,

$282,000,000, in the fourth year $311,000,000. In the then-estimated, and I repeat then-estimated, fifth year of operation, fiscal year 1980, pipeline tariff was calculated at $ .47 a barrel with marine transportation costs of $ .52 leaving a wellhead value of $2.56 per barrel. In that year, fiscal 1980, we showed then, a total of $348,000,000 in total royalties and severance taxes from the pipeline. And we didn't stop with one set of assumptions. Other assumptions were run with different assumptions. Estimates were run with different assumptions. For example, one set the pipeline cost $1 billion again with the initial production year 1976. A wellhead value of $2.75 with lower marine transportation and tariff, produced ~~showed~~ $212,000,000 in revenues the first year of production and the fifth year of production on this optimistic, optimistic from the point of view of the billion cost of the pipeline, was assumed to capture, the State ~~I say~~ was assumed to capture in that year $412,000,000 in pipeline revenues. A then pessimistic case which assumed a pipeline cost of 2.5 billion showed a wellhead value of $1.76 in the initial year of 1976 and royalties and taxes of $136 million in that year. In 1980, however, at a wellhead value of $2.20 a barrel, royalties and severance taxes reached the figure of $297,000,000. Incidentally, and obviously, in all these case, one of the main reasons wellhead value increases over the years is that transportation costs go down as the volume of oil shipped increases. Now several important events have come to light which have required the State to revise downward drastically its revenue estimates. The first indication of the fact that the State was incorrect in assuming as it did, in July, 1971, for its contribution to the Impact Statement, the first indication that the State was incorrect at that time in making an assumption that a production flow starting at 600 barrels per day would reach 1.7 million barrels per day in the second year of ptoduction was disclosed in the summary description of the transalaskan pipeline system received by the State this fall. On page 55 of that document it is stated the pipeline will be brought to full capacity in stages. In the initial phase of operation the system will have the ability to transport 600,000

barrels a day, and I'm paraphrasing page 55 of the summary impact statement. The reports goes on to state that the second phase is tentatively scheduled to be completed approximately 2 years after initial start-up. In this phase the report states the system will have the designed capacity of 1.2 million barrels per day. The final phase so says the report, is expected to be completed approximately seven years after initial start up, that is a pumpage flow at which time the pipeline will reach its ultimate capacity of 2.0 million barrels per day according to the description in the statement. In other words, ~~it~~ there willbe, according to the statement, at least five hundred thousand barrels per day less production in the second year of operations and each year thereafter for the initial seven years. The next shock to the State was ~~XXX~~ disclosed by the S.E.C. Registration Statement filed by British Petroleum Company Ltd. ~~submitted~~ on October 12, 1971. In the offering circular accompanying that registration statement the following statement is made on page 24, "the initial construction phase of the pipeline is expected to provide a minimum aggregate throughput capacity upon completion of 600,000 barrels per day. This capacity is designed to be expanded in two stages. The first stage resulting in a total capacity of 1.2 million barrels per day, and the second a total capacity of 2.0 million barrels per day. Parenthetically, no reference to the time of build-up. It is presently estimated that the cost of the pipeline upon completion to the 600,000 barrels per day capacity would be approximately 2.3 billion and that increasing the capacity to 2 million barrels per day would increase the cost by $400,000,000. On November 10, 1971 Atlantic Richfield, together with the City Service Company, filed a registration statement with the Security and Exchange Commission stating that "the cost of the system upon completion ~~X~~ to the 600,000 barrel per day capacity is presently estimated to be approximately 2.4 billion of which the company will be responsible for approximately $675,000,000. The additional costs to all particpants of increasing the capacity to 2 million barrels per day is estimated to be at least $400,000,000. Thus by m'd-November, 1971, the total pipeline costs ~~were~~ had escalated to 2.8 billion, or $500,000,000 over the average case assumed in July when the State made its revenue estimates. In fact, it increased $100,000,000

in less than one month between two SEC filings by companies involved in the North Slope pipeline. This dramatic increase in pipeline costs, revealed in official documents at the time of Governor Egan's first announcement on State ownership, made it urgently necessary that the State finally determine independently the likely magnitude of the pipeline costs. Commissioner Campbell has already indicated the independence study which the State has made through its consulting engineers, Tibbets, Evan, McCarthy and Stratton, and the foundation for the present estimate of 3.5 billion. These figures have been recently developed, along with an independent evaluation of operating costs, so that for the first time the State can make a reasonable projection ofthe probable amount it can expect to capture from North Slope revenue. And incidentally, in the hand-out of exhibits there is a breakdown in addition to the comparison of public and private ownership of the construction costs table which Mr. Campbell referred to yesterday. We will make additional copies of those available if they are in short supply, other senators, representatives or members of the public desire to see them. The base case shown today in graphic form assumes the total pipeline cost of 3.5 billion financed 90% by debt, at an interest rate of 8%. It conforms to the Aleyska throughput assumption of full production only in the 7th year of pipeline operation. It shows the same ICC permitted rate of return as shown in the State's projection in July. In the fourth year from the beginning of construction or the first year of operation, for 1977 we now show a negative well-head value or no state revenues. This was the year comparable to that in which it was earlier shown that the state would capture at least $164,000,000 in total revenues consisting of royalties and severance fees. The fifth year, 1978, the second assumed year of operation we earlier estimated $278,000,000 in State revenues. In these two years alone the net revenue loss to the State over earlier estimates amount to $442,000,000. By the sixth year, or 1979, the new projection shows $84.6 million in oil severance and royalties revenues. Earlier we estimated $282,000,000 for that year. The net loss by that year over earlier estimates is $640,000,000. Not until the 15th year of pipeline operation do royalties and severance taxes amount to near the amount shown in our previously made estimate before the second calculated year

In that 15th year we show severance and royalty revenues of $277 million. Now the question ~~is~~ it has been asked, and not only has/been asked, it has been asserted that this is the most pessimistic of all/cases possible which can be produced by the State for its revenue picture in the late 1970's and 1980's. I'd say that the answer to that is clearly no, for three reasons. In the first place the revenue loss figure mentioned above is no effect to our expectations now of first pipeline operation in the year 1977 whereas in July we assumed the full year of revenues starting on July 1, 1975. That is to say we show a $640,000,000 loss comparing three years of operation regardless of start. In the second place we show state taxes in each year of operation of approximately $33,000,000. For these first three years of operation ~~the~~ state income taxes are estimated to total approximately $100,000,000 or 3 times the $33,000,000 a year. This assumes full state ~~income taxes~~ income tax on pipeline profits. Experts have indicated that this itself may not be/a realistic assumption. Even, however, with the most optimistic income tax estimate, net revenue loss from earlier projections amounts to $540,000,000 during the critical first three years of operation. Thirdly, calculation of the 7% permitted rate of return on valuation may err on the low side. This was alluded to yesterday by Mr. Temple as the legalities of the possibilities were discussed by Attorney General Havelock. I can only say that the leading text on the ~~XXXXX~~ subject which is Petroleum Pipelines and Public Policy by Arthur Johnson, cites numerous instances of the slowness of the ICC to actually evaluate pipeline costs and its heavy reliance on figures supplied by industry. And its well known to the Committe and/to the public at large that the Cook Inlet pipeline valuation itself took nearly three years to complete. The 7% figure again is not high when it is remembered that there are seven separate proposed pipeline owners, each of whom may aggregate earnings of each of its other pipelines when the 7% rate is considered. We will hear further expert testimony on this later. The point here is that is entirely possible that higher return rates ~~will~~ may be permitted at least until the valuation of the pipeline is complete and possibly there after when earnings of other pipeline companies are aggregated to arrive at a total rate of return for a particular pipeline company. The next case shown on the chart and to some, seeable on the wall, assumes the case

of the economic effect of State ownership of the pipeline. Financing is assumed in the amount of $1 billion dollars in each of the first two years of construction at 8%. $900,000,000 in the third year of construction at 6.5%, $215,000,000 at 8% in the first year of operation and $310,000,000 in the second year of operation, and I may say that Mr. Eppenbach who will follow me will give you some more precise detail on the assumptions that went into the assumed case of public ownership I'm now discussing. This case also assumes the same ICC permitted rate of dividend payoff as assumed for the private case. The 7% percent which is a cash dividend payout limitation in each year of the projection. In arriving at the State's net cash flow which is indicated at the top of the chart assuming public ownership, pipeline income, royalty and production payments, in arriving at the State's net cash flow operating expenses, amoritazation and interest on bonds, are deducted from gross income. During the first year of operation net cash flow to the state through tariff is, as you can see from the chart, $230,000,000 and royalty and severance taxes amount to $15.7 million for a total of $245,000,000. Obviously, in State ownership no Federal or State income taxes are calculated on pipeline income. Mr. Kades will speak to this later today, explaining in detail the assumption legal rationale for that statement. In the fifth year from the beginning of construction, or the second year of operation, net cash flow is $228,000,000 which together with royalty and severance taxes of $17,000,000 produce a total of $245,000,000 for the State. In the sixth year from the beginning of construction and the third year of operation, net cash flow amounts to $227,000,000 through the tariff and total royalties and severance taxes amount to $123,000,000 for a total $350,000,000 or for those who are farsighted, $350.94 million as shown on the chart. In the 15th year cash flow is reduced to ~~$180,000,000~~ $183,000,000 by reason of the fact that the pipeline has depreciated but total royalties and severance taxes amount to $297,000,000 for a total to the State Treasury of $480,000,000. Now let me emphasize that this case makes almost identical assumptions to the private case described before. It should be

emphasized that net income to the State is computed after debt service on State bonds. To avoid a speculative argument on the possible differential between interest rates on the State's debt, which may be tax exempt, versus taxable interest on private borrowing, we show all but $900,000,000 in state bonds at the same 8% rate as shown in the private case. I think the 8% can be, we could spend the day arguing 8%, 7% or 9%, we all know the trend of interest rates in recent years, the fact that double AA corporate ~~XXX~~ bonds are selling today at about an interest rate level of 7.23 gives me comfort that 8% is as good an estimate of interest on both state and public borrowing and indeed conservative on state borrowing ~~which~~ as can be arrived at today. The main differences between the assumptions lie of course as I have stated before, ~~is~~ In the fact, that the State is not subject to Federal income tax and obviously will receive no State income taxes from the pipeline since ~~XXX~~ it is assumed to be the owner. The timing of the bond issues for both the public and the private cases is the same, although the term of the public bond issue is ~~short~~ shorter, 25 years, indicating heavier debt service loads and the state of course is assumed to finance the pipeline 100% ~~and~~ on a step basis. Now we ~~can~~ could make numerous additional assumptions, and we have made additional assumptions, on the question of the matter of public financing, the manner of private of private financing, the assumed debt equity ratio of private financing, the rate of return permitted either to the State or to private pipeline owners, interest rates payable by the State and private pipeline owners, the effective tax rate in private ownership, to mention only a few. We know and the Committee knows, and I believe ~~that~~ each Senator and Representative in this room knows, that estimating the effect of a project of this size and magnitude based on events three to seven years away, must rest on ~~XX~~ assumptions which are to a degree speculative and you will hear testimony that our assumptions are probably incorrect. The point is that no one can say with absolute certainty what our revenue picture will be with the pipeline in private ownership. We have now, however, tested ~~XXXXX~~ prior assumptions based on new and in two instances, official information before us. I refer to the Aleyeska Impact Statement and the more recent SEC

filings of ~~the~~ two of the member companies. This effort and this information has convinced the administration thatit must attempt to do now what it can to remove the uncertainty of the revenue picture in the late 1970's and the late 1980's and this attempt to remove the speculation and to give the State the tool to move forward in this regard is the thrust of the billsthat are here before ~~XXX~~ you today. The details of the bills, the theory and rationality ~~XXXXXXXXXXXXX will be~~ addressed by other members to come before you, but I see it in the context of State's effort to remove the degree of speculation about which we are in when the pipeline ~~is~~ starts to flow and when State revenue's can, to some degree begin to be hoped for.

Mr. Larry Eppenbach, L. E. Eppenbach, will explain to you now how our projections were made ~~and~~ in some additional details, and some of the detail on the chart before you. Thank you.

Thank you Commissioner.

Mr. Havelock. A little comments, perhaps, about now to explain the methodology used in discussing with Commissioner Wohlforth, Mr. Chairman, he acknowleged recognition that there is considerable complexity to the testimony as presented by himself and Mr. Eppenbach and if the Chairman wishes that...so that details are not lost in the minds of those

END TAPE 6

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

Date of meeting: March 7, 1972

MR. EPPENBACH: Mr. Chairman, Committee Members: In testimony already presented, you have heard a great deal about revenues, talks of pipelines, calculations of royalties and production taxes, and permitted dividends. Rather than to add more numbers, more formulas, more calculations, I think it would be prudent now to pause and develop perspective on the numbers already given to you about the many charts. To do this I should like to talk first about how the State brought all of its pipeline information together, to calculate what is the most important piece of information thus far--that is, the new estimates of total annual income from the North Slope. As has already been indicated, we employed a computer model which simulated each year the economic operation of the pipeline, the various conditions regarding ownership, financing, taxes, and earnings limitations. In a sense, an income statement was prepared each year for the owner of the line. This income statement does not appear so very different, at least in terms of these expressions, from that of any other income statement. Gross revenues to the pipeline are derived from its tariff charge in barrels of oil transported through the line. That gross revenue less the cost of operating and maintaining the line less depreciation less interest cost of financing the line will produce the net income figure. From that we deducted any Federal or State income taxes paid to calculate a net-after-taxes income. Similarly, the cash flows to a pipeline company is much like that of any other business, is equal to the net-after-tax income plus any additional cash flows which may be generated because the depreciation chargethat is provided for in the income statement happens to be greater than the volume of bond retirements made by the company. The only place the pipeline operation appears different economically to that of the ordinary company is in the dividend payout allowed each year by the pipeline company to its owners. Again, as was discussed yesterday and this morning, that dividend is not some percentage of equity or some rate of return on capital investment,

but is a percentage dividend allowed on the valuation of the pipeline as determined by the ICC. The ICC valuation approach takes into account many issues: original cost of the line, depreciation, percentage increases for going concern value, and additional percentage increases for inflation. Our computer model had to also simulate this ICC valuation. In very general terms, during the first year of operation we calculated ICC valuation to be about $3.25 billion. In the following years it decreased and increased slightly as additional phases of operation were under way providing for a higher throughput and eventually decreased in value as the line began to depreciated.

The dividend limitation on ICC valuation is a critical variable in the economics of pipeline ownership. Our model, given a dividend rate calculated back up the income statement to find out what kind of tariff would have to be placed on the pipeline any year to provide gross revenue required to generate the appropriate cash flow for the dividend. During the first year of operation of the trans-Alaska pipeline, the 7 per cent dividend limitation provides for a dividend to the parent company of over $230 million, a legal dividend provided only to the owner or owners of the pipeline.

If I may turn your attention now to the large chart located up there, which is also the first chart on the Committee Members' chart portfolio here, it is that very dividend that accounts for the vast difference in estimated income to the State of Alaska under conditions of public ownership on the top line, shown in red on the large chart, versus conditions of private ownership, the bottom line. You will note that both lines slope upward as the throughput of oil through the line increases, clearly shown as a step increase between operation of the line in Phase One, a capacity of 600,000 barrels a day up to Phase Two, a design capacity of 1,200,000 barrels per day. But the graph does not display all of the information which is in the tables alongside of it.

First, in public ownership, the major part of revenue during the early years is derived from dividends with positive and growing amounts of revenue coming from wellhead value royalty and production taxes. You will note that there are no State income taxes included here as a revenue source to the State under conditions of public ownership of the line.

Under conditions of private ownership, a very different case develops. Here in the initial year a total of about $37 million should accrue to the State. Where does it come from? Three million two hundred thousand dollars of it only comes from the North Slope in the form of gas royalty and production tax payments. This is gas that is assumed to be shipped in a trans-Canadian gas pipeline. The remaining $34 million comes from State income taxes. In the 7 per cent dividend case displayed here there is no positive wellhead value for oil during the first two years of operation under private ownership. In this case, for there to begin to be some positive wellhead for oil during those first two years, the dividend payments must be no greater than 4.75 per cent, and even if the dividend was lowered to zero during those two years, the State's income of approximately $53 million under those conditions would be, of course, less than one-third of that estimated as recently as last year.

I shall present at the close of the testimony this afternoon a series of cases for the Committee to study that explore this question of taxation and dividend limition. For the present, however, let us return to these two cases that we have displayed before you. Again, they provide a legal 7 per cent ICC dividend. In the private case, even though a negative wellhead value is indicated for the first two years, it is quite possible that the oil companies would still pump oil as their true cost of shipping their own oil through their own pipeline may be different from their calculated cost of shipping the State's oil through their own pipeline. Not only is the dividend permitted legal, but together with the

costs and throughput capacity limitations as stated in the Impact Statement, this case of private ownership of the line appears quite possible. So are the revenues it generates.

That finishes my testimony. I believe now questions are in order.

CHAIRMAN: We'll take questions from the Committee, Senate group, Senate Commerce Committe; Senator Groth?

SENATOR GROTH: At one time when the legislative oil consultant testified before the Legislature he indicated that it would be possible that the oil companies may hasten the date on which the 2-million-barrels-per-day capacity goes into the line. Assumptions here, as I understand you, are based on the premise that throughput 2 million basrels per day will not be achieved for a period of seven years. My question is: Have you inquired of the companies as to whether they intend to hasten that throughput arrangement to sometime earlier than seven years?

WOHLFORTH: We plan to answer that, Senator ~~Groth~~. The official document which came to the State is dated August 1971, and received and analyzed about in the September-October time frame. We made reference as recently as Friday directly to the main impact Statement itself to determine where that seven-year throughput date was in the official Impact Statement. Commissioner Brewer called the several officials in Washington who could make that determination, and he has assured us that that is the figure that's there. I feel it's a figure we have to live with, and we may hear testimony from oil companies later that indeed that is not the correct assumption, but I really think that's a matter for them to ~~see~~ speak to and perhaps Mr. Sparr, himself, whom I understand is the lead-off and direct witness.

GROTH: Eric, I understand that if you've looked at the Statement, but insofar

as a direct inquiry then, gentlemen, do you intend to do this sooner than seven years? That discussion, I gather, has not taken place.

WOHLFORTH: We've had discussions. I, personally, have not discussed it with any oil company official. Others have, may have, discussed it. I do not know what their direct answers may have been to that statement.

GROTH: Thank you.

CHAIRMAN: Thank you. Are you through? Senator Christiansen. Please stand up and speak up as loud as you can, please, so they can hear in the back.

CHRISTIANSEN: Mr. Chairman, yesterday just before we left I asked a question and I believe Mr. Havelock said that I would be answered later on. As a matter of fact I think you answered part of it when I asked the question came out where this bond, in case it didn't pass, then what would happen? Would we still have the pipeline or what would we do?

HAVELOCK: I think I indicated, Senator, that we are not now proposing that a bond issue be proposed to the people, but we do have a constitutional amendment to propose that will allow State guarantee. That question would be an academic one. There is always the question of whether the people or the Legislature of the State of Alaska wants to do something, and if the Legislature does not wish to do something, then ~~something~~ nothing will happen. The wishes of the people, the wishes of the Legislature are binding on the State.

CHAIRMAN: Are there any other questions? Senator Meland? Members of the, Senator Holm.

HOLM: Perhaps you can tell me why you only made it a ten-year projection or an eleven-year projection on this chart. What happens if project it to maybe 20 years?

EPPENBACH: For reasons of room and also time here, and having our computer results transmitted from Massachusetts to here in Alaska, we confined the analysis to specific years--first five years and then the eighth, tenth, and fifteenth year of operation. We have the ability to make a longer term estimate. We have analyzed ten years of operation with fifteen years of time periods overall. A more direct answer to your question--~~we tried to~~ the trend establish in a graph to about 1988 within stock since you would be in Phase Three Operation at that point. They would tend to level off a bit. There may be some marginal increases but on the whole we would expect the effects of inflation to just about equal both in costs and in higher refining prices of oil.

HOLM: So then you expect the next ten years the distance would level--would start to narrow.

EPPENBACH: That's right. The capacity of the pipeline, as we understand it now, will not be increased ~~in another~~ during these ten years. It would take an increase in capacity to have those charts continue to move up right off the paper.

HOLM: Then one further question. If I were the Alyeska Pipeline Company and knew I wasn't going to get any additional profit from ownership and operation of the pipeline, I doubt if I'd contract with you to build at the same price that I would build if I were building for my own use. Now, are you assuming that they will build at the same price for you as they would build for themselves?

WOHLFORTH: Well, I think we try to achieve comparability in the suit cases. I indicated in my testimony (I hope I sufficiently indicated) that we had now achieved something which we felt was a great deal firmer in concept than we had certainly last July. To achieve comparability in the one case versus the other the $3.5 billion total landed cost of the figure was assumed. It may be, indeed, that that is not the ultimate price. It may be, indeed, that some of the $3.5 billion cost is not an allocable, ascertainable cost of the State or some slight

amount may be more, but as a gross, and I should say perform an economic projection, we thought it would do the Committee a service to stay with the basic landed at stall cost figures.

HOLM: I also assume that you have not considered any other contractor for the construction of this pipeline becuase they are already the owners of all this pipe and a lot of construction so far.

WOHLFORTH: Mr. Campbell is far better--is he here this morning?

CHAIRMAN: Yes, he's here.

WOHLFORTH: Far better to speak to the composites of the $3.5 million ($3.5 billion --I guess I'll do that every five minutes for the next couple of days) which are set forth in the chart which is here before you and indeed there is a figure here which shows costs to date before start of construction and makes component references to costs thereafter. I defer anything further on that to Commissioner Henri.

? With your permission, may I comment first?

HOLM: I just wanted to assume (1) that Alyeska is the only party that you considered as being the contractor for this, and that they then will probably build in a little bit extra cost to the pipeline because they are almost a captive contractor.

HAVELOCK: First of all, Mr. Holm, the State ownership of the pipeline does not mean that there is no interest or profit available to the industry. Their interests and our interests basically identical in one respect--that we all expect to enjoy a substantial benefit to getting that pipe, that oil underground, and moving it to market, and the fact that the incidence of their benefit shifts from the profitsobtained from the pipeline to other aspects of the chain of commerce

doesn't seem to me reduces their incentive. As to the particular incentives in operation, if the pipeline is owned by the State of Alaska and they are a contractor to build that pipeline, they have a particular incentive to operate with maximum efficiency in that construction because under the ICC rule the contractural costs will become the valuation base which we will in turn charge back to the shipping companies for the cost of transportation. So they would then have an incentive which in fact does not exist now to keep costs down. Thirdly, you touch upon a question, or applied in a question which I believe Senator ~~Groth~~ Gross commented on yesterday or addressed you yesterday, which is: What if the pipeline owner/company just don't cooperate? And I think there are three responses to that. First of all, the first response that comes to my mind is: What if the sovereign State of Alaska doesn't cooperate? This is not exactly a situation where the State is without bargaining position. Not only do we have bargaining position, but we also have a substantial interest. This is a situation where the private interest involved vastly exceeds the interests of the public of the State of Alaska.

I may say that in our discussions with the industry we have given some consideration to alternative contractors, but in our discussions have mainly assumed with the industry that in the event that public ownership was deemed to be in the public interest that in fact they would be willing and agreeable to contract. Once they get by the hurdle of public ownership in the first place, as a question of State public policy, I don't believe that we would expect their non-cooperation. There has been no sign in the hundreds of man hours we had in talking with various representatives of the industry that they that they in any ultimate sense, that ~~they~~ the industry would refuse to cooperate. They approach our negotiations with the most--we have had occasional confrontations-type of meetings where tempers where tempers have got up, which is expectable under the circumstances, but they have approached it by and large as a gentleman and

responsible businessman. I have not heard anybody speak in the terms used as to noncooperation. Which reminds me of Commodore Vanderbilt's famous line: "The public be damned--ain't it my railroad?" Nobody has said to us: "The public of Alaska be damned--ain't it our pipeline?" So in the discussions we had, rather than and the people of the State of Alaska, our discussions have pretty well worked themselves out based upon feasibility and the desirability from the point of view of the public policy of the State, and the extent of the commitment or sacrifice that we might be calling upon the industry to make in adjusting these new arrangements. And it is not only a question of sacrifice, of course, but of benfit to the industry. We have not asked them to give up, without compensatory advantages, which we can see for the industry in these arrangements.

The last point I might make on it is that we aren't really going to find out where we are until we have the tools, that is, the permissive legislation which would enable us to go forward and talk with them and move into the next stage of negotiation with the industry based upon an authority bill that the Legislature might adopt. I think it is first for the Legislature of the State of Alaska to decide whether it is the public policy of the State, or should be the public policy of the State, to have public ownership of the line and then to ask questions as to what the attitude of the industry is and whether they are willing to go along rather than the other way around.

Sorry to have talked at such length, but that does meet some of your points.

CHAIRMAN: Are there any other questions on State affairs? Senator Christiansen.

CHRISTIANSEN: Mr. Chairman, I hate to keep asking this question, but talking about $3.5 billion, and if we don't bond outself, where are we going to get that $3.5 billion to build the pipeline? Then if we do build it, are we going to use

this first revenue to pay it back, or?

WOHLFORTH: I may just point out that the pipeline income here is shown under public ownership. This income is after debt service, Senator. Debt service is off before you get to this , that's been calculated. On the assumptions we've made so far, the debt service is shown as a deduction from gross income and this is net income, and I think that may answer a tiny portion of your question. It is assumed that the money would be borrowed in all events.

CHAIRMAN: The next three witnesses will be addressing themselves to the question you raised as to the market situation. Senator Young.

YOUNG: Will we be allowed to call any of these witnesses back again?

CHAIRMAN: That's the plan. The reason we're departing from the regular procedure is that because this witness will probably not be available at that time. Address questions to the administrative or administration officers. Mr. Rose.

ROSE: Only one question Mr. That's on the difficulty on our payment during the initial payment statement Civil revenue starts going in. Now, I assume that the bonds require a yearly net interest payment, and how would that be met?

WOHLFORTH: Again, we'll address more specifically from the case of authority bond issue by Mr. Kades. Explained As with other public authority issues, interest is borrowed or capitalized during the construction period.

CHAIRMAN: Any other questions, members of the State Affairs Committee? Senator Rettig.

RETTIG: Question to Mr. Wohlforth. You referred to the first table in the indicated income from the pipeline under "Private and State Ownership." In the year 1988 you called our attention to the sharp drop in pipeline income from $235 million

in 1983 to $183 million in 1988, and I believe you attributed that to the impact of depreciation that had then taken place. Recalling Mr. Temple's testimony of yesterday, it indicated that pipeline valuation, which is the base ICC permitted profit, you stated, I believe that this valuation was based on replacement costs. Well, what effect would this depreciation have then, if that be the case?

WOHLFORTH: First, let me say, Mr. Chairman, I'm going to turn this over to Mr. Eppenbach who will have the full text of Mr. Temple's testimony before you hopefully within an hour or so, and you take it away on that basis, Larry.

EPPENBACH: Senator, replacement cost is clearly a function of replacement from original cost. The higher the value of the line, then, the larger the dividend, assuming a constant rate of dividend, whether it be 5.5 or 7 per cent, or higher. Now, Peter Herbert Temple did testify that replacement cost was a significant component of the ICC valuation formula. In developing this model to simulate what ICC valuations would be in any particular year, we did include a percentage inflation factor to estimate replacement costs. We found, however, that the formula was quite complex, and in later years it was also a component of the formula, we'll call that depreciation, so that the net effect was yes, inflation was there it was beefing up the value of the pipeline for a period of time, but then eventually using the ICC's own table for depreciation. The value of the pipeline fell off. Now, I can't tell you more than that right now other to say what we did--what will happen--how the ICC will value the pipeline. As far as I'm concerned, it is a matter of great uncertainty right now. Thank you.

RETTIG: That's all I have.

CHAIRMAN: Are there any questions now from other members of either the House or the Senate? Senator Palmer.

PALMER: Yes, Mr. Chairman. Perhaps this information has already been given

and, if so, please forgive me, but I do have four questions--they are all related. We will all hope, of course, that there will be many more structures found on the North Slope that will use the pipeline. On the other hand, we have to assume that there may not be. Therefore, what figures do you ~~have~~ for ~~First of all for total~~ Prudhoe Bay Reservoirs and then the amounts recoverable? We did think of that yesterday, I think, but I would like to know what figures you used.

WOHLFORTH: Really, Mr. Herbert is the expert witness on this subject. We know, Senator Palmer, that 9.4, which is the de ~~Gaulle~~ Galle, or 9.6 billion, which is the de ~~Gaulle~~ Galle-McNaughton proven reserve estimate, has been variously assumed to have been increased to $14 billion, and in a Canadian magazine referred to as 50 billion in the total field and adjoining field. The figures that we used, very frankly, showed enough oil to flow for 25 years to amortize at the rates of, amortize a $3.5 billion bond issue.

PALMER: Do you have that figure?

[illegible]

EPPENBACH: No sir. We made that assumption that given the 9.6 billion barrels proven today that there would be additional (cough) reserves proven by the time (cough) within the first or the last bond issue was issued to support a 25 year debt. They contrasted that on private financing, that is, ownership of the line by private industry. We calculated 30-year debts, assuming they would also pledge their credit behind their bonds.

PALMER: You are basing the debt service on the assumption that there will be a reserve found? The pipeline will be utilizing those reserves in addition to the Prudhoe reserve?

WOHLFORTH: That's correct.

Palmer: That concluded my group of questions.

CHAIRMAN: Are there any further questions? Senator Rettig.

RETTIG: Just one item of clarification to Mr. Havelock. Perhaps in your

in reference to your comments that the State does have a certain amount of bargaining power because its, ah

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TAPE # 8

Senator Rettig: The oil that we are speaking about, have we not already sold the 7/8th interest in that oil and is not that now a right to the 7/8ths of the oil invested in the oil companies, doesn't this perhaps give them some sort of a weighted vote in these matters:

Havelock: Well I think that certainly in our discussions Senator, we have attempted to weigh and recognize the private rights that are involved, and I don't mean by any means to suggest that the private rights of the industry should not be given all the considerations appropriate. While the oil is in the ground, my understanding is that it is the oil of the people of Alaska and if the leases are not exploited it will revert to the people of Alaska, but certainly you are quite correct that 7/8ths that one, as the oil comes out of the ground, it's theirs and it is entitled to be given recognition as we recognize any body else's right to private property in the State.

Senator Rettig: Are there any other questions now? (Ten minute break)
The State of Alaska would like to call the Honorable Joseph Henri, Commissioner of Administration who will testify as to the impact of State revenues on the State budget and related issues. I am state as Mr. Henri has found, that in discussion with him he has indicated that he would like to have the opportunity to get full presentation before the committee in advance and that if he has no objections to questions relating to his testimony when he concludes his remarks. I would like further to say with regards to, I said the later witnesses would be answering Senator Christianson's questions, I was really referring to Mr Kades, Mr. Gilderhouse, and Mr. Macy who are the witnesses that follow Commissioner Henri.

Joseph Henri: Written Testimony

TESTIMONY OF JOSEPH R. HENRI
Commissioner of Administration, State of Alaska,
Before the Senate Commerce Committee
And the House State Affairs Committee
At Juneau, Alaska, 6 March 1972,
Regarding Income From North Slope Oil and Gas,
And How it Affects the State Budget

Mr. Chairman and Members:

I am Joseph Henri, Commissioner of Administration. This part of the State's presentation deals with budget expenditures vis-a-vis income to be derived from North Slope oil and gas extraction. The essential questions are:

1. Will we be able to maintain our current level of services, adjusted for population growth and inflation?

2. Will we be able to increase our level of service to meet compelling needs recognized by this administration, the legislature and the citizens of Alaska?

3. Will we have to reduce our level of service, and if so, what are the activities affected?

The answers to these questions rest in the amount of dollars the State can expect as its share of the Prudhoe Bay oil basin. Once upon a time, the Department of Administration felt much more certain about future State income than it does today. When will the

pipeline begin? What extraordinary man-caused interruptions will delay its completion? What will be the first year capacity of the line? The second year? The third? What is the maximum extraction rate the basin structure will prudently allow? What volumes of oil can be expected in any of the first seven years of the pipeline? What will be its final cost?

All of these variable factors, well known to each of us in this room, make budget planning extremely difficult, because the major part of Alaska's State revenue has come and will come from ~~the~~ North Slope resources. In the budget now pending before the legislature, we have recommended a total general fund expenditure of $311.7 million; these are state dollars. of this sum, $97 million will have to come directly from the Prudhoe Bay bonus money, the principal, and $52 million more from interest earnings on the investment. As we dip heavily into the corpus - invade the principal - interest earnings diminish, compounding the revenue problem. Our present or anticipated re-curring revenues are simply too low to fund our present and anticipated expenditures. We are depleting our savings account. As the following year's budget figure increases, more of the principal will have to be spent; the interest yield will dwindle further. Obviously, we will soon hit the bottom of the barrel. Only large and new revenues from the North Slope can allow us to continue our present budget growth rates.

What is the growth rate we have recommended for Fiscal Year 1973? For the general fund, it is 3.5%; for the total budget, 4.6%. We have had to slash so dramatically the rate of increase because pipeline delays and cost escalations have darkly influenced

our future revenue projections. With such a small increase in the budget, a number of programs have already felt the chill winds of dollar scarcity. The proposed Fiscal Year 1973 budget contains such unpalatable things as holding school foundation funding to the current year's level, regardless of enlarged student population; keeping the University's of Alaska increase to $800,000 in the face of a claimed need for an addition of over $5 million just to maintain current activities; a limitation of nursing home care and general medical relief; foregoing general obligation bonds for lengthening two more ferry boats, and for a larger program of airport construction. There are many more "pinches" in the budget, besides those I have mentioned. Nonetheless, so far we have not jeopardized any State activity essential to health and safety. These painful adjustments herein noted were recommended in spite of the fact oil was projected on stream in July 1976; now another year's delay - or more - seems probable. The consequences are obvious.

Our budget book for Fiscal Year 1973 projects a growth rate of 6% compounded annually through 1976, and 8% thereafter through Fiscal Year 1977 1981, covering a ten-year period. Further, it envisions capital improvement bond authorizations of $60 million in 1974, and $100 million in the next biennial election, and each one thereafter. I can only characterize these projected budgets as "modest." They are very little more than maintenance figures. Program dollars will still be limited. Careful budgeting and allocation will still be required. New starts and new programs will be exceedingly selective. The 6 and 8% growth rates most likely mean a shortage of funding for the school foundation plan, and for the revenue sharing program with local governments. Yet, I express to you the gravest concern that actual receipts in the State treasury during the next ten years may be pitifully shy of the sums needed even to maintain our austerity.

Previously, in the testimony of Commissioner Wohlforth and the Department of Revenue, test cases have been articulated regarding revenue to be derived under (A) private ownership and (B) State ownership of the crude oil pipeline. All of us realize that a multitude of variations in revenues and expenditures are possible under each heading, that is under private ownership or public ~~xxxxxxxx~~ ownership. Nevertheless, for purposes of comparison we have presented two likely cases and their dollar results: Both examples entail the seven-year oil volume build up delineated in the Department of the Interior Environmental Impact Statement submission by Alyeska, a 7% dividend to the owner, a line cost of $3.5 billion, and oil on stream in July 1977.

Exhibits A and B, attached at the conclusion of these remarks, protray the figures - and the story - for the decade 1972 - 1982.

We might ~~x~~ just pause, Mr. Chairman, and refer the committee to those for a second if I may. Exhibit A is the computer run on private ownership, and you can see the assumptions that go into these calculations, the debt service for each year on these bonds, the growth rates of the budget for each year, and so forth. Then Exhibit B, are the same assumptions, identical assumptions based on private ownership. I beg your pardon, Mr. Chairman, Exhibit A is the private ownership and Exhibit B is the public ownership. As you can see the bottom column of the right hand side in exhibit A that is the general fund at the end of the fiscal year 1982, has a deficit of $1,135,000,000 under the private ownership case, whereas in exhibt B, the general fund in the lower right hand column at the same year at the~~xxx~~ end of fiscal 1982, has a surplus in it of $450,000,000. Those runs of course need to be carefully studied and I shan't take up your time this morning with them.

Under the private ownership case, Exhibit A, were Alaska to continue to increase its budget expenditures at the 6 and 8% rates, mentioned earlier, the first year of

deficit would be Fiscal Year 1978, wherein we would experience a shortfall of over $156 million. This shortage would increase so that by Fiscal Year 1982 the deficit would be $1,135,000,000. Of course, deficits for operating expenditures are in fact impossible under our State constitution; instead of experiencing a billion dollar deficit ten years from now, we would in actuality have to reduce State expenditures radically.

Under the private ownership case the State could have in its treasury at the end of Fiscal Year 1982 the sum of $45 million if, and only if, its operating expenditures in every year of the planning decade rose annually by only 1%. Now an increase of 1% equals in fact a huge cut in all programs, and the elimination of many. And what the figures look like in that case are protrayed in Exhibit C which is the computer run showing budget increases of 1% annually over that period. And, the assumptions there are the same, the assumptions as of the first two exhibits; when the line will start and through what volume and so forth.

The dollar crunch is graphically portrayed by the following paradigm. Under the private ownership operating budget column, increasing annually at 1%, the available dollars, are, recorded. And there, Mr. Chairman, if I may direct the committee's attention to the following page of my testimony, page 6, to the paradigm which is also available, I thought they were in big figures, they are when you try to see them on the wall over Mr. Weiner's head. In the charts called "Comparison of Funds Available, Private vs Public Ownership, and I might say all these figures are in thousands so that actually the figures on the paradigm are in millions of dollars. It addresses itself only to our operating budget. Now this year for a base of reference in our budget book is $276 million. This figure is referenced in my testimony under fiscal year 1973. So getting into the 1974 budget, which is the one the legislature will be considering just next year, you already begin to see a difference in available dollars under public and private ownership, whereas under public ownership in 1974 we would have available to spend approximately $293

million, under the private ownership plan there would only be available $279 million. And so forth on up where you get into very dramatic areas. Let's compare, for instance, fiscal year 1978 which isn't too many years away, under State ownership of the pipeline in the example we furnished you here, the state would have to spend on operations, that's not the total budget, just the operating portion, $384 million whereas under private ownership the state would have to spend in the same YEAR for operations, $290 million. Almost $100 million difference in that year. And as we say at the end of the column of figures the difference over the planning decade, in operating expenditure OPERATING DOLLARS the State would have available to it ~~would be~~ IS $925 million. The difference in CAPITAL debt authorizations, that is ~~capital improvements~~ THE NUMBER OF BUILDINGS AND OTHER IMPROVEMENTS, ~~what~~ THAT the legislature and the people would authorize, ~~is~~ WHAT WE COULD AFFORD WOULD BE a difference of $365 million, WORTH OF BUILDINGS PLUS

Returning, then, to my testimony, Mr. Chairman at the top of page 5.

The Contrast ~~these with the operating budget under~~ public ownership, ~~the first~~ column ~~on the left~~. ~~The figure~~ shows that if the State of Alaska owned the pipeline there would be sufficient dollars in each of the next ten years to meet our planned 6 and 8% annual increases. In fact, the revenue would be sufficient to raise the budget from these maintenance or austerity levels so that expansion of present services and the addition of new ones could be handily realized. Were the oil line privately owned the State would have almost a billion less dollars to spend over the next ten years and We would be able to authorize 365 million fewer dollars for capital improvements.

I might say, Mr. Chairman that the 6% and 8% increase in the budget ~~which is~~ THAT'S portrayed in our budget books ~~presented~~ SUBMITTED to you in January, by THE GOVERNOR those increases were projected on the State Revenue Projections figures which Commissioner Wohlforth and Mr. Eppenbach TO THE COMMITTEE EARLIER HAVE discussed in great detail this morning. Now the projections are not valid because the revenues will not materialize at the dollar amounts portrayed to you in the revenue book. Going on to page 7.

You might want to briefly look at these Mrs. Chairman.

The attached graphs, Exhibits D and E, portray what I have been saying. Exhibit D is on the front of the room behind the co-chairman - behind Mrs. Briggs and it shows in graphic form what we have just testified to, that if the budget went up at the 6 and 8% rates under the private ownership example here, the general fund would be depleted, completely depleted in January of 1978, in the middle of fiscal year 1977, that is the blue line on the left of the chart. Whereas under public ownership, State ownership of the pipeline, the State general fund would dip to a low of $231 million in the fiscal year 1976 and go up at the end of the decade we're speaking of, 1982, to about $450 million in the Treasury. That's exhibit D, Exhibit E is the graph portrayal of Exhibits B and C. In other words Exhibit B is the public ownership case raising the budget at 6 and 8% and Exhibit C is the private ownership case, you might say the subsistence case, whereby the State budget would go up 1% annually. And if the State budget were to go up only 1% annually under the factors given in our private ownership example here the State treasury would have $45 million dollars in 1982. But as I say, all of the programs we have believed in would have been decimated thoroughly.

In Exhibit D, under private ownership of the oil pipeline, the general fund would be depleted around January of 1978. On the contrary, under State ownership of the line, the precipitate dive to insolvency would stop in 1976 at a general fund balance of $231 million, and rise to a plateau of $450 million in the general fund by 1982. Furthermore, as Exhibit B shows, the total expenditure for that year would be approximately $605 million, and the total revenue $602 million; a parity between income and expenditure would have been achieved, and a surplus of almost half a billion dollars enjoyed. In actuality, no doubt, were the funds from State ownership available, the administration and the legislature would have expanded the budget faster than the 8% increase portrayed for the years 1977 and beyond so that no such surplus would likely exist at the end of fiscal year 1982.

The private ownership case I have presented to the Committeees, Mrs. Chairman,

necessitates an abrupt and drastic reduction in State services and activities. I cannot tell you with certainty where the administration or the legislature would cut, but I can cite a few startling and likely areas of impingement in each of our program categories:

The State pays approximately 90% of local ~~xk~~ school district costs, constituting roughly 30% of annual State dollar expenditures. That State aid would be materially reduced; it would be impossible for the local areas to maintain present educational standards through increased property taxes. State Operated Schools and the University of Alaska would have to radically abate their present service levels.

The welfare or social services activities of the State would experience vast curtailment in the number of eligible cases and the amount of benefit dollars; many people would be compelled to leave Alaska; distress or even starvation would haunt many who decided to stay. Public health and mental health retrenchments could force the closing of the Alaska Psychiatric Institute, and a diminution or abolishment of the State's work in drug abuse, alcoholism, tuberculosis testing and venereal disease control. The necessitated nullifications of State expenditure in these areas will in turn lose large amounts of federal dollars now enjoyed. Our ability to operate and maintain an effective Pioneers' Homes program will be materially impaired.

No new fish hatcheries would be built. No hunter safety program would be initiated. Salmon yields in Southeast Alaska would remain significantly below maximum sustained yield. Land use planning and the inventorying of our natural wealth would be jeopardized, thus making management of the State's surface and subsurface resources haphazard at best. Added park and recreational sites would be forgotten, and the maintenance of existing facilities lessened. Many Alaska communities would remain without sewage treatment facilities. Programs for coastal zone management, environmental engineering, permafrost and soils engineering would likely be abolished.

In the category of Public Protection, disaster planning, the Public Utilities Commission, the Alaska Transportation Commission, and most consumer protection programs would be impaired or fatally weakened.

The State police would experience a great shrinkage in manpower, and the courts and their ancillary agencies could not cope with their workloads.

Tourist promotion would have to be seriously curtailed and our work in research, in community improvements and grant assistance, and conventions and trade shows would most likely fall by the board. The work of the agricultural loan fund and the small grain incentive program would be enfeebled or eliminated. The Division of Planning and Research and the State Economic Opportunity Office would be crippled or possibly dropped.

Our program of revenue sharing with the local governments, around $7 million in the current year, would no doubt go out the window. The Marine Transporation System for Southwest Alaska would likely be eliminated, and service in Southeast materially contracted. Airport maintenance in rural Alaska would be severely curtailed, likely forcing the winter closure of those ports, thus isolating a large part of Alaska for five months of the year, denying medical and other critical services. Likewise, winter maintenance of many of our highways would be only a pale reflection of the excellent job being performed today.

The various boards and commissions whereby Alaskan citizens take a direct and active part in the work of the State government would be minimally funded, or in some cases, unfunded. I am speaking of activities like the Western Interstate Conference on Higher Education, the Athletic Commission, the Status of Women Commission, the International Development Commission, the Pioneers' Advisory Board, the Yukon Taiya Commission, the Rural Affairs Commission, the International North Pacific Fisheries

Commission. Our Youth in Government program, recently instituted with such great success, would likely be abandoned.

I might say, Mr. Chairman, that I notice a certain aura of disbelief when I recite these cuts here, but I can tell you from my own experience as chairman of the budget review committee, that each one of these representations I have made, is made with a lot of insight and forethought, and I am absolutely confident that if the revenues materialize as projected under the private ownership case, very many of the exact programs I have mentioned will have to be severely cut or even abolished. There is no other way to do it, our State does not have the ability to, as you know, _____ with huge annual deficits. We have to make our budget balance. I do not represent to you as the view of this administration, that each of these reductions suggested above, would come to pass under the private ownership case, where trade in Exhibits A and C. Nevertheless, no one can say that many of the above dire consequences would not eventuate under that case. Undoubtedly some would. The ~~ec~~ economic and social dislocation would be grievous indeed.

The purport of my remarks is that this State has a vital interest in an adequate share of North Slope riches. If we do not realize that share, State expenditures over the next decade will be woefully inadequate to do the job Alaskans expect from their government. The solution we propose to sufficiently fund the budget is the ownership of the crude oil pipeline by the State of Alaska.

I thank you for your attention.

Mr. Hyde

Groh: May we have questions now from the members of the Senate.

COMPARISON OF FUNDS AVAILABLE

PRIVATE VS PUBLIC OWNERSHIP

(ALL FIGURES IN 1000)

FISCAL YEAR	PUBLIC OWNERSHIP OPERATING BUDGET *	PUBLIC OWNERSHIP DEBT AUTHORIZED	PRIVATE OWNERSHIP OPERATING BUDGET *	PRIVATE OWNERSHIP DEBT AUTHORIZED
1972	260186.5	71000.0	260186.5	71000.0
1973	276232.7		276232.7	
1974	292910.7	60000.0	278994.8	15000.0
1975	310485.1		281784.3	
1976	329114.1	100000.0	284601.8	20000.0
1977	355443.1		287447.4	
1978	383878.5	100000.0	290321.5	20000.0
1979	414588.8		293224.3	
1980	447755.8	100000.0	296156.1	20000.0
1981	483576.2		299117.3	
1982	522262.2	100000.0	302108.1	20000.0
TOTAL	4075433.7	531000.0	3150174.8	166000.0

* All figures refer to expenditure from general fund only

Difference in Operating Expenditure is over $925,000,000

Difference in Capital Debt Authorization = $365,000,000

Exhibit A

STATE OF ALASKA
DIVISION OF BUDGET AND MANAGEMENT

BUDGET PLANNING MODEL

Private

RUN ID RUN 3

DATE MARCH 3, 1972

COMMENTS
PRIVATE OWNERSHIP
7% TARIFF
BASE CASE
OIL IN 77

ASSUMPTIONS

ANNUAL RATE OF INTEREST ON GENERAL FUND = 6.00%

ANNUAL RATE OF INTEREST ON NEW BONDS = 6.00%

MATURITY PERIOD ON NEW BONDS IN YEARS = 20.

% ABOVE G.F. UNENCUMBERED BAL. UNEXPENDED = 0.0 %

GROWTH RATES FOR OPERATING EXPENDITURE FROM PRIOR YEAR

1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
6.20	6.00	6.00	6.00	8.00	8.00	8.00	8.00	8.00	8.00

NEW BOND AUTHORIZATIONS IN EACH YEAR

1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
71[illegible].0	0.0	60000.0	0.0	100000.0	0.0	100000.0	0.0	100000.0	0.0

FISCAL YEAR	NON INVESTMENT REVENUE	INVESTMENT INTEREST	TOTAL REVENUE	OPERATING EXPENDITURE	DEBT SERVICE	MISC EXP SHD TAXES OF CAP EX	TOTAL EXPENDITURE	SURPLUS OR DEFICIT	GENERAL FUND END OF YEAR
1972									761268.2
1973	162264.1	42466.7	204730.7	276331.0	24020.8	11358.6	311710.3	-106979.6	654288.4
1974	182367.0	35772.1	218139.0	292910.7	29646.2	11756.5	334313.4	-116174.4	538114.0
1975	190047.0	28146.4	218193.4	310485.1	3297315	12749.8	356208.4	-138015.0	4CCC99.0
1976	136752.0	18960.8	207712.8	329114.1	33479.2	13290.6	375883.8	-168171.1	231927.9
1977	220569.0	8673.9	229242.8	355443.1	35373.3	13153.0	403969.4	-174726.6	57201.4
1978	225954.9	-2988.6	222966.3	383878.5	39390.5	13719.0	436988.0	-214021.8	-156820.4
1979	314776.0	-14823.9	299952.1	414588.8	42494.9	23358.3	480441.8	-180489.8	-337310.1
1980	329299.9	-26743.6	302556.3	447755.8	46529.0	25105.1	519389.9	-216833.6	-554143.8
1981	332012.4	-41200.4	290811.9	483576.2	47129.4	25167.5	555873.0	-265061.1	-819204.8
1982	344154.7	-58641.5	285513.1	522262.2	52863.3	[illegible]8.5	601824.0	-316310.9	-1135515.0
	2490194.0	-10379.5	2479816.0	3816342.0	383899.9	176356.8	4376599.0	-1896782.0	

AGO 530752

Exhibit B

STATE OF ALASKA
DIVISION OF BUDGET AND MANAGEMENT

BUDGET PLANNING MODEL

RUN ID RUN 4

DATE MARCH 3, 1972

COMMENTS
PUBLIC OWNERSHIP
7% TARIFF
BASE CASE
OIL IN 77

ASSUMPTIONS

ANNUAL RATE OF INTEREST ON GENERAL FUND = 6.00%

ANNUAL RATE OF INTEREST ON NEW BONDS = 6.00%

MATURITY PERIOD ON NEW BONDS IN YEARS = 20.

% ABOVE G.F.UNENCUMBERED BAL. UNEXPENDED = 0.0 %

GROWTH RATES FOR OPERATING EXPENDITURE FROM PRIOR YEAR

1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
6.00	6.00	6.00	6.00	8.00	8.00	8.00	8.00	8.00	8.00

NEW BOND AUTHORIZATIONS IN EACH YEAR

1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
71000.0	0.0	60000.0	0.0	100000.0	0.0	100000.0	0.0	100000.0	0.0

FISCAL YEAR	NON INVESTMENT REVENUE	INVESTMENT INTEREST	TOTAL REVENUE	OPERATING EXPENDITURE	DEBT SERVICE	MISC EXP SHD TAXES OF CAP EX	TOTAL EXPENDITURE	SURPLUS OR DEFICIT	GENERAL FUND END OF YEAR
1972									761268.2
1973	162264.1	42466.7	204730.7	276331.0	24020.8	11358.6	311710.3	-106979.6	654288.4
1974	182367.0	35772.1	218139.0	292910.7	29646.2	11756.5	334313.4	-116174.4	538114.0
1975	190047.0	28146.4	218193.4	310485.1	32973.5	12749.8	356208.4	-138015.0	400099.0
1976	188752.0	18960.8	207712.8	329114.1	33479.2	13220.6	375883.8	-168171.1	231927.9
1977	430209.0	15116.4	445325.4	355443.1	35373.3	14482.8	405299.1	40026.3	271954.3
1978	434394.9	16695.3	451090.2	383878.5	39390.5	15217.0	438486.0	12604.2	284558.4
1979	547046.0	19533.7	566579.7	414588.8	42494.9	27486.9	484570.4	82009.3	366567.7
1980	550369.9	23532.2	573902.1	447755.8	46529.0	28343.7	522628.5	51273.6	417841.3
1981	567982.4	26121.0	594083.3	483576.2	47129.4	28359.7	559065.2	35018.1	452859.4
1982	575119.7	27090.4	602210.1	522262.2	52843.3	29787.4	604912.9	-2702.8	450156.6
	3828529.0	253434.8	4081965.0	3816342.0	383899.9	193 .9	4393075.0	-311111.4	

AGO 530753

Exhibit C

STATE OF ALASKA
DIVISION OF BUDGET AND MANAGEMENT

BUDGET PLANNING MODEL

Budget Increases Annual

RUN ID RUN 3

DATE MARCH 3, 1972

COMMENTS
PRIVATE OWNERSHIP
7% TARIFF
1% GROWTH
GREATLY REDUCED CAPITAL EXPENDITURES

ASSUMPTIONS

ANNUAL RATE OF INTEREST ON GENERAL FUND = 6.00%

ANNUAL RATE OF INTEREST ON NEW BONDS = 6.00%

MATURITY PERIOD ON NEW BONDS IN YEARS = 20.

% ABOVE G.F.UNENCUMBERED BAL. UNEXPENDED = 0.0 %

ANN OPER EXPEND GROWTH RATE AFTER 1ST YR = 1.00%

NEW BOND AUTHORIZATIONS IN EACH YEAR

1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
71000.0	0.0	15000.0	0.0	20000.0	0.0	20000.0	0.0	20000.0	0.0

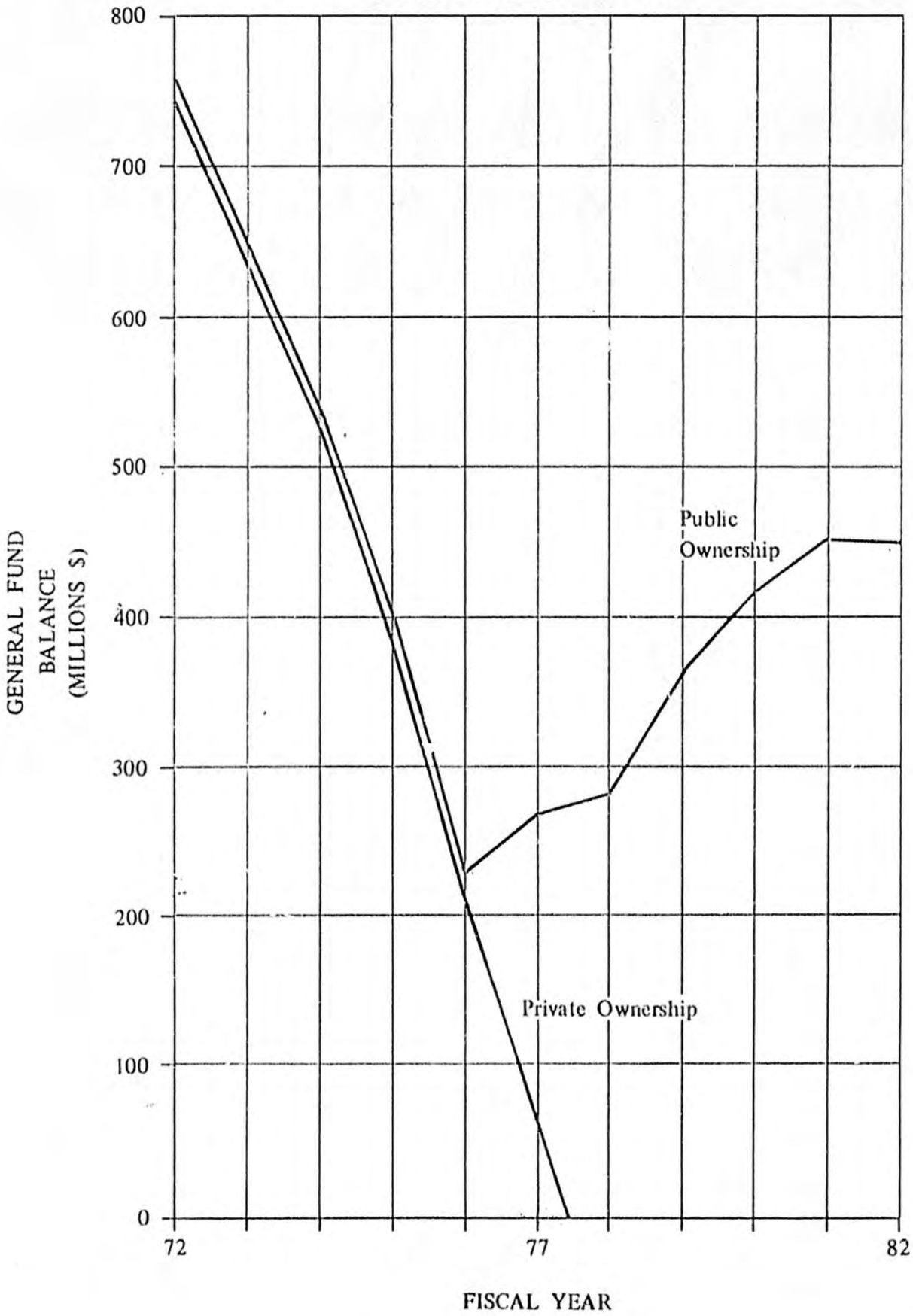
FISCAL YEAR	NON INVESTMENT REVENUE	INVESTMENT INTEREST	TOTAL REVENUE	OPERATING EXPENDITURE	DEBT SERVICE	MISC EXP SHD TAXES GF CAP EX	TOTAL EXPENDITURE	SURPLUS OR DEFICIT	GENERAL FUND END OF YEAR
1972									761268.2
1973	162264.1	42469.7	204733.8	276232.7	24020.8	11358.6	311612.0	-106878.3	654389.8
1974	182367.0	36208.7	218575.7	278994.8	29646.2	11756.5	320397.5	-101821.8	552567.9
1975	170047.0	29928.1	219975.1	281784.3	32973.5	12749.8	327507.6	-107532.5	445035.4
1976	188752.0	23147.4	211899.3	284601.8	32478.4	13290.6	330390.6	-118491.3	326544.1
1977	220569.0	16705.2	237274.2	287447.4	32921.2	13153.0	333521.5	-96247.3	230296.8
1978	225954.9	10787.1	236741.9	290321.5	33723.5	13719.0	337764.0	-101022.1	129274.8
1979	314776.0	6882.4	321658.3	293224.3	34212.3	23358.3	350794.8	-29136.4	100138.3
1980	329299.9	5394.7	334694.5	296156.1	33687.2	25105.1	355148.3	-20453.8	79684.5
1981	332012.4	4182.2	336194.5	299117.3	31872.0	25167.5	356156.8	-19962.3	59722.2
1982	344154.7	3140.6	347295.2	302108.1	33246.7	26698.5	362053.3	-14758.1	44964.1
	2493194.0	178845.6	2667040.0	2899986.0	319031.6	17[illegible].8	3385343.0	-716303.9	

AGO 530754

Exhibit D

ENDING GENERAL FUND BALANCE

Private vs Public Ownership
Budget Book Expenditure Plan

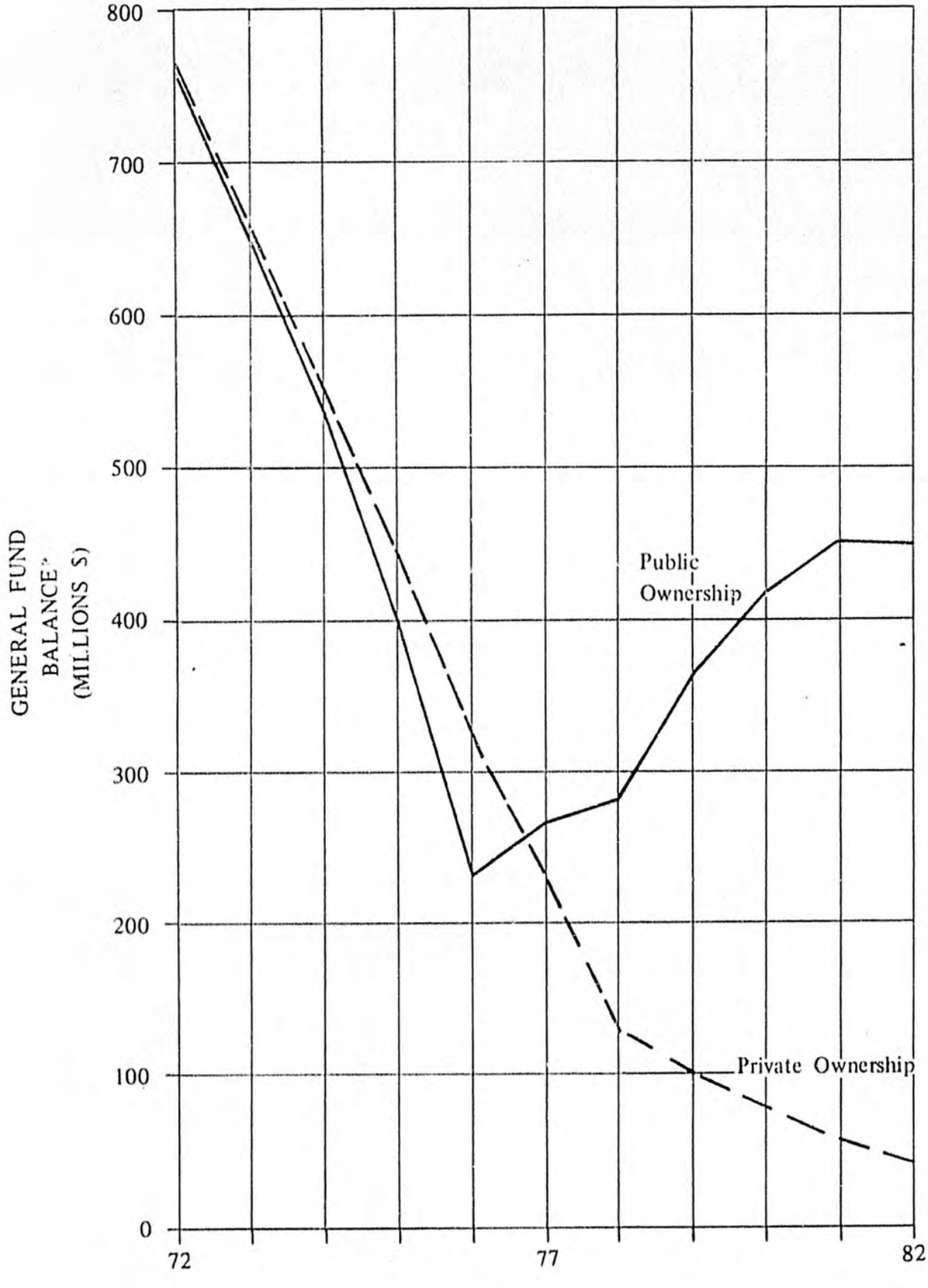


AGO 530755

Exhibit E

ENDING GENERAL FUND BALANCE

Public Ownership Budget Book Expenditure Plan
vs
Private Ownership Subsistence Expenditure Plan



AGO 530756

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

TAPE # 9

...Groth:...selected land less valid federal leases, and just the other day here within the last couple of months we have selected another 77 million acres. You anticipate no revenues from any of these places?

Henri: Senator, the examples I have given you, Exhibits A and C on the private case do not contain any private ownership, any further income of the private ownership case but I'd like to fortify or expand on that observation by saying the amount we are spending over income right now is about $150,000,000 over/this year and as the budget increases, the dollars over income will expand rather dramatically and so except for the Prudhoe Bay oil in those huge volumes there would be no way in my estimation to lift further bonus sales ~~from~~ or some other economic development to make up the dollars we need to increase the budget even by 6% to say 8%, so let me say that just by general allusions of possible sales and possible income we analyze those possibilities the dollar volume is not there.

Groth: It still remains inconceivable to me if you can make $900,000,000 out of 400,000 acres which is what we did, you have a million and a half acres right there in round figures, I don't know what the correct figure is, but that is what Chuck testified to, and if you've got 77 million acres of additional land or at least in that portion of it which we're going to get out under the Statehood act, whether that's 77 million acres is it or not, I don't know how you can conceiveably say that that is going to produce zero money. And in the case of the public versus private ownership of the pipeline you say that that is going to produce zero money in order to argue for the public ownership, it just doesn't seem reasonable. I can't conceive that nothing is going to come out of that.

Henri: Senator, I am addressing my remarks for the next planning decade not presume for the next 50 years and I ~~assume~~ that once the environmental business is settled satisfactorily for this country, that leases will be valuable again, but I am very doubtful that any oil company is going to go up and lease further land until they are pretty sure about whether they know what the government is going to do about their present holdings. So I don't believe that it is prudent at all to anticipate income up there in the reasonably ~~recent~~ near future. And further on the amount of dollars if we were to find a taker for our future lease offering, you will notice that Commissioner Herbert's testimony covered, i think it was almost a million dollars sold before the September, 1969 sale which brought in hardly a tenth of that. In other words, there may be a ~~land~~ unique sale.

Groth: Mr. Chairman, I understand Joe, my problem is that i can't conceive that in these projections that you have, did not feed anything in on these estimates on the basis that all of the other lands that the State owns, and all of the other interests/ the State has , and the/ the boom and doom here is to what is going to happen to get into public ownership of the pipeline is the inevitable result without putting in any bucks at all for all of these other assets. And that is where I have the problem.

Not to be argumentative, believe me I am not going to be arguing to be

HENRI: My references from a budget point of view , now there is an underlying conviction that we have here from the Governor on down, and that is that the budgets of the state should be increasing steadily and systematically, in other words you shouldn/t have a budget that high rise then next year cut off a lot of people who have been depending on these expenditures, so unless we can pretty clearly say that out there somewhere ~~xhex~~ at the end of the ten year period that there is going to be some more money coming in, if we can't ~~xxxxx~~

say that with some certainty then we have to adjust this years spending and next years spending as if there wern't that money there because it is too speculative, it too remote, and that, what I am addressing myself to is the budget and if we can't reasonably calculate some money out there then I think the budget has to be adjusted each year now as if ~~we are~~ we weren't going to get the money. Now that's based on one thing that is different since 1970, and that is that we are spending beyond our income in this State for the first time. We would have no trouble anywhere near like that if our expenditures were equivalent to our ~~income~~ income, but it is not, as I say we are spending almost twice as much as we are taking in which means that our savings account will be depleated, and then where are we if these new revenues do not materialize.

Groth: Without being argumentative Joe, you presume those to sign in zero value to all that other land and that 77 million acres and I respectively suggest to you that it may have some value greater than zero, and if you feed that into the projections then all of the alcoholism, VD center, programs athletic commissions and youth commissions might still continue.

Senator Young: Mr. Chairman, first let me say that I think Sir has made my complete report of the presentation some of the proposed testimony taken place at the present place in the administrative & state tax game protection right now.

But one thing bothers me, Mr. Henri and this is if we build this pipeline we have to go into debt or a guaranteed debt of 3-1/2 billion dollars, what effect is this going to have on proposed bond issues already before the legislature, for instance 6 million for highways, sewers and waters, etc. According to my latest figures it will be so far in debt for guarantees that there will be no market for the bonds

they are putting before the legislature now.

Henri: Senator, I would like to refer the answer to that if I may to Mr. Macy, who is here from Kuhn, Loeb and also Commissioner Wohlforth who I think can do a better job.

Wohlforth: I think the basic answer to that question is that, as I represented in New York as I stated about a month ago, a North Slope bond issue of necessity would have to be so well secured and so able to stand on its own feet that it would not jeopardize ordinary State bonding programs, that the essential security of state general obligation bonds are recurring revenues of the State of the State's ultimate power to tax on an ad valorem basis its 2.7 million assessed evaluation. What we are talking about here and what will be described in detail by Mr. Gilderhouse and Mr. Macy is a bond issue which is essentially self liquidating and which does not reflect adversely and therefore would not reflect adversely on the State's general obligation bonding power. It would be I believe a separate sustaining utility type bond issue, as compared to our general obligation bond issues each of which do encumber our States credit and each of which are assessed in the bond rating communities on a per capita debt basis, on the basis of assessed valuation to total bonded indebtedness. In addition it is pointed out to me that as said previously that we, the bond issue of this size can have a positive effect on Alaska bonds of necessity it would reach a broad market of new investors and create interests in Alaska, those, a range of investors in Alaska that are growing now but who have not yet nearly reached the number we had hoped for, and of course the net income which we show available after debt service in the public case, is income to the State

treasury.

Young: O. K. Let's carry this thing a little further. Lets say the pipeline to build, if the state builds the pipeline, we're dealing with a world energy here and if they find that other oil companies or companies find a cheaper source of power for world energy, now true they have to produce a certain amount, but what if they are not competitive ~~sources above that leave~~ the the State. In paying their bond issues off.

Wohlforth: To a certain extent I have ~~xkx~~ analagized this with the question which was posed yesterday, there was a replacement found for ~~xpossibx~~ Fossil Fuels, we expect a replacement from Fossil Fuels maybe in the year 2010. The existing indications are that there is a need for North Slope oil and that will continue. The refinery price on the west cost has escalated and indeed it is much higher on the east coast, so that there are projections underlying projections that are used, just as there are in other financings based on utility type self liquidating financing which give , it seems to me, the degree of confidence necessary to finance the pipeline itself. And indeed no bond investor is going to put monies at debt, and at risk unless he ~~similarly~~ similarly is assured the State that the oil will flow in the estimated quantities. It to a certain extent has to be and will be a test of the market.

Young: Commissioner Henri, another thing , Senator Groth hit upon , that you geared our whole income into the ownership of the pipeline of the North Slope Oil . Entering the projections of the other testimonies given today is there any thought given to the possibility of revenues generated by the ~~gap~~ gas field that is on the North Slope, the monies that will be generated to the mid west states , that the pipeline will possibily go through Canada?

Wohlforth: I think Mr. Eppenbach can answer that.

Eppenbach: Yes sir. They are fully included in our estimates. We assume that in 1977 the price of gas at the wellhead will be about 20 cents. Obviously the production of gas is the function of the production of oil. We've made those consistent and we assume the price of gas at the wellhead will increase about 1 cent every five years, assuming that gas will be transported through Canada through a Trans Canadian pipeline into the mid western markets in the U. S.

Holm: Commissioner Henri, as I read the figures, the first chart up to the left there, and I added them all up, if my arithmetic is correct, we are saying that State ownership will total a billion and one half dollars net increase to the State over the next 10 or 11 years. That is if everything goes right. Presuming that the States bargining position is good now and might be a little bit worse in the coming years without ~~_____~~ oil erosion by the State, after all any oil company worth its salt can see that we are going to desparately need money due to the testimony that has been given. What is going to happen to our future oil lease sales and the net income to the ~~city~~ state; have you built this in; what is going to happen as the oil companies see this localization or parallel to nationalization of the oil industry in the State of Alaska and as they contemplate this couldn't we ~~xxxxx~~ lose more money that way by investments in the State in the oil leases, by investments in the State in the oil industry than we would gain theoretically by taking over the pipeline ownership.

Henri: Representative Holm, Senator Groth referred to additional oil lands in the North, I would like to speak a little bit further on that latter, but, there are more as we all know than 7 oil companies. Now if there were other oil companies that wanted to get these future oil lease lands I think that State ownership ~~along these~~ of the

lines would enhance the desirability of those leases because they would know the State, as a public agency would allow them to use the line , whereas if the line were dominated by the ~~owner~~ who had the existing discovery of the oil it may not be that way. So I think the ownership would not be a hendrance, it would be a help.

Holm: Well, aren't we presuming, at least this has been my understanding it is going to be a public carrier either way?

Henri: Yes, but I will defer to Mr. Hellen and others about how that concept works under ICC regulations of private ownership. My impression is, simply saying, ~~it is~~ a public carrier does not give all the answers. Furthermore in the State's case of private ownership Mr. Temple clearly brought out yesterday that there is going to have to be a voluntariness, what ever you want to call it, between the oil companies and the ~~State~~ State if the State is ever going to own the pipeline, at least under the sale of bonds, municipal bonds and I would think that if the package were not fairly palatable to the oil companies that somehow they are not going to do it anyway.

Holm: Well then you are presuming in all of your figures , projections, that the State take over the pipeline, will not depress the market for our future sale of oil leases?

Henri: I think that would be something that we ~~tend~~ have to guard against very carefully. We obviously would not want to do that. I think we all agree with Senator Rettigs' remarks that we want the state to be a favorable place for investment. But nevertheless we have a great stake of getting something out of our resources to?

Huber: Mr. Chairman, Commissioner Henri, on Page 3 of your testimon v

Joe, you project about, rounded off, $50,000,000 a year general obligation bonding programs for State capital programs. Now what ~~ix~~ retirement term is anticipated on those bonds, and ~~can~~ the interest from principal payments ~~thx~~ been included in the public ownership draft line on exhibit E?

Henri: The term, Mr. Chairman, Mr. Huber, is 20 years, and debt service has been included in the run and if I may Mr. Huber, refer ~~k~~ you to exhibit B where it that information is given there. Exhibit B in the computer run/gives the interest assumptions, the annual rate of ~~interest~~ in the general fund, in other words what we have earned in the Bank of America funds of 6% and so forth, is all spelled out, and your answer is the debt service was included for 20 year payoff.

Huber: Well what concerned me was the debt service in the initial bonding.

Barber: Mr. Henri, through the Chairman, the Committee it ~~ah~~ has always been my assumption that we are currently using up our North Slope $900,000,000 to the extent of the State ~~h~~ sharing in local government and in other ~~efforts~~. In other words of our normal budget is running somewhere between 220 and 240 million dollars and we're using up somewhere between 60 and 80 million dollars a year out of our North Slope fund. Now are those figures approximately correct?

Henri: I think the, we are using this year, Mr. Huber, the Governor's budget proposed ~~in~~ taking 97 million of the principal of the North Slope Fund and of that almost entirely used for local government.

Barber: That was my understanding. Thank you.

Senator Thomas: Mr. Chairman, I have the impression that they haven't really explored all of the alternatives, and I would like to ask, since we may not have a chance to ask later on, if they have looked into the alternative of increasing

the severance tax or / and at the same time possibly substituting the cents per barrel for the severance tax; if it is so to what extent would each of those have to be changed to forestall this down the road based upon your 3.5 billion dollar figure.

Henri: Mr. Chairman I will defer a full rounded explanation of that, Senator Thomas, I do have two observations if I may. One, the severance tax as it exists, is as you know a percentage of the value of the oil per barrel of the wellhead. Obviously, under the private case that he's giving you the wellhead has no value the first few years, so would produce no severance income. If the severance tax were amended to instead of an ad valorem item, to be a cents per barrel item, there is no magic to making up the deficiency in our budgetary income because no government is allowed to tax to confiscation. I haven't actually calculated that out , I would say that the , to equal the throwoff of ownership of the pipeline which is a legal, valid receipt of money, to equal that to heist up the severance portion would probably be confiscatory, I don't know. I suspect it would be a God awful amount of cents per barrel.

Thomas: Mr. Chairman, could I just ask would it be possible by using the cent barrel arrangement to persuade industry not to take such great profits out of the operation of the pipeline.

Henri: I couldn't answer that. They own their line and I presume they ~~like~~ have a right to take a dividend from it.

McVay: Mr. Chairman, one more, ~~if we had an exchange~~ when we have a chance to hear their response during these hearings, the pipeline committees have proposed a lease sale arrangement.

Josephson: Someone mentioned that ~~was the~~ the most alarming thing about

your three r's is Joe, that we might be able even to increase legislative salary.

Henri: I carefully avoided that.

Josephson: Commissioner, have you predicated the impact of the Native Land Claim Settlement in your revenue projections , how do they fit into your revenue projections?

Henri: Yes sir, they are in there, I am going to ask Larry Eppenbach to tell you exactly how they are in there, but the impact of the native 2% over-rise in in the figures.

Josephson: No I meant the additional economy or impact , favorable impact of the economy generated by economic activities.

Henri: Again I'd like to get Larry... My impression is that we haven't tried to estimate what the ~~funny money~~ spending of these native corporations will mean to the States economy. There again it is so speculative, and I'd just like to re-emphasize Mr. Chairman, my point of view in these hearings, it comes as chairman of the budget review committee and from a convention which is probably shared by many in the room, that the budget shohldn't be at a certain level one year then come into a cleft so to speak and fall off. I think you have to calculate your budget increases or decreases if they are necessitated gradually over a period of years. In other words at least , ~~while~~ what- we have now given to you, the legislature, a 5 year planning projection and we have tried to avoid the very speculative incomes in the future so as to keep our budget ~~study~~ steady and reliable.

Palmer: Mr. Henri, you have mentioned this matter of ~~the~~ speculative items of the budget several times, this was a responce, as I understand it, as Senator Lisak mentioned,

additional land sales, plugged into future revenue projections because it was to speculate, a few weeks ago, before the Senate Finance Committee and then later that week before the resource committee we had the same type of commentary testimony from the people in charge of the Division of Oil and Gas, Mr. Burrill and Mr. Gilbreath. When it was pointed out that the revenue projections for North Slope Oil would decrease in the 1980's because of the 9.6 million recoverable barrels, or billions rather, and that this would be decreasing in the mid 80's, I believe it is ~~rated~~ 2 billion barrels a day and in about 14 years those reserves would be ~~xxxxxxxxxx~~ exhausted. Now in response to the question of , Mr. Burrel said that it was too speculative as far as any other reserves up there to slug any other values into revenues. That they could not because they had to be prudent, come up with any other figures for production through that pipeline and therefore revenues would decrease in the 1980's. And yet you are saying, as I understand it, that it will require 25 years of production rather than 12 or 13 years of production, to amortize the cost of the construction of the pipeline. If the State builds it, it is our gamble, if the company builds it,it is their gamble. I don't understand how we cannot afford to ~~xxx~~ be speculative in one instance and we can in the other.

Henri: Well Senator, you have spoken to two sides of the budget, income versus expenditures. My remarks on speculation were primarily about the level of expenditure and as to the ingredients of the revenue side of the budget I defer that it to Mr. Eppenbach who has those computer runs and why he thinks they are valid.

Rettig: Mr. Henri just to verify Senator Palmer's question , his question was a very good one, he did refer to the speculative nature of the possible lease sales, on

the other hand the State ~~xxx~~ in suggesting State ownership and the 3-1/2 billion dollar debt is speculating that there is a lot more oil than we now know is in the Prudhoe Bay field. Is that your point Senator?

Palmer: Yes sir.

Eppenbach: Senator, when revenue estimates were prepared and discussed with you by Mr. Burrell and Mr. Gilbreath they were referring to 9.6 bilion barrels of Prudhoe Bay reserves. We based our reserve figures here for purposes of financing State ownership of the pipeline from the total of the resvoirs on the North Slope already leased. And I would defer further questions on this to Commissioner Herbert. Now Have I... In terms of State financing of the lines we were not speculating on it, future reserves, we were planning that additional resvoirs would come onto line, those resvoirs already located in the lease area. Their timing may be characterized as a form of intuitive judgement, but we have looked at nevertheless we expect over the 10-20 years that there would be additional reserves of oil coming from new resvoirs that have not yet been estimated to contain reserves but are nevertheless there, that would provide oil to the Trans Alaska pipeline. That is oil in addition to the 9.6 billion barrels that Mr. Burrell talked about.

Palmer: Would you we have the assurance that of these reserves that will be recoverable from the Division of oil and gas, ~~the existing~~.

Eppenbach: Commissioner Herbert already testified on that point, that there are no assurances to date, he did imply that right now it would take perhaps ~~xx~~ another year to get those assurances but he did ~~communicate~~ indicate about 100 million barrels of oil were available at least in one of the pools. I for one would like to hear the

oil companies respond to this question in some detail.

Palmer: A second question if I may then, it was stated that an increase in severance tax , this is a response to Senator Thomas' question questions, in order to reach the income required by the State it might reach the confiscatory level and therefore be impossible, but it seems to me that there is a given amount of money to come from this resourse regardless whether it from the pipeline or whether it is severance tax or regardless of where it comes from , that there is still X number of dollars that will be available. I don't understand how it would be confiscatory if we take it through severance tax and it would not be if we take it thoough a pipeline profit.

Havelock: If I may comment at this point Senator, I think that a cent per barrel tax that is one of the alternatives of the legilature can consider among other tax possibilities. I don't think it is our intent to say that it is not an appropriate tax. There are a number of reasons why it has economic disadvantages, and the man who should probably testify most on this would be Walter Levy. The cents per barrel tax is a little bit like a lot of complaints we've heard about the gross receipts tax , apply to the cents per barrel tax, that is it does not necessarily relate to economic realities in the oil industry. But it certainly is a possibility as providing a floor shall we say to revenue, I think the industry, the ~~economics~~ comments they've made to us about it, is they would rather pay taxes in other _____ through the cents per barrel formula. That is my impression. But it certainly is one of the tax avenues that the legislature can consider.

Palmer I might add that Walter Levy

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

Tape #12

Mr. Kades: It is not due to the failure to pledge credit or any special tax of the State. The reason is due to a prevailing view in the Internal Revenue Service, that if you have bonds issued for a project, companies (private companies) or non-exempt persons have a right to the use of that project for a long-term period and that isn't defined, but twenty-five years or say would be undoubtedly a long time. And they agree that they will pay for the right to put oil into the pipeline or take power even though the pipeline or the transmission line isn't available. For example, there's a forced _____ which impedes the operation of the pipeline. But nevertheless, they must continue to pay for it so that they have the risk of loss. And also they have all the rights of ownership; then there is doubt about the interest or the bonds being exempt. But it really isn't directly related to the purging of the taxes, because even though the bonds were general obligation bonds of the State such as the bill which was withdrawn provided, that would still be true in that case - that if private companies have the unrestricted right to the use of a project and they're bound over a long-term period to pay for the project even though they don't get reuse of the project; then it's considered that the bonds have been issued for the trade of business of the non-exempt persons. Now, I don't think that situation exists here, because we have a common carrier, and if other oil companies come to Alaska to explore and decide to utilize the pipeline, under my understanding of the law, ways and means must be found whereby they're served. The pipeline must open up, in other words, the rights or withdrawals. They're not firmament. It's not like the pipeline was leased to one or two or seven oil companies and no other oil companies could untilize it, so I have reasonable hopes of being able to secure a favorable ruling once we're in a position to make an application

Tape #12 (continued)

for the ruling, but we've discussed this with counsel for the oil companies since last November and there's simply no answer to this question without going to the Commissioner of Internal Revenue, and as I stated we're hand strung. We're not in a position to move because all we have is a hypothetical proposition to put to the Treasury and the Treasury won't rule on that type of a proposition. But long before any bond is ever issued, long before the authority makes any firm commitment, with any oil company, we'll know what the answer is to this point and we ought to know pretty soon so that plans can be made and so there's no delay.

(Mr. Rettig)

LET ME APPROACH THIS JUST IN A SLIGHTLY DIFFERENT MANNER FOR CLARIFICATION. I THINK WE HEARD TESTIMONY AT SOME LENGTH EARLIER THAT PROBABLY AND CERTAINLY IN THE FIRST TWO YEARS OF THE OPERATION OF THE PIPELINE THERE WOULD BE NO WELL HEAD VALUE AND PERHAPS EVEN LONGER AND AS A CONSEQUENCE THERE WOULD BE NO SEVERANCE TAX REVENUE. AND RECOGNIZING THIS PLEDGING OF THAT TYPE OF SEVERANCE TAX REVENUE MAY NOT SATISFY BOND HOLDERS. COULD THEY THEN OR WOULD YOU RECCOMEND THEN THAT WE LEAVE THIS DEDICATION OPEN TO PERMIT THE POSSIBLE SUPPLEMENTAL DEDICATION OF FOR EXAMPLE INCOME TAX INCREASES TO THESE [illegible]SERVICE? WOULD THIS BE WHAT IS CONTEMPLATED IN THIS GENERAL OPENING UP OF THE DEDICATION FEATURE?

Mr. Kades: I'm not quite ready to answer the question. It wasn't intended to open it up so that you could pledge the income taxes. On the other hand, it may be an excellent idea. It might be just exactly what the doctor ordered as far as the prospective concourses are concerned and I think again I'll have to . . . I don't like to knock squarely into the question but I think Mr. Macy has poor confidence in_____.

Tape #12 (continued)

Mr. McVay: I just have one brief question. If an authority (State) were created, would ICC control it the same way as if it were in title ownership?

Mr. Havelock: May I respond to that?

Mr. Rettig: Please do.

Mr. Havelock: The answer is that to the extent, the ICC would control the pipeline and if they would control the pipeline, they would also control it if it were publicly owned..

Mr. Kades: I suppose that's another answer to your question, sir, as to perhaps it wasn't yours but a question that was asked me about reasonableness of the rates.

Mr. Havelock: That would also be subject to the ultimate jurisdiction of the ICC so that the rates would necessarily have to be [illegible] reasons.

Mr. McVay: Is there a problem of a Federal regulatory agency, namely the ICC, controlling a State entity? Is there a constitutional problem there?

Mr. Havelock: I don't believe so, Mr. McVay. The common example would be the various court authorities which are controlled by which are municipally or State owned which are regulated by the United States. There is precedence among these for Federal regulation of State owned

_____.

Mr. Kades: The power authorities which are rather analogous are all subject to the supervision of the Federal Power Commission and the Automic Energy Commission if they struck nuclear plans. They spend a great deal of time in Washington.

Mr. Rose: I have one additional question for Mr. Kades. Mr. Kades, the question I had before but it isn't quite clear in my mind as to what you provided by way of an answer. As I read this House Joint Resolution

for the constitutional amendment, Section 7 permits the dedication of funds but Section 8 which was the guaranty would open up the State credit to the full extent as well as permit specific funds such as rural needs or whatever. That way you have the alternative of going either way, is that right?

Mr. Kades: That's right. It was intended for flexibility to go either way or both ways.

Mr. Rose: But it could be the whole budget of the State on one hand or a specific fund.

Mr. Kades: That's right. Or both or it could be to one part of the bond issue and not to all of it.

Mr. Rose: Thank you

Mr. Havelock: Mr. Co-Chairman of the _____ chair of the committee, we forgot to enter an exhibit that should have been entered with Mr. Wohlforth's testimony. Could we have 90 seconds allowed Mr. Wohlforth to insert this for the record. Would that be permissible?

Mr. McVay: Well let's . . we were going to take a ten minute break in a little while from now, but let's go ahead and take it now, and then we'll come back . . .

Commissioner Wohlforth: The assumptions upon which the analysis is based are contained in the first four pages and there are charts showing various assumptions of estimated incomes to State and private ownership at dividend varying dividend and tax levels showing estimated income to State under private ownership with a 5-1/2% dividend and the industry wide average facts, a 4% dividend and zero income tax, estimated income with State public ownership and a 7% dividend, a 5-1/2% dividend and a4% dividend. And we will be submitting to the committee, very shortly, further more detailed income statements. I think you will want a moment

Tape #12 (continued)

to reflect and read these documents, and, therefore, request that questioning be held until after the committee members have an opportunity to read. Thank you very much.

Mr. Havelock: Mr. Chairman, Members of the Committee, at this time we would like to call Mr. Tom Guilderhouse of the firm Temple, Parker & Slone, Economic Consultants to the State. Mr. Guilderhouse. . . . He will speak about the arrangements for public financing, various alternatives for public financing available to the State, public financing and pipeline. Mr. Guilderhouse . . . .

Mr. Guilderhouse: Thank you very much Mr. Chairman, Ladies and Gentlemen of the Committee. I am pleased to have this opportunity to discuss with you this afternoon a plan to accomplish the public financing of the State ownership of the Trans-Alaska Pipeline. Before discussing the plan, however, I would like to make the following observations. _____to understand the plan that I will discuss and answer questions on today is a plan prepared by Temple, Parker & Slone. Although the plan has been reviewed by the State, it has been reviewed by the investment banking group, it has been reviewed by at least some of the oil companies. It has not been particularly approved by any of them. It has been looked at and discussed. The second point I would like to make is that this is a preliminary plan and is in no way intended to be definitive in nature. The definitive plan for financing an operation of this size and nature takes weeks and even months of intensive negotiations between the interested parties. One of the issues under consideration in these hearings is the creation of such an authority and such a party to negotiate on the State's behalf. Related to this point is that I'm going to refrain from trying to be terribly specific in my testimony. I will be happy to answer and respond to any questions. Financing of

Tape #12 (continued)

this nature has a tremendous number of details, and I hope to be able to avoid my testimony getting down to the nitty gritties so to speak. As I say though, I will be most happy to answer to the best of my ability any and all questions. With that understanding, I would like to preface the plan and point out that there are essentially eight (8) general assumptions that outline our approach to try to find a reasonable and feasible financing program. The first is the assumption that the operation of a pipeline is a sound business and that the operation of the Trans-Alaska Pipeline is a sound business. The testimony that you heard today, the charts on the wall show that either set of circumstances, public or private, the pipeline itself is expected to generate revenues in excess of costs over the long run. I don't think that we would be trying to recommend State ownership if it was felt that the pipeline ownership was a bad business. Secondly, I have the greatest respect for the oil companies, These men have sound business judgment and they are very interested in getting into the pipeline business, and I think that is just a further indication of the fact that it's a good business. The second assumption is that the cost would approximate $3.5 billion dollars. The third assumption, and most important, is that bond holders obviously need adequate guarantees in order to lend money to the State's authority to undertake this project. They need guarantees in essentially two areas--the guarantee that the project will be built and secondly that it will be utilized to the extent to provide payment of interest, amortization and operating costs. The fourth assumption is that the State of Alaska's credit, of and by itself, this associated from the oil, or this associated from this particular activity, is not an adequate to raise ourself $3.5 billion dollars worth of debt. I don't think barely any state's general obligation powers from one issue are that good, but Alaska's are not being debated. The fifth assumption is that the oil companies, as has been

Tape #12 (continued)

stated many times in these areas, cannot be reasonably expected to lend their full faith and credit to secure the financing of a State-owned pipeline. It's just simply, fair is fair and it doesn't make a great deal of sense to ask them to go on the bottom line for $3.5 billion dollars and not own the pipeline. The fifth assumption is, and this is a critical assumption, There exists both a proven supply of oil on the North Slope of Alaska in existing reserves and reserves beyond that and that there exists a demand in the lower 48 to take at least 2 million barrels of oil a day for the next twenty-five years. That's a very important assumption. We have to bear that in mind. The next assumption is that if the financing of State ownership can be achieved without the encumbrance of the oil companies credit, that this might be attractive to the oil companies who would then be relieved of having to utilize $3.5 billion dollars in this particular project whereas there are other places in other areas where they might be able to invest that same amount of money in the construction of new refineries, further exploration or other activities. To the extent that this could be achieved, we felt that it might be actractive and the oil companies might be interested. So....those particular assumptions in mind, I would like at this point to outline the essentials of a plan, a plan that we have suggested is worthy of consideration and which has not been deemed completely unacceptable in its totality by anybody. Certain parts of it obviously are not well received by some people. The essence of the plan for financing State ownership of the Trans-Alaska Pipeline is contained within the following four major items. The first is that the oil companies enter into an agreement with the State's authority whereby the oil companies or the users, the original users and any new users to come on stream in the future years, would agree to 1.) shipped through

Tape #12 (continued)

the Trans-Alaska Pipeline taps a minimum number of barrels of oil on a quarterly or annual basis. For arguments sake, one might imagine that enter into an agreement lets say to ship a million barrels of oil a day when the pipeline is up to its capacity of 2 million barrels. The second part of this agreement would be that the oil companies would agree to use the Trans-Alaska Pipeline until its capacity was full before using any other source of shipment or transportation for North Slope oil. This is to assure before other means of transportation are used that the pipeline is full and there is not enough capacity to meet demand. The third issue, and I will try to elaborate alittle bit on these in my testimony, is that the oil companies would agree to sell or otherwise assign at the well head or in the field to another member of the consortium or the unit or to the State should no other member of the unit or the consortium want the oil enough oil so that the State could assume the responsibility of shipping the oil through the pipeline to market. This is obviously relying on the oil as a "black gold" if you will to secure the interest of the bond holders. The second major part of this proposed financing plan is that the authority of the State of Alaska will provide the other oil companies with reasonable assurance on rates based on cost and volumes for as long as the minimum shipping agreement remains in force. This is a quick _____. You really can't ask or expect someone to make a deal with you unless you make a deal with him, and give him some protection for his responsibilities. The third major portion of this plan is that the Alyeska Pipeline Service Company would construct the pipeline for the State under contract to the State with full conformance and completion guarantees. Fourth - that the authority obviously would provide the appropriate and necessary

Tape #12 (continued)

guarantees to the bond holders through pledges of all surplus revenues and pipeline operations and provide a general reserve fund adequate to provide for one year to eighteen months of operating cost, interest and amortization. The basic premise in this plan, there's three basic premises, is 1.) that the oil companies in this case are only being asked to do something they are surely planning to do already, mainly ship the oil as quick as possible. It's inconceivable to me, or I think alot of people that the oil companies would have invested the amount of money they have today anticipating investing an additional $3.5 billion dollars unless they were expecting to ship oil to market just as fast as they could possibly get it out of the ground and down to wherever its going, somewhere in the lower 48. All the State is asking the oil companies to do is to promise to ship at a minimum rate probably far less than they are anticipating shipping at the moment within a guaranteed price range again based on cost of volume of movement for a period of say twenty (20) years or twenty-five (25) years depending on the negotiation or until the approximate exhaustion are put in reserves. The second basic premise is that this minimum shipping agreement and the fact that the State is ultimately taking the responsibility to move the oil to market allows for a pledge of revenues by the State's authority. For with this minimum pumping and shipping contract the State will have guaranteed income to pledge. The third major premise is concerning the risk of completion which is to address one of the other bond holder needs that the performance and completion be guaranteed to the State under a contractual basis, a negotiated contract basis, unless the bond holders will have sufficient guarantees that the project will be completed once undertaken. I would like now to

Tape #12 (continued)

go back and address in limited detail some of the four conditions and major portions of this plan. The first one with respect to the minimum shipping agreement. The first question that will obviously arise is that isn't this really a hell or high water or take or pay or an agreement of some sort, we're just calling it by another name and it's really just the same thing as people have discarded already. This is just a Rube Goldberg invention to get around to some of the problems. Though, I don't think it is. What we're doing here is guaranteeing and pledging essentially to the bond holders the oil which is in the ground, and we're not really pledging the credit of the oil companies. We have talked with commercial bankers, bond rating agencies, accounting firms and investment bankers with respect to their attitudes and thoughts as to whether an agreement of this nature would infact really encumber the credits of the participating oil companies. It's their unanimous opinion that it probably wouldn't. Now everyone always has to wait and see how things are and you never want to make a 100% opinion on anything as nebulous as this particular proposal is at this particular time, but to the extent that some of the oil companies would be relieved of this burden that's looking over their shoulders at the moment of $900,000,000, $600,000,000 to them. (I keep forgetting zeroes) in this project. It would be helpful. With respect to the minimum number of barrels of oil, I think this has to be negotiated. You obviously have two factors going - you've got the depending on how few barrels that ultimately you agree with on a minimum shipment depends on the height of the tariff that you'll have to charge in order to be able to break even if you will and provide interest, amortization and operating costs. The lower the absolute guarantee you would have to assume the higher the tariff and consequently on the other side of the coin the higher the minimum guarantee the lower the tariff associated with that.

Tape #12 (continued)

With respect to using only the pipeline, I don't think it's unreasonable to request that the pipeline be used to its capacity and the State provide the facilities to its capacity before other types of transportation were used. With respect to the assignment of oil and the sale of oil at the well head, I believe and I don't think I'm incorrect that there is a considerable amount of buying and selling of oil in fields and at well heads that goes on in the industry today. It's not an entirely unusual thing for one oil company to sell to another oil company its production out of a producing field and sell it at the well head at the posted price in the field. So this is not an unusal or Rube Goldberg agreement. It's something that's done all the time. With respect to the reasonable assurance on rates, this again has to be negotiated. We are intermediaries here for the State and there is no real way that you can come to rest. We have some ideas how it might be negotiated, but it certainly is impossible at this particular point in time to say how it could be negotiated. Certainly there is an area I think of agreement where reasonable guarantees could be provided to both the authority and to the oil companies to make a workable plan. With respect to the construction contract with Alyeska, there was a question I think earlier as to would it might not be possible that the Alyeska would spend more money building the pipeline under contract to the State than they would if they built the pipeline for themselves. I suggest that this is not a probable case. Ultimately, I think that this is a very good incentive contract, because the tariffs of the pipeline will ultimately be based in some degree on the cost of the pipeline. So to that extent that Alyeska builds the pipeline for the State, they are infact controlling to a large part their future tariffs because the tariffs the State will charge for movement of oil will be based on the cost of the pipeline which they're

Tape #12 (continued)

responsible for bidding for and building. So they infact, under this arrangement would be controllers of their own destiny so to speak with respect to what the tariffs would have to be. The fourth item with respect to the necessary pledges, it's difficult at this point to say exactly, I think in Mr. Kades's testimony the range of full faith and credit down to a particular pledge, down to a pledge of severance or perhaps a pledge of royalty or perhaps no pledge depending on what things look like twelve (12) months from now or eighteen (18) months from now if indeed we're able to get full cooperation and interchange of information and people working together. Perhaps the revenues in the market projections will be such that a revenue bond alone could be sold, but I think the only thing you can say at this particular point in time is that there would have to be some pledges by the authority. The minimum one would be the revenues of the authority would first be pledged to the bond holders and any surpluses from pipeline operations would have to be first pledged to the bond holders to make sure all the demands of the interest, amortization and operating costs were met and there would have to be established a general reserve fund to also further protect the bond holders interest. I'd now just like to sum up this part and respond to questions on what I think are basic rationale for acceptance of this proposal by the three really interested parties - the State on the one hand, the oil companies on the other, the investment community of prospective bond holders on the third. With respect to the oil companies, it seems to me that their acceptance of a proposal of this nature or concept of State ownership and their cooperation with it is first in that they are in no way required to guarantee monies or otherwise assume

Tape #12 (continued)

contingent liability through a monetary sense with respect to this program. Their commitments are only to pump and ship at a minimum rate which they intend to do already under reasonable and negotiated tariff guarantees. Should they fail to meet that commitment, the only sanction against them is they must transfer their pumping rights; first to another person in the field, for whatever negotiated price he can get, and then to the extent that another fellow in the field doesn't want it, the State will come in and insure the movement of the oil to market. As I said before, their acceptance and cooperation is further encouraged by the fact that they're only being asked to do something they are already planning to do. From the bond holders point of view, we feel that he will be more than adequately protected by the following: 1.) the minimum shipping _____from the oil companies and the State's obligation to step in and move the oil to market in the event that they chose not to. 2.)

Guilderhouse: The domestic oil, the crude oil in the lower forty-eight, and the proven and expected to be realized reserves on the north slope oil. As far as the State is concerned, it seems to me that the State is accomplishing a great many of its objectives in this case. It is positioning itself in the middle of, on an equal basis or more equal basis with the very few economic entities. It becomes a part of the total development and movement to market of Alaska's natural resources. It does it in a fashion which promotes, I think, cooperation with the oil companies, and I think it gives the State a position to protect what it is seeking to protect, either through regulation or ownership, the projected income to the State from its royalties and revenues. In closing I want to point out that it is our opinion that in a hostile atmosphere with the oil companies the public financing of the pipeline is probably ~~imposible~~ IMPOSSIBLE. It is our feeling that unless there is agreement and cooperation and unity it would be really ~~imposible~~ IMPOSSIBLE to sell this many bonds to the public so we have to (1) establish a climate in which the oil companies and the State can work together around a program of this or any other PROGRAM to address the issues as they have been stated and I do think that we can then proceed to go to market with a ~~negotiated~~ NEGOTIABLE security and SALEABLE security. Now I will be happy to respond to any questions.

?: We'll use the same sheet for Senator Groth.

?: Is this on?

?: Yes sir.

Groth: You said one thing that I wonder about Mr. Guilderhouse, and I'm not sure you amplified it. You said would enter into a construction contract with ~~Aleyeska~~ ALYESKA and then you said, how do we guarentee, who takes the risk of completion on that construction contract?

Guilderhouse: The way I would foresee it is that it would be a, let's TAKE YOU a little example any contract the State lets. The State lets a contract and it's a contract with specifications and let's say it's a fixed price contract. Let's just first take the fixed price contract, obviously there is ~~a~~ SOME problems with the

fixed price contract in this case, but let's say that it was a fixed price contract well, it has been freely negotiated, openly arrived at fixed price contract and the obligation of the contractor is to finish that project. Now I suggest there is ~~suficient~~ SUFFICIENT financial strength within the oil companies who are the owners of the ~~Aleyeska~~ ALYESKA P S C pipeline service company to guarantee any contract ~~the State~~ THAT THEY openly ~~or~~ freely negotiated and I would look to the performance and completion of the contract from the ~~Aleyeska~~ ALYESKA P S C pipeline service company as they provide their own guarantees or their own bonds that they will complete a contract that they freely entered into.

~~Groth:~~ GROH In other words, we would ask them to guarantee the construction of the contract and take the risk of completion on this project.

Guilderhouse: The risk is included in the price, right. They're acting as general contractors like any other general contractor would operate.

~~Groth:~~ GROH And do they make a profit here?

Guilderhouse: I would assume so, yes, just like any other contractor in their price and in their bid they would receive a mark-up on their labor, certainly.

~~Groth:~~ GROH Do they put up bonds in the event of a noncompletion?

Guilderhouse: Well I don't think that it is necessary for Humble Oil or ARCO or these oil companies to go to the bonding market to receive bonds. I think that the assets and the strength of the oil companies are probably greater than most of the bonding companies so I do not think it would be a requirement to post bonds.

~~Groth:~~ GROH To that extent isn't ~~there~~ THEIR credit seriously ~~impared~~ IMPAIRED to the tune of three and a half billion dollars?

Guilderhouse: No I don't think so because they have negotiated a contract and they are going to get paid 3.5 billion dollars. Let's say ~~we~~ THAT we negotiated a contract ~~of~~ of 3.5 billion dollars. Their only liability is to the fact that they don't meet the terms of the contract

~~Groth:~~ GROH Okay, thank you. I have no other questions, Mr. Chairman, thank you.

McVeigh: Senator

Ross: Mr. Whelan

_____: Questions from members of the house panel. Mr. Rose.

Mr. Rose: What do you want Mr. ~~Kevin~~ CHAIRMAN that is ~~a~~ AT PAGE phase four of the study that was made. I see that you ~~was willing to face~~ GO ON THE BASIS OF five ISSUES of bonds and first two ~~ones~~ have an eight per cent each interest and the third one on a tax exempt rate of 6 1/2 per cent. Now why is it that if we can qualify for the 6 1/2 PERCENT tax exempt rate that we wouldn't find that in the first two?

Guilderhouse: I'm not quite sure what, okay. Well, I would say what the study shows here is just a variety of possible interest rates because until you go to market and the underwriters finally bid on your INSTRUMENT you really don't know what the interest rate is going to be. I think that one, I'm not familiar with this particular study here, but I would say that if the interest rate is judged to be higher in the early issues than it is in the later issues the assumption is that the risk is greater and it would be a harder sell on the first issues of the bonds, when people are more accustomed to the flow of the bonds and they just won't have to pay as much money to get the money.

Rose: Say if you ~~have to~~ ISSUE #5 _____ which would be the last one and the smallest, not the smallest, but almost the smallest one, second smallest ~~one~~ is also indicated at eight per cent but the thing that I don't understand if we were to qualify for tax exempt status which would appear to be the case on the assumption of issue number three then why would not that assumption hold as well on the other four issues?

Guilderhouse: I hate to duck questions, I'll have to REFER IT ~~report~~ to the fellow who made this document, I'm not clear why issue three is at a lower interest rate than issues one and two and four and five.

Wohlforth: Issue three is a gross assumption of those facilities which would be conventionally tax exempt without question, gross etc., and/or would qualify under the environmental exceptions to Section 1085 of the Internal Revenue

Code about which Mr. Cady spoke at such great length. That is the rational behind the 6 1/2 per cent 900 million portion of the total issue.

Rose: Do we expect then that if tax exempt status is obtainable on the others that the interest rate would also be likely to be lower.

Wohlforth: It might be, although we've gotten no affirmative reading from the bankers, no banker has put himself on the line and said yes, it will absolutely be a hundred ~~bases~~ BASIS points lower because of the size of hundred bases BASIS point one per cent because of the size of the issue. We have bearing indications from time to time of a hundred twenty-five ~~bases~~ BASIS points to seventy-five bases BASIS points 1 1/4 per cent to 3/4 of one per cent but we have tried to portray the conservative case of PARITY of interest rate on the State and the private case excluding only giving ourselves credit if you will only for the Academy environmental protection portion of the gross 3.5 billion dollar bond issue.

McVay: The Senator Rettig has a question?

Rettig: Mr. Guilderhouse, I believe that in the early part of your remarks that you characterize your financing plan as one in which the oil companies would not be asked to do anything that they have not already planning to do; is that their PLANS statement?

Guilderhouse: Well, I guess that it would not with respect to the shipment of oil.

Rettig: And I believe in that you referred as one of the elements, an agreement to ship a minimum quantity of oil, you cited as an example, I believe, a million barrels a day. That may not be the one or not, but would it be reasonable to expect that this might be something that the oil companies were not planning to do if the vaguries of the market are such that they may not plan to ship that minimum under CERTAIN circumstances?

Guilderhouse: Yes, I guess ~~that~~ I have to say THAT one can't postulate circumstances one would not be planning to ship the oil. That is the reason we have the State

entering in under those circumstances and shipping the oil. For example, I can, lets take for example Arco who has a refinery down Seattle way. Lets say that that refinery burned up, or blew up, for some reason or another, and a hundred thousand barrels a day of Arco's oil would not have its normal place to flow, and it might be given away at unit rates, I am not quite sure how they can stop their percentage of the unit from flowing downstream to the market anyway. But, on the assumption that there was some way that they could, we would then have them reobligate it to offer that one hundred thousand barrels first to another member of the consortium, which I think they probably do under any circumstances as it is, but if, for some reason or another, another member of the consortium didn't want the oil either, then we would expect the State to step in and move the oil to market for the bond holders' welfare.

Rettig: Your further condition being to secure an agreement that the oil companies, failing to ship the minimum, would agree then to sell to the State, presumably as a back-up to the guarantee this minimum. Is that correct?

Guilderhouse: If it was first offered to another oil company.

Rettig: Failing in that, the State would have the option to purchase?

Guilderhouse: Yes sir.

Rettig: What would the State do with this?

Guilderhouse: Well, I said that the premise is that there exists, and will exist, continue to exist, a demand in the "lower 48" for Alaskan crude and that the assumption is that Alaska crude will be competitive with other sources of domestic crude ~~crude~~ oil over the long run. On that assumption, I assume that the State could find a buyer for the oil. Now, I understand ~~that~~ there are great amounts of complexity involving oil companies make their plans ~~lease~~ time six months. They know where their oil is coming for any particular refinery. So it is entirely possible to suggest that the State could not market or sell the oil. That nobody would buy it, I think it's highly unlikely and I think you can get testimony more expert than I, to suggest that Alaska oil will be marketable somewhere in the United States over the long run. I would suggest that is the

reason the oil companies are willing to spend six billion dollars in the long run to bring that oil to market. They believe that over the next 25 years, they'll have a place to sell it.

Rettig: Wouldn't it be reasonable to assume that if the minimum under the contract fails its probably because of failure of the market. Those who are in the business of marketing if their market fails, would you suggest a place that the state might find a market for this oil.

Guilderhouse: I would say that if the market for Alaskan crude oil is non-existent, the State will not be able to sell oil. I also say that I don't think the market for Alaskan crude will be nonexistent. I do not think that the State will probably ever have to sell a barrel of oil because I think that the oil companies will sell the oil over the next 25 years and the circumstance for which we are providing in this case is highly unlikely ever to occur. And I would also say that if there was no market for Alaskan oil, the State could not sell it and ~~that would be a risk~~ that's the risk that we'd be asking the bond-holder to take is that the market for Alaskan oil evaporates because we're providing to move the oil to a market that is assumed to exist. If the market is not there—

Rettig: Just one additional point--I believe you referred to this minimum guarantee requirement as in effect a mere pledge of the oil in the ground. Is that?

Guilderhouse: Yes sir.

Rettig: I don't think that term is quite clear to me. In relating it to your initial statement that we're not asking the oil companies to guarantee any credit, now this is their oil, is it not? At least seven-eights of it is.

Guilderhouse: I think the oil belongs to the people of the State of Alaska

~~And they have~~ AND THEY have paid to develop the oil and bring it to market. The oil belongs to the people of the State of Alaska and the oil companies have a lease to develop and bring to market that oil. But maybe I'm wrong on that. Is that correct?

Rettig: You were telling me that this oil that we have in effect sold to the oil companies still belongs to the people of the State?

Guilderhouse: Well, I'm not--it was my understanding that a lease--the oil companies have leased the land under which the oil exists--they haven't bought the oil.

Rettig: Do they not have a right to 7/8ths of that oil?

Guilderhouse : Yes sir.

Rettig: Then....isn't that title to it, if they have full right to it?

Guilderhouse: I'm not a lawyer, and I'm not going to ~~---[illegible]~~

Rettig: I fail to see how we can regard that oil as ours when we have sold it.....

Guilderhouse: Well, I

Rettig: .....and have received the money.

Guilderhouse: I'm going to have to deal with MR. HARRISON the lawyer addressing the LEGALITY OF the lease, in terms of what it means.

Rettig: All right, that will be fine.

CHAIRMAN: SENATOR _____: We touched on this before and ~~I think~~ ownership as we have discovered, such items as the Native Land Claims, is a divisible interest and certainly we recognize that there are private rights of ownership in this oil that are the property of the bidder that bid on the oil; there are also interests the State of Alaska has which might also be described as being ownership rights in general, diversionary rights, ~~belonging to an ownership~~ AND WHICH ARE ANCILLARY THIS

....right of ownership. Title is an intangible subject.

_____: I don't think this is really the thrust of my question, in any event, but the fact that we are pledging, asking the oil companies to pledge this minimal amount of oil to secure this bond service - something/~~xexxxx~~ not otherwise planning to do.

_____: Well, if you ~~figure the~~ pieces.....we are asking them as part of a mutually beneficial arrangement, and not forcing them because I have stated that there is a hostile atmosphere and we can't work this out, this does not make sense with all the parties concerned, nothing will ever happen in terms of public financing. If this doesn't make any sense, ~~xxx~~ there is no way that anybody is going to make them do it, now I would suggest.... now I'm talking about encumbering their credit, or encumbering the ability of the oil company, let's say to go to a commercial banker, and the commercial banker will say "you have such a large _____ liability ~~with~~ that pipeline arrangement you have with the State of Alaska, I won't lend you any more money because I am concerned about that liability." Or to the extend that a bond rating agency would reduce the bond rating of a particular oil company because he entered into an arrangement of this sort. I am suggesting, and I think it is substantiated, that such an agreement would not encumber the credit of oil companies in this attitude. With respect to their being a footnote perhaps in their balance sheet, because this is a material commitment on their part, a significant commitment that needs to be brought to the attention of the share holders and other people that certainly would be ~~missing~~, but when I say encumber their credit, its not like you take ~~xxxxxxxxxxxxxxxxxxxx~~ a play where they say "if you don't ship you have to pay money", or in this case we say "if you don't ship we'll come in and ship the oil for you and pay you".

_____: Thank you.

_____: I have a couple of questions . Going to your point that any agreements should be made between the two ....must be between the two partners, and must benefit both partners, it would seem to me and I ....this is pretty basic but I am having a little trouble, it would seem to me that as cheap as we can build the line is the most desirable thing both for the State and for the oil companies. Now if the State would build it, perhaps they would sell the bonds at ...if they were revenue or tax free bonds...would sell them at an interest rate less than what normal bonds could be sold for. Is that right?

_____: Yes, sir.

_____: We would figure the point spread from ..I think anywhere from 1.5 to 2 points. Is that correct?

_____: PRETTY CLOSE

_____: So this is very general. So that would result in substantial savings, as far as debt service is concerned. would it not

_____: It depends on how much of the pipeline is going to be financed by equity on the part of the oil companies, and how much of the pipeline is going to be openly financed by debt on the part of the ~~pipeline~~ oil companies. Because if the State would go out and lets say borrow all (~~or, million?~~) 3.5 billion dollars, then the State would be paying, for arguments sake, lets say 7% interest on that, it is possible that the oil companies will not be able to borrow 3.5 million dollars, they will only be able to borrow say half of that, and for the rest they will have to sell shares of stock to the public and also use their own cash flow of retained earnings, to finance this. Well there is a cost associated with that capital which I think with the oil companies is higher than 7%, and there is also a cost associated with the debt which I think the oil companies, for in this magnitude, will be higher than 7%. So in a long-winded way, yes, it would be cheaper for the State to finance it in terms of tax exempt bonds.

_____: And we're talking about maybe 1 or 1.5 per cent?

_____: Now, in the other area, as far as the Federal government is concerned, if the State owned the pipeline, then the State would be entitled as a private company to make the suggested 7% ... the ICC allowance, then a 7% profit would be taxable if the line were held in private ownership by the Federal government. The 7% profit would not be taxable by the Federal government if held under State ownership. Now, in millions of dollars, estimate what that saving would be. It seems to me that there would be a substantial piece of money and that that would eventually inure to the benefit of the shipper - the oil companies - as well as the State.

_____: Yes sir, I think you are right on it.

_____: Can you estimate what that figure.....

_____: Should have a run..... more specifically

_____: Lets do it, it can be done somewhere, but lets say that it costs three billion dollars, and the State lets say in the first year will pay ...well in the first year the whole debt issue ...in the State, would pay 7% interest on that, so you are talking 210 million dollars in interest, and if the oil companies lets say had 100% financing you said that they had a cost associated with it, of lets just say for argument's sake 9% which I think is lower than the oil companies would like it, they earn on their assets, you've got 2% difference there, thats essentially 60 million right there, I guess. And of the income tax, thats a year, ...

_____: Let me continue with Federal and State taxes that we calculated, that would be paid by private ownership, in our private ownership base case.

They are, the first year, 33.73 million dollars in State income taxes; BUT 158.8 million dollars Federal income taxes.

In the second year, a similar amount 33 plus million dollars IN STATE TAXES, and again ~~150~~ 156 and a quarter million dollars in Federal income tax.

Moving on to the third year of operation, the Federal income tax and State income tax SHARE remain roughly the same - 34 million in State, 158 million dollars IN Federal.

_____: Thats third year? NOW?

_____: Third year. Yes sir.

_____: Well, I can have all these figures.....

_____: No, thats not necessary....as my rough fig ures show thats about 200 million dollars a year in tax savings if the State would own it. Am I right?

_____: You are right.

_____: Now, that/200 million dollars,/a substantial piece of money going to be distributed?Wouldn't the oil companies benefit in part because ,/say for example if it takes 75¢ to ship a barrel of oil from Prudhoe to Valdez, but you don't have to pay tax on it, you could say, then MAYBE in rough figures, say then it only cost them 50¢ a barrel.....is that right?

_____: THAT IS Correct, I am not sure of your numbers.....actual tax savings are definitely a part of the tariff calculation, the lower the taxes the lower the tariff.

_____: All right, now let me ask you another question: would the tax savings anywhere compare to the 7% profits they would make if they held the title under private? You see what I mean?

_____: Yes.

_____: In other words they would save a quarter a barrel if its PRIVATE

in State ownership, but are they going to make profit at a quarter a barrel if they hold it in their own hands? Is there any way to equate that?

_____: The situation you just described, yes, you ~~just can't~~ CERTAINLY CAN equate it .....it looks like a PUSH. The profit that ....theoretically the profit ~~that~~ SUCH of 7% - if we're going to use the 7% NUMBER, with a 3 billion dollar pip eline, the profit is 210 million dollars. Thats how much profit they can make. Its /that simple a calculation, 7% of 3 billion dollars. Now the profit - if you're going to use the 7%, is 210 million dollars. Equate... AND use these numbers and we come up to around 200 million dollars. ~~Well~~, SO in terms of the cash position of the oil companies, its a ~~foot~~ PUSH. BUT IT I could say something....I'll make it quite clear that this is a T.E.S. "(?)" sort of an opinion and nobody else really has anything to do with it, its strictly ours. That there might be a way to make this concept more feasible and engender the environment in which cooperation might take place, by Suggesting to the oil companies that under state ownership it might not chose to build its tariff structure around a 7% return. Say perhaps the State not only would provide this type of savings but ~~could~~ conceivably, COULD develop its tariff structure on a basis/less than something the maximum. Again I want to emphasize that this is Temple, Barker & Sloan speaking. As a suggestion for consideration, if you ever reach the point where you ~~are driving~~ TRY TO ENGENDER this ~~is~~ favorable climate TO TRY TO COME TOGETHER ON THE VARIOUS ISSUES

_____: Right, that was sort of what I was thinking, in terms of each having a be nefit, not one at the expense of the other.

_____: I heartily recommend that.

_____: Only one other thing that bothers me - the oil companies of course would have the right to depreciate the pipeline as ~~xx~~ an asset, I assume.

_____: Yes sir.

_____: And that would be a tax of paper transaction - because we assume the pipeline is going to be there and carry all the oil out and I suppose _____zero. But The State wouldn't have that....the State wouldn't, since it doesn't get doesn't pay taxes, it ~~xxxxxxxxxxxx~~ the depreciation quite obviously. Now, how does that gear into that?

_____: Well, the intricacies of oil company financing and accounting, it's is an art unto itself. And I'm not really qualified to say exactly how much the depreciation in of the pipeline is worth to a particular oil company, or in under the undivided interest structure what value ~~xxx~~ a particular member of the consortium would place to that depreciation. With respect....lets say that it was a separate entity, a corporate entity, and not an undivided interest structure, the depreciation would really not make a whole lot of difference to the private ownership on the basis of the 7% consent decree limitation. Because that's a cash dividend limitation figure, and what they're working on on that basis, so they can just take 7% cash out of the dividends and that ...and then the depreciation within this the structure would not be a significant item at all.

_____: ~~xxxxxxxxxxxxxxxxxxxxx~~ Okey.

_____: But thats not in the same place with the undivided interest, because it's then it's that is all folded back within the parent corporation, and the depreciation may well have some values beyond the.....

_____: All right, now in just again the painting with the broad brush, we've got 200 million dollars here that can be saved in taxes

_____: Yes, sir.

_____: Isn't that....and if the oil companies are going to share in some of the savings, right? now isn't that going to....not withstanding the

arrangement between the State and the oil companies, isn't that going to result in the oil companies being more competitive in their own area of marketing? I would think that would follow.

_____: You mean to the extent that their costs are lower, that they are more competitive in the market? Yes sir.

_____: So they'd get a substantial advance, I would think.

I THINK SO, YES, SIR, UNDER

~~Under~~ the right circumstances I think there are tremendous advantages to the oil companies, both in reduced costs and in reduced financing burdens.

HERE, I'LL LET HIM HERE

_____: Mr. Rettig is a banker...~~I'm going to~~ continue, as I'm getting a cold in my head.

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

Guilderhouse: _____referred to establishing the tariffs, and I would suggest it should be a factor in establishing the tariffs. In order to recover the costs.

Rettig: Yes sir, I'm sorry, I just wanted to clarify a point. When I performed an analysis on the income statements of an owner of the pipeline, be it the state or a private secrete, I did in fact include straight line depreciation over a 30 year line for 15% _____VALUE, in either case.

Guilderhouse: Thank you, I had thought it was important to make it clearer that we all understood the treatment of depreciation in either case.

Eppenback: If I may add _____Mr. Chairman, the cases showing estimated income to state public ownership which Chairman McVay was eluding to you. and shown on chart 3 and reduce dividen levels 7, 5.5, and 4, so that the committee has this information before us and again to perhaps being a little oversensative to refute any imputation of the state had shown only the worse case or that the governor has made it the only worse case, these charts are before the committee and we'll be ready to respond to them at your pleasure.

Rettig: thank you.

Wohlforth: Senator Raider has a question,

Raider: I have a question for Mr. Guilderhouse , under the various proposals here how would the issues of 3 ½ million involved or would it effect our abilities to issue bonds for normal governmental purposes? That question was asked this morning, but I'd like to have your opinion.

Guilderhouse: Well, mines just an opinion, I happen to believe that ownership of the pipeline will enhance the states ability to issue general revenue bonds. I think that ownership of the pipeline increases the security of the states total income package. I think, first of all, I think the pipeline is a good business, and because its a good business , or a sound business, and lets say it would be operated in a sound fashion. The abillty to protect the states well head and protect the states royalities and severences, generate lets aay a moderate surplus or even a large surplus, however

if we're at doubt from pipeline operations to develope other activities in the state, would enhanse the states abilitating the state would be in a stronger financial ~~XXXXXXXXX~~ position rather than a weaker, financial position.

Holm: Mr. Guilderhouse, haven't you assumed that the price per barral for transportation to the line is the same ~~weather~~ whether its state ownership or private ownership?

Guilderhouse: No sir, I would say in line with the discussions we have there, that there would be some costs savings, ah, in state ownership because of the reduced cost of financing the reduced cost of taxation. That the actual cost of moving under state ownership would be less than the actual costs of moving under private ownership, given equal efficiency in operations.

Holm: Than what relationship do~~XX~~ these charges have, or these charts upon the wall have to a diferential between the rate charged and thus the competive position of the state operating the pipeline, the oil that passes through that, on the world market as compared with that under private ownership?

Guilderhouse: Could you rephrase it sir, I'm sorry.

Holm: Well, under private ownership they will have a certain value on the world market, because it will be certain costs, ah, is state ownership going to put the oil on the market at a better competive price to compete with Venezuelian Oil, East Indian Oil, any other oil? Or have we built in basically the same end price in Bellingham?

Guilderhouse: I'm not really qualified to testify on the world market prices, I had some discussion with a Mr. Whelley, several long discussions, and he states that ~~Alaska~~ Alaskan oil, I hope I'm not misphrasing him, as I understood him, stated that ~~Alaska~~ Alaskan oil will probable be a price taker and not a price maker for a long time. So, I can't talk aboun Indonesian Oil, or Venezuelian Oil, but I am saying the cost associated with the transportation move of the oil to the market is probable given equally efficient operation of the pipeline to be some magnatude less on the public ownership, than private. The actual cost _____ _____the cost of plans.

Holm: Now these figures predicated thou upon a specific figure, now I thought they were the same, I thought you were using the same figures, weather under private ownership or the other. If you want to let someone else answer that I can ask that later. May I ask you one other question? You stated earlier major risks of the bond holder was maybe lack of market, ah, isn't it a major risk of the bond holder, to contemplate strike, to contemplate injunctions because of a, a maybe the ~~bitterman~~ fisherman getting all worked up over some oil spills and so forth, how will this relate to the cost of our bond?

Guilderhouse: To the cost of the bonds? ah,

Holm: What happens, for example if these things occur and the state is in an impossible position of delivering?

Guilderhouse: Well, that is the reason you would establish a general reserve fund. If you remember one of the things I talked about, was that, it would have to be established under conditions of state ownership, A substantial reserve fund that was equal to, lets for discussion sakes, say one year or 18 months of the total operation costs of an interest in amunization costs associated with the pipeline, to provide sufficient income to meet the authorities obligations in the event of a situation such as you described.

Holm: You don't think that will have a depressing effect on the cost of our bond?

Guilderhouse: Well, it depends on how vague, in terms of the interest costs, it depends on how vague you ultimately decide to make the general reserve, I you made it for a 10 year period or a 5 year period which is _____of course, but it, it depends on how big a general reserve fund you make, and how the market proceedes and risks, you have described occur. I would say that, yea, there are, this is not going to be the cheepest bond that was ever issued. I would say that, given one the size, you have to attract a lot of people,

Farrow: In answer to Representative McVay, You, on one question indicated that this was a darn good business to be in, ah, with that in mind, do you think its necessary for the

state legislature to put the full faith and credit of the of the state on the line to quarantee anything?

Guilderhouse: No sir, I don't think its necessary to put the full faith and credit of the state on the line.

Farrow: Thank you

Guilderhouse: Mr. Farrow,

Farrow: The point you brought up in response to this

1. What representation can you make with respect to the duration the _____ duration Such a fund _____ would have to be established for, how would you establish it in terms of the senate of revenue? and secondly, how would this enhance the states ability to _____ obligation box? Or would it decrease the states ability to establish a ah, 20% ah, revenue,

Guilderhouse: May I restate the question to make sure I understood? You're asking essentially 3 questions, How would you go about establishing the size of the general reserve fund? and how much it should be, and then how it would effect the ability to sell the bond.

1) How you go about establishing, it is first, ah, you figure out what the cost, for lets say 1 year cause thats a convenient term, what the interest costs are, what the amortization costs are , and what the operating costs to the pipeline are. Fortunately pipeline is you can get a pretty good fix to what costs are because its not labor intensive, you know, you can really figure out after awhile pretty close to what it cost to operate a pipeline. You know your interest in your amortization, so you say that if, for some reason or another we have a force ~~majeure~~ or the injunction to the strike that the senator mentioned, ah, how long is this liable to last, what is the biggest exposure and how long do we have to pledge to the investment bankers who are representing the investment community _____, How much do they say that you've got to give us before we can sell you bonds? And its negotiated and is sometimes an excruciatingly agonizing process

to come to drifts with how long this is, with the state or the seller of the bonds saying, "well it only needs to be 18 months," and the investment banker saying,"well gee, I can't sell it unless its 3 years," and then you say, "well I'll give you 20 months," for if he can say, I can sell in 2 and 1.5 years. Its this process of evaulation of risks, ah, and the likelyhood and the probability of risks as well as what the actual costs are that ultimately come in to whats necessary to sell the bond, and its generally some multiple of what the costs are to operate the line in case its shut down. Or operate the facilities in case its shut down, and with respect to its impact on the states ability to sell other bonds, I don't see how it would have an adverse effect on it. The ensistance of the general reserve fund will send the context of the pipeline. I don't believe it would have an adverse effect.

McVay: Excuse me, Mr Farrow, are you through? Just one more point, it would seem to me that if ~~and if~~ the state pays off this bond, it aquires an etquity position in terms of a very expensive asset. That would seem to me, to help the general obligation situation. directly or indirectly,would it not? In a concrete way, at the end of five years if you've got 100 million dollar equity that you didn't have five years before, or an asset, or equity unit asset, then that would be helpful for the general balance sheet, would it not?

Guilderhouse: Yes sir, in my opinion it would.

McVay: Would that be an _____? as to how this would improve the G.O. picture.

Guilderhouse: I don't see how the existance of the general reserve funds would _____ contract to the overall financeing of the pipeling. It would be damageing to the G.O.

Havelock: Ah, I'm going to have a ten minute break.

McVay: _____ Like to call Robert Macy, _____ Company of N.Y. who will discuss the marketing of public pipeline issues. Mr. Macy. Mr. Macy, would you' ~~XXXXX~~ please, before you start, ~~XXXXXXXXXXXXXXXXX~~ just for the record, give us just a brief backgroung of your experience.

Macy: I am Vice Pres. _____ of N.Y., i have been a student over the past 3 years. I have had 4 years of economic investment consulting, for National Company in Washington Prior to that time _____ for approximately the previous 4 years I was with _____ Company, which I was responsible for annalysing various investment projects.

McVay: Thank you. (Macy) Mr. Chairman, members of the committee. As a representative of _____ I wish to note that we are pleased to be here to express our views as members of the investment banking group, which is consisting to state in evaulating the fesability of state financing of the oil pipeline project. A project of this unpresedented magnitude obviously poses many unusual considerations, in analyzing various approached to the financial market. The first and most important group of consideration is the identification of the major risk factors involved. In this category we would include the following major investors concern, 1st) Are there sufficient oil reserves on the north slope to establish an economic justification for long term financing 2nd) Are there adequate assurances that the pipeline can be constructed within reasonable time and cost estimates. 3rd) Once built, can the pipeling be operated and maintained on a satisfactorally economic basis. 4th) are there adequate assurances that once built, sufficient revenue will be generated, , to cover operating maintanience in debt serviceing requirements _____ that issue. 5th) assuming the financeing would have to be accomplished in stages, what ~~XX~~ assurance do the investors in the earlier stages have that market conditions will continue to sustain the timely injection of funds needed to complete the project. 6th) Are there back-up alturnatives that the state finds that it cannot finance, build, or operate the pipeline on an economic basis. 7th) Does the status of domestic and world oil markets as projected, give satisfactory promise oil ~~from~~ for this source over the life of the issue and at what maximum price? 8th) What additional finance over reserves are there incorporated in the financing plans, to cover unforseen problems in the future? Few if any of the above

~~XXXXX~~

risks can be satisfied by absolute guarantees to the investor. Each, however must be addressed to some degree in the financing plan, and the relative degree to which these risks are secured. We'll determine not only the fesability of the financing, but also the cost. We understand that entensive, economic and engineering studies are available as background data and _____some investors concern. The sizeable investment already made by the oil companies is undoubtably as physiological plus. In addition the state could, in theory, take certain steps to provide additional financial reserve to cushion the impact on death serviceing of temporary unforseen problems related to the afore major risks, However, these assurances alone, we believe, are insufficient to ficilitate the market, the successful marketing of an issue of this magnatude. Furthermore, from all the suggestions which our group has considered, we know of no feasible plan which does not involve to some degree the cooperation of the oil ~~copanies~~ companies with the state, in arriving at a feasible financing plan. The question is what form of co-operation is necessary and desirable? The first and most obvious to an investor, is to have both the full faith and guarantee of the state and the oil ~~copanies~~ companies behind the issue, however we understand while the oil companies imparticuliar may not wish to pledge their credit in this fashion. An alturnative, and one we must recognize as a significant ~~question~~ jump, interms of the risk, as viwed by the investor. Is to restrict the liability or financial exposure of the oil companies in any financing , to the state which they have in the AKN oil venture. We have heard several possibilities suggested along each lines including those expeessed earlier in these proceedings. Upon consideration, we believe that subject to the conclusion of satisfactory, contractual agreements with the oil company and others pertaining to the construction and utaiization of the pipeling, that it is possible that these agreements coupled with satisfactory guarantees by the state, could make such an issue feasible. In conclusion, we believe that if as there appears to be in earlier testimony, there are sound , economic, and social reasons for the state

and the oil companies to coperate in the financing of this project. ~~the~~ establishment of a legislative and organizational framwork as presently under consideration by the legislature, should facilitate discussions between the stateand the oil companies. The output of such discussions could greately assist us as well, in providing a more definitive judgement as to weather we believe a state finance oil pipeling is feasible at this time. Thank you

McVay: We'll take, ah, questions in the usual order.

Groth: Mr. Macy, you say that subject to the conclusion of satisfactory contracts it is possible , couples with satisfactory guarantees by the state that it might work., ah, what kind of state guarantees are we talking about?

Macy: Senator Groth, One of the difficulties I think we all encounter in answering questions like this and one of the reasons why I really outlined what we considered the major risk to the investors in such an issue, is that to satisfy any one of these risks theres a whole varity of different guarantees, different methods, that could be used to satisfy the risk element to the investor. I think that perhaps it would be, I think it is pre-mature, if I may say so, to try to disect one risk, or one method. And say well if we provided this then this would make is feasible, because frankly, I think until the legislation has been passed to set frame. And some feasible plan, or some mode of cooperation has been established with the oil company. That you cannot come up with sufficient pieces of a plan to satisfy, to really make any meaningful judgement.

Groth: Mr. Chairman, Thats one of the things that troubles me, and has troubled me since this discussion first arose.. Because, ah, seems to me, wether we have a bill or don't have a bill, somebody should go to oil companies and make an ~~emporte~~, gentlemen, are you prepared to sell what you already have, and are you prepared to enter into meaningful negotiations with us presumming we have the power to do so. And it becomes a discussion and arrangement that troubles me very greatly. The first inquiry seems to me

I mean we all talk about establishing, buying meaningful negotiations, and opportunities for cooperation, but I'm troubled by the fact that maybe the first inquiry hasen't been made.

McVay: May I recognise that your not the XXXXX person for me to ask that question. I haven't had any other questions. Thank you

Barber: Mr. Macy, I would like to ~~also~~ ask you if you _____ that the passage of this house bill 569, The Trans Alaskan Authority, is a matter which should be determined prior to negotiations with the oil industry, as to their reseption, of state XXX ownership of the pipeline.

Macy: I believe it is.

Barber: The prime factor in initial negotiation.

Macy: Well I think that it, if I can try to expand a little ~~bit~~ little _____. I think that, _____ ~~I think~~ perhaps a healthly indication in our system for private companies to exhibit considerable reserve in entering openly in cooperative agreements with public organizations. I think it's possibly, partly due to communication, it's partly due to some misgivings concerning motivations, objectives, goals _____ of interest and what have you. I think the variety of such motivation, on the part of public organizations, is certainly, probably greater than the variety on the corporate side. I think to the extent the state can exhibit through legislation their willingness to cut down and to focus what their motivations and interests are. It's really not only the legislation it's even the hearings and the testimony that we have here that exhibit what the goals and objectives of the state are and this is crystallized, I believe, in this legislation. I think this is very helpful to the corporations in better focusing on in what is involved in this, ~~the~~ this very broad term of cooperation of the State in such a project of this magnitude.

Barber; The saving in corporate tax determination would also very possibly, would it not, be a prime consideration to the oil industry.

Macy: In other words, you're saying if, if we

Barber: Won before I.R.S., and got a favorable decision, ~~it~~ that would enhance this Trans-Alaska Authority.

Macy: I believe this is the case. I think there is perhaps one additional factor that has to be brought to bear. Let us assume that you have a basic security. All things being equal, what might be the difference in interest costs between a tax, if it were taxable, or if it were non-taxable? The question here also involves one other factor. An issue of this size is going to ~~be~~ have to be marketed very broadly. Some of the institutions which would have to be included in the market, such as life insurance companies, do not have the same tax structures as other institutions to which tax exempt securities might you might say, might normally be, to which they might normally be marketed. Therefore, I think you would probably because of the sheer size of this issue and the marketing problem, have to give up a portion of that differential between a, the normal differential, between a taxable and a non-taxable issue.

Barber: Senator Rettig

Rettig: Mr. Macy, in your studies of this situation, this proposition so far, are you and you as representing your associates and the companies that perhaps you're associated with in this study together this proposal, are you in a position to suggest that we should pass this, in other words, do you feel the chances are favorable that once it is passed that these bonds and various contracts could be worked out? Would you, in other words, recommend that we act favorable on this?

Macy: I would recommend that you act favorable on this. There is an urge to be somewhat flip in saying that you will never know, or you may never know, if such a financing were feasible until you provide a framework which would allow, I think, for what I consider a more cooperative exchange between the State and the oil companies.

Rettig: You're saying we can't do this unless we do have the vehicle.

Macy: Well, I say I find it highly doubtful that you could do that without the vehicle.

Rettig: Thank you.

Macy: I'm not guaranteeing that you'll be successful.

Rettig: I understand.

McVay: Any other questions - Mr. Farrow

Farrow: Thank you, Mr. Chairman. Assuming that the State goes ahead Mr. Macy, and starts to build the pipeline, despite an outstanding agreement with the oil companies, will this _____, or not?

It seems to me that we'd be able to save the time _____ at this time, There must be some area that you can say how the State has to guarantee its own _____. What areas are we talking about?

Macy: I'm afraid I have to come back to the same answer that I gave to Senator Groh earlier, that frankly, mind you, one of the

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TAPE 15:

page 1

such as satisfactory, reasonable, sufficient ~~[illegible]~~ if ~~[illegible]~~ Aside from the risks which I have listed here, there are undoubtedly others I could list, throw in another dozen; anyone of these risks can be met in a number of ways. To get focused on one ~~WEAK~~ way of this risk to attenuate part of the problem/by looking to the State for certain guarantees , is, really misleading.

I think that if you want a ~~broad~~-- broader statement,which is highly generalized, the State and the oil companies, if such a plan, vaguely along these lines, were developed, have a stake in the development, exploitation, shipment,of oil to ~~(27)~~ THE North Slope. When you put together a prospectus to market this issue, and assuming that you're not counting on external guarantees by the oil companies, I give full credit to the oil companies, you're going to have to BE VERY focus on the economics of the North Slope, its oil and its future market, and cost of getting it there. You're going to be focused on what the state has invested IN there. I think THAT perhaps that to the degree the revenues and stake that the State has, and that the oil companies have, that these are areas in which you will undoubtedly be exploring for certain assurances, guarantees, AND agreements. I am sorry, I don't think it is meaningful to be more explicit than that.

BETTIS: I ~~believe~~ THANK ----------
Mr. Macey,/ you have indicated that you feel the chances of working out a suitable arrangement with the oil companies are sufficiently good that you would recommend the passage of HB 569, and would/agree that you also AS up to that we should proceed with passing the ~~loan~~ authorization ~~(28)~~ or bond measure at the same time? Is that a necessary part of the...at this stage of the game?

MACEY: I think this is very useful. THE ~~[illegible]~~ the acceptance of these levels of financing to which the State to some degree is going to have its name

attached, because the legislature is going to go along with this, I think this is very important.

RETTIG. We have, perhaps as you are no doubt aware, one of the highest per capita of bond indebtednesses of any state at this time, and I am aware that many of the bond underwriters look as if its on the books already to be authorized.

With the many, many still unanswered questions in connection with the three and one half billion dollar issue, would the very fact that that is on the books, have any effect upon our other general obligation bonds that we may have to market immediately or in the near future?

MACY: I don't believe so. It is not, as I understand frmm Mr. Cady's interpretation.....what is really involved in the issue here , as I understand it, before any obligation of this type could occur, it requires so many plans enabling .....enabling legislation...I cannot really see where this would have effect on it anyhow.

Thank you.

MCVAE Any further questions? Mrs. Fisher?

Mrs. Fisher: Mr. MACY (Meisdig???) If HB 569 is passed, if everything went right, what time would you estimate the first bonds could be sold? This could be a guessistimate.

MACY: I would say the first bonds might be sold.....the time factor, point of departure, the time after this cooperative agreement is reached with the oil companies so it becomes, given that that is reached, and that with suitable inputs from the investment community, that this agreement can be brought up to.....the investment bankers judge to be a satisfactory level of investment grade, if you will I would assume that within three

to six months after that, the bonds ~~could~~ you could ..... ~~would~~ begin to sell the bonds. (~~???~~)

Now we also have conditions over which none of us have co ntrol. It is not only as I understand it _____

it's ~~is~~ NOT ONLY a question of whether you can sell the bonds AS ~~you might be able to~~ HOW MUCH YOU CAN sell the bonds, how much OF THE BONDS you can sell ~~the bonds for~~, AND at what cost. AND these are subject to market conditions, which we have relatively little control over.

MCVAE!
Other questions? Mr. ~~Groh~~? ~~(?)~~ Grohs~~?~~

GROH! _____: One quick one - in the broadest general terms, Mr. Macy, what are potential underwriting counsel fees, / in connection with the three and a half billion dollar issue? HM. HM.....No, just as.....I think the people of Alaska ~~would like to~~ OUGHT to know. I'd like to know.

MACY _____: I THINK THAT This again is something that I WOULD ALWAYS STOP AND ~~would~~ say is existing subject to/market conditions HIGHLY GRADED IT IS AND SO FORTH I would say that you have to accep t ~~that~~ THE initial issues are going to have a larger underwriting spread, which is investment banking fee I think you are referring to, than the later issues because it is A SHEER educational effort that is going to have to go into the market. I think that various comments that we have discussed ~~with~~ AMONG THE members of the group, I think ~~the~~ THAT THE WHATEVER that the underwriting discount here WOULD BE ...somewhere between 1-1/2 and 2-1/2 %. Now admittedly I have heard of rumors in the newspapers that somebody is willing to ~~HIXH~~ bid slightly higher than that for the underwriters service, but I THINK THAT this is perhaps a realistic REALM in today's market.

GROH:
You deal in these figures all the time - would you translate that for me?

MACY _____: Yes, that is the principal ~~(???)~~ amount of THE ISSUE.

TAPE 15:

Page 4

McVAE: I would like ~~verification~~ CLARIFICATION on that...are .....are you.... are you saying 1-1/2 to 2% of the entire issue, or would that 1-1/2 to 2% say of the first hundred million?

MACY: No, each series, as it comes. Theoretically, at the end of the total issue, the total underwriting spreads should total 1-1/2 to 2-1/2 % of the total principal amount of the bonds - in this case 3-1/2 billion dollars.

McVAE: you say seventy million.....2% would be 70 million?.....

(much hilarity)

HOLM:

MR. MACY, I just want to follow that up - would this be the same, whether it was sold by private industry or not?

MACY: Now in general, the underwriting spread for a private issue here, on this particular case - I think the alternative you are referring to would be the oil companies (yes) financing - would be less.

HOLM: Approximately how much less?

MACY: This gets very subjective: I'd say that it might run a half percent lower.

HOLM: So we pay a half per cent premium? Why do we pay a half per cent premium?

MACY: I think it is because of THE WAY IN WHICH the differences in which corporate municipal or issues are marketed, and the way ~~in which~~ public issues are marketed, the relationship between the sale being ---- IF YOU WILL, THE SELLERS, the underwriters and the institution, THEN IT WOULD BE --

HOLM: Well, ~~anyway~~, doesn't that narrow that 1-1/2 % spread that was talked about, A LITTLE BIT earlier - I suppose you were here DOESN'T - this narrow that down to one, and some of the other questions THAT WERE RAISED - took another half per cent ~~out~~ OFF,

MACY : Well, ~~we~~ you have to understand....you have two things here.... in an underwriting discount, our spread, if you will, which is a one time cost at the front end. ~~It~~ This comes out and is deducted from the net proceeds ~~that~~ of the ~~are~~ offering.

HOLM : So it is just the first year, MACY: Its not an annual thing?

HOLM : No. I UNDERSTAND, BUT ITS

_____ : ~~I understand, the~~.....

MACY : I think the spread that you're referring to was the spread in the interest cost, for the life of the issues. ~~(???)~~

HOLM : For the first year there would be ....the spread wouldn't be nearly as great?

MACY : That is correct.

HOLM : Thank you.

RETTIG : Mr. Macy, would you be willing to pay the bond counsels fee out of that?

RETTIG (laughter) you don't have to answer that.

Mr. Rose?

Mr. Rose : My question, Mr. Chairman, was along the same line that you were just asking.....the answer to Senator ~~Rowe's~~ GROH (~~??~~) question. I am interested in the underwriting fee, but Senator Groh asked about the counsel fee - what kind of a spread does that represent?

MACY : I am afraid I couldn't GUESS MYSELF.

Mr. Rose : You have no idea? There is no DOOR OPEN FOR THIS KIND OF THING.

MACY : There may be - ~~I believe Mr.~~ TO RESPOND TO

RETTIG : I believe Mr. Macy has indicated he is not prepared ~~for~~ that, ~~xxxxxxxxxxxxxxxxxx~~ not being bond counseler.

RETTIG : Are there any other questions?

CHRISTENSON: Yes.....where can we get this figure?

RETTIG: Mr. Wohlforth, would you care to volunteer this information?

Wohlforth: ~~I am afraid I am not any improvement as unfortunately I was in conversation at my table.~~ there was some

~~_____: Can you rephrase it?~~

ROSE: Senator Groh asked earlier about what the normal liquidation bond fee counsel/would be ..... RETTIG: what would be the bond counsel's fee for representing the State in this issue?

WOHLFORTH: Well, again since I didn't hear the question, I imprudently came to the table .....

RETTIG: Are there any other questions?

WOHLFORTH: ~~It~~ Is the largest would be the largest PROJECT FINANCED ~~this would certainly be the largest project~~ in the Western Hemisphere and I THINK .....the second largest in the world, to be perhaps "smart alecky" negotiable - AGAIN, an arms length transaction between those public officials responsible for the public purse, or those people who are performing services. And again, I ~~think~~ its of the magnitude on which unfortunately I ~~where I~~ don't think the committee can begin on meaninful information.

MCVAE: Its not on a minimum fee schedule?

RETTIG: Mr. Macy, do I understand that you have to leave town tomorrow? Tonight, there'll be a few minutes perhaps shottly, that any members who want to consult with Mr. Macy, may do so later.

_____: Thank you very much, Mr. Macy, for appearing.

RETTIG: In this hearing we've considered only the various aspects ~~in~~ of possible State ownership of the pipeline. There are other majors introduced by the administration ..sponsored by the administration....namely SB 313, 14 and 15 concerning rights of ways, safety standards and pipeline regulations. Mr. Havelock,

are you ready to proceed?

Mr. Havelock: Senator, the....if I may be allowed a moment of digression to answer ~~the~~ A NON- question of Senator Groh earlier - he asked ...he made an inquiry about .....he couldn't understand why we hadn't approached the oil companies ~~about~~ TO FIND OUT this preliminary question of whether they were willing to.....if I may answer this in sort of an analogy.....I suppose if possible that I could get up from this table and go and ask the attractive girl at the end of the table whether she's willing , and I'm sure she'd tell me to go jump in the lake. IF I DID SO. On the other hand, if I invited her out TO DINNER I might get a good deal more information ABOUT whether she was willing.....start looking in store windows, AT FURS & DIAMONDS I would probably get a good deal more information! An old negotiator like Senator ~~Grothe~~ GROH is probably quite aware of the answer to this. (laughter) This is Attorney General OLAF HELLIN who will discuss the bills YOU REFERRED TO

GROH : Mr. Ch airman, I have a comment....my question is, have you ever called them?

HAVELOCK : We've talked to them hundreds of hours,

GROH : Did you ever ask them "are you willing to sell?"

BETTIG : ~~According to the papers, quite willing. (???)~~ IT'S BEEN carried in the papers quite fully.

BETTIG : The answer was"no."

GROH : Then, what are we doing here?

BETTIG : He is still taking them out to dinner!

GROH : I SEE, Havelock: before MR. Hellin starts with his ~~as part of the~~ testimony, Mr. Chairman, I would just like to comment that there is a bill that is not before this committee, BUT which will relate to the subject matter generally which will be testified TO before other committees, which is the so-called 20 mill property tax ~~law~~ on ~~the oil~~ OIL pipeline EQUIPMENT transportation, which is very much related to the subject

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Testimony of Eric E. Wohlforth
Commissioner of Revenue

March 6, 1972

I am Eric Wohlforth, Commissioner of Revenue. I will summarize past projections of North Slope revenues and those presented today based on private ownership, and contrast the revenue effect of private ownership case with the case of a pipeline owned by the State.

The most recent public North Slope oil revenue projections, before those referred to the Governor last week, were made by the Division of Oil and Gas in cooperation with the Department of Revenue as part of the State's contribution to the federal pipeline Impact Statement released by Governor Egan on July 30, 1971. These projections were developed from a computer model which was based on the information then available to the State and showed numerous economic cases on differing assumptions again based on facts then assumed to be ascertainable.

The July 30 report states on page 166 that, "the originally estimated $900 million cost of the pipeline has already increased considerably. Present cost estimates range from about $1.0 to $2.3 billion." The revenue projections used the assumption of $1 billion as the lowest installed cost and $2.5 billion

as the highest estimate. The footnote to this statement gives the backup for the State's cost estimates. It notes that as late as June 19, 1971 Alyeska furnished the State Department of Revenue an estimate of $969 million as the cost of the entire contract and concludes with reference to a statement from Interior Secretary Rogers C. B. Morton in late spring of 1971 that environmental precautions are contributing to a higher price tag of around $2.3 billion. This figure of $2.3 billion total cost was used in the State's "most likely" estimate of North Slope revenues. The revenue estimates included in the State's Report developed from this estimate of total cost, assumed refinery values in fiscal year 1976, the then estimated start up year, of $3.37, marine transportation costs of 44 cents, a pipeline tariff initially of 80 cents per barrel, giving a wellhead value of $2.12. From these figures it was estimated that total royalties and taxes would amount to $164 million a year in fiscal year 1976, the first year of pipeline operation. In the second year of operation, fiscal 1977, total revenue was estimated at $278 million, the third year $282 million, and the fourth year $311 million. In the then estimated fifth year of production, fiscal 1980, the pipeline tariff was calculated at 47 cents a barrel with the marine transportation costing 52 cents leaving a wellhead value of $2.56. In that year we showed a total of $348 million in total royalties and severance taxes from the pipeline.

Other estimates were also run with different assumptions. For example, one set the pipeline cost at $1 billion with again the initial production year assumed in fiscal 1976. A wellhead value of $2.75, with lower marine transportation and tariffs produced $212 million in revenues in the first year of production and the fifth year of production on this optimistic projection the State was assumed to capture $412 million in oil pipeline revenues. A then pessimistic case which assumed a pipeline cost of $2.5 billion shows a wellhead value of $1.76 in the initial year of 1976 and royalties and taxes of $136 million in that year. In 1980, however, at a wellhead value of $2.20 a barrel, royalties and severance taxes reached a figure of $297 million. Incidently, in all of these cases, one of the main reasons wellhead value increases over the years is that transportation costs go down as the volume of oil shipped increases.

Several important events have now come to light which have required the State to revise downwards drastically its revenue estimates. The first indication of the fact that the State was incorrect in assuming as it did in the Impact Statement that a production flow starting at 600,000 barrels per day would reach 1.7 million barrels per day in the second year of production was disclosed in the summary project description of the trans-Alaska pipeline system received by the State this fall. On page 55 of that document it is stated that

the pipeline system will be brought to its full capacity in stages. In the initial phase of operation the system will have the ability to transport 600,000 barrels per day. The report goes on to state that the second phase is tentatively scheduled to be completed approximately two years after initial start up. In this phase the system will have a design capacity of 1,200,000 barrels per day. The final phase is expected to be completed approximately seven years after initial start up at which time the pipeline will reach its ultimate capacity of 2,000,000 barrels per day according to the project description. In other words, there will be at least 500,000 barrels per day less production in the second year of operation and every year thereafter for the initial seven years.

The next shock to the State was disclosed by the SEC Registration Statement filed by British Petroleum Co., Ltd., on October 12, 1971. In the offering circular accompanying the registration statement the following statement is made at page 24:

> ... "The initial construction phase of the pipeline is expected to provide a minimum aggregate throughput capacity upon completion of 600,000 barrels per day. This capacity is designed to be expanded in two stages, the first stage resulting in a total capacity of 1,200,000 barrels per day, and the second in a total capacity of 2,000,000 barrels

per day./ It is presently estimated that the cost of the pipeline upon completion to the 600,000 barrels per day capacity would be approximately $2.3 billion, and that increasing the capacity to 2,000,000 barrels per day would increase the cost by approximately $400 million." (Emphasis added.)

On November 10, 1971, Atlantic Richfield /filed a Registration Statement with the SEC stating that:

... "The cost of the system upon completion to the 600,000 barrel per day capacity is presently estimated to be approximately $2.4 billion, of which the Company will be responsible for approximately $675 million. The additional cost to all participants of increasing the capacity to 2,000,000 barrels per day is estimated to be at least $400 million." (Emphasis added.)

Thus, by mid November,/the total pipeline cost had escalated to $2.8 billion or $500 million over the average case assumed in July when the State made its revenue estimates. In fact it increased $100 million in less than one month

between SEC filings. This dramatic increase in pipeline costs revealed in official documents at the time of Governor Egan's first announcement on State ownership made it urgently necessary that the State finally determine the likely magnitude of pipeline costs. Commissioner Campbell has already indicated the independent study which the State has made through its consulting engineers, Tibbets, Abbott, McCarthy and Stratton, and the foundation for the present estimate of $3.5 billion. These figures have recently been developed along with an independent evaluation of operating costs so that for the first time the State can make a reasonable projection of the probable amount it can expect to capture from North Slope oil revenues.

The base case shown to you today in graphic form assumes the total pipeline cost of $3.5 billion financed 90% by debt at an interest rate of 8%. It conforms to the Alyeska throughput assumptions of full production only in the seventh year of pipeline operation. It shows the same ICC permitted rate of return as shown in the State's projection in July. In the fourth year from the beginning of construction or the first year of production, or 1977, we now show a negative wellhead or no State oil revenues. This was the year comparable to that in which it was earlier shown that the State would capture at least $164 million in revenues. The fifth year, 1978 the second assumed year of operation,

we earlier estimated $278 million in State revenues. In those two years alone the net revenue loss to the State over earlier estimates amounts to $442 million. By the sixth year or 1979 the new projection shows $84.6 million in oil severance and royalty revenues. Earlier we estimated $282 million for that year. The net loss by that year over earlier estimates is $640 million. Not until the 15th year of the pipeline operation do royalties and severance taxes amount to near the amount shown to our previously calculated second year. In the 15th year we show severance and royalty revenues of $277 million.

The question may be asked whether this is most pessimistic of cases which can be produced. The answer is clearly no for three reasons. In the first place the revenue loss figure mentioned above gives no effect to our expectation now of first pipeline operation in the year 1977, whereas in July we assumed a full year of revenues starting on July 1, 1975.

In the second place we show State taxes in each year of operation of approximately $33 million. For the first three years of operation State income taxes are estimated to total approximately $100 million or $33 million a year. This assumes the full State income tax rate on pipeline profits. Experts have indicated that this may not be a realistic assumption. Even, however, with the most optimistic income tax estimate net revenue loss from earlier projections amounts to $540 million during the critical first three years of operation.

Thirdly, calculation of the 7% permitted rate of return on valuation may err on the low side. The leading text on the subject "Petroleum Pipelines and Public Policy" by Arthur Johnson cites numerous instances of the slowness of the ICC to actually evaluate pipeline costs and its heavy reliance on industry figures. The Cook Inlet pipeline valuation itself took three years to complete.

The 7% figure is not high also when it is remembered there are seven separate proposed pipeline owners, each of which may aggregate earnings of other pipelines when the 7% rate is considered. It is entirely possible that higher return rates may be permitted until the valuation of the line is complete and even thereafter when earnings of other pipeline companies are aggregated to arrive at a total rate of return.

The next case presented shows the possible economic effect of State ownership of the pipeline. Financing is assumed in the amount of $1 billion in each of the first two years of construction at 8%, $900,000,000 in the third year of construction at 6-1/2%, $250,000,000 at 8% in the first year of operation, and $310,000,000 in the second year of operation. This case also assumes the same ICC permitted rate of dividend payout as assumed for the private case, namely, 7% which is a cash dividend payout limitation in each year of the projection. In arriving at the State's net cash flow, operating expenses, amortization, and interest on bonds are deducted from the gross income. During the

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first year of operation net cash flow to the State through its tariff on the pipeline is $230 million and royalty and severance taxes of $15.7 million for a total of $245 million. Obviously, in State ownership no federal or state income taxes are calculated on pipeline income. In the fifth year from beginning of construction or the second year of operation net cash flow is $228 million which together with royalty and severance taxes of $17 million produce a total of $245 million. In the sixth year from the beginning of construction and the third year of operation net cash flow amounts to $227 million through the tariff and total royalties and severance taxes amount to $123 for a total of $350 million. In the 15th year cash flow is reduced to $183 million by reason of the fact that the pipeline has depreciated but total royalties and severance taxes amount to $297 million for a total to the State treasury of $480 million.

It is emphasized that this case makes almost identical assumptions to that for the private case described above. It should be emphasized that the net income shown to the State is computed after debt service on State bonds. To avoid a speculative argument on the possible differential between interest rates on the State's debt which may be tax exempt versus taxable interest on the private borrowing we show all but $900,000,000 in State bonds at the same 8% rate. The main differences, of course, lie in the fact that the State is not subject to federal income tax and will receive no state income tax from pipeline operations

since it is the owner. The timing of the bond issues for both private and public ownership is the same although the term of the public bond issue is shorter indicating heavier debt service loads and the State of course is financing the pipeline 100% on a debt basis.

Numerous additional assumptions can be made on the question of the manner of public financing, the rate of return permitted either to the State or to private pipeline owners, interest rates payable by the State and private owners, the effective tax rate in private ownership, to mention only a few. We know that estimating the effect of economic projects based on events three to seven years away must rest on assumptions which are to a degree speculative. You will hear testimony that our assumptions are incorrect. The point is that no one can say with positive certainty what our revenue picture will be with the pipeline in private ownership. We have, however, tested prior assumptions based on official information now before us. This effort has convinced the administration that it must do what it can now to remove the uncertainty of the revenue picture in the late 1970's and in the 1980's. Mr. Eppenbach will explain how our projections were made and some of the detail on the charts before you.

JOINT HEARINGS ON PROPOSED PIPELINE LEGISLATION

MARCH 6 THROUGH MARCH 9, 1972

WITNESS REGISTER

	NAME	AFFILIATION	REPRESENTING
1.	H. A. Boucher	Lt. Governor	Administration
2.	Charles Herbert	Commissioner, Nat. Resources	Administration
3.	John E. Havelock	Attorney General	Administration
4.	Bruce Campbell	Commissioner of Highways	Administration
5.	Eric E. Wehlforth	Commissioner of Revenue	Administration
6.	Larry Epperbach	Department of Revenue	Administration
7.	Joseph R. Henri	Commissioner of Administration	Administration
8.	H. M. Temple III	Temple, Barker & Sloane	Administration
9.	Charles Kades	Hawkins, Delafield & Wood	Administration
10.	Tom Gildehaus	Temple, Barker & Sloane	Administration
11.	L. E. Crowley	Salomon Brothers	Administration
12.	Robert Macy	Kuhn, Loeb & Company	Administration
13.	John E. Havelock	Attorney General	Administration
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PLEASE NOTE: THE PRECEDING PAGES WERE TREATED AS A UNIT IN THE ORIGINAL DOCUMENT.

JOINT HEARINGS ON PROPOSED PIPELINE LEGISLATION

MARCH 6 THROUGH MARCH 9, 1972

WITNESS REGISTER

	NAME	AFFILIATION	REPRESENTING
1.	Charles E. Spahr	Aleyeska Pipeline	Standard Oil of Ohio (SOHIO)
2.	W.J. Williamson	Aleyeska Pipeline	Law Professor U. of Houston
3.	Harry R. Jones	Aleyeska Pipeline	Attorney specializing in State & Interstate commerce. Houston, Texas
4.	Donald W. Markham	Aleyeska Pipeline	Washington, D.C. Attorney
5.	Edward L. Patton	Aleyeska Pipeline	President of Aleyeska Pipeline
6.	Joseph R. Cortese	Aleyeska Pipeline	Attorney Ohio, specialistin law re Powers of State & localgovt
7.	Raymond B. Gary	Aleyeska Pipeline	Investment Banking, Underwriting & distrib of securities.
8.	George A. Seymour	Aleyeska Pipeline	Mobil Pipe Line Company.
9.	Thomas R. Broussard	Aleyeska Pipeline	Atty. Spec in taxation, Legal Dept ARCO
10.	Edward L. Patton	Aleyeska Pipeline	Aleyeska President. See 5 above
11.	Joseph R. Cortese	Aleyeska Pipeline	Same as 6 above.
12.	Richard M. Donaldson	Aleyeska Pipeline	V-Pres & Gen Counsel of SOHIO
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AGO 530826

JOINT HEARINGS ON PROPOSED PIPELINE LEGISLATION

MARCH 6 THROUGH MARCH 9, 1972

WITNESS REGISTER

	NAME	AFFILIATION	REPRESENTING
1.	S. C. SANDUSKY	DIVISIONAL MANAGER	MARATHON OIL COMPANY
2.	DON DICKEY	GENERAL MANAGER	STATE CHAMBER OF COMMERCE
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IN THE HOUSE

BY THE RULES COMMITTEE BY REQUEST OF THE GOVERNOR

HOUSE JOINT RESOLUTION NO.

IN THE LEGISLATURE OF THE STATE OF ALASKA

SEVENTH LEGISLATURE - SECOND SESSION

Proposing an amendment to the Constitution of the State of Alaska provisions regarding the use of state funds for the debt of public corporations.

BE IT RESOLVED BY THE LEGISLATURE OF THE STATE OF ALASKA:

* Section 1. Sec. 7, art. IX of the Constitution of the State of Alaska is amended to read:

SECTION 7. DEDICATED FUNDS. The proceeds of any state tax or license shall not be dedicated to any special purpose, except when required by the federal government for state participation in federal programs, or when dedication is provided by law, for the purpose of securing the payment of bonds and notes of a public enterprise or public corporation of the state or a political subdivision of the state. This provision shall not prohibit the continuance of any dedication for special purposes existing upon the date of ratification of this constitution by the people of Alaska.

* Sec. 2. Sec. 8, art. IX of the Constitution of the State of Alaska is amended to read:

SECTION 8. STATE DEBT. No state debt shall be contracted unless authorized by law for capital improvements and ratified by a majority of the qualified voters of the State who vote on the question except that the State may guarantee by law bonds and notes of a public enterprise or a public corporation of the State created or empowered to construct pipelines for the transportation of oil or gas or both and may by law authorize such public enterprise or public corporation to mortgage any State lands or properties

and royalties or rents, issues and profits therefrom as additional security for its bonds or notes, whether or not guaranteed by the State. The State may, as provided by law and without ratification, contract debt for the purpose of repelling invasion, suppressing insurrection, defending the State in war, meeting natural disasters, or redeeming indebtedness outstanding at the time the constitution becomes effective.

* Sec. 3. The amendment proposed by this resolution shall be placed before the voters of the state at the next statewide election in conformity with sec. 1, art. XIII of the Constitution of the State of Alaska and the state election laws.

PROPOSED AMENDMENTS TO HOUSE BILL NO. 569

Page 2, line 26:

After the word "interest." strike the words "It is also declared to be in the public interest for the state to guarantee the principal and interest on bonds issued to finance the facility."

Page 19, line 12:

Delete all of AS 44.58.260.

AGO 530830

Statement of Charles F. Herbert
Commissioner of Natural Resources

In 1964 the State of Alaska selected 1,593,705 acres on the North Slope, between Naval Petroleum Reserve No. 4 and the Arctic Wildlife Range. The land selected was considered to have good potential for petroleum but none suspected that it would contain the largest oil pool ever found in North America. On the map, the lands north of the heavy green line are those selected in 1964 and the orange-shaded area covers the Prudhoe Bay oil field. I want to emphasize that not all of the land within the shaded area will be productive of oil or gas--in fact, there are a number of dry holes within the area shown as the oil field.

Although millions of dollars had been spent in an unsuccessful search for oil on Federal lands southwest of State lands, the first lease sale of North Slope lands by the State was moderately successful and provided revenue at a time when it was needed badly. Greater interest was shown in subsequent lease sales even though drilling on State lands had been disappointing. Finally, on what was said to be a "last try" for oil on the North Slope, ARCO announced a major discovery in July, 1968. The State then selected an additional 2,852,880 acres south of the original North Slope selection. This later selection, for which tentative approval by the Bureau of Land Management has not been received, lies between

the green and brown lines on the map. Note that over half of the area in the later selection is covered by leases. These are Federal noncompetitive leases which had been issued prior to State selection. Some have expired recently and many are due to expire within the next few years, unless oil or gas is found in productive quantities.

With oil interest at fever pitch, the State sold much of remaining tentatively approved North Slope lands at a lease sale on September 10, 1969. The total of bonus bids received at that sale is the largest ever recorded anywhere.

Bonuses received from the sale of State leases on the North Slope:

Date of Sale	Acres Leased	Bonus/Acre	Total Bonus
Dec. 8, 1964	476,147	$ 9.20	$ 4,379,729.91
July 15, 1965	403,000	15.25	6,145,472.59
Jan. 24, 1967	42,397	34.87	1,478,777.23
Sept. 10, 1969	412,548	2,181.66	900,041,605.34
	1,334,092*	$ 683.65	$912,045,585.07

* This figure includes some offshore lands and some duplication caused by forfeiture of leases and subsequent re-leasing.

Bonuses on future sales of leases on the North Slope are most difficult to estimate. Certainly, there is little incentive to purchase leases in the area until such time as construction of a pipeline is assured. About all we know is that the State does own, or will own, land that can be offered for competitive oil and gas leasing.

We estimate that the following land may be offered at some future date:

Unleased land on which the State now has tentative approval	200,000 acres
Selected land, less valid Federal leases - at least	1,000,000 acres
Offshore lands between Pet. 4 and and the Arctic Wildlife Range	300,000 acres

Since Alaska now ranks second among the states in proven oil reserves, and will probably outrank the leading state, Texas, when more active drilling is resumed, Alaska can look forward for very many years to substantial income from oil and gas royalties and severance taxes.

The Prudhoe Bay field alone has a proven reserve of 9.6 billion barrels of oil and 26 trillion cubic feet of natural gas. To the west of Prudhoe Bay, the Ugnu field has oil but there has not been enough drilling to permit a reliable estimate of reserves. Wells in the Ugnu field are much less productive than those in the Prudhoe Bay field but they should add materially to North Slope production. Other potentially productive structures are known so we think that an estimate of 20 billion barrels of oil from State lands on the North Slope is justified.

In addition to production from State lands and offshore lands on the North Slope, oil and gas will be produced from lands that may be selected by Native Regional Corporations and from Federal lands that are or may be leased. We expect that someday Petroleum Reserve No. 4 will be developed, and there is some possibility that the very attractive Marsh Creek anticline in the northwesterly portion of the Arctic Wildlife

Range may be drilled. The highly regarded Canadian publication, OILWEEK, estimates that the Alaskan North Slope will produce 50 billion barrels of oil and many trillions of cubic feet of natural gas. Most certainly, oil and gas pipelines from the North Slope will be busy for many years.

In all existing leases on the North Slope, royalty is fixed at 12-1/2% of the wellhead value. However, leases issued prior to 1969 provide for a royalty of 5% of the production from a lease on which a discovery of a new field is made. Only one lease in the Prudhoe Bay field is entitled to the reduced royalty and that privilege expires in 1978, ten years after the date of discovery.

All existing North Slope leases have a term of ten years, or as long as production is maintained. Leases may also be extended if committed to an approved unit agreement. Unit agreements, which are formed by pooling of interests of all lessees on a geologic structure capable of, or believed to be capable of, producing oil or gas, carry specific drilling requirements which must be approved by the Department of Natural Resources if on State land, or by the U.S. Geological Survey if on Federal land. Prior to 1969, leases on lands to which the State had only received tentative approval were issued as conditional leases and the lease term did not begin to run until the State received patent to the land. With the exception of the leases sold in the September, 1969 sale, North Slope leases are conditional and the term of lease has

not begun to run.

The wellhead price of oil or gas, on which royalty and severance taxes are based, is stated in each lease as the highest of (1) the price actually paid by a purchaser at the well, (2) the posted price by the Lessee in the oil or gas field, or (3) the prevailing price paid to other producers. Since nearly all Alaskan oil is sold on the West Coast of the United States, the wellhead price is determined by the field price at the point of delivery on the West Coast, less transportation charges. Since these charges are variable among producing companies there has been enough confusion in the Cook Inlet Basin to cause a lawsuit between the State and one of the producers. Since this matter is now before the court I cannot comment further, other than to hope that clear guidelines for the determination of wellhead price are established either by directive from the court or by general agreement.

All oil and gas produced from State lands on the North Slope, other than offshore lands, is subject to a payment of 2% of the gross value (i.e., wellhead price) to the Alaska Native Fund, until such time as $500 million has been paid into that fund from all sources of State income subject to such payment. Although provision for payment to the Alaska Native Fund effectively reduces State royalty on a standard oil and gas lease to 10-1/2%, the payment is treated in State accounts as an obligation against the State treasury and so does not enter into estimates of State income from minerals.

After deduction of royalty from wellhead price, the remaining value is subject to a State severance tax based on the rate of production from each producing well. The tax on oil is:

3% on the first 300 barrels per day

5% on the next 700 barrels per day

6% on the next 1,500 barrels per day

8% on all production over 2,500 barrels per day

The severance tax on natural gas is 4% of the wellhead price, regardless of the rate of production.

Derivation of State income from royalty and severance tax is:

Assumed wellhead price of oil	$ 2.00
State royalty @12-1/2%	0.25
Taxable value of oil	1.75
Severance tax @ 7% (best estimate)	0.12

Total State income then would be $0.37, or 18-1/2% of the wellhead price, a percentage that is probably applicable to oil production from the North Slope, regardless of wellhead price. For natural gas, State income is 16% of the wellhead price.

INTRODUCTORY STATEMENT BY LIEUTENANT GOVERNOR MARCH 6, 1972

I HAVE BEEN ASKED BY GOVERNOR EGAN TO DELIVER HIS MESSAGE TO THE PEOPLE OF THE STATE OF ALASKA IN HIS ABSENCE.....AS LIEUTENANT GOVERNOR I HAVE HAD THE OPPORTUNITY TO WATCH OUR CHIEF EXECUTIVE DEAL WITH THE AGONIZING REALITIES THAT DELAY IN PIPELINE CONSTRUCTION AND SPIRILING COSTS HAVE RESULTED IN.... AND WHILE APPRAISALS THAT DO NOT VIEW A PORTION OF OUR FUTURE TOTALLY THROUGH ROSE COLORED GLASSES ARE DISTASTEFUL TO SOME.... I HAVE NEVER SEEN OUR CHIEF EXECUTIVE SWERVE FROM HIS DUTY TO OUR STOCKHOLDERS.....THE PEOPLE OF THE STATE OF ALASKA

THE FUTURE OF OUR STATE IS A BRILLIANT ONE....NO ONE KNOWS THIS BETTER THAN OUR GOVERNOR WHO HAS DEVOTED OVER THIRTY YEARS OF HIS LIFE IN SERVICE TO ALASKA AND HER PEOPLE....THERE HAVE BEEN ROCKY SHOALS BEFORE AND OUR SHIP OF STATE HAS NAVIGATED THEM.... THEY WERE NOT OVERCOME BY WISHFUL THINKING...WE NEED NOT BE AT ODDS WITH OUR PARTNERS IN THE FUTURE...THE OIL INDUSTRY...WE RECOGNIZE YOUR CORPORATE RESPONSIBILITIES....I AM SURE YOU WILL RECOGNIZE AS GOOD CITIZENS OUR RESPONSIBILITIES...AND IT IS IN THIS SPIRIT THAT GOVERNOE EGAN HAS ASKED THAT I READ THIS MESSAGE INTO THE RECORD.....

SCHEDULE OF JOINT HEARINGS ON PROPOSED PIPELINE LEGISLATION

COMMITTEES:

SENATE COMMERCE COMMITTEE, RON L. RETTIG, CHAIRMAN.

HOUSE STATE AFFAIRS COMMITTEE, RICHARD L. MCVEIGH, CHAIRMAN.

LOCATION: GOLD ROOM, BARANOF HOTEL

BILLS TO BE CONSIDERED:

SB 313 - Relating to lease of rights-of-way.

SB 314 - Relating to safety standard for oil and gas transportation.

SB 315 - Creating Alaska Oil and Gas Transportation Commission.

SB 294 - Creating Alaska Leasing Board.

HB 569 - Establishing Trans-Alaska Authority.

HB 570 - G. O. bonds, $3,500,000,000.

MEETING SCHEDULE:

Monday, March 6, 1972	2:00 p.m. to 6:00 p.m.
Tuesday, March 7, 1972	8:00 a.m. to 11:00 p.m. 2:00 p.m. to 6:00 p.m.
Wednesday, March 8, 1972	8:00 a.m. to 12:00 p.m. 1:30 p.m. to 6:00 p.m.
Thursday, March 9, 1972	8:00 a.m. to Completion

A special section will be reserved for other Members of the Legislature.

Testimony of Lawrence Eppenbach
State Investment Officer

March 6, 1972

Mr. Chairman, Committee Members. In testimony already presented you have heard a great deal about revenues, costs of pipelines, calculations of royalties and severance taxes and permitted dividends. Rather than to add more numbers, more formulas, more calculations, I think it would be prudent now to pause and develop perspective on the numbers already given to you and about the many charts. To do this, I should like to talk first about how the State brought all of its pipeline information together to calculate what is really the most important piece of information thus far and that is an estimate of total revenue from the North Slope.

We employed a computer model which simulated each year, economic operation of the pipeline under varying conditions regarding ownership, financing, taxes, and earnings limitations. In a sense, an income statement was prepared each year for the owner of the line. This income statement does not appear so very different, at least in terms of its expressions, from that of any other income statement. Gross revenues to the pipeline are derived from its tariff charge on barrels of oil transported through the line. That gross revenue less the cost of operating and maintaining the line, less depreciation, and less interest costs for financing

the line, will produce a net income figure. From that we deducted any federal or state income taxes paid to yield a net after taxes income.

Similarly, the cash flow to a pipeline company is much like that of any other business. The net after tax income plus any additional cash flows which may be generated because the depreciation charge that is provided for in the income statement happens to be greater than the bond retirement actually made by the company. The only place that pipeline operation appears different, economically, to that of the ordinary company, is in the dividend payout allowed each year by the pipeline company to its owners.

That dividend is not some percentage of equity or some rate of return of capital investment, it is a percentage dividend allowed on the valuation of the pipeline as determined by the ICC. The ICC valuation approach takes into account many issues: original cost of the line, depreciation, percentage increases for going concern value, and additional percentage increases for inflation. Our computer model had to also simulate this ICC valuation. In general terms, during the first year of operation ICC valuation was about $3-1/4 billion. In the following years it increases slightly as additional phases of operation were under way providing for higher throughput and then decreased in value as the line began to depreciate.

The dividend limitation on ICC valuation is a critical variable in the

economics of pipeline ownership. Our model, given a dividend rate calculated back up the income statement to find out what kind of tariff would have to be placed upon the pipeline in any year to provide gross revenue required to generate the appropriate cash flow for the dividend. During the first year of operation of the trans-Alaska pipeline, the 7% dividend limitation provides for a dividend to the parent company of over $230 million, a legal dividend provided only to the owner of the pipeline.

If I may turn your attention now to the large chart, it is that very dividend that accounts for the vast difference between estimated income to the State of Alaska under conditions of public ownership on the top line, versus conditions of private ownership, the bottom line. You will note that both lines slope upward as the throughput of oil through the line increases, clearly shown as a step increase between operation of the line in phase one, a capacity of 600,000 barrels a day up to phase 2, a design capacity of 1,200,000 barrels per day. But the graph does not display all of the information which is in the tables alongside of it.

First, in public ownership, the major part of revenue during the early years is derived from dividends with positive and growing amounts of revenue coming from wellhead value royalty and production taxation. You will note that there are no state income taxes included here as a revenue source to the State

under conditions of public ownership.

Under conditions of private ownership, a very different case develops. Here in the initial year a total of about $37 million should accrue to the State. Where does it come from? $3.2 million of it only comes from the North Slope in the form of gas royalty and production tax payments. This is gas that is assumed to be shipped in a trans-Canadian gas pipeline. The remaining $34 million comes from state income taxes. In the 7% dividend case displayed here there is no positive wellhead value for oil during the first two years of operation under private ownership. In this case, for there to begin to be some positive wellhead for oil during the first two years, the dividend payments must be no greater than 4.75% and even if the dividend were lowered to zero the State's income from royalty and severance tax of approximately $53 million would be less than one third of that estimated as recently as last year.

I shall present at the close of the testimony this afternoon a series of cases for the committee to study that explore this question of taxation and dividend limitation. For the present, however, let us return to these two cases that we have displayed before you. Again, they provide a legal 7% ICC dividend. In the private case even though a negative wellhead value is indicated for the first two years it is quite possible that the oil companies would still pump oil

as their true cost of shipping their own oil through their own pipeline may be different than their calculated cost of shipping the State's oil through their own pipeline. Not only is the dividend permitted legal, but together with the costs and throughput capacity limitations as stated in the Impact Statement, this case of private ownership of the line appears quite possible. So are the revenues it generates. Speaking next to the very important question of what these revenues will mean to the State will be the Commissioner of Administration, Joseph Henri.

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

TESTIMONY OF JOSEPH R. HENRI
Commissioner of Administration, State of Alaska,
Before the Senate Commerce Committee
And the House State Affairs Committee
At Juneau, Alaska, 6 March 1972,
Regarding Income From North Slope Oil and Gas,
And How it Affects the State Budget

Mr. Chairman and Members:

I am Joseph Henri, Commissioner of Administration. This part of the State's presentation deals with budget expenditures vis-a-vis income to be derived from North Slope oil and gas extraction. The essential questions are:

1. Will we be able to maintain our current level of services, adjusted for population growth and inflation?

2. Will we be able to increase our level of service to meet compelling needs recognized by this administration, the legislature and the citizens of Alaska?

3. Will we have to reduce our level of service, and if so, what are the activities affected?

The answers to these questions rest in the amount of dollars the State can expect as its share of the Prudhoe Bay oil basin. Once upon a time, the Department of Administration felt much more certain about future State income than it does today. When will the

pipeline begin? What extraordinary man-caused interruptions will delay its completion? What will be the first year capacity of the line? The second year? The third? What is the maximum extraction rate the basin structure will prudently allow? What volumes of oil can be expected in any of the first seven years of the pipeline? What will be its final cost?

All of these variable factors, well known to each of us in this room, make budget planning extremely difficult, because the major part of Alaska's State revenue has come and will come from the North Slope resources. In the budget now pending before the legislature, we have recommended a total general fund expenditure of $311.7 million; those are State $ of this sum, $97 million will have to come directly from the Prudhoe Bay bonus money, the principal, and $52 million more from interest earnings on the investment. As we dip heavily into the corpus - invade the principal - interest earnings diminish, compounding the revenue problem. Our present or anticipated recurring revenues are simply too low to fund our present and anticipated expenditures. We are depleting our savings account. As the following year's budget figure increases, more of the principal will have to be spent; the interest yield will dwindle further. Obviously, we will soon hit the bottom of the barrel. Only large and new revenues from the North Slope can allow us to continue our present budget growth rates.

What is the growth rate we have recommended for Fiscal Year 1973? For the general fund, it is 3.5%; for the total budget, 4.6%. We have had to slash so dramatically the rate of increase because pipeline delays and cost escalations have darkly influenced

our future revenue projections. With ~~such~~ a small increase in the budget, a number of programs have already felt the chill winds of dollar scarcity. The proposed Fiscal Year 1973 budget contains such unpalatable ~~things~~ items as holding school foundation funding to the current year's level, regardless of enlarged student population; keeping the University's 19 Alaska increase to $800,000 in the face of a claimed need for an addition of over $5 million just to maintain current activities; a limitation of nursing home care and general medical relief; foregoing general obligation bonds for lengthening two more ferry boats, and for a larger program of airport construction. There are many more "pinches" in the budget, besides those I mention. Nonetheless, so far we have not jeopardized any State activity essential to health and safety. These painful adjustments herein noted were recommended in spite of the fact oil was projected on stream in July 1976; now another year's delay - or more - seems probable. The consequences are obvious.

Our budget book for Fiscal Year 1973 projects a growth rate of 6% compounded annually through 1976, and 8% thereafter through Fiscal Year 1981, covering a ten-year period. Further, it envisions capital improvement bond authorizations of $60 million in 1974, and $100 million in the next biennial election, and each one thereafter. I can only characterize these projected budgets as "modest." They are very little more than maintenance figures. Program dollars will still be limited. Careful budgeting and allocation will still be required. New starts and new programs will be exceedingly selective. The 6 and 8% growth rates most likely mean a shortage of funding for the school foundation plan, and for the revenue sharing program with local governments. Yet, I express to you the gravest concern that actual receipts in the State treasury during the next ten years may be pitifully shy of the sums needed even to maintain our austerity.

Previously, in the testimony Commissioner Wohlforth and the Department of Revenue, test cases have been articulated regarding revenue to be derived under (A) private ownership and (B) State ownership of the crude oil pipeline. All of us realize that a multitude of variations in revenues and expenditures are possible under each heading. Nevertheless, for purposes of comparison we have presented two likely cases and their dollar results: Both examples entail the seven-year oil volume build up delineated in the Department of the Interior Environmental Impact Statement submission by Alyeska, a 7% dividend to the owner, a line cost of $3.5 billion, and oil on stream in July 1977.

Exhibits A and B, attached at the conclusion of these remarks, portray the figures - and the story - for the decade 1972-1982. Under the private ownership case, Exhibit A, were Alaska to continue to increase its budget expenditures at the 6 and 8% rates, mentioned earlier, the first year of deficit would be Fiscal Year 1978, wherein we would experience a shortfall of over $156 million. This shortage would increase so that by Fiscal Year 1982 the deficit would be $1,135,000,000. Of course, deficits for operating expenditures are in fact impossible under our State constitution; instead of experiencing a billion dollar deficit ten years from now, we would in actuality have to reduce State expenditures radically.

Under the private ownership case the State could have in its treasury at the end of Fiscal Year 1982 the sum of $45 million <u>if, and only if</u>, its operating expenditures in every year of the planning decade rose annually by only 1% (see Exhibit C). Now an increase of 1% equals a huge cut in all programs, and the elimination of many.

The dollar crunch is graphically portrayed in the following paradigm. Under the private ownership operating budget column, increasing annually at 1%, the available dollars are recorded. Contrast these with the operating budget under public ownership, the first column on the left. The figure shows that if the State of Alaska owned the pipeline there would be sufficient dollars in each of the next ten years to meet our planned 6 and 8% annual increases. In fact, the revenue would be sufficient to raise the budget from these maintenance or austerity levels so that expansion of present services and the addition of new ones could be handily realized. Were the oil line privately owned the State would have almost billion less dollars to spend over the next ten years. We would be able to authorize 365 million fewer dollars for capital improvements.

(Graph on following page)

COMPARISON OF FUNDS AVAILABLE

PRIVATE VS PUBLIC OWNERSHIP

(ALL FIGURES IN 1000)

FISCAL YEAR	PUBLIC OWNERSHIP OPERATING BUDGET *	PUBLIC OWNERSHIP DEBT AUTHORIZED	PRIVATE OWNERSHIP OPERATING BUDGET *	PRIVATE OWNERSHIP DEBT AUTHORIZED
1972	260186.5	71000.0	260186.5	71000.0
1973	276232.7		276232.7	
1974	292910.7	60000.0	278994.8	15000.0
1975	310485.1		281784.3	
1976	329114.1	100000.0	284601.8	20000.0
1977	355443.1		287447.4	
1978	383878.5	100000.0	290321.5	20000.0
1979	414588.8		293224.3	
1980	447755.8	100000.0	296156.1	20000.0
1981	483576.2		299117.3	
1982	522262.2	100000.0	302108.1	20000.0
TOTAL	4075433.7	531000.0	3150174.8	166000.0

* All figures refer to expenditure from general fund only

Difference in Operating Expenditure is over $925,000,000

Difference in Capital Debt Authorization = $365,000,000

The attached graphs, Exhibits D and E, portrary what I have been saying. In Exhibit D, under private ownership of the oil pipeline, the general fund would be depleted around January of 1978. On the contrary, under State ownership of the line, the precipitate dive to insolvency would stop in 1976 at a general fund balance of $231 million, and rise to a plateau of $450 million in the general fund by 1982. Furthermore, as Exhibit B shows, the total expenditure for that year would be approximately $605 million, and the total revenue $602 million; a parity between income and expenditure would have been achieved, and a surplus of almost half a billion dollars enjoyed. In actuality, no doubt, were the funds from State ownership available, the administration and the legislature would have expanded the budget faster than the 8% increase portrayed for the years 1977 and beyond so that no such surplus would likely exist at the end of Fiscal 1982.

The private ownership case I have presented to the Committees, Mr. Chairman, necessitates an abrupt and drastic reduction in State services and activities. I cannot tell you with certainty where the administration or the legislature would cut, but I can cite a few startling and likely areas of impingement in each of our program categories:

The State pays approximately 90% of local school district costs, constituting roughly 30% of annual State dollar expenditure. That State aid would be materially reduced; it would be impossible for the local areas to maintain present educational standards through increased property taxes. State Operated Schools and the University

of Alaska would have to radically abate their present service levels.

The welfare or social services activities of the State would experience vast curtailment in the number of eligible cases and the amount of benefits; many people would be compelled to leave Alaska; distress or even starvation would haunt many who decided to stay. Public health and mental health retrenchments could force the closing of the Alaska Psychiatric Institute, and a diminution or abolishment of the State's work in drug abuse, alcoholism, tuberculosis testing and venereal disease control. The necessitated nullifications of State expenditure in these areas will in turn lose large amounts of federal dollars now enjoyed. Our ability to operate and maintain an effective Pioneers' Homes program will be materially impaired.

No new fish hatcheries would be built. No hunter safety program would be initiated. Salmon yields in Southeast Alaska would remain significantly below maximum sustained yield. Land use planning and the inventorying of our natural wealth would be jeopardized, thus making management of the State's surface and subsurface resources haphazard at best. Added park and recreation sites would be forgotten, and the maintenance of existing facilities lessened. Many Alaska communities would remain without sewage treatment facilities. Programs for coastal zone management, environmental engineering, permafrost and soils engineering would likely be abolished.

In the category of Public Protection, disaster planning, the Public Utilities Commission, the Alaska Transportation Commission, and most consumer protection programs would be impaired or totally eliminated.

The State police would experience a great shrinkage in manpower, and the courts and their ancillary agencies could not cope with their workloads.

Tourist promotion would have to be seriously curtailed and our work in research, in community improvement and grant assistance, and at conventions and trade shows would most likely fall by the board. The work of the agricultural loan fund and the small grain incentive program would be enfeebled or eliminated. The Division of Planning and Research and the State Economic Opportunity Office would be crippled or possibly dropped.

Our program of revenue sharing with the local governments, around $7 million in the current year, would no doubt go out the window. The Marine Transportation System for Southwest Alaska would likely be eliminated, and service in Southeast materially contracted. Airport maintenance in rural Alaska would be severly curtailed, likely forcing the winter closure of those ports, thus isolating a large part of Alaska for five months of the year, denying medical and other critical services. Likewise, winter maintenance of many of our highways would be only a pale reflection of the excellent job being performed today.

The various boards and commissions whereby Alaskan citizens take a direct and active part in the work of the State government would be minimally funded, or in some cases, unfunded. I am speaking of activities like the Western Interstate Conference on Higher Education, the Athletic Commission, the Status of Women Commission, the International Development Commission, the Pioneers'

Advisory Board, the Yukon Taiya Commission, the Rural Affairs Commission, the International North Pacific Fisheries Commission. Our Youth in Government program, recently instituted with such great success, would likely be abandoned.

I do not represent to you, as the view of this administration, that each of these reductions suggested above would come to pass under the private ownership case portrayed in Exhibits A and C. Nevertheless, no one can say that many of the above dire consequences would not eventuate under that case; undoubtedly some would. The economic and social dislocation would be grievous indeed.

The purport of my remarks is that this State has a vital interest in an adequate share of North Slope riches. If we do not realize that share, State expenditures over the next decade will be woefully inadequate to do the job Alaskans expect from their government. The solution we propose to sufficiently fund the budget is the ownership of the crude oil pipeline by the State of Alaska.

Exhibit A

STATE OF ALASKA
DIVISION OF BUDGET AND MANAGEMENT

BUDGET PLANNING MODEL

RUN ID RUN 3

DATE MARCH 3, 1972

COMMENTS
PRIVATE OWNERSHIP
7% TARIFF
BASE CASE
OIL IN 77

ASSUMPTIONS

ANNUAL RATE OF INTEREST ON GENERAL FUND = 6.00%

ANNUAL RATE OF INTEREST ON NEW BONDS = 6.00%

MATURITY PERIOD ON NEW BONDS IN YEARS = 20.

% ABOVE G.F.UNENCUMBERED BAL. UNEXPENDED = 0.0 %

GROWTH RATES FOR OPERATING EXPENDITURE FROM PRIOR YEAR

1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
6.00	6.00	6.00	6.00	8.00	8.00	8.00	8.00	8.00	8.00

NEW BOND AUTHORIZATIONS IN EACH YEAR

1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
710000.0	0.0	60000.0	0.0	100000.0	0.0	100000.0	0.0	100000.0	0.0

FISCAL YEAR	NON INVESTMENT REVENUE	INVESTMENT INTEREST	TOTAL REVENUE	OPERATING EXPENDITURE	DEBT SERVICE	MISC EXP SHD TAXES OF CAP EX	TOTAL EXPENDITURE	SURPLUS OR DEFICIT	GENERAL FUND END OF YEAR
1972									761268.2
1973	162264.1	42466.7	204730.7	276331.0	24020.8	11358.6	311710.3	-106979.6	654288.4
1974	182367.0	35772.1	218139.0	292910.7	29646.2	11756.5	334313.4	-116174.4	538114.0
1975	190047.0	28146.4	218193.4	310485.1	32973.5	12749.8	356208.4	-138015.0	400099.0
1976	186752.0	18960.8	207712.8	329114.1	33479.2	13290.6	375883.8	-168171.1	231927.9
1977	220569.0	8673.9	229242.8	355443.1	35373.3	13153.0	403969.4	-174726.6	57201.4
1978	225954.9	-2988.6	222966.3	383878.5	39390.5	13719.0	436988.0	-214021.8	-156820.4
1979	314776.0	-14823.9	299952.1	414588.8	42494.9	23358.3	480441.8	-180489.8	-337310.1
1980	329299.9	-26743.6	302556.3	447755.8	46529.0	25105.1	519389.9	-216833.6	-554143.8
1981	337012.4	-41200.4	290811.9	483576.2	47129.4	25167.5	555873.0	-265061.1	-819204.8
1982	344154.7	-58641.5	285513.1	522262.2	52863.3	26698.5	601824.0	-316310.9	-1135515.0
	2490194.0	-10378.5	2479816.0	3916342.0	383899.9	176356.8	4376599.0	-1896782.0	

AGO 530854

Exhibit B

STATE OF ALASKA
DIVISION OF BUDGET AND MANAGEMENT

BUDGET PLANNING MODEL

RUN ID RUN 4

DATE MARCH 3, 1972

COMMENTS
PUBLIC OWNERSHIP
7% TARIFF
BASE CASE
OIL IN 77

ASSUMPTIONS

ANNUAL RATE OF INTEREST ON GENERAL FUND = 6.00%

ANNUAL RATE OF INTEREST ON NEW BONDS = 6.00%

MATURITY PERIOD ON NEW BONDS IN YEARS = 20.

% ABOVE G.F.UNENCUMBERED BAL. UNEXPENDED = 0.0 %

GROWTH RATES FOR OPERATING EXPENDITURE FROM PRIOR YEAR

1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
6.20	6.00	6.00	6.00	8.00	8.00	8.00	8.00	8.00	8.00

NEW BOND AUTHORIZATIONS IN EACH YEAR

1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
71000.0	0.0	60000.0	0.0	100000.0	0.0	100000.0	0.0	100000.0	0.0

FISCAL YEAR	NON INVESTMENT REVENUE	INVESTMENT INTEREST	TOTAL REVENUE	OPERATING EXPENDITURE	DEBT SERVICE	MISC EXP SHD TAXES GF CAP EX	TOTAL EXPENDITURE	SURPLUS OR DEFICIT	GENERAL FUND END OF YEAR
1972									761268.2
1973	162264.1	42466.7	204730.7	276331.0	24020.8	11358.6	311710.3	-106979.6	654288.4
1974	182367.0	35772.1	218139.0	292918.7	29646.2	11756.5	334313.4	-116174.4	538114.0
1975	190047.0	28146.4	218193.4	310485.1	32973.5	12749.8	356208.4	-138015.0	400099.0
1976	188752.0	18960.8	207712.8	329114.1	33479.2	13290.6	375883.8	-168171.1	231927.9
1977	430209.0	15116.4	445325.4	355443.1	35373.3	14482.8	405299.1	40026.3	271954.3
1978	434394.9	16695.3	451090.2	383878.5	39390.5	15217.0	438486.0	12604.2	284558.4
1979	547046.0	19533.7	566579.7	414588.8	42494.9	27486.9	484570.4	82009.3	366567.7
1980	550369.9	23532.2	573902.1	447755.8	46529.0	28343.7	522628.5	51273.6	417841.3
1981	567962.4	26121.0	594083.3	483576.2	47129.4	28359.7	559065.2	35018.1	452859.4
1982	575119.7	27090.4	602210.1	522262.2	52863.3	29787.4	604912.9	-2702.8	450156.6
	3828529.0	253434.8	4081965.0	3816342.0	383899.9	192832.9	4393075.0	-311111.4	

AGO 530855

Exhibit C

STATE OF ALASKA
DIVISION OF BUDGET AND MANAGEMENT

BUDGET PLANNING MODEL

RUN ID RUN 3

DATE MARCH 3, 1972

COMMENTS
PRIVATE OWNERSHIP
7% TARIFF
1% GROWTH
GREATLY REDUCED CAPITAL EXPENDITURES

ASSUMPTIONS

ANNUAL RATE OF INTEREST ON GENERAL FUND = 6.00%

ANNUAL RATE OF INTEREST ON NEW BONDS = 6.00%

MATURITY PERIOD ON NEW BONDS IN YEARS = 20.

% ABOVE G.F.UNENCUMBERED BAL. UNEXPENDED = 0.0 %

ANN OPER EXPEND GROWTH RATE AFTER 1ST YR = 1.00%

NEW BOND AUTHORIZATIONS IN EACH YEAR

1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
71033.0	0.0	15000.0	0.0	20000.0	0.0	20000.0	0.0	20000.0	0.0

FISCAL YEAR	NON INVESTMENT REVENUE	INVESTMENT INTEREST	TOTAL REVENUE	OPERATING EXPENDITURE	DEBT SERVICE	MISC EXP SHD TAXES OF CAP EX	TOTAL EXPENDITURE	SURPLUS OR DEFICIT	GENERAL FUND END OF YEAR
1972									761268.2
1973	162264.1	42469.7	204733.8	276232.7	24020.8	11358.6	311612.0	-106878.3	654389.8
1974	182367.0	36208.7	218575.7	278994.8	29646.2	11756.5	320397.5	-101821.8	552567.9
1975	170047.0	29928.1	219975.1	281784.3	32973.5	12749.8	327507.6	-107532.5	445035.4
1976	188752.0	23147.4	211899.3	284601.8	32498.4	13290.6	330390.6	-118491.3	326544.1
1977	220669.0	16605.2	237274.2	287447.4	32421.2	13153.0	333521.5	-96247.3	230296.8
1978	225954.9	10787.1	236741.9	290321.5	33723.5	13719.0	337764.0	-101022.1	129274.8
1979	314776.0	6882.4	321658.3	293224.3	34212.3	23358.3	350794.8	-29136.4	100138.3
1980	329299.9	5394.7	334694.5	296156.1	33887.2	25105.1	355148.3	-20453.8	79684.5
1981	332012.4	4182.2	336194.5	299117.3	31872.0	25167.5	356156.8	-19962.3	59722.2
1982	344194.7	3140.6	347295.2	302108.1	33246.7	26698.5	362053.3	-14758.1	44964.1
	2490194.0	178845.6	2669040.0	2889986.0	319031.6	176356.8	3385343.0	-716303.9	

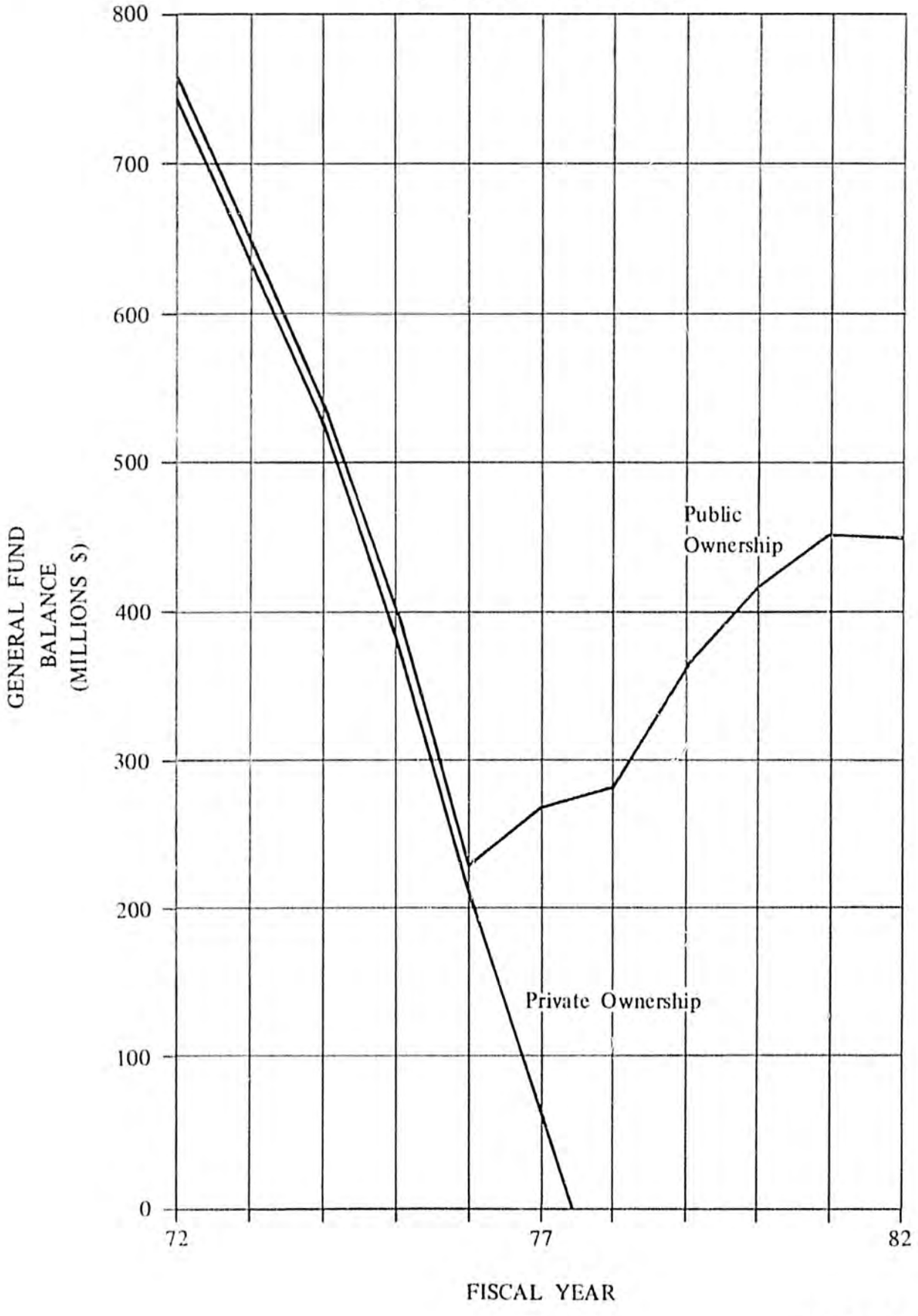
AGO 530852

Exhibit D

ENDING GENERAL FUND BALANCE

Private vs Public Ownership

Budget Book Expenditure Plan

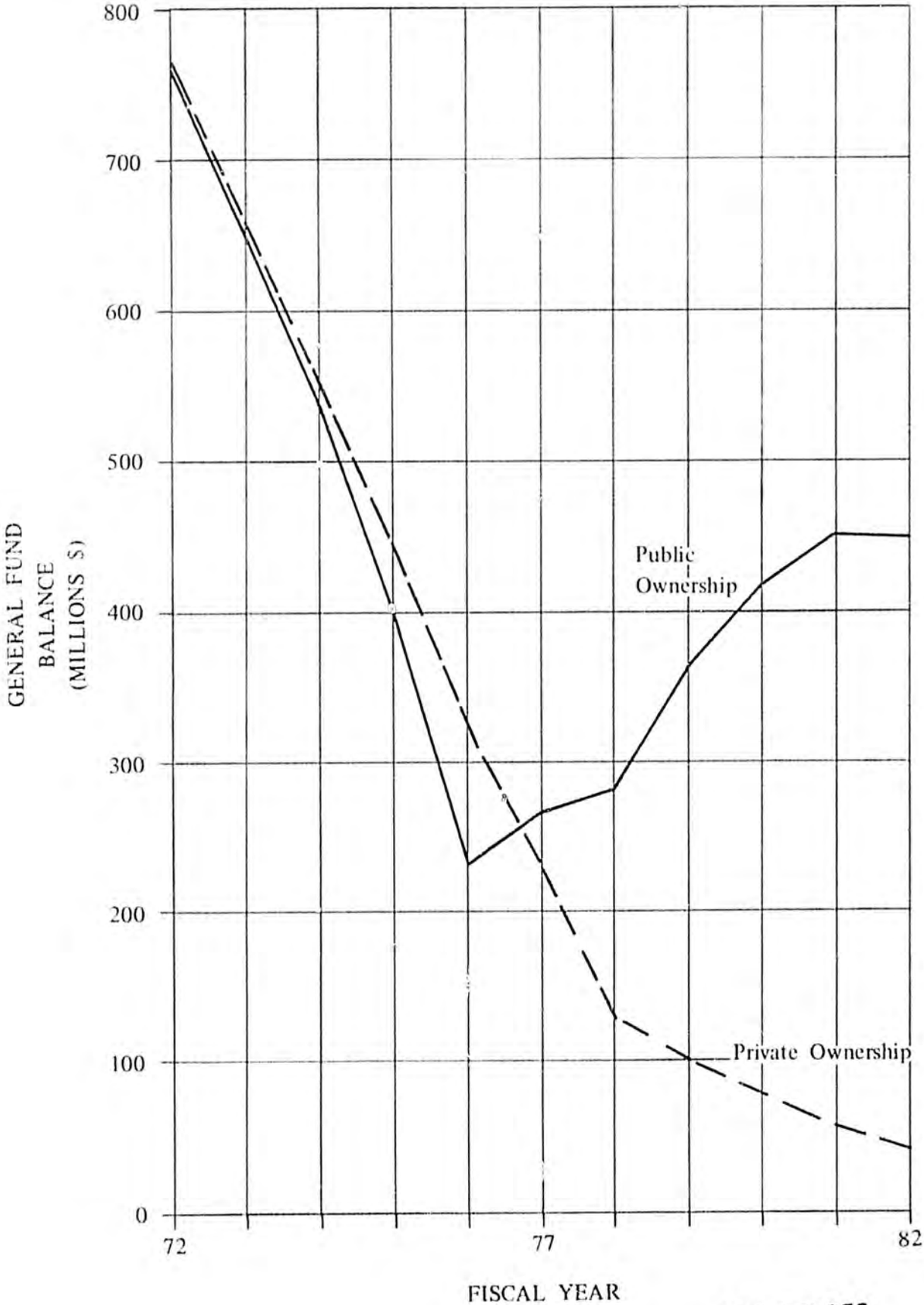


AGO 530857

Exhibit E

ENDING GENERAL FUND BALANCE

Public Ownership Budget Book Expenditure Plan
vs
Private Ownership Subsistence Expenditure Plan



AGO 530858

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

SCOMM

#12:3

Roll Call at 11.00 ?

1 HOLM
2 FISCHER
3 CHRISTIANSEN
4 GROTH.

1 BARBER
2 FERGUSON
3 YOUNG
4 HARRIS
5 HUBERT
6 ROSÉ
7 MILLER
8 SEN. HELAND

1. ~~Senator~~ Rep Holm
2 " ~~Packard~~ Fischer
3 Christiansen
4 Groh

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1 Rep. Ed Barker
2 Frank Ferguson
3 John ~~Harper~~ YOUNG
4 ~~Nolan~~ Meland
5 John Nyder
6 Mike Rose
7 Jess Harris
8. Mike Miller

McVeigh
Reilly

JOINT HEARINGS ON PROPOSED PIPELINE LEGISLATION

MARCH 6 THROUGH MARCH 9, 1972

WITNESS REGISTER

	NAME	AFFILIATION	REPRESENTING
1.	Charles E. Spahr	Aleyeska Pipeline	Standard Oil of Ohio (SOHIO)
2.	W.J. Williamson	Aleyeska Pipeline	Law Professor U. of Houston
3.	Harry R. Jones	Aleyeska Pipeline	Attorney specializing in State & Interstate commerce. Houston, Texas
4.	Donald W. Markham	Aleyeska Pipeline	Washington, D.C. Attorney
5.	Edward L. Patton	Aleyeska Pipeline	President of Aleyeska Pipeline
6.	Joseph R. Cortese	Aleyeska Pipeline	Attorney Ohio, specialistin law re Powers of State & localgovt
7.	Raymond B. Gary	Aleyeska Pipeline	Investment Banking, Underwriting & distrib of securities.
8.	George A. Seymour	Aleyeska Pipeline	Mobil Pipe Line Company.
9.	Thomas R. Broussard	Aleyeska Pipeline	Atty. Spec in taxation, Legal Dept ARCO
10.	Edward L. Patton	Aleyeska Pipeline	Aleyeska President. See 5 above
11.	Joseph R. Cortese	Aleyeska Pipeline	Same as 6 above.
12.	Richard M. Donaldson	Aleyeska Pipeline	V-Pres & Gen Counsel of SOHIO
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JOINT HEARINGS ON PROPOSED PIPELINE LEGISLATION

MARCH 6 THROUGH MARCH 9, 1972

WITNESS REGISTER

	NAME	AFFILIATION	REPRESENTING
1.	S. C. SANDUSKY	DIVISIONAL MANAGER	MARATHON OIL COMPANY
2.	DON DICKEY	GENERAL MANAGER	STATE CHAMBER OF COMMERCE
3.	Phil Holsworth		~~SENATE COMMERCE~~ Pres. & Chamber of Commerce
4.	William Hopkins		
5.	William Allen		
6.	John Cabaniss		
7.	James P. Jamieson		DuPont
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JOINT HEARINGS ON PROPOSED PIPELINE LEGISLATION

MARCH 6 THROUGH MARCH 9, 1972

WITNESS REGISTER

	NAME	AFFILIATION	REPRESENTING
1.	H. A. Boucher	Lt. Governor	Administration
2.	Charles Herbert	Commissioner, Nat. Resources	Administration
3.	John E. Havelock	Attorney General	Administration
4.	Bruce Campbell	Commissioner of Highways	Administration
5.	Eric E. Wehlforth	Commissioner of Revenue	Administration
6.	Larry Epperbach	Department of Revenue	Administration
7.	Joseph R. Henri	Commissioner of Administration	Administration
8.	H. M. Temple III	Temple, Barker & Sloane	Administration
9.	Charles Kales	Hawkins, Delafield & Wood	Administration
10.	Tom Gildehaus	Temple, Barker & Sloane	Administration
11.	L. E. Crowley	Salomon Brothers	Administration
12.	Robert Macy	Kuhn, Loeb & Company	Administration
13.	John E. Havelock	Attorney General	Administration
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TESTIMONY OF WILLIAM H. ALLEN

COVINGTON AND BURLING

WASHINGTON, D. C.

Witnesses for the Administration, particularly the Attorney General in his testimony, have expressed reservations on the question whether the Interstate Commerce Commission would have jurisdiction under Part I of the Interstate Commerce Act to regulate aspects of the transportation of crude oil by way of the Trans-Alaska Pipeline System to Valdez where the oil will be trans-shipped in tanker vessels to ultimate destinations outside of Alaska.

The reservations expressed were a result of my advice. My advice was given in response to a request by the Attorney General that, in connection with possible State ownership of the Trans-Alaska Pipeline, I consider questions relating to the existence, extent and nature of regulation by federal authorities, notably, of course, the Interstate Commerce Commission.

In his written submission on behalf of the owners and in a supplement thereto, Mr. Harry R. Jones has stated the view that, even though physically the pipeline and the transportation it performs will be entirely within Alaska, they are clearly subject to regulations by the Interstate Commerce Commission under Part I of the Interstate Commerce Act. My research and analysis of the pertinent authorities leave me

unable to express so firm an opinion as Mr. Jones. My view is that there is at the least a substantial doubt whether the Trans-Alaska Pipeline operations are indeed subject to regulation under Part I of the Interstate Commerce Act and reason to believe that they are not.

Let me begin by laying out the ground that is common to Mr. Jones and me.

First, there is no doubt that, if the Interstate Commerce Commission has jurisdiction, it has such jurisdiction regardless whether the pipeline system is owned by private interests or by the State. Cases decided by the United States Supreme Court involving a state-owned belt line railroad leave no doubt on that score.

Second, there is no doubt that the Congress has the power under the commerce clause of the Constitution to provide for regulation of the transportation between the North Slope and Valdez as a part of a continuous movement in interstate commerce.

Many - not all - of the cases cited in Mr. Jones' written submissions are cases defining the scope of the commerce clause and not that of the Interstate Commerce Act. Some of these cases seem to indicate that if a transaction is within the reach of the Congress under the commerce clause it is beyond the power of the states to regulate regardless of the extent to which Congress has exercised its power. That, I believe, can no longer be taken to be the law. The authorities supporting that belief include cases such as Pennsylvania R.R. v. Public Util. Comm., 298 U.S. 170 (1936). As will be seen,

it is principally with respect to the proper interpretation of that case that my analysis diverges from that of Mr. Jones.

The relevant facts here are familiar to all of us. The pipeline will transport crude petroleum from the producing areas on the North Slope through Alaska to Valdez, where the oil will be transferred into ocean-going vessels. The vessels, according to Mr. Jones, will be owned by the shippers.

The coverage of Part I of the Interstate Commerce Act, which is the part of the Act applicable to oil pipelines, is delimited in Sections 1(1) and 1(2) of the Act, 49 U.S.C. §§ 1(1), (2).

Section 1(1)(b) of the Act provides that Part I applies to "common carriers engaged in . . . [t]he transportation of oil . . . by pipe line, or partly by pipe line and partly by railroad or by water . . . from one State . . . to any other State . . . or from . . . any place in the United States to . . . a foreign country . . . ." Section 1(1)(a) deals in very much the same terms with common carriage by railroad. Section 1(3)(a) defines the term "common carrier" to include "all pipe-line companies." Section 1(2)(a) provides that Part I applies also to "such transportation," i.e., the kind of transportation described in Section 1(1) but not to "the transportation of . . . property . . . wholly within one State and not shipped to or from a foreign country from or to any place in the United States as aforesaid . . . ."

The question whether a particular carrier or a particular operation of a carrier is subject to regulation by the Interstate Commerce Commission under Part I depends,

analytically, on whether the carrier's operations fit within the descriptions in Sections 1(1) and 1(2). It is obvious that the pipeline subsidiaries of the North Slope producers, which will own undivided interests in TAPS, are common carriers by pipeline engaged in interstate transportation within the meaning of Section 1 and thus subject to ICC regulation. The question is whether the particular transportation by pipeline that we are concerned with here is transportation within the meaning of Section 1. There is a heavy judicial gloss on Section 1, and the decisions, I am bound to say, have been influenced by doctrines relating to when and where through transportation begins and ends for purposes of the commerce clause.

That is, the cases have not always engaged in close analysis of the precise terms of Sections 1(1) and (2).

The cases have been concerned not only with the ultimate origin or destination of goods that, in the hands of one carrier, move only intrastate but also with the nature of the originating or continuing interstate or foreign carriage, whether private or for-hire regulated or nonregulated.

Although no case has been found expressly so holding the ICC has apparently assumed that it has regulatory authority over a pipeline lying wholly within one state, where the product transported by the pipeline is subsequently shipped by ocean vessel to another state or to a foreign country. In Reduced Pipe Line Rates and Gathering Charges, 243 I.C.C. 115, 124 (1940), the Commission noted that some of the pipelines

whose rates were being regulated ran from origins in Texas to the Texas coast, where the oil was put in tankers for transshipment to east coast refineries or to foreign destinations. The question whether regulation of these pipelines' rates was proper was not raised, and the Commission thus cannot be regarded as having answered it.

In the contexts of other modes of transportation there has been litigation of the question of the permissibility under the Interstate Commerce Act of tacking separate transportation segments together to justify a finding that the kind of transportation with which the Act deals is involved and permit the invocation of federal regulation over a wholly intra-state segment. Subject to qualifications that I will set out later, the cases seem to establish that, where two segments of a unitary transportation scheme are both for-hire carriage, the two segments may be tacked together to permit federal regulation of a segment that lies wholly within a single state. The earliest cases so holding were cases involving segmented transportation to or from foreign destinations. The Supreme Court readily found that intrastate rail transportation, when combined with prior or subsequent for-hire water carriage to or from a foreign port, is subject to ICC jurisdiction. Texas & N.O.R.R. v. Sabine Tram Co., 227 U.S. 111 (1913); United States v. Erie R.R., 280 U.S. 98 (1929).

There is authority, moreover, that despite the apparent limitation contained in Section 1(2)(a) the ICC may regulate intrastate for-hire rail or motor carriage where it is preceded or followed by for-hire interstate carriage and

where the two transportation segments are in fact (although not in form) merely portions of a single through movement. The motor carrier decisions are under Part II of the Interstate Commerce Act, whose coverage provisions are not identical to those of Part I but into which, as we shall see, the same principles have been worked. E.g., William E. Rush - Common Carrier Application, 17 M.C.C. 661, 673 (1939) (intrastate motor transportation followed by interstate rail transportation); Joseph A. Bisceglia - Contract Carrier Application , 34 M.C.C. 233, 236 (1942) (intrastate motor transportation followed by interstate water transportation); Humble Oil & Ref. Co. v. Texas & Pac. Ry., 155 Tex. 483, 289 S.W.2d 547, 548 (1955) (interstate pipeline transportation followed by intrastate rail transportation).

On the other hand, where for-hire rail carriage occurring wholly within a single state is combined with private carriage across a state line the Supreme Court's decision in Pennsylvania R.R. v. Public Util. Comm'n, 298 U.S. 170 (1936), to which I have previously referred, holds that the for-hire rail carriage is not subject to ICC regulation. In that case a shipper who mined coal in Pennsylvania moved his own product from the mine in Pennsylvania to a railhead in Ohio by means of a combination of private rail cars and private barges. Coal was then shipped via several for-hire rail carriers to destinations within Ohio. The question was whether such intrastate rail transportation could properly command interstate rail rates or only the lower intrastate rates regulated by a state commission. Mr. Justice Cardozo found the answer for the Court in the

provisions of Section 1 of the Interstate Commerce Act.

> "Not all commerce is transportation, and not all transportation is by common carriers by rail. The question for us here is not whether the movement of the coal is to be classified as commerce or even as commerce between states. The question is whether it is that particular form of interstate commerce which Congress has subjected to regulation in respect of rates by a federal commission.
>
> * * *
>
> "There are limitations, moreover, in respect of the conduct to be controlled in addition to the foregoing limitations in respect of the carriers to be regulated. Even though the activities are those of common carriers by rail, the statute does not apply 'to the transportation of passengers or property . . . wholly within one State and not shipped to or from a foreign country from or to any place in the United States.' § 1(2)(a), (b).
>
> For many purposes, as for example in testing the validity of state taxation, merchandise is deemed to be in interstate commerce when it has started on its journey, though still in the possession of consignor or seller . . . . Not so, however, in determining the application of this act. Transportation begins for that purpose, if not for others, when the merchandise has been placed in the possession of a carrier . . . . And 'wherever the word "carrier" is used in this chapter it shall be held to mean "common carrier"' § 1(3)." 298 U.S. at 174-75 (Emphasis supplied.)

Applying these principles, the Court held that the for-hire rail transportation was exempt from ICC regulation.

Mr. Jones distinguishes the Pennsylvania Railroad case on two grounds in a supplemental memorandum, which is addressed specifically to that case. One ground, as I understand, is that there is an enormous factual difference between

hauling a few barges full of coal privately along a river from one state to another and there transshipping them by common carrier within the state and the flow of oil ultimately destined for massive out-of-state points that we are concerned with here. Railroad Comm'n. v. Worthington, 225 U.S. 101 (1912), involving a substantial through movement of coal and prohibiting a state from fixing the rate for an intrastate railroad segment, is cited as more nearly in point. I shall return to this point, the force of which I am bound to acknowledge.

The other ground, if I understand, relies upon emphasizing the fact that in the Pennsylvania Railroad case the intrastate movement followed an interstate movement, and that the Court spoke in terms of the transportation's beginning when goods are placed in the hands of a common carrier. In our case, on the other hand, the common carrier intrastate transportation precedes the private out-of-state transportation to destination and obviously begins when the oil is tendered to the pipeline. I find such a restricted reading of the Pennsylvania Railroad case hard to justify under the language of the statute. I am fortified in my tendency to discount the importance of whether the intrastate leg is the first or the last by the fact that a tribunal whose decisions are peculiarly important to our consideration here has not read the Pennsylvania Railroad case so restrictively. I refer to the Interstate Commerce Commission.

Some Commission decisions subsequent to the Pennsylvania Railroad case declined to apply that precedent to

motor carrier cases arising under Part II of the Act, holding that its force was limited to cases arising under the provisions of Part I. See, e.g., Joseph A. Bisceglia - Contract Carrier Application, 34 M.C.C. 233, 237 (1942), holding that for hire motor carriage entirely within the State of California followed by private water carriage beyond the State was nevertheless subject to ICC economic regulation.

In Motor Transportation of Property Within a Single State, 94 M.C.C. 541 (1964), aff'd per curiam sub nom. Pennsylvania R.R. v. United States, 242 F. Supp. 890 (E.D. Pa. 1965), aff'd per curiam sub nom. American Trucking Ass'ns. Inc. v. United States, 382 U.S. 372 (1966), however, the Bisceglia case was explicitly overruled in this respect, and the principle was established that the Pennsylvania Railroad precedent applies under Part II of the Act as well as under Part I. And that precedent was treated as covering an intrastate common carrier movement either following or preceding a movement in private carriage. In its opinion the Commission explicitly found "that for-hire motor transportation, within the confines of a single State, of property which has moved from, or will move to, points beyond the same state in private motor carriage, is, so far as the for-hire transportation is concerned, not in interstate commerce subject to economic regulation under Part II of the Interstate Commerce Act. . . ." 94 M.C.C. at 551. In reaching that conclusion the Commission offered the following significant interpretation of the Pennsylvania Railroad decision:

> "[W]e think that the Pennsylvania decision does not permit the combination of for hire transportation wholly within a single State

> with carriage by an owner across a State line for the purpose of subjecting the former to Federal economic regulation. . . ." Id. at 550.

See also L. A. Tucker Truck Lines Inc. v. United States, 215 F. Supp. 261, 263-64 (E.D. Mo. 1963), where the Pennsylvania Railroad principle was cited for a finding that interstate private barge transportation could not be the first leg of an interstate shipment so as to subject subsequent intrastate for-hire motor transportation to ICC regulation.

In Behnken Truck Service, Inc., Extension -- Exbarge Traffic, 103 M.C.C. 787 (1967), the Pennsylvania Railroad principle was extended still further. Relying on a dictum in Mr. Justice Cardozo's opinion, see 298 U.S. at 176-77, the Commission held that even for-hire transportation across a state line cannot be tacked to subsequent intrastate for-hire transportation, so as to subject the latter to ICC regulation, so long as the former is exempt from such regulation. 103 MCC at 794-95. In Behnken the interstate for-hire barge transportation was exempt from federal economic regulation under Section 303(b) of the Act, 49 U.S.C. § 903(b). As a result, the subsequent for-hire motor carriage was also held to be exempt. And see W. J. Holliday & Co. v. Liberty Trucking Co., 53 M.C.C. 22 (1951). The Behnken holding has subsequently been followed in Commercial Carrier Corp. Extension - Salt, 112 M.C.C. 415, 419 (1970).

It may not be necessary to go further along this line since it is said that the forward movement from Valdez will be

in private vessels. However, Mr. Jones has said that if the oil moved in contract or common carrier vessels the Pennsylvania Railroad principle would not apply. I cannot regard even that as clear. The issue may depend on whether the carriage is regulated, and carriage of oil in tankers between Alaska and the other states seems not to be subject to economic regulation.

I should state at the outset that there is authority for the proposition that, if the forward movement were to a foreign port and even in a private shipper-owned vessel, the pipeline movement to that extent is within the Interstate Commerce Act. Long Beach Banana Distributors, Inc. v. Atchison, T. & S.F. Ry., 407 F.2d 1173 (9th Cir. 1969), cert. denied, 396 U.S. 819 (1969). There is some support for the Banana Distributors holding in the language of Section 1(2)(a) of the Act.

The Interstate Commerce Commission, under Part III of the Act, has broad authority to regulate the activities of water carriers operating in interstate commerce, defined in § 302(i)(1), 49 U.S.C. § 902(i)(1), as transportation "wholly by water from a place in a State to a place in any other State, whether or not such transportation takes place wholly in the United States. . . ." However, in derogation of this general grant of authority, the regulation of water carriage between the State of Alaska and other states in the United States has been specifically entrusted to the Federal Maritime Commission, to the exclusion of the ICC. Section 27(b) of the

Alaska Statehood Act, 48 U.S.C.A. note preceding § 21, prov s as follows:

> "Nothing contained in this or any other Act shall be construed as depriving the Federal Maritime Board [now Commission] of the exclusive jurisdiction heretofore conferred on it over common carriers engaged in transportation by water between any port in the State of Alaska and other ports in the United States, its territories or possessions, or as conferring upon the Interstate Commerce Commission jurisdiction over transportation by water between any such ports."1/

The Federal Maritime Commission does regulate, pursuant to the Shipping Act, common carriage by water between Alaskan ports and the contiguous 48 states. See Alaskan Rates, 2 U.S.M.C. 558 (1941); Puget Sound Tug and Barge Co. v. Foss Launch & Tug Co., 7 F.M.C. 43 (1962). Such regulation consists principally of rate regulation pursuant to Section 18 of the Shipping Act, 46 U.S.C. § 817, and Sections 2, 3, and 4 of the Intercoastal Shipping Act, 46 U.S.C. §§ 844, 845, 845a. The Commission's jurisdiction over rates is, however, clearly limited to common carriers and does not embrace private or contract carriers. See 46 U.S.C. §§ 817, 844; see also Activities, Tariff Filing Practices and Carrier Status of

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1/ In any event, § 303(d) of the Interstate Commerce Act, 49 U.S.C. § 903(d), specifically exempts from ICC regulation under Part III "the transportation by water of liquid cargoes in bulk in tank vessels designed for use exclusively in such service and certified under regulations approved by the Commandant of the Coast Guard pursuant to the provisions of section 391a of Title 46." Under this provision, therefore, the tanker transportation of petroleum from Valdez to ports within the contiguous 48 states would be exempt from Interstate Commerce Commission regulation, even if the Alaska trade were not otherwise removed from ICC jurisdiction.

Containerships, Inc, 9 F.M.C. 56, 66-67 (1965).

Under the Shipping Acts the term "common carrier" means a common carrier at common law. Containerships, supra at 62; Consolo v. Grace Line, Inc., 4 F.M.B. 293, 300 (1953).

> "[T]he essential characteristics of the common carrier [at common law] are that he holds himself out as such to the world; that he undertakes generally, and for all persons indifferently, to carry goods and deliver them, for hire; and that his public profession of his employment be such that, if he refuse, without some just ground, to carry goods for any one, in the course of his employment and for a reasonable and customary price, he will be liable to an action." Moore, Carriers 20 as quoted in The Wildenfels, 161 Fed. 864, 866 (2d. Cir. 1908).

The common carrier is to be distinguished from the private or proprietary carrier, who merely transports his own cargo in his own ship and does not hold himself out to transport cargo for others. Moreover, effective ownership of a vessel may be acquired not only by purchase but also by "bareboat charter," which amounts to a rental of the vessel, giving the charterer complete control of her navigation and working. The acquisition of a vessel by bareboat charter "is as complete ownership, during the occasion of the charter," as acquisition by purchase. "It follows that in the case of a bona fide bareboat charter there is no carrier-shipper relationship as respects cargo of the charterer transported in the vessel, and that as to such cargo the bareboat charterer is a private carrier." In re Intercoastal Charters, 2 U.S.M.C. 154, 161 (1939). Private carriers are, of course, exempt from regulation by the Federal Maritime Commission. Id. at 160-161.

The common carrier must also be distinguished from the contract carrier, a term that has been defined to include:

> "[E]very carrier by water which under a charter, contract, agreement, arrangement, or understanding, operates an entire ship, or some principal part thereof, for the specified purposes of the charterer during a specified term, or for a specified voyage, in consideration of a certain sum of money, generally per unit of time, or weight, or both, or for the whole period or adventure described." Intercoastal Navigation, 1 U.S.S.B.B. 400, 458 (1935).

A subsequent Commission decision makes plain that the relation of contract carrier and shipper arises whenever, under a charter, one obtains the exclusive use of a vessel's service, leaving the control and management of the vessel to its owner. In re Intercoastal Charters, supra at 161, 162-63. There is no question that contract carriers are presently exempt from Commission regulation under the Shipping Acts. See Container-ships, supra at 66-67.

The law is clear that the existence of the contract carrier relationship does not depend on the duration of the charter. One may be a contract carrier either under a time charter or under a voyage charter. In re Intercoastal Charters, supra at 161. In one early case it was specifically held "that a ship hired for a specific voyage to carry a particular cargo for the charterers, is not a common carrier but a bailee for hire . . . ." The Wildenfels, 161 Fed. 864, 866 (2d Cir. 1908). And see The Fri, 154 Fed. 333, 338 (2d Cir. 1907), cert. denied, 210 U.S. 431 (1907). This precedent has been followed by the Federal Maritime Commission. D.L. Piazza Co. v. West Coast Line, Inc, 3 F.M.B. 608, 612 (1951).

It is my understanding that the engagement by a shipper of a tanker vessel is typically of its full capacity.

There remains the point to which I promised to return, the other apparent attempted ground of distinction of the Pennsylvania Railroad case -- the comparative triviliaty of the movement of coal there involved as contrasted with the massive flow of oil here from Alaska to out-of-state points. There is no doubt that the Trans-Alaska Pipeline System will be highly visible, and its operation will be a matter of substantial national concern. That might be regarded by some as a reason why Congress should undertake to see that it is regulated in the national public interest. And I cannot deny that views as to what Congress should have done have their influence on decisions that in terms relate to what Congress in fact has done. Certainly no tribunal would be comfortable in deciding against ICC jurisdiction if it were not convinced that there would be regulation of some sort.

I should note in this regard that the case that has been cited as more nearly analogous to the case of the Trans-Alaska pipeline than the Pennsylvania Railroad case, Railroad Comm'n v. Worthington, 225 U.S. 101 (1912), was decided solely on constitutional grounds. That is, the imposition of state regulation on the intrastate coal movement was held to constitute a burden on interstate commerce forbidden by the negative implications of the affirmative grant of power to Congress by the commerce clause itself. The court did not hold that the rates were subject to regulation by the Interstate Commerce

Commission. Because the court rested its decision on constitutional grounds, it found it unnecessary to decide whether the railroad was correct in its argument that the transportation was not within Section 1 of the Interstate Commerce Act. Id. at 110-11. That approach to decisions relating to the allocation of state and federal powers, as I have suggested above is outmoded.

Today there is forthright recognition that Congress has the power of allocation. Southern Pac. Co. v. Arizona, 325 U.S. 761, 769 (1945). Literally, the Lake Cargo Coal decision left open the possibility that the rates were not subject to regulation at all. That kind of decision is nearly impossible to imagine today. To turn the matter around, it is most unlikely that the ICC or a court would rule against ICC jurisdiction were there no state regulatory regime in existence to assume the responsibility of regulation.

In light of all this, if the petroleum that is carried to Valdez by pipeline is subsequently transshipped to ports in the United States in vessels owned or chartered by the shippers, that water transportation would not be subject to economic regulation by any federal agency. There is reason to believe that in these circumstances the ICC or a court would hold the pipeline operations within Alaska to be free from ICC regulation as occurring wholly within the confines of a single state. That this would be the outcome cannot be predicted with certainty, especially because of the considerations to which I have just adverted, but such an outcome would be supported by the authorities I have cited.

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JOINT HEARINGS

SENATE COMMERCE COMMITTEE

HOUSE STATE AFFAIRS COMMITTEE

Juneau, Alaska

March 6-9, 1972

MARATHON OIL COMPANY

My name is Samuel C. Sandusky; I am Division Manager for Marathon Oil Company in Anchorage. I want to thank the Committees for inviting Marathon to participate in these hearings. To my knowledge, the industry has had no input into the legislation being considered by these Committees, and certainly it is fitting and proper that the industry most vitally affected by this legislation should be heard.

Marathon Oil Company produces oil and gas in the Cook Inlet area of the State of Alaska. Marathon is one of the owners of the Cook Inlet Pipeline Company which operates facilities to carry oil produced from west side Cook Inlet fields to Drive River Terminal for tanker loading. We are also one of the owners of the gas pipeline on the east side of the Inlet which gathers gas from the Kenai Gas Field for delivery primarily to industrial complexes north of the city of Kenai. We are presently participating in the construction of a 52-mile casinghead gas gathering system from the west side of the Inlet to the Nikiski area on the east side. We are not one of the owners of the proposed trans-Alaska pipeline.

Senator Rettig's letter of invitation indicated that he hoped industry representatives would make suggestions concerning the question of how Alaska can help stimulate growth of the petroleum industry in the State, as well as to discuss the proposed legislation. My testimony will consider both problems, as they are certainly interrelated.

First, I am sure there is no pat answer to the question of what Alaska can do to stimulate growth of the petroleum industry. However, it can and must recognize that this is an extremely high cost area in which to operate; that the final product, oil or gas, must compete in the worldwide market; that additional costs, either through monetary payments or operational restrictions, only serve to lessen the economic attractiveness of Alaska production; and finally that Alaska cannot solve all of its economic problems through the oil industry.

Second, I am sure that among the things the State should not do if it expects to stimulate industry, is to pass the type of legislation being considered at these hearings. By discussing these bills from the viewpoint of a healthy business climate, I hope to show you why.

In my opinion, effective stimulation of industry growth will not be aided by adding an arbitrarily determined and exorbitant right-of-way cost to an already tremendous cost resulting from difficult logistics, high cost labor and transportation, hostile geographical and meteorological conditions, and the rightful protection of a virgin environment. The right-of-way leasing bills create added costs for administrative burden and delay time as well as for the right-of-way itself.

Added costs will be the result of Section 38.40.370 in Senate Bill 294, as well as Section 38.35.020 of Senate Bill 313, which provide for calculating annual rental payments for State right-of-way leases. Both bills, though containing different formulas, generally base rental payments upon the cost of the facility as well as income derived from the facility. Neither of these items has any direct relationship to the value of State lands used for right-of-way. Thus the right-of-way costs proposed in these bills appear to really be a facility tax rather than a reasonable charge for the use of State lands to construct pipelines. In addition, I submit that to compute such costs on the basis of the total system investment, when the amount of State land used for the facility

may be less, and in some cases substantially less, than 100 percent, is a concept that is both arbitrary and patently unfair, and in my view, is not conducive to the growth of the industry nor the wellbeing of the State.

As an example of the administrative burden, I refer you to Senate Bill 294, Section ~~38.40.250, Paragraph (b)~~, which requires that all parties, including the designers and builders of the pipeline, join in applications for leases and certificates. It appears that all recourse by the Board will be directed toward the carrier and that the others required to join in the applications have no CONNECTED responsibility. The administrative burden associated with this provision is obviously unnecessary and will do nothing but cause delay and confusion.

Further administrative burden and delay will result from ~~Paragraph (c), Section 38.40.390 of Senate Bill 294~~, which provides that the carrier receive the authorization of the Board for all financing transactions. This is an unnecessary requirement, for if the Board approves a proposed application and issues a certificate therefor, it follows that the carrier should be permitted to proceed with the financing required to permit him to perform under the terms of the certificate.

Involving the State at this point in time will undoubtedly cause delay costly to both the private and public sectors.

The climate for business growth will be dampened by legislation which predetermines the allowed return on capital at a level which may be inadequate to encourage the overall monetary risk involved in a pipeline project. The alternate computation for lease rental provided by Section 38.40.370, Paragraph (a) (2) of Senate Bill 294, appears to do just that. Moreover, even the formulated basepoint is tenuous since the rental can be increased by the Board pursuant to both Paragraph (c) of the above Section and Paragraph (12) of Section 38.35.020 of Senate Bill 213. Also, the fact that the rental is unknown makes it impossible for a potential carrier to make an economic judgement on whether or not to proceed with an application, therefore, effecting a potential waste of his time as well as that of the Board and the associated public. Furthermore, such flexibility leads to the specter that the Board might require the stated minimum rental from one carrier yet establish a higher rental for another. Such authority to discriminate between one pipeline and another is backed by a statement of policy and purpose broad enough to be the charter for State government itself, and is not conducive to industrial growth.

Another possibility for discriminatory treatment lies in Section 38.40.440 of Senate Bill 294, which gives to the Board authority to require as a stipulation of the lease, actions by carriers toward achievement of certain social goals which may not be required of other business, industrial, or public enterprises.

Industrial growth cannot be stimulated if the State is unwilling to contract for the use of its land for a time period equal to that for which private enterprise is willing to provide a service requiring the use of such land. The establishment of a finite term inconsistent with the expected life of the pipeline is a serious defect in the bills which could be an obstacle to arranging financing at reasonable cost over the expected life of the project. The five-year term provided in Senate Bill 313 is totally inconsistent with normally expected pipeline life. SB 294 grants a longer term; however, Section 38.40.330 is not clear whether such maximum term is 10 or 20 years, and is still a finite period which probably will be inconsistent with pipeline life.

In addition, the short term lease places the carrier at the mercy of the State at renewal time since he has already made substantial investment and since renewal of the lease is essential to his continued operation and the ultimate success of his project. Businessmen will be reluctant to accept such terms, and it is my opinion that if the State enacts such legislation it will install a substantial roadblock to industry growth.

Industry will not be encouraged by legislation which does not include among its goals some reasonable protection of the rights of business.

For example, while Section 34.40.020 of Senate Bill 294 sets forth the objective of achieving transportation at reasonable rates, the complementing objective of assuring the carrier of an opportunity to earn a fair return is conspicuously absent.

Another example of failure to temper a mandate with some protection is shown by Paragraph (1) of Section 38.40.350 of Senate Bill 294 and Section 38.35.020, Paragraph (2) of Senate Bill 313, which are covenants to assume a position of

common carrier. Transportation must be furnished without any regard to specifications consistent with the primary usage of the pipeline. Certainly such protection should be available by making this type requirement subject to the tariffs established by the carrier and approved by the appropriate regulatory body. Similarly, Section 38.40.420 of Senate Bill 294 requires the carrier to provide any sort of service which may be demanded, with no protection whatever against unreasonable demands as may be determined by the appropriate regulatory body.

Both Senate Bill 294 and 313 stipulate that as a condition of the right-of-way lease a carrier must agree to the jurisdiction of an appropriate State regulatory body. Since no carrier can choose between State and Federal authority in case of a jurisdictional dispute, he may not be able to perform and thus his lease would be in jeopardy through no fault of the carrier. The provision is obviously unworkable, and thus unreasonable.

It is detrimental to business growth for the State to give itself the option of enjoying the benefits of successful investments without risking unsuccessful ventures and with the help of 20/20 hindsight. Section 38.40.360 of Senate Bill 294

~~and paragraph (11) of Section 38.35.020 in~~ Both Bills Senate Bill 313 require lease provisions granting the State the right at any time to purchase an undivided interest in a pipeline at a price to be set at the time the lease is executed. In addition to the aspect of choosing its time and place of participation, and perhaps more objectionable from an ethical point of view, is the fact that it puts the State in position of being both the regulator and the benefactor of those regulations. The conflict of interest is obvious.

As to the proposition of State ownership in pipelines per se, I can only state that as a representative of private enterprise and a citizen, I am opposed to this concept. This opposition is predicated upon the historical function of private and public economic sectors, with the latter serving those functions which cannot or will not be accomplished by private enterprise. Certainly it is my observation that the private sector has been more than willing to provide, and in fact thus far has provided, the pipelines necessary to transport Alaska oil and gas resources to such markets as may exist for them. Thus I question the need for such legislative proposals. It is my opinion that such legislation will cause the business environment to deteriorate and that growth of the petroleum industry in particular will be stifled.

Marathon has no objection to the State receiving reasonable compensation for the use of its land for the installation of pipelines. If legislation is needed to establish a schedule of fees, it should be limited to this proprietary function of the State. However, for the reasons outlined we are opposed to the two bills pertaining to right-of-way leasing. For Alaska to consider such a radical departure from our established system ~~of government~~ should require a need which in my opinion has not been demonstrated, and its ultimate effect will not be to the best interest of the State or its citizens.

I would like to turn now to Senate Bill 315, the pipeline regulation bill. Marathon is opposed to this bill as drawn. In view of the stagnation of development due to circumstances beyond industry control, we also question the need for a crash program to provide such regulation. If it is the conclusion of this Committee that legislation is ~~now~~ needed, we suggest a joint effort by industry and State personnel be directed to the end of writing legislation ~~which~~ will be mutually acceptable to the State and to the industry.

Without going into great detail, I would like to point out several aspects of this proposed bill which cause us concern.

Section 42.06.141 appears to extend the authority of this Commission to matters subject to Federal regulation. As has been pointed out before, imposing upon the proposed Commission the power as well as the duty to regulate the oil and gas transportation within the State which is subject to paramount Federal regulation is unrealistic and unenforceable.

The proposed bill seems to authorize the Commission to grant a monopoly for transportation where there are competing applications. Traditionally this treatment has not been accorded to crude oil pipelines for the simple reason that it eliminates competition and its attendant benefits which are lower transportation tariffs. In this sense, crude oil pipelines are not "utilities" but are in the free market business of transporting oil at the lowest price. The need for a monopoly for such transportation should be carefully examined.

The bill in several places gives the Commission the power to make determinations requiring additional commitments by the carrier which could very well be to the carrier's detriment. The possibility of issuance of satisfactory initial certificates only to be arbitrarily modified later ~~as provided in Section 42.06.271,~~ is clearly an unreasonable possibility.

The concept of authority in the Commission to order service re-instated as is set forth in Subsection (b) of 42.06.261, of the bill, is alarming since if abandonment had previously been authorized, the carrier may have removed the facility altogether and no longer be in existence and couldn't possibly respond to a resumption of service order.

The imposition of criminal penalties for willful violations of any provisions of the Act including regulations or orders of the Commission ~~as set forth in Section 42.06.556~~ is unreasonable and unnecessary. The injunctive and monetary sanctions together with civil penalties imposed by later provisions of the bill should suffice to be an effective deterrent against violations.

We believe that there are areas of conflict between authority contained in this bill and existing State agencies. For instance, ~~in Section 42.06.221, Paragraph (a),~~ the Commission would declare before issuing a certificate for service that "efficient production and marketing" will require the service. This Commission's authority should concern transportation rather than production, as the latter is clearly regulated elsewhere in the Alaska Statutes. We do not understand the

intent of including the term "marketing" as we see no relationship to the proposed Commission. Gas pipelines insofar as they serve the citizens of Alaska, appear to be adequately controlled by the Alaska Public Utilities Commission. Likewise, involvement in ~~health, welfare, and~~ environmental activities are proper functions of existing agencies. Accordingly, it would seem that careful investigation is warranted as to the interrelationship of this type of legislation with existing authority and commissions. This would determine whether existing agencies could, with modification, handle these matters, and carefully eliminate conflict and duplication in the event a new agency is deemed desirable.

Gentlemen, that concludes my testimony. Thank you again for the opportunity to present our views.

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

HOUSE BILLS 569 and 570

STATE OR AUTHORITY FINANCING OF TRANS-ALASKA PIPELINE

LEGAL ASPECTS

Testimony of Joseph R. Cortese, Squire, Sanders &
Dempsey, Bond Attorneys, Cleveland, Ohio (by invitation)

Introduction.

The legal aspects of the financing of the pipeline by the State or a state authority are important considerations, for the legal problems involved materially enlarge the serious doubts as to the ability of the State to provide public financing of the facility. However, as we discuss those legal problems, it should be borne in mind that even if there were no legal questions concerning state financing, a most serious, persistent and unavoidable concern is that the State simply cannot market this massive volume of financing within the time frame required. Cogent testimony has been presented on that aspect. At this point some of the legal problems will be discussed to further illustrate the sincere concerns of the producers that the State financing package being considered would cause further substantial delays and ultimately flounder.

A. Test Litigation - Substantial Questions.

Alaska, in recent years, has undertaken bond financing in relatively novel areas, such as through the Alaska State Mortgage Association, Alaska State Development Corporation, and for the Alaska Mortgage Adjustment Plan in connection with the 1964 earthquake. In each of these instances the State has advisedly taken the basic questions of law to the Alaska Supreme Court to remove any doubt that the bonds would be valid when issued so that concerns as to legality would not further burden or thwart the marketing of them. It seems most likely that such test litigation would be important with reference to House Bills 569 and 570.

Among the legal propositions which would need to be negated by such litigation are the following:

(1) That the use of the state credit to finance the pipeline project is unwarranted in view of the availability of private financing, and use of state credit for such a facility in the circumstances would not serve a public purpose as required by Article IX, Section 6, Alaska Constitution.

(2) That the State guarantee of the bonds of the Trans-Alaska Authority provided for in House Bill 569 would create a State debt contrary to Article IX, Section 8.

(3) That the leasing of the pipeline by the Authority to the State as provided in House Bill 569 would result in a State debt under Article IX, Section 8, not qualifying under the exceptions provided in Section 11.

(4) That House Bill 569 would be a local or special act in violation of Article II, Section 19, Alaska Constitution.

(5) That House Bill 569 involves unlawful delegation of legislative powers to the proposed Trans-Alaska Authority and to other executive and administrative officers.

These and other legal aspects of House Bills 569 and 570 will be discussed further below.

The course and outcome of such test litigation cannot be reliably predicted. Since the proposed State ownership and financing of the pipeline may be an active public issue, this might become quite different from the test litigation of the past. It is conceivable that citizens or citizen groups would intervene in the litigation, such that the scheduling of the litigation might not be that normally expected. Motions, demands for introduction of extensive testimony, and ancillary litigation, could produce extraordinary delays. It may be noted that the Alaska State Mortgage Association litigation consumed over two and one-half years. This is not rare, for bond litigation elsewhere has been quite lengthy, especially where it involves a controversial issue, as with the Phoenix Civic Center lease financing which took over 5 years, and Cincinnati and Louisiana stadiums taking a couple of years each.

B. Independent Litigation - The No-Litigation Requirement for Bond Financing.

Even if the State and its bond counsel should decide that test litigation is not necessary, the basis for adverse legal contentions is sufficiently present to indicate that others, acting independently of such determination, might nevertheless file litigation. This would pose a very serious problem in the marketing of the bonds because of the normal requirement for successful marketing that a no-litigation certificate be delivered with the bonds. The no-litigation certificate is to the effect that no litigation is pending questioning the validity of the bonds, the authority under which they are to be issued, or the authority to provide for payment from the general or special funds committed thereto. The simple point of such certificate requirement is that a prospective bond purchaser does not want to buy litigation. In this context it would appear that the pendency of such litigation would preclude giving the accepted form of certificate and thereby prevent the marketing of the bonds.

C. Four Types of Bonds.

House Bills 569 and 570 would authorize what might be depicted as four categories of bonds:

(1) General obligation bonds of the State, backed by the full faith and credit and the taxing power of the State in the normal fashion;

(2) Bonds of the Trans-Alaska Authority guaranteed by the State;

(3) Bonds of the Trans-Alaska Authority backed by the general credit of the State through the device of leasing the pipeline to the State with the State paying rentals from its general funds in sufficient amounts to subsidize any operating losses, pay principal and interest on the bonds and establish and maintain reserves to further secure the bonds.

(4) Bonds of the Authority payable solely out of such net operating revenues of the Authority as might be generated over the life of the bonds, with the bondholders taking the ~~full~~ risk of any inability to pay by reason of inadequacy of revenues resulting from delays or interruption in construction, inadequacy of funds to complete the project, any interruption in operation, or changed economic conditions.

D. Public Purpose Question - Is There A Need For The State To Use Its Credit?

In view of the fact that private capital is ready, willing and able to finance the pipeline project, there is a substantial question whether the use and consequent burdening of the State's credit for this project would be for a public purpose within the constitutional prohibition against use of the credit of the State for other than a public purpose.

Alaska Constitution, Article IX, Section 6, provides:

> "No tax shall be levied, or appropriation of public money made, or public property transferred, nor shall the public credit be used, except for a public purpose."

In Ault v. Alaska State Mortgage Association, 387 P. 2d 698 (1963), the Alaska Supreme Court held that the findings and statement of public purpose in an act of the Legislature did not foreclose determination by the Court of the question of whether the act would serve a public purpose, and the Supreme Court remanded the case to the Superior Court for a taking of evidence pertaining to the question. There, the Alaska State Mortgage Association was to issue revenue bonds to provide moneys in the secondary mortgage market to stimulate housing construction. The Supreme Court said it wanted to see evidence as to the adequacy or lack of private funds in the secondary mortgage market, the effect thereon of termination of a federal program, and how the Association would reduce or eliminate adverse effects.

After the case was remanded to the Superior Court and detailed testimony taken, upon a second appeal the Supreme Court approved the program, two and one-half years after its original decision. Walker v. Alaska State Mortgage Association, 416 P. 2d 245 (1966). The Court ruled that a public purpose existed because there was a need for public financing in view of the inadequacy of private funds, as shown by the evidence, and that the program would not merely compete with private funds because the Association would make moneys available only where financing could not be obtained in the private market.

Likewise, in DeArmond v. Alaska State Development Corporation, 376 P. 2d 717 (1962), The Alaska Supreme Court approved a program for business development loans to be provided by the issuance of revenue bonds, only after determining that private financing was not sufficiently available for long term development loans.

In Wright v. City of Palmer, ~~468 P. 2d 326~~ (1970), the City's issuance of general obligation bonds to construct a plant to be leased to a manufacturer was approved upon evidence that the object and effect would be to encourage industrial development which was urgently needed because the City's economic growth was nil, high year-round unemployment existed, jobs had been lost by the closing of mining and lumbering enterprises, there was no manufacturing in the City, and businesses were moving out of the City. The need for the City itself to take an active role in financing was apparent.

It has been held that industrial development financing serves no public purpose where the facts make it plain that private funds will provide for the project without the injection of public financing; that no public purpose is served by substituting public credit for private funds. Manning v. Fiscal Court of Jefferson County, 405 S.W. 2d 755 (Ky. 1966). There private capital had already been committed to the facility.

That result appears to be consistent with the approaches taken by the Alaska Supreme Court in the cases mentioned above.

From an examination of the proposed statement of legislative findings and policies contained in House Bill 569, it is difficult to perceive any necessity whatever for State financing in order to achieve the objects stated, especially when it is apparent that the planning, development, and expertise represented in Alyeska Pipeline Service Company are essential to the early achievement of the pipeline project consistent with those objectives, and in view of the substantial questions as to the practical ability of the State to finance the project. It should be borne in mind that private capital has already spent or encumbered a half billion dollars for this pipeline ~~project,~~ and is ready, willing and able to provide the balance needed.

In short, the ability to obtain the objectives through private financing and ownership presents a material question of whether the use of the State's credit for this project is unwarranted and impermissible under the Alaska Constitution.

E. State Guarantee of Authority Bonds - Unconstitutional State Debt.

The State guarantee to be placed upon an unlimited amount of bonds of the Trans-Alaska Authority merely upon signature by the Governor pursuant to Section 44.58.260 of House Bill 569, would constitute State debt which is not authorized under either Section 8 or 11 of Article IX, Alaska Constitution.

Section 8 of Article IX prohibits State debt except as ratified by the voters of the State with certain exceptions not relevant here. Section 11 provides an exception for revenue bonds issued by a public enterprise or public corporation "when the only security is the revenues of the enterprise or corporation." The State guarantee clearly would provide security beyond those revenues, and would be inconsistent with this Section 11.

The bill itself acknowledges the creation of State debt. Section .260(e) states, "The state is liable on notes or bonds guaranteed under this section but is not liable on notes or bonds not guaranteed by the state, which may not be debt of the state." It might be noted in this connection that the section would not inhibit issuance of non-guaranteed bonds on a parity with the guaranteed bonds so that revenues could be siphoned off for the non-guaranteed bonds leaving the State with full liability on the guaranteed bonds. No provision is made as to how the State would make good on its guarantees. Perhaps this omission is compelled by the Constitution's prohibition against the dedication of any tax or license to any special purpose. Article IX, Section 7. Thus, the entire financial resources of the State would be obligated. It should be noted that the annual principal and interest requirements on $3.5 billion of bonds would be approximately equal to the total annual revenues of the State at the present time.

House Bill 570, providing for ratification of $3,500,000,000 general obligation bonds of the State to be issued by the State Bond Committee, would not serve to give constitutional authorization for the guarantee of revenue bonds of the Trans-Alaska Authority. Further, it is questionable whether Article IX, Section 8, contemplates any State debt created by way of guarantees. Rather, it may be that an amendment of the Constitution would be needed for that purpose.

In any event, it seems clear that a State guarantee of the Authority bonds could not be given without authorization thereof by vote of the people, and any attempt to vest such powers in the Trans-Alaska Authority and the Governor merely by legislative act would be unconstitutional.

F. State Lease Rental Commitment - Unconstitutional State Debt.

The provisions of Section .250 of House Bill 569 for the Trans-Alaska Authority to lease the project to the State and for the State to operate or sublease the project pose serious questions as to whether State debt would be unconstitutionally created thereby.

Section .250 would authorize the Governor to enter into such a lease in connection with the Authority's financing of the project, and to agree that the State would pay the Authority sufficient amounts to pay the principal and interest on the bonds, the operating and maintenance expenses of the project, and to provide reserves for debt service and operating and maintenance expenses. No limitation of amount is provided and the lease may be for any agreed term or may be unlimited in time. Under the lease, the Governor may also commit the State to subsidize costs of the project in any amount agreed upon.

No restriction is provided as to the sources of funds of the State which would be needed to pay the rentals.

The only apparent object of these provisions is to place the State in the middle so that purchasers of the Authority's bonds might view the State's credit as standing behind the bonds, and thus obtain the benefit of the State credit without a vote of the people.

Such lease-type financing has been used or tried in other states and has been sustained in some and declared unconstitutional in others as creating a state debt without constitutional authorization. Still other states have adopted constitutional amendments to permit such financing. The validity of such financing has not been determined by the Alaska Supreme Court.

The legal question is clearly presented where a unique single purpose project is involved, such as this crude oil pipeline. For example the Illinois Supreme Court, in Rosemont Building Supply, Inc. v. Illinois Highway Trust Authority, 258 N.E. 2d 569 (1970), held invalid a plan whereby the Authority would issue bonds, which the act said were not to be deemed obligations of the State, to finance highways, bridges and related facilities. The Authority was to pay off its bonds from its own revenues, but its principal source was to be rentals to be received from the State through leasing the projects to the State. The State was not to be committed to pay rentals except as periodically appropriated, and if rentals were not paid the Authority could undertake operation and charge tolls or lease the projects to others.

The Illinois Supreme Court had previously approved that type of financing for various buildings, but here it distinguished those cases as involving the type of facilities which were readily adaptable to other uses so that it could be assumed that other lessees could be found to pay sufficient sums if the State ceased to pay rentals. However, here it was apparent to the Supreme Court that while the State was not legally obligated to continue appropriations, there would be no real alternatives for use of such highway facilities. Thus, the Court concluded that an unconstitutional State debt would be created by such leasing program.

Much the same can be said of the proposed lease commitment of the State of Alaska in connection with the pipeline project; for if at any time the pipeline was not earning enough to cover the debt, there would be no practical way to avoid a burden on the State general fund for there would be no takers for a losing facility which has no other practical use.

Thus with the vast cost, and consequent heavy debt service burden, of this single purpose facility, the type of financing involving a lease commitment by the State poses substantial constitutional questions.

G. Local or Special Law.

House Bill No. 569 should also be considered in light of Article II, Section 19 of the Constitution which provides that "the legislature shall pass no local or special act if a general act can be made applicable. Whether a general act can be made applicable shall be subject to judicial determination." Provisions of the bill pertaining to the issuance of bonds and notes, the State guarantee of such obligations, and the

entering into of leases and agreements are all limited to the "project", which is defined in Section 44.58.500 as a pipeline from Prudhoe Bay and adjacent areas to the Port of Valdez and other ports and related facilities.

These key provisions of the bill, therefore, relate only to a single pipeline project, which suggests that the bill is a local and special act when a general act providing for pipeline projects anywhere in the State could be made applicable. This point of law has been the subject of litigation which delayed financing for five years. In State, ex rel. Saxbe v. Underground Parking Commission, 155 N.E. 2d 678 (1959), the Ohio Supreme Court held unconstitutional a state providing for the construction and financing of a public parking garage under the grounds of the state capitol building in Columbus under a similar constitutional provision. The applicable provision of the Ohio Constitution, Article II, Section 26, provides in part that "all laws, of a general nature, shall have a uniform operation throughout the state." The court said that the construction of underground parking facilities was a matter which could affect other areas of the state and not just the City of Columbus and that, therefore, the law was a law that dealt with a subject of general nature and was invalid because of its limited application.

Thus, it appears that these important features of House Bill 569 are subject to constitutional challenge and necessitate judicial determination before reliance upon them.

H. Unlawful Delegation of Legislative Powers.

A serious question also exists as to the validity of H.B. No. 569 when considered in relation to Article II, Section 1 of the Alaska Constitution which provides that "the legislative power of the State is vested in a legislature." This bill purports to do more than delegate just rule-making power to an agency or officer, which is a form of permitted delegation of legislative authority, when appropriate standards are provided. Kelly v. Zamarello, 486 P. 2d 906 (1971). This bill is lacking in standards for limitation of rule-making authority, but even more than that, it would take out of the hands of the elected law-making representatives of the people the power to make decisions for the State on matters of the utmost importance concerning State policy and finances.

Consideration of just a few of the more notable examples of attempts to confer unlimited or nearly unlimited powers and discretion upon executive and administrative officers under this bill should suffice to illustrate the manner in which this proposed law might violate Article II, Section 1 of the Alaska Constitution.

1. Section 44.58.055. This section, which is duplicated in identical language in Section 44.58.330, purports to confer on the Authority "sole and exclusive jurisdiction, control and supervision of all pipelines and other transportation facilities for the transportation of oil and natural gas produced in the state," and to authorize the Authority to "do whatever necessary or convenient to carry out its purposes, including without limitation the specific powers enumerated in this chapter." Any such attempt to so regulate and control a pipeline engaged in interstate commerce is clearly violative of the U.S. Constitution. But quite apart from the question whether the State, under the United States or Alaska Constitutions, could assume "sole and exclusive jurisdiction, control and supervision" of the types of facilities named, nowhere in House Bill No. 569 are there to be found any standards or limitations under which the Authority is to be governed in the exercise of this sweeping and all-inclusive grant of power. The entire bill, and this section in particular, would attempt to turn over to an appointed public corporation consisting of three members, which in most matters may act by the votes of two members, power to undertake and carry out, without further action by the legislature of the State, a project which probably would constitute the most massive public works project ever undertaken by any State.

2. Section 44.58.250. This section would authorize the Authority and the Governor, acting on behalf of the State, to enter into leases or agreements for lease of the project by the Authority to the State and for the operation and maintenance of the project by the State. The State could also, acting again through the Governor alone, sublease or enter into any agreement with any person, firm or corporation for the operation and management of the project. A purely permissive provision is made that the amount payable under any lease or agreement between the Authority and the State may include provision for all or any part or share of the amounts necessary to pay debt service on bonds issued to finance the project, to pay costs of operation and maintenance or to

maintain reserves or sinking funds for the purpose of payment of debt service or operation and maintenance. The Governor would also be authorized in such an agreement or lease to commit the State to pay to the Authority, for an unlimited time and in unlimited amounts, the cost of financing the project. No standards or guidelines or restrictions on such leases, subleases and agreements are provided, however, and it would be difficult to imagine a more unlimited grant of discretion to executive or administrative officers than the provision in this section, which is made applicable both to agreements with the Authority and with sublessees or others entered into by the Governor, that "the agreement or lease may be made for a specified or unlimited time on terms and conditions which may be approved by the governor."

3. Section 44.58.260. This section would permit the Authority, by so providing in a bond agreement, to commit the State to guarantee the payment of principal and interest on any bonds or notes issued by the Authority. Even if such a State guarantee were permitted by the Alaska Constitution, this section is of questionable validity in permitting executive and administrative officers, in their unlimited discretion, to make such a guarantee.

These examples of unrestrained power in executive officers are of such vast scope that no truly comparable legislative efforts at delegation of powers can be found in the Alaska cases. Thus, these would appear to be unreliable aspects of the bill in the absence of a court determination addressed directly to them.

Conclusion.

It appears that House Bills 569 and 570 raise many substantial legal problems that could keep a large number of lawyers busy for many years; and there are justifiable concerns that they would do precisely that if enacted. In view of the delays of the project already experienced, and the economic cost thereby to the State, the concerns over legal problems under House Bills 569 and 570 and the further delays they can cause are important considerations for the Legislature. Again it should be emphasized that, as previously testified to, even in the complete absence of any legal question, the patent inability of the State or a public corporation of the State to successfully market such a huge volume of bonds in the short time required, presents a direct, practical, and critical problem which strongly indicates that House Bills 569 and 570 are not practical approaches for achievement of the objectives of the State.

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

REMARKS OF RAYMOND B. GARY
PARTNER, MORGAN STANLEY & CO.
TO ALASKAN SENATE AND HOUSE COMMITTEES
ON PROPOSED LEGISLATION CONCERNING
PIPELINE REGULATION, RIGHT-OF-WAY AND
STATE OWNERSHIP -- MARCH 6, 7 & 8

INTRODUCTION

MY NAME IS RAYMOND B. GARY AND MY BUSINESS ADDRESS IS 140 BROADWAY, NEW YORK, NEW YORK. I JOINED MORGAN STANLEY & CO. IN 1955, FOLLOWING UNDERGRADUATE STUDIES AT YALE, GRADUATE WORK AT HARVARD, AND SERVICE IN THE U. S. NAVY. I HAVE BEEN A GENERAL PARTNER IN THE FIRM SINCE 1964. I AM ALSO A MANAGING DIRECTOR OF MORGAN STANLEY & CO. INCORPORATED, A PARALLEL CORPORATION WHICH CONDUCTS OUR UNDERWRITING AND BROKERAGE ACTIVITIES.

MORGAN STANLEY IS AN INVESTMENT BANKING FIRM ENGAGED IN ALL PHASES OF THE UNDERWRITING AND DISTRIBUTION OF SECURITIES OF INDUSTRIAL CORPORATIONS, PUBLIC UTILITIES, FINANCIAL CORPORATIONS, TRANSPORTATION COMPANIES INCLUDING AIRLINES AND PIPELINES, AND FOREIGN CORPORATIONS AND GOVERNMENTS. WE ARE MEMBERS OF THE NEW YORK STOCK EXCHANGE AND ASSOCIATE MEMBERS OF THE AMERICAN STOCK EXCHANGE. SINCE 1935, THE YEAR MORGAN STANLEY & CO. WAS FOUNDED, THE FIRM, INCLUDING ITS FOREIGN AFFILIATE, MORGAN & CIE

INTERNATIONAL S. A., HAS MANAGED OR CO-MANAGED A TOTAL OF APPROXIMATELY $60 BILLION OF SECURITY OFFERINGS. IN ADDITION TO ACTIVITIES RELATED TO UNDERWRITING AND PRIVATE PLACEMENTS, MORGAN STANLEY PROVIDES GENERAL FINANCIAL ADVISORY SERVICES ON A WIDE RANGE OF MATTERS INCLUDING LONG-RANGE FINANCIAL POLICY AND PLANNING.

THE $60 BILLION TOTAL FINANCING VOLUME I MENTIONED INCLUDES OVER $2 BILLION OF ISSUES DONE BY OUR FIRM FOR 18 PIPELINE COMPANIES. IT ALSO INCLUDES THE LARGEST PUBLIC CORPORATE BOND OFFERING EVER MADE, $1.6 BILLION OF AMERICAN TELEPHONE & TELEGRAPH COMPANY DEBENTURES WITH WARRANTS ATTACHED, AND THE LARGEST PRIVATE PLACEMENT EVER DONE. WE ALSO HANDLED THE PRIVATE PLACEMENT OF $550 MILLION FOR CONSTRUCTION OF A HYDROELECTRIC PROJECT IN LABRADOR BY CHURCHILL FALLS (LABRADOR) CORPORATION LIMITED, WHICH IS THE LARGEST PROJECT EVER PRIVATELY FINANCED. THESE RECORD-SIZED CORPORATE FINANCINGS EXCEED IN SIZE ANY LONG-TERM ISSUE SOLD BY A STATE GOVERNMENT. THE ONLY LARGER BOND ISSUES HAVE BEEN THOSE OF NATIONAL GOVERNMENTS, WITH THEIR UNLIMITED TAXING POWER AND ABILITY TO ISSUE MONEY.

HENCE, THE PERSPECTIVE FROM WHICH I SPEAK IS THAT OF A MANAGING DIRECTOR OF A LEADING UNDERWRITER WHOSE PRINCIPAL BUSINESS IS THE RAISING OF CAPITAL, WITH EXPERIENCE IN RAISING VERY LARGE SUMS OF MONEY SUCH AS WOULD BE INVOLVED IN THE

FINANCING OF THE TRANS ALASKA PIPELINE SYSTEM. I AM PLEASED TO HAVE THIS OPPORTUNITY TO SPEAK BEFORE THE COMMITTEE. I SPEAK NOT AS PROPONENT OF ANY FIXED POINT OF VIEW, BUT AS ONE WHO, I BELIEVE, SHARES THE COMMON OBJECTIVES OF ALASKANS AND THE OIL COMPANIES, ALL OF WHOM WISH TO SEE THE PIPELINE CONSTRUCTED IN THE MOST EFFICIENT MANNER, AT THE LOWEST COST, AND AS SOON AS POSSIBLE - IN ORDER TO (1) OPEN UP ONE OF ALASKA'S GREAT NATURAL RESOURCES, (2) HELP MEET THE GROWING NEED FOR ENERGY IN ALL OF THE UNITED STATES, AND (3) MAKE A SIGNIFICANT FAVORABLE CONTRIBUTION TO THE COUNTRY'S BALANCE OF PAYMENTS.

I HOPE THAT BY SHARING WITH YOU MY FIRM'S EXPERIENCE IN FINANCING MANY LARGE UNDERTAKINGS I CAN BE OF ASSISTANCE IN REACHING A SATISFACTORY SOLUTION CONCERNING THE PENDING LEGISLATION.

THE BILLS BEFORE YOUR COMMITTEE, BROADLY SPEAKING, INVOLVE LEGISLATION WHICH WOULD REGULATE THE OPERATION OF THE PIPELINE AND WHICH WOULD PROVIDE FOR POSSIBLE OWNERSHIP OF THE PIPELINE BY THE STATE. I WISH TO DIRECT MYSELF TO DISCUSSING THE POTENTIAL IMPACT OF THESE BILLS UPON THE SUCCESSFUL FINANCING OF THE PIPELINE.

CONVENTIONAL FINANCING OF PIPELINES

I THINK IT MIGHT BE USEFUL IF I TALK BRIEFLY ABOUT HOW JOINTLY-OWNED PIPELINES ARE CUSTOMARILY FINANCED. JOINTLY-

OWNED COMMON CARRIER PIPELINES HAVE BEEN CONVENTIONALLY ORGANIZED AND FINANCED IN ONE OF TWO WAYS, EITHER AS SO-CALLED "PROJECT FINANCING" OF PIPELINE COMPANIES ORGANIZED TO OWN PIPELINES IN CORPORATE FORM, OR, AS IS THE CASE IN TRANS ALASKA PIPELINE SYSTEM, AS UNDIVIDED JOINT INTEREST SYSTEMS.

IN THE FIRST CASE, WHERE PROJECT FINANCING IS DONE, THE CONVENTIONAL PRACTICE IS TO FORM A PIPELINE COMPANY WHICH CONSTRUCTS AND OPERATES THE SYSTEM AND ISSUES DEBT FOR VIRTUALLY ALL OF THE COST OF CONSTRUCTION, THE TYPICAL AMOUNT BEING 90% OF FINAL COST. THE DEBT IS SECURED BY THE PLEDGE OF COMPLETION AGREEMENTS AND THROUGHPUT AGREEMENTS UNDERTAKEN BY THE SEVERAL SHIPPER-OWNERS OF THE PIPELINE. THE TYPICAL SECURITY ARRANGEMENTS INCLUDE UNCONDITIONAL COMMITMENTS OF THE SHIPPER-OWNERS TO COMPLETE THE FACILITIES TO OPERATE THEM, AND IF OPERATION IS INTERRUPTED FOR ANY REASON, TO TAKE NECESSARY STEPS TO RESTORE THE FACILITIES TO OPERATION. AS PART OF THE THROUGHPUT AGREEMENTS, THE "CASH DEFICIENCY OBLIGATIONS" INEVITABLY CONTINUE REGARDLESS OF FORCE MAJEURE (ANY EVENT INTERFERING WITH OPERATION OF THE LINE). IN EFFECT, THEY REQUIRE THE SHIPPER-OWNERS TO MAINTAIN THE PIPELINE'S FUNDS AT A LEVEL WHICH WOULD ENABLE IT TO MEET ALL ITS OBLIGATIONS WHEN THEY BECOME DUE AND PAYABLE. AS SUCH, THEY ARE FIRM APPLICATIONS OF THE FULL CREDIT OF THE OIL COMPANIES INVOLVED AND, FOR THE

PURPOSES OF FINANCING, ARE EQUIVALENT TO GUARANTEES OF THE PIPELINE COMPANY'S INDEBTEDNESS.

IN THIS TYPE OF FINANCING, THE PROJECT ITSELF MUST BE DEMONSTRATED TO BE ECONOMIC AND VIABLE, AND THE QUALITY OF THE OBLIGATIONS IS MEASURED BY THE COMPOSITE CREDIT OF THE SEVERAL OIL COMPANIES INVOLVED. IN OTHER WORDS, THE INVESTORS ARE CONCERNED, FIRST THAT THE PROJECT STANDS ON ITS OWN FEET, BUT ALSO THEY LOOK THROUGH THE PROJECT TO THE ULTIMATE GUARANTORS. THIS TYPE OF FINANCING IS STANDARD AND WELL UNDERSTOOD BY PROFESSIONAL INVESTORS, AND HAS BEEN IN COMMON USE SINCE THE TIME OF THE ELKINS ACT - PIPELINE CONSENT DECREE ENTERED INTO IN 1941.

YOU MIGHT WONDER WHY OIL COMPANIES WISH TO RAISE AND LENDERS READILY PROVIDE INDEBTEDNESS AS HIGH AS 90% OF TOTAL CAPITALIZATION. THE FIRST ANSWER IS THAT THE CONSENT DECREE HAS LIMITED THE RETURN FROM PIPELINE OPERATIONS TO A SPECIFIED PERCENTAGE OF PIPELINE VALUATION. THIS INVARIABLY DICTATES THAT OIL COMPANIES MAXIMIZE THE USE OF DEBT, THE OBJECTIVE BEING TO MATCH AS CLOSELY AS POSSIBLE PERMITTED ICC DEPRECIATION WITH REPAYMENT OF DEBT. THE REASON THAT LENDERS ACCEPT HIGH DEBT RATIOS ON PIPELINES IS THAT THEY RECOGNIZE THE THROUGHPUT UNDERTAKINGS TO BE FULL APPLICATION OF THE CREDIT OF THE OIL COMPANY OR COMPANIES INVOLVED. CONSEQUENTLY, THE LENDERS ARE NOT TAKING THE RISKS OF FAILURE OF THE PIPELINE

OPERATION. THESE RISKS ARE BORNE BY THE OIL COMPANIES IN THE FORM OF THEIR BACKSTOPPING, AS WELL AS THEIR EQUITY INTEREST. THE END RESULT IS THAT THE OIL COMPANY HAS DEDICATED ONE OF ITS VALUABLE ASSETS, NAMELY ITS CREDIT, TO OBTAIN USE OF A PIPELINE SYSTEM AND A REGULATED PROFIT ON ITS INVESTMENT.

THE SECOND WAY OF ORGANIZING AND FINANCING JOINTLY OWNED PIPELINES IS AS UNDIVIDED JOINT INTEREST SYSTEMS. THIS IS HOW TRANS ALASKA PIPELINE SYSTEM IS ORGANIZED. FOR CONSENT DECREE REASONS OWNERSHIP IS CUSTOMARILY INVESTED IN, AND THE INDEBTEDNESS IS USUALLY RAISED BY, A WHOLLY-OWNED PIPELINE SUBSIDIARY OF EACH OWNER, BUT THE ARRANGEMENT STILL AMOUNTS TO A FULL USE OF THE OWNER COMPANY'S CREDIT.

IN A JOINT VENTURE, EACH OF THE OIL COMPANIES OWNS A SHARE OF THE FACILITIES, EITHER DIRECTLY OR THROUGH ITS PIPELINE SUBSIDIARY. THE PIPELINE IS NOT FINANCED AS A PROJECT; EACH OWNER COMPANY COMPLETES ITS OWN SHARE OF THE SYSTEM AND FINANCES ITS SHARE OF THE COST IN THE SAME WAY IT DOES OTHER ITEMS IN ITS CORPORATE BUDGET. THESE ARE FINANCED OUT OF ALL CORPORATE RESOURCES, INCLUDING WORKING CAPITAL, INTERNAL CASH FLOW AND ISSUANCE OF SECURITIES - IN EFFECT REFLECTING ITS OVERALL CAPITAL STRUCTURE AND DEBT/EQUITY MIX. THE EFFECT ON THE OIL COMPANY

IS THE SAME AS IN PROJECT FINANCING - IT HAS COMMITTED AN IMPORTANT AMOUNT OF ITS RESOURCES AND CREDIT TO AN UNDERTAKING THAT HAS ASSOCIATED WITH IT SIGNIFICANT RISKS. THIS IS AS REAL A USE OF CREDIT AS ANY OTHER, AND PRE-EMPTS ITS USE FOR OTHER INVESTMENTS. THEREFORE, TO COMPENSATE FOR THESE RISKS, AN OIL COMPANY MUST BE ABLE TO CONTROL THE OPERATION OF THE FACILITIES AND MUST HAVE PROSPECTS OF EARNING A FAIR RETURN ON ITS INVESTMENT COMPARABLE TO THE POTENTIAL RETURN AVAILABLE TO IT ON ALTERNATIVE INVESTMENTS.

FINANCING OF TAPS

NOW LET ME TURN TO THE FINANCING OF TAPS AND WHY WE HAVE CONSIDERABLE CONCERN ABOUT THE PROPOSED LEGISLATION AND ITS POSSIBLE EFFECT ON THE FEASIBILITY OF FINANCING TAPS.

WE ARE ADDRESSING OURSELVES TO THE FINANCING OVER A PERIOD OF YEARS OF EXPENDITURES WHICH MAY AMOUNT TO AS MUCH AS $3 1/2 BILLION. I WOULD LIKE TO EMPHASIZE AGAIN THAT WE HAVE A HEALTHY RESPECT FOR THE AMOUNT OF MONEY INVOLVED HERE. THE CHURCHILL FALLS PROJECT, TO WHICH I HAVE ALREADY REFERRED, IS THE LARGEST PRIVATELY FINANCED PROJECT IN HISTORY, AND TAPS IS 3 TO 5 TIMES AS LARGE DEPENDING UPON HOW YOU MEASURE IT.

THESE EXPENDITURES ARE TO BE BORNE BY SEVEN OIL COMPANIES, WHICH DIFFER IN SIZE AND CAPABILITY TO SUPPORT

THE COMMITMENTS INVOLVED. WE HAVE STUDIED EACH COMPANY AND MADE AN ASSESSMENT OF THE FINANCIAL CAPABILITY OF EACH TO DISCHARGE THESE COMMITMENTS WITHIN THE LIMITS OF ITS INDIVIDUAL FINANCIAL STRENGTH. TO PUT THIS IN PERSPECTIVE, I MIGHT POINT OUT THAT THE THREE COMPANIES THAT WILL OWN OVER 80% OF THE UNDIVIDED JOINT INTEREST ARE ASSUMING AN AGGREGATE CONSTRUCTION LIABILITY OF 80% OF $3.5 BILLION, OR OVER $2.8 BILLION. IF THIS AMOUNT WERE RAISED BY DEBT, IT WOULD REPRESENT AN INCREASE OF 170% OVER THE AGGREGATE INDEBTEDNESS THOSE THREE COMPANIES HAD OUTSTANDING ON DECEMBER 31, 1970.

DESPITE OUR RESPECT FOR THE SIZE OF THE TAPS PROJECT, WE HAVE COME TO THE OPINION THAT - ABSENT THE PROPOSED LEGISLATION - THE EXPENDITURES NECESSARY TO CONSTRUCT THE PIPELINE CAN BE SUCCESSFULLY FINANCED BY THE OIL COMPANIES INVOLVED. HOWEVER, THE BILLS HERE UNDER CONSIDERATION REPRESENT A SERIOUS IMPEDIMENT TO THAT FINANCING, AND I SHOULD LIKE TO SHARE WITH YOU MY CONCERN ABOUT THE EFFECT THIS LEGISLATION WOULD HAVE UPON THE ABILITY OF THE OIL COMPANIES TO CONDUCT THE NECESSARY FINANCING AND BUILD THE PIPELINE. THERE ARE SOME MAJOR PROBLEMS WHICH ARISE OUT OF THESE PROPOSALS:

1. <u>THE LIMITATION OF THE LEASE TO FIVE YEARS DURATION</u>: NORMAL PRACTICE WOULD BE FOR A PIPELINE TO HAVE

UNDISPUTED RIGHT-OF-WAY PRIVILEGES FOR THE EXPECTED ECONOMIC AND PHYSICAL LIFE OF THE SYSTEM, BUT IN NO EVENT LESS THAN THE PERIOD OF TIME REQUIRED TO RECOVER THE COST ON REASONABLE TERMS. LENDERS WOULD REGARD THE 5-YEAR LEASE LIMITATION AS A MAJOR INFIRMITY IMPAIRING THE ECONOMIC VIABILITY OF THE SYSTEM. OIL COMPANIES COULD NOT PRUDENTLY COMMIT FUNDS FOR WHAT IS IN ESSENCE A LONG-TERM VENTURE IF THERE WAS A THREAT THAT THE ECONOMIC LIFE COULD BE TERMINATED OR MODIFIED AT THE END OF THE FIVE-YEAR PERIOD.

REGARDLESS OF THE LENGTH OF THE LEASE, I THINK IT IS IMPORTANT TO EMPHASIZE THAT WHERE A PORTION OF THE RIGHT-OF-WAY OF A PIPELINE IS GOVERNMENT-OWNED, THE GENERAL ATTITUDE OF THE HOST GOVERNMENT TOWARD THE PIPELINE WILL ENTER IMPORTANTLY INTO THE CONSIDERATIONS OF LENDERS.

2. <u>LOSS OF OWNERSHIP</u>: THE PROSPECT THAT OWNERSHIP MIGHT BE TAKEN AWAY FROM SHIPPER-OWNERS AT SOME INDETERMINATE TIME IN THE FUTURE NULLIFIES ANY ECONOMIC JUSTIFICATION FOR TAKING THE RISKS INVOLVED IN COMMITTING THE SUBSTANTIAL FUNDS NECESSARY TO COMPLETE THE PROJECT. AS MENTIONED BEFORE, IF AN OIL COMPANY HAS USED ITS CREDIT IN THIS CONNECTION, IT HAS FOREGONE ITS USE IN OTHER PROFITABLE INVESTMENTS. IT MUST, THEREFORE, HAVE THE EXPECTATION OF MAKING A RETURN ON ITS INVESTMENT.

FURTHERMORE, BECAUSE THE SYSTEM IS TO BE A COMMON CARRIER AVAILABLE TO ALL PRODUCERS, OWNERS WILL BE SHARING THEIR SPACE WITH OTHER SHIPPERS. THEREFORE, IT SEEMS TO US THAT THOSE THAT HAVE ASSUMED THE COST AND RISK OF BUILDING THE SYSTEM MUST BE IN POSITION TO RECOVER THEIR INVESTMENT IN PART THROUGH PROFITS DERIVED FROM USE OF THE SYSTEM BY OTHERS. OTHERWISE, THE COMPANIES BUILDING THE PIPELINE WOULD HAVE USED THEIR CREDIT FOR THE BENEFIT OF OTHERS WITHOUT COMPENSATION, WHICH VIOLATES A CARDINAL RULE OF SOUND FINANCE.

3. REGULATION: THERE HAS BEEN IN THIS COUNTRY MASSIVE FINANCING OF CRUDE OIL AND PRODUCTS PIPELINES SUBJECT TO REGULATION OF THE ICC, AND THE EFFECT OF THIS REGULATION ON THE PIPELINES AND THEIR OWNERS IS WELL UNDERSTOOD BY INSTITUTIONAL INVESTORS. WE NOTE THAT PROVISIONS OF ONE OF THE BILLS APPEAR TO GIVE THE PROPOSED TRANSPORTATION COMMISSION THE AUTHORITY TO ESTABLISH DEPRECIATION RATES AND TARIFFS INDEPENDENTLY OF THE ICC; FURTHER, THE DEPRECIATION RULES APPEAR TO BE AT VARIANCE WITH THOSE PRESCRIBED BY THE ICC.

UNLESS THESE DIFFERENCES ARE ULTIMATELY RESOLVED, WE ARE NOT ABLE TO MEASURE THE IMPACT THEY MAY HAVE ON FINANCING FEASIBILITY, BUT THE IMPACT MAY BE SUBSTANTIAL IF LENDERS CANNOT BE CONVINCED THAT THE OWNERS OF THE PIPELINE WILL BE ABLE TO

EARN A FAIR RETURN ON THEIR INVESTMENTS. AS I SHALL MENTION LATER, UNCERTAINTY WITH REGARD TO SUCH QUESTION, OR TO THE OUTCOME OF COURT TESTS DETERMINING JURISDICTION, CAN CAUSE DELAYS AND INCREASED COSTS IN FINANCING.

4. REDEMPTION PENALTY: THE CONTEMPLATED LEGISLATION CREATES THE POSSIBILITY THAT THE OIL COMPANIES FINANCING THE PIPELINE WILL FIND THEMSELVES IN THE POSITION, VIS-A-VIS THE STATE OF ALASKA, OF "HEADS YOU WIN, TAILS I LOSE." WHEN THEY BORROW TO FINANCE THE LINE, THEY WILL PLEDGE THEIR FULL CREDIT TO REPAY REGARDLESS OF WHETHER THE PIPELINE IS BUILT, OPERATES PROFITABLY, OR IS SHUT DOWN TEMPORARILY OR PERMANENTLY FOR ANY OF A NUMBER OF REASONS. THESE ARE SUBSTANTIAL RISKS. UNDER THE PROPOSED LEGISLATION, HOWEVER, IF THE LINE IS BUILT AND OPERATES SUCCESSFULLY AND PROFITABLY, ALASKA WOULD BE IN POSITION TO TAKE OWNERSHIP AWAY FROM THEM. NOT ONLY WOULD THE COMPANIES LOSE THE ASSET GAINED THROUGH THE INCURRENCE OF RISK, BUT THEY WOULD BE FORCED TO PAY A PENALTY TO THE LENDERS WHEN THEY REDEEMED THE INDEBTEDNESS INCURRED TO BUILD THE LINE.

THERE IS A REASON LENDERS ASK FOR REDEMPTION PREMIUMS. THE TYPES OF LENDERS WHO NORMALLY FURNISH FUNDS FOR THE CONSTRUCTION OF MAJOR PROJECTS, SUCH AS TAPS, HAVE

LONG-TERM LIABILITIES, AND THEY WISH TO INVEST THEIR FUNDS AT WHAT THEY BELIEVE ARE SATISFACTORY RATES FOR LONG PERIODS OF TIME. IF A LOAN IS TO BE PAID OFF PREMATURELY THEY DEMAND COMPENSATION, USUALLY IN THE FORM OF A REDEMPTION PREMIUM. THIS IS TO OFFSET THE POSSIBILITY THAT THE PROCEEDS RECEIVED FROM THE EARLY REPAYMENT OF THE LOAN MAY HAVE TO BE INVESTED AT A LOWER RATE THAN THEY HAVE BEEN RECEIVING. BECAUSE OF THE THREAT THIS LEGISLATION POSES, I BELIEVE THAT THE PREMIUM ASKED FOR REDEMPTION IN THE EARLY YEARS WOULD BE LARGE, IT MIGHT BE AS HIGH AS 10%. AGAINST BORROWINGS OF THE TOTAL PIPE-LINE COSTS, THIS WOULD REPRESENT AN ADDITIONAL $350 MILLION. THIS MIGHT BE MORE THAN THE OIL COMPANIES WILL BE WILLING TO CONTRACT TO PAY, AND THE ALTERNATIVE MIGHT HAVE TO BE TO AGREE TO A HIGHER INTEREST RATE THAN WOULD OTHERWISE BE THE CASE. IN ANY EVENT THERE WOULD BE SUBSTANTIAL (AND UNNECESSARY) ADDITIONAL COST.

5. <u>UNCERTAINTY</u>: ANY FINANCING IS DIFFICULT (AND MAY BE IMPOSSIBLE) UNDER CONDITIONS OF UNCERTAINTY. THE PROPOSED LEGISLATION CREATES UNCERTAINTY. NEITHER POTENTIAL BORROWERS NOR POTENTIAL LENDERS KNOW WHETHER LEGISLATION SIMILAR TO THAT IN THE PROPOSED BILLS WILL BE PASSED. PLANS CANNOT BE MADE. TO THE EXTENT THAT THIS UNCERTAINTY HAS THE

EFFECT OF DELAYING THE PROJECT, IT POSSIBLY COULD LEAD TO HIGHER CONSTRUCTION COSTS. A SHORT DELAY COULD EASILY RESULT IN A LOSS OF A WHOLE YEAR BECAUSE OF THE ALASKAN CLIMATE. UNCERTAINTY IS ALREADY HOLDING UP FINANCING BY COMPANIES INVOLVED WITH THE PIPELINE. I AM NOT GOING TO ATTEMPT TO FORECAST THE OUTLOOK FOR INTEREST RATES, BUT I WOULD LIKE TO MENTION PARENTHETICALLY THAT CURRENT RATES ARE WELL BELOW WHAT THEY WERE ONLY A SHORT TIME AGO. IN ADDITION, FUNDS ARE MORE READILY AVAILABLE TO INVESTING INSTITUTIONS FOR LENDING PURPOSES THAN HAS BEEN THE CASE FOR A NUMBER OF YEARS. THIS IS LIKELY TO BE A TEMPORARY SITUATION. MANY BANKERS AND ECONOMISTS BELIEVE THAT AS BUSINESS RECOVERS INTEREST RATES MAY RISE AND, THEREFORE, ANY DELAY IN ARRANGING THE FINANCING COULD WELL RESULT IN THE COMPANIES INCURRING HIGHER INTEREST COSTS. BECAUSE OF THE AMOUNTS INVOLVED, AN INTEREST RATE CHANGE OF 1% RAISES COSTS ANNUALLY BY $35 MILLION.

THEREFORE, I WOULD LIKE TO URGE MOST STRONGLY IN THE INTEREST OF ALL CONCERNED THAT THIS SITUATION OF UNCERTAINTY BE RESOLVED AS PROMPTLY AS POSSIBLE.

ABILITY OF THE STATE TO FINANCE CONSTRUCTION OF THE PIPELINE

FINALLY, WE HAVE GIVEN CONSIDERATION TO THE ABILITY

OF THE STATE TO FINANCE THE CONSTRUCTION OF THE PIPELINE. THIS INVOLVES RAISING THE STAGGERING SUM OF $3.5 BILLION, AND NO STATE HAS EVER SOLD AN ISSUE OF THIS SIZE. I AM CERTAINLY NOT TRYING TO BE NEGATIVE, BUT IT IS IMPORTANT THAT WE BE REALISTIC AND RECOGNIZE THE PROBLEMS INVOLVED IN RAISING THIS AMOUNT OF MONEY, EVEN IF IT WERE TO BE ATTEMPTED OVER THE PERIOD OF CONSTRUCTION RATHER THAN ALL AT ONCE.

ALTHOUGH CERTAINLY THE TAX-EXEMPT MARKET IS A LARGE ONE, IT IS OUR OPINION THAT IN ORDER FOR ALASKA TO HAVE ANY HOPE OF ACCOMPLISHING SUCH A FINANCING OPERATION, ALL OF THE COUNTRY'S LARGE RESERVOIRS OF CAPITAL WOULD NEED TO BE TAPPED. IN OUR VIEW, THIS WOULD HAVE TO INCLUDE THOSE INSTITUTIONS WHICH ARE NOT NORMALLY BUYERS OF TAX-EXEMPT OBLIGATIONS BECAUSE THEY GET LITTLE OR NO BENEFIT THEREFROM, NAMELY, LIFE INSURANCE COMPANIES AND PENSION FUNDS. THESE INSTITUTIONS ARE THE NORMAL SUPPLIERS OF CAPITAL FOR PIPELINE PROJECTS, AND THEY HAVE REQUIRED THE UNCONDITIONAL BACKSTOPPING BY FINANCIALLY CAPABLE PARTIES THAT I HAVE ALREADY DESCRIBED. FOR TAPS THE OIL COMPANIES ARE ABLE TO PROVIDE THIS, BUT THE STATE DOES NOT PRESENTLY HAVE THE FINANCIAL CAPACITY TO SUBSTITUTE FOR THEM.

WE HAVE HEARD THE THEORY ADVANCED THAT THE STATE CAN

DEDICATE TO THIS PROJECT ITS ANTICIPATED REVENUES FROM OIL ROYALTIES AND SEVERANCE TAXES FROM THE NORTH SLOPE, BUT THOSE REVENUES DEPEND UPON OPERATION OF THE PIPELINE AND ARE NOT "BANKABLE" ASSETS AT THE PRESENT TIME. IN FACT, THEY DO NOT BECOME VALUABLE FOR ADDING SUBSTANCE TO A FINANCIAL UNDERTAKING UNTIL THE PIPELINE IS COMPLETED AND IN OPERATION, BECAUSE THEY ARE COMPLETELY DEPENDENT ON ITS SUCCESS.

THESE CONSIDERATIONS LEAD US TO THE OPINION THAT THE STATE OF ALASKA CANNOT RAISE THE MONEY TO BUILD THE PIPELINE ON THE STRENGTH OF ITS PRESENT CREDIT RESOURCES. IN OUR VIEW, SUCCESSFUL FINANCING OF THE LINE DEPENDS, IN THE FINAL ANALYSIS, ON THE BACKING OF THE OIL COMPANIES' CREDIT.

THE QUESTION HAS ALSO BEEN RAISED OF THE STATE'S ABILITY TO RAISE AN APPROPRIATE AMOUNT OF MONEY TO TAKE OVER THE PIPELINE IN THE FUTURE, AFTER IT HAS BEEN OPERATING SUCCESSFULLY AS A GOING CONCERN. WE DO NOT FEEL THAT ANY EXPERT CAN MAKE AN INTELLIGENT JUDGMENT AT THIS JUNCTURE. THE ANSWER WOULD DEPEND UPON A HOST OF FACTORS - ECONOMICS OF THE SYSTEM AS FINALLY CONSTRUCTED, ECONOMICS OF THE CRUDE AT WEST COAST PORTS, TECHNICAL OPERATING EXPERIENCE, THE LEVEL OF TARIFFS AND DEBT SERVICE BURDENS, ECONOMICS OF ALTERNATIVE FORMS OF TRANSPORTATION THAT MAY BE AVAILABLE AT THE TIME , CONDITIONS

OF MARKETS AND LEVELS OF INTEREST RATES AT THE TIME. AS A CAUTIOUS, BUT EXPERIENCED INVESTMENT BANKER, I HAVE TO SAY THERE WILL BE OTHER FACTORS NONE OF US CAN THINK OF NOW. IF ALL THESE FACTORS TURNED OUT FAVORABLY - AND THAT HAS TO BE A LOT OF IFS - THEN IT IS CONCEIVABLE THAT THE STATE MIGHT, OVER A PERIOD OF TIME, RAISE SUBSTANTIAL SUMS WITH LESS THAN THE UNCONDITIONAL CREDIT BACKING OF THE SHIPPERS.

TO DO SO, HOWEVER, WOULD IN ALL PROBABILITY REQUIRE THAT THE STATE DEDICATE TO THE BORROWING NOT JUST THE PIPELINE EARNINGS, BUT ALL OF THE STATE'S POTENTIAL OIL INCOME IN ORDER TO EFFECT SUCCESSFUL SALES OF BONDS IN THE AMOUNTS NECESSARY TO PAY FOR THE PIPELINE. OBVIOUSLY, SUCH A DEDICATION WOULD SIGNIFICANTLY REDUCE THE STATE'S POTENTIAL ABILITY TO BORROW FOR OTHER PURPOSES, SUCH AS SCHOOLS, HOSPITALS, ROADS AND OTHER WORTHWHILE PROJECTS. IT WOULD ALSO SEEM LIKELY THAT, AT THAT STAGE, THE LARGE INCREASE IN THE AMOUNT OF GENERAL OBLIGATIONS OF THE STATE WHICH WOULD BE OUTSTANDING UNDOUBTEDLY WOULD RAISE THE INTEREST COSTS OF ANY BORROWINGS THAT MIGHT BE UNDERTAKEN FOR REGULAR FINANCING NEEDS.

Concluding Note

To sum up, the proposed legislation puts a number of clouds over the financing of this pipeline.

If it is passed as it presently stands, there would be considerable doubt in the eyes of the investing public whether the oil companies could maintain control of the operation and earn an adequate return on their investment. When doubts of this kind exist, they are severe impediments to financing and would result in having to pay higher interest costs.

We are all painfully aware how the cost of TAPS has already escalated while its construction has been delayed in Washington. I would therefore urge in the interest of both Alaska and the producers that they avoid delay and an additional increase in cost by resolving their differences so that the project can go ahead.

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

ARTICLE 116–2: Compensation of State officers and employees. XIV–16–7439 I. T. 2886

REVENUE ACT OF 1934.

Profits derived by the State of Virginia from the operation of liquor stores by the State are not subject to Federal income tax. The compensation of employees of the State for services rendered in connection with the operation of liquor stores by the State is subject to Federal income tax.

In G. C. M. 14407 [below], it was held that profits derived by the State of Montana from the operation of its liquor stores are not subject to Federal income tax. In the light of the conclusions reached in that memorandum, it is held that profits derived by the State of Virginia from the operation of liquor stores by the State are not subject to Federal income tax.

Attention is invited to the fact, however, that when a State or political subdivision engages in the operation of liquor stores it is acting in a proprietary capacity. Accordingly, the compensation of employees of the State whose services are rendered in connection with the operation of liquor stores by the State is subject to Federal income tax.

SECTION 116(d). XIV–7–7316 G. C. M. 14407

REVENUE ACT OF 1934.

Profits realized by the State of Montana from the operation of liquor stores by the State are not subject to Federal income tax under the Revenue Act of 1934.

G. C. M. 13745 (C. B. XIII–2, 76) is not to be considered as a ruling on the constitutional issue involved.

The State Liquor Control Act of Montana, approved March 14, 1933 (Laws of Montana, 1933, chapter 105, as amended by chapter 57, Laws of the Extraordinary Session of 1933–34), provides for the creation of the Montana Liquor Control Board, which is given power to buy, possess for sale, and sell liquor; to control its sale and delivery; to determine the location of State liquor stores and to establish such stores; to grant, refuse, or cancel permits for the purchase of liquor; to appoint vendors and officers and employees required for the carrying out of the act; to issue club licenses and special permits for the sale of liquor; and to make regulations for carrying out the provisions of the act. All moneys received from the sale of liquor by the State liquor stores, and from license fees and fees for permits, shall be paid to the board, and no provision is made for segregating the moneys derived from fees from the moneys derived from liquor sales. Out of the profits arising under the act, there is to be created a reserve fund to meet any losses incurred by the State in connection with the administration of the act. When all of the liquor stores which can be established throughout the State have been established and the administration expenses have been paid, the net profits are to be allocated 50 per cent to the emergency relief fund of the State of Montana, and 50 per cent to the general fund of the State until February 1, 1935; thereafter, all such profits are to be allocated 50 per cent to the

general fund of the State and 50 per cent to the general funds of the counties in the proportion that the population of each county bears to the total population of the State.

The questions raised for consideration are (1) whether the Revenue Act of 1934 imposes a tax upon the income derived by the State of Montana from the operation of its liquor stores, and (2) whether, if the Act be found to impose such a tax, the taxation of such income within the constitutional powers of the Federal Government.

The Revenue Act of 1934 taxes at different rates the income of "individuals" and "corporations," but nowhere in the Act is a tax expressly imposed upon a State. It may be stated with assurance that a State is not an "individual" within the meaning of the Act, if for no other reason than that the credits and exemptions provided for an individual are obviously not applicable to a State. Whether or not a State is a "corporation" depends, to use the language of Mr. Justice Sutherland, "upon the connection in which the word is found." (*Ohio* v. *Helvering* (1934), 292 U. S., 360.)

Clearly, with the possible exception of section 116(d), there is nothing in the Revenue Act of 1934 to indicate that States should be taxed as corporations, and the proper interpretation of that section indicates rather that States should not be so taxed. The first paragraph of section 116(d) of that Act, relating to the "Income of States, municipalities, etc.," provides for the exemption from taxation of the following type of income:

* * * Income derived from any public utility or the exercise of any essential governmental function and accruing to any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, or income accruing to the government of any possession of the United States, or any political subdivision thereof.

It will be observed that the paragraph quoted refers to the income "derived from any public utility or the exercise of any essential governmental function and accruing to any State, Territory or the District of Columbia." Had Congress meant to include within this exemption income derived by the State itself from an activity which it carries on directly, it is suggested that it would have said "income derived from * * * by any State, Territory, etc.," since the words "accruing to" connote the receipt of income from a contract or investment rather than from an act of the recipient. The use of these words serves, if not to make clear that the income referred to must have been derived by an entity other than a State, Territory, or the District of Columbia, at least to raise an ambiguity which justifies resort to extrinsic evidence for its resolution.

In determining the meaning of a provision which is ambiguous the practical interpretation given that provision by the officer charged with its administration must be given great weight, especially when the practice has been long-continuing and the provision has been frequently reenacted by Congress. (*Brewster* v. *Gage*, 280 U. S., 327; *Massachusetts Mutual Life Insurance Co.* v. *United States*, 288 U. S., 269.) This rule does not appear to be limited to affirmative and express construction. It would seem that "the neglect of lawfully constituted authorities to assess taxes [illegible] is not applicable if [illegible]

Koeln v. *St. Louis Y. M. C. A.*, 259 Mo., 233, 168 S. W., 589; *Westerman* v. *Supreme Lodge K. P.*, 196 Mo., 670, 94 S. W., 470.) (See also *Mintz et al.* v. *Baldwin*, 289 U. S., 346; *United States* v. *Farrar*, 281 U. S., 624.) The practice of the Bureau of Internal Revenue over a course of years, in the light of the ambiguity of the legislation under consideration coupled with the frequent reenactment of that legislation without substantial change, supports the inference just suggested that the first paragraph of section 116(d) was intended to refer, not to the income of a State or municipality resulting from its own direct participation in industry, but rather to that part of the income of a corporation engaged in the operation of a public utility or in the performance of some governmental function which accrues to a State or municipality by virtue of its ownership of such corporation. Parenthetically it should be noted that this construction is entirely consistent with the undoubted effect of the second paragraph of that section in exempting from tax that part of the proceeds from the operation of a public utility which accrues to a State or municipality under a contract entered into with "any person."

In the entire period since the enactment of the Tariff Act of 1913, the Bureau has regularly considered section 116(d) and the corresponding provisions of prior Revenue Acts from the standpoint of the taxability of corporations owned by, or operating under contract with, States or municipalities. (See, for example, I. T. 2436, C. B. VII–2, 147; S. M. 2941, C. B. IV–1, 210; O. D. 250, C. B. 1, 92.) (See also *Jamestown & Newport Ferry Co.* v. *Commissioner*, 41 Fed. (2d), 920.) Not only has the Bureau failed to tax the direct income of any State or municipality but it has throughout this period of 22 years made no effort to obtain income returns from States or municipalities, or to determine by any other means whether any State or municipality has had income of this nature. This persistent nonenforcement of the tax against States may be reasonably explained only as indicating a tacit construction by the Bureau in accordance with the interpretation which has just been suggested.

To assume that this inaction on the part of the Bureau was due to an oversight is highly unreasonable. Eight years prior to the passage of the 1913 Act, the Supreme Court had declared in *South Carolina* v. *United States* (1905) (199 U. S., 437) that agents of a State operating a liquor dispensary system were subject to the special excise tax on retail liquor dealers, and, for at least three years following 1913, the Bureau was actively engaged in collecting this special excise tax from State liquor dispensaries in South Carolina. This in itself is clear evidence that the Bureau was aware of the participation by States in this class of activities, but even stronger evidence is found in the fact that, during the existence of the income tax laws, questions involving the taxability of the income of employees of a city or State engaged directly in carrying on a nonessential governmental function have frequently been determined by the Bureau. In determining such questions, the Bureau has recognized that the States and municipalities were acting in a proprietary capacity, and that their employees were not exempt from the payment of the Federal income tax; yet no attempt has ever been made to tax the income derived by States and municipalities from these activities. (See, for

example, S. M. 2232, C. B. III–2, 83 (cafeterias in public schools); I. T. 2357, C. B. VI–1, 52 (county hospitals); S. M. 5190, C. B. V–1, 37 (Rural Credit Board).) (See also I. T. 2782, C. B. XIII–1, 83; I. T. 2376, C. B. VI–2, 55; *D. G. Wood et ux.* v. *Commissioner*, 29 B. T. A., 919; *Shelby Wiggins* v. *Commissioner*, 27 B. T. A., 576; *T. P. Wittschen* v. *Commissioner*, 25 B. T. A., 46.)

During the time that the Bureau may be said to have been asserting this construction, the first paragraph of section 116(d) has been reenacted eight times with but a single change and that an inconsequential one. On any of these occasions, Congress could, had it disagreed with the interpretation given the paragraph by the Bureau, have so amended the Act as to make it entirely clear that States and municipalities were to be included within the scope of the Act; yet there is no evidence that such action was ever considered.

Additional support for the conclusion that Congress did not intend to tax the income derived directly by States as such is found in the committee reports and the debates on the floor of Congress preceding the passage of the Tariff Act of 1913 (see Senate Report No. 80 on H. R. 3321, Sixty-third Congress, first session, 50 Congressional Record (part 6), pages 5329–5321). They make it clear that what Congress was concerned with, in considering the enactment of the first paragraph of section II G(a) of the Tariff Act of 1913 (section 116(d) of the Revenue Act of 1934), was that part of the income derived by a corporation from the public utility business or from the performance of a governmental function which would accrue to a State or a municipality by virtue of its possession of a "beneficial interest" in the corporation. The type situations cited were all of such corporations. Nowhere in the report or debates is there consideration of the taxation of the income of States or municipalities which would result to them directly without the intervention of the corporate form and it appears to have been taken for granted that such income would not be subject to tax.

It is suggested that Congress, in not taxing the income of States, may well have been motivated by a desire not to limit the activities in which States might otherwise engage. The line between those revenue-producing activities of a State which are "governmental" and those which are "proprietary" is one which is in its nature difficult to draw and which has as yet been only faintly traced by decisions of the courts. For example, while the conduct or operation of prisons is strictly within the sovereign functions of the State, the revenue derived from the manufacture and sale of prison-made merchandise may or may not be the essential result of a governmental activity. Similarly, such activities as the loaning of State funds or the sale of surplus properties are of a character which makes it difficult to predict in which category they would be placed. It may be assumed that Congress did not desire in any way to restrict a State's participation in enterprises which might be useful in carrying out those projects desirable from the standpoint of the State Government which, on a broad consideration of the question, may be the function of the sovereign to conduct; and it may reasonably be considered that it was the possibility of such restriction which persuaded Congress not to include

State income within the subjects taxed by the various Revenue Acts since 1913. While such speculation has, of course, no conclusive effect, it may be proper as an aid in determining the intention of Congress in order to construe legislation patently ambiguous.

It follows from what has been said that the State of Montana is not a "corporation" within the meaning of the Revenue Act of 1934. This conclusion is reached in the belief that, in interpreting a statute, administrative agencies of the Government should not take the position against their better judgment that a tax is payable. While it is true that the possibilities of a judicial review of such an interpretation are meager, the effect of this position is merely to shift the burden of consideration from the courts to the legislature.

Since the question has been determined on the point of construction, the constitutional question need not be considered.

In G. C. M. 13745, supra, the opinion was expressed that profits derived by the State of Oregon from its liquor stores are not subject to Federal income tax. This opinion was prepared as a reversal of I. T. 2797 (C. B. XIII-2, 74), in which it was held to be within the power of the Federal Government to tax the profits from the Oregon liquor stores; and, in withdrawing I. T. 2797, it was pointed out that the decisions in *South Carolina* v. *United States*, supra, and *Ohio* v. *Helvering*, supra, were not controlling on the question discussed in that opinion. In order to clear up any doubt as to the meaning of G. C. M. 13745, it should be pointed out that that opinion is not to be considered as authority for any ruling other than that the income under consideration is not taxable by the Federal Government under existing legislation. It may not be taken as a determination of the constitutional question involved.

The conclusion is, therefore, that the income derived from the operation of liquor stores by the State of Montana is not subject to Federal income tax under the Revenue Act of 1934.

HERMAN OLIPHANT,
General Counsel for the Department of the Treasury.

SECTION 117.—CAPITAL GAINS AND LOSSES.

ARTICLE 117-1: Meaning of capital assets. XIV-3-7261
T. D. 4511

Income tax—Capital gains and losses.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

PARAGRAPH A. Section 117 (Title I—Income Tax) of the Revenue Act of 1934 provides:

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *General rule.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 1 year;

municipal bond interest, for Federal income tax purposes, upon its realization by them. If the investors hold the bonds until redemption thereof by the municipality, they will then realize recognized gain of the entire excess of the (par) redemption price received over the purchase price which they paid. If, instead, the investors sell the bonds, they will then realize recognized gain of the entire sale price received or accrued over such purchase price, or sustain recognized loss of the excess of such purchase price over the sale price received or accrued. Such gains or losses to the investors will be taxable or allowable as capital gains or losses, *i. e.*, in accordance with and subject to the capital gain and loss provisions of the 1954 Code.

(Also Section 115.) Rev. Rul. 57-151

The income earned by the Oklahoma County Utility Services Authority, a trust created under State law for the furtherance of public functions, is not subject to Federal income tax. Mortgage bonds and debenture notes issued by such Authority for the purpose of financing facilities for certain utility services to a county are considered to be issued in behalf of a political subdivision and the interest paid thereon is also exempt from Federal income tax.

Advice has been requested whether the income realized by the Oklahoma County Utility Services Authority, a trust created under State laws for the furtherance of public functions, and the interest paid on obligations issued by it are exempt from Federal income tax.

Under the terms of an Oklahoma statute entitled "Trusts for the Furtherance of Public Functions," Title 60 Oklahoma Statutes 1951, sections 176-180, as amended by Laws 1953, express trusts may be created with the State or any political subdivision thereof as the beneficiary for the purpose of furthering any authorized function of the beneficiary. Title 60, section 176, Oklahoma Statutes. Before the trusts can become effective, the beneficial interest therein must be formally accepted by the Governor of the State or by the governing body of the political subdivision which is named as the beneficiary in the trust instrument. Title 60, section 177. The statute designates the trustees under such an instrument as an agency of the State and provides that the trust may be terminated only by agreement of the trustees and the governing body of the beneficiary, with the approval of the Governor of the State. Title 60, sections 178 and 180.

The Oklahoma County Utility Services Authority is a trust created pursuant to the provisions of the statute referred to above, for the purpose of providing municipal utility services, such as water supply, fire protection and sewage disposal, for the residents in the outlying areas of Oklahoma County. The Board of County Commissioners of Oklahoma County has formally accepted the beneficial interest in the trust and has thereby rendered the trust effective. Under the terms of the trust instrument, the Authority is empowered to issue first mortgage revenue bonds, secured on trust properties and unsecured debenture notes. The revenues of the Authority primarily available for meeting its obligations are derived from the sale of water produced and distributed, although the Authority may have other revenues from other operations in which it may engage in the performance of trust purposes. No obligation of the trust, however, shall

become a liability of the beneficiary. No funds of the Authority be diverted to any private use and, upon termination of the trust payment of all debts and obligations, the remainder of the assets shall be distributed to the beneficiary. The Supreme Court of the State of Oklahoma sustained the validity of the trust the acceptance of the beneficial interest by the Board of County Commissioners of Oklahoma County, and held that the trustees under trust instrument are an agency of the State of Oklahoma and its duly constituted authority for the performance of the functions which the trust was created. *Board of County Commissioners* [illegible], Okl., 285 P. 2d 1034 (1955).

On the basis of the facts present in this case, it is held that the income to be earned by the Oklahoma County Utility Services Authority from the furnishing of municipal utility services such as water supply, fire protection and sewage disposal, and which income will never accrue to the benefit of any person, firm, or corporation except the county which is the beneficiary of the trust, will not be subject to Federal income tax. It is further held that the mortgage revenue and debenture notes to be issued by the Authority for the purpose of financing the facilities to be used in providing municipal utility services will be considered as issued in behalf of the County, a political subdivision, and the interest paid thereon will be exempt from Federal income tax under section 103(a)(1) of the Internal Revenue Code of 1954. Cf. Rev. Rul. 54-296, C. B. 1954-2, 59.

Rev. Rul. 57-187

Bonds issued by an Industrial Development Board formed under Title 37, Chapter 17 of the Code of Alabama, are considered issued on behalf of a municipality, a political subdivision of the State. Interest received on such bonds is exempt from Federal income tax under section 103(a)(1) of the 1954 Code.

A ruling has been requested whether interest received on bonds issued by an Industrial Development Board formed under Title 37, Chapter 17 of the Code of Alabama, is exempt from Federal income

Under Title 37, Chapter 17 of the Alabama Code 1940, sections [illegible], as amended, the legislature has authorized the incorporation by the several municipalities of public corporations designated Industrial Development Boards to acquire, own, lease and dispose of properties to the end that such corporations may be able to promote industry and develop trade by inducing manufacturing, industrial and commercial enterprises to locate in the State. Title 37, Section [illegible].

Under the statute an Industrial Development Board may be formed [illegible] the governing body of the municipality concerned has given formal approval to the creation of the Board and to the [illegible] certificate of incorporation. Title 37, Section 817. The [illegible] directors of each Industrial Development Board is elected [illegible] governing body of the municipality concerned and serves [illegible] corporation. Title 37, Section 821. The corporate powers [illegible] power to acquire, improve, maintain, equip and furnish [illegible] such projects and collect rent; to sell and convey

Chicago's Public Works [illegible] said he sees Mayor Milton Tikonsky [illegible] the money by the deadline. He said: "We have just been told by County officials that Chicago can't expect any more help this year from its motor fuel tax funds. Last year, we got $1.5 million from the County and with $2 million of city money we qualified for $7 million in State funds for the CTA."

This formula of matching $2 from the State for each $1 in local contributions is the general rule in applying for the $200 million for mass [illegible] will be placed in the general pool for capital improvements.

Michael Cafferty, CTA chairman, was counting on the entire subsidy when he said there would be no increase in the basic fare, which now is 45 cents, plus 10 cents for a transfer.

The CTA went $18,650,774 further into the red in 1971 and passed a deficit budget for calendar 1972 which exceeds revenues by $43,870,000, exclusive of cost-of-living wage increases.

VOLUME OF STATE AND MUNICIPAL BORROWING 1896 - 1971

The following table, compiled by "The Daily Bond Buyer" of New York, presents a 76-year record of long-term and short-term State and municipal financing:

Year	Par Amount — Long-Term Issues $	Short-Term Issues $	All Issues $	No. of All Issues
1971	24,369,536,105	26,281,467,539	50,651,003,644	8,811
1970	17,761,645,833	17,879,952,793	35,641,598,626	7,604
1969	11,460,251,103	11,783,127,124	23,243,378,227	6,395
1968	16,374,332,960	8,658,556,650	25,032,889,610	7,887
1967	14,287,949,346	8,025,331,071	22,313,280,417	7,964
1966	11,088,938,349	6,523,534,545	17,612,472,894	7,430
1965	11,084,188,715	6,537,396,751	17,621,585,466	7,977
1964	10,544,127,114	5,423,258,660	15,967,385,774	8,138
1963	10,106,665,364	5,480,807,517	15,587,472,881	8,574
1962	8,558,200,662	4,763,474,695	13,321,675,357	8,689
1961	8,359,512,134	4,514,171,800	12,873,683,934	8,490
1960	7,229,500,359	4,006,185,985	11,235,686,344	8,397
1959	7,681,053,623	4,178,641,998	11,859,695,621	8,568
1958	7,448,803,189	3,910,463,987	11,359,267,176	8,523
1957	6,958,152,145	3,273,508,182	10,231,660,327	8,242
1956	5,446,419,571	2,706,324,575	8,152,744,146	7,689
1955	5,976,503,820	2,592,945,267	8,569,449,087	7,732
1954	6,968,641,896	3,350,234,995	10,318,876,891	7,747
1953	5,557,887,369	2,756,631,122	8,314,518,491	7,263
1952	4,401,317,467	2,049,150,972	6,450,468,439	6,410
1951	3,278,153,053	1,636,758,897	4,914,911,950	5,885
1950	3,693,604,165	1,611,133,561	5,304,737,726	6,533
1949	2,995,425,049	1,332,836,205	4,328,261,254	5,794
1948	2,989,731,949	1,004,728,795	3,994,460,744	5,178
1947	2,353,771,562	957,537,229	3,311,308,791	4,338
1946	1,203,557,909	740,844,100	1,944,402,009	3,886
1945	818,781,728	665,118,894	1,483,900,622	2,397
1944	712,305,515	568,897,659	1,281,203,174	1,798
1943	507,566,466	711,162,706	1,218,729,372	1,637
1942	575,588,229	1,113,241,228	1,688,829,457	3,341
1941	1,229,493,072	1,407,782,154	2,637,275,226	6,483
1940	1,497,683,294	1,626,271,523	3,123,954,817	6,055
1939	1,098,604,265	1,208,386,966	2,306,991,231	6,486
1938	1,229,105,539	1,167,926,831	2,397,032,370	7,165
1937	984,094,835	712,255,997	1,696,350,832	5,574
1936	1,156,254,317	733,137,912	1,889,392,229	6,032
1935	1,195,717,486	987,568,002	2,183,285,438	5,208
1934	1,175,333,698	933,072,871	2,108,406,569	5,432
1933	1,127,576,381	988,014,011	2,115,590,392	3,250
1932	936,855,060	1,092,066,907	2,028,921,967	4,108
1931	1,251,771,394	1,086,765,138	2,338,536,532	5,346
1930	1,382,870,539	952,121,721	2,334,992,260	6,661
1929	1,442,381,438	920,982,191	2,363,363,629	6,781
1928	1,389,818,717	716,792,625	2,106,611,342	7,856
1927	1,477,769,824	624,872,483	2,102,642,307	8,312
1926	1,362,037,801	661,210,870	2,023,248,671	7,625
1925	1,404,702,240	866,061,013	2,270,763,253	8,356
1924	1,446,688,993	979,030,752	2,425,769,745	7,736
1923	1,135,167,134	514,156,200	1,649,323,334	8,000
1922	1,279,553,134	395,578,427	1,675,131,561	9,434
1921	1,383,368,900	762,037,232	2,145,406,132	7,227
1920	773,663,986	664,087,293	1,437,751,279	5,499
1919	770,195,248	450,093,607	1,220,288,855	6,752
1918	262,818,844	473,134,727	735,953,571	3,871
1917	444,932,848	392,443,858	837,376,706	5,712
1916	497,403,751	292,407,269	789,811,020	6,560
1915	492,590,441	154,728,247	647,318,688	5,231
1914	445,968,510	286,054,624	732,023,134	4,605
1913	408,477,702	483,217,696	891,695,098	4,191
1912	399,046,083	192,450,139	591,496,223	4,605
1911	452,113,716	190,683,131	642,796,847	4,891
1910	324,360,955	197,166,473	521,527,428	4,512
1909	363,630,786	118,340,309	481,971,095	4,702
1908	355,384,466	174,647,263	530,031,729	4,330
1907	301,048,503	167,841,555	468,890,058	3,641
1906	301,168,061	125,232,239	426,400,300	3,775
1905	197,719,077	150,401,683	348,120,760	3,712
1904	286,708,289	130,797,555	417,505,844	3,531
1903	.....	.....	224,728,526	3,085
1902	.....	.....	210,473,052	3,064
1901	.....	.....	168,168,773	2,594
1900	.....	.....	174,578,040	2,312
1899	.....	.....	144,403,454	2,684
1898	.....	.....	128,015,728	2,199
1897	.....	.....	163,352,254	2,024
1896	.....	.....	119,538,424	1,294

STATE OF ALASKA

MEMORANDUM

TO: The Honorable William A. Egan
Governor
State of Alaska

DATE: November 1, 1971

FROM: Eric E. Wohlforth
Eric E. Wohlforth
Commissioner of Revenue

SUBJECT: Relative Standing of Investment Banking Houses - 1970; All Municipal Issues

Number of Issues Underwritten			Par Value of Issues Underwritten (1,000's omitted)		
1.	Halsey, Stuart	243	1.	Halsey, Stuart	1,007,619
2.	Merrill, Lynch	238	2.	Merrill, Lynch	705,187
3.	John Nuveen	229	3.	Lehman Bros.	610,910
4.	Blyth & Co.	149	4.	Blyth & Co.	554,999
5.	First of Michigan	113	5.	First Boston	544,210
6.	First Boston	112	6.	Salomon Brothers	543,494
7.	Smith, Barney	109	7.	John Nuveen	503,393
8.	Lehman Brothers	102	8.	Smith Barney	490,691
9.	Kidder Peabody	91	9.	Kidder Peabody	371,558
10.	Salomon Brothers	80	10.	Dupont Glore Forgan	324,114
11.	Underwood, Neuhaus	75			
12.	White, Weld	67			
13.	Phelps, Fenn	66			
14.	W.H. Morton	62			
15.	Dupont Glore Forgan	59			

*REVENUE ISSUES ONLY

Number of Issues			Par Value		
1.	Merrill, Lynch	110	1.	Halsey, Stuart	548,000
2.	John Nuveen	101	2.	Merrill, Lynch	395,000
3.	Halsey, Stuart	89	3.	Blyth & Co.	379,000
4.	Blyth & Co.	61	4.	Smith Barney	340,000
5.	Smith, Barney	61	5.	Kidder, Peabody	295,000
6.	Kidder, Peabody	56	6.	John Nuveen	271,000
7.	Lehman	45	7.	First Boston	229,000
8.	First Boston	45	8.	White, Weld	204,000
9.	White, Weld	41	9.	Dupont Glore Forgan	188,000
10.	Eastman Dillon	31	10.	Salomon Brothers	179,000
11.	Salomon Brothers	29			
12.	Dupont Glore Forgan	28			
13.	Boettcher & Sharrod	28			
14.	WH Morton	27			
15.	Rothschild	27			

REMARKS OF THOMAS BROUSSARD
TO THE JOINT HEARING OF THE SENATE COMMERCE COMMITTEE
AND THE HOUSE STATE AFFAIRS COMMITTEE
ON PROPOSED ALASKAN LEGISLATION CONCERNING
PIPELINE REGULATION, RIGHT-OF-WAY AND
STATE OWNERSHIP -- MARCH 6, 7, & 8, 1972

MR. CHAIRMAN: MY NAME IS THOMAS BROUSSARD, AND I AM A TAX ATTORNEY IN THE LEGAL DEPARTMENT OF ATLANTIC-RICHFIELD COMPANY.

TOGETHER WITH COUNSEL REPRESENTING SEVERAL OTHER OIL COMPANIES, INCLUDING COUNSEL FROM SEVERAL LAW FIRMS, I HAVE STUDIED THE QUESTIONS OF FEDERAL TAXATION OF THE STATE OF ALASKA ON POTENTIAL PROFITS TO BE DERIVED FROM OWNERSHIP OF A TRANS-ALASKA PIPELINE AND THE SEPARATE QUESTION OF THE TAXATION OF INTEREST RECEIVED BY BONDHOLDERS FROM ANY BONDS THAT MIGHT BE ISSUED BY THE STATE OR A PUBLIC AUTHORITY FOR THE PURPOSE OF BUILDING THE PIPE-LINE. IT IS MY OPINION AND THAT OF MY COLLEAGUES THAT IT IS VERY DOUBTFUL THAT EITHER THE STATE OR ITS BONDHOLDERS, UNDER THE BILLS INTRODUCED BY THE ADMINISTRATION, WILL BE EXEMPT FROM FEDERAL INCOME TAX.

THE PROPOSAL FOR PIPELINE OWNERSHIP AS DESCRIBED TO THE COMMITTEES SEEKS TWO TAX ADVANTAGES TO INCREASE STATE REVENUES AT THE EXPENSE OF THE FEDERAL TREASURY. THE FIRST ASSUMED ADVANTAGE IS FOR THE STATE ITSELF TO RECEIVE AS PIPELINE PROFIT AN AMOUNT EQUAL TO THE FEDERAL INCOME TAX WHICH WOULD BE PAID BY THE OIL COMPANIES ON ANY INCOME EARNED FROM THE PIPELINE. THE SECOND

HOPED FOR ADVANTAGE IS TO REDUCE THE INTEREST COST ON DEBT FINANCING OF THE LINE BY AN AMOUNT EQUAL TO THE FEDERAL INCOME TAX WHICH WOULD BE PAID BY HOLDERS OF PRIVATE COMPANIES' BONDS.

CONSIDERING THE LIKELIHOOD OF THE STATE'S EXEMPTION FROM FEDERAL INCOME TAX ON PROFIT FROM THE PIPELINE, THERE IS NO QUESTION THAT CONGRESS HAS THE CONSTITUTIONAL POWER TO TAX THE STATE ON ITS INCOME FROM BUSINESS OPERATIONS. THE PAST POSITION OF THE IRS HAS BEEN THAT CONGRESS HAS NOT IMPOSED THE FEDERAL INCOME TAX ON A STATE DIRECTLY ENGAGED IN A BUSINESS ACTIVITY FOR THE PURPOSE OF PROVIDING A PUBLIC NECESSITY OR IN THE EXERCISE OF ITS POLICE POWER. HOWEVER, IT IS DOUBTFUL THAT THE IRS WILL MAINTAIN THAT POSITION IF ASKED TO RULE ON THE QUESTION OF THE STATE OF ALASKA OPERATING A 3.5 BILLION DOLLAR PIPELINE TO CARRY OIL FOR A LIMITED NUMBER OF PRIVATE OIL COMPANIES.

IF THE IRS DID GRANT A FAVORABLE RULING, WHERE, AS STATED BEFORE THIS COMMITTEE, THE INTENTION OF THE STATE IS TO SUBSTITUTE ITSELF FOR PRIVATE BUSINESSES WHICH ARE READY, ABLE AND WILLING TO ENGAGE IN A COMMERCIAL ACTIVITY FOR THE BENEFIT OF RELATIVELY FEW PRIVATE USERS, AND then PASS ON TO THOSE COMPANIES ALL OR A MAJOR PORTION OF THE SAVINGS FROM ITS PRIVILEGE OF TAX EXEMPTION, CONGRESS IS ALMOST CERTAIN TO EXAMINE WHETHER THE PRIVILEGE OF TAX IMMUNITY SHOULD BE CONTINUED. THE RESULT, I believe, WOULD BE AN AMENDMENT TO THE STATUTE TO MAKE CLEAR THE INTENTION OF CONGRESS THAT SUCH INCOME SHOULD NOT ESCAPE FEDERAL TAXATION. IN FACT, IT IS DOUBTFUL THAT CONGRESSIONAL REACTION to this proposal WOULD BE LIMITED TO THIS STATE ACTIVITY.

WITH RESPECT TO THE POSSIBILITY OF THE EXEMPTION FROM FEDERAL INCOME TAX OF INTEREST RECEIVED BY THE HOLDERS OF BONDS ISSUED BY A

STATE AUTHORITY TO FINANCE THE PIPELINE, THE ANSWER IS CLEAR. INTEREST ON STATE BONDS IS EXEMPT FROM FEDERAL TAX SOLELY BY VIRTUE OF SECTION 103(A) OF THE INTERNAL REVENUE CODE.

IN THE WORDS EARLIER THIS YEAR OF AN ATTORNEY-ADVISOR IN THE OFFICE OF TAX LEGISLATIVE COUNSEL OF THE U.S. TREASURY DEPARTMENT, "THE INCREASING USE OF TAX-EXEMPT FINANCING FOR PURPOSES BEYOND THOSE ORIGINALLY CONTEMPLATED BY SECTION 103(A) HAS LED TO A SERIES OF ACTIONS BY THE TREASURY AND THE CONGRESS TO RESTRICT SUCH FINANCING TO THE PURPOSES FOR WHICH THE EXEMPTION WAS ORIGINALLY GRANTED."

THE ABUSES WHICH PROMPTED CONGRESS IN 1968 TO AMEND SECTION 103 WAS PRIMARILY THE USE BY STATES OF THE TAX EXEMPTION TO FINANCE INDUSTRIAL PROJECTS FOR PRIVATE COMPANIES. TO MY KNOWLEDGE, THE LARGEST SUCH PROJECT INVOLVED STATE BONDS OF LESS THAN 100 MILLION DOLLARS. THE PROPOSED LEGISLATION WOULD UTILIZE THIS PRIVILEGE FOR A PROJECT ESTIMATED AT 35 TIMES THAT AMOUNT. THE PREVIOUS CONCERNS EXPRESSED BY CONGRESS AND THE TREASURY THAT EARLIER ISSUES WERE CREATING UNINTENDED BENEFITS FOR PRIVATE BUSINESS AND REDUCING THE MARKET FOR MUNICIPAL BONDS FOR NEEDED GOVERNMENTAL SERVICES ARE DWARFED BY THE MAGNITUDE OF THIS PROPOSAL.

THE ACTION BY CONGRESS TO RESTRICT THE TAX EXEMPTION OF INTEREST ON MUNICIPAL BONDS ARE CONTAINED IN SECTION 103(C) OF THE INTERNAL REVENUE CODE WHICH DENIES TAX EXEMPTION FOR INTEREST ON INDUSTRIAL DEVELOPMENT BONDS. FOR OUR PURPOSES AN INDUSTRIAL DEVELOPMENT BOND MAY BE DEFINED TO MEAN ANY OBLIGATION ISSUED AS A PART OF AN ISSUE, ALL OR A MAJOR PORTION

OF THE PROCEEDS OF WHICH ARE TO BE USED DIRECTLY OR INDIRECTLY IN ANY TRADE OR BUSINESS CARRIED ON BY ANY NON-TAX-EXEMPT PERSON AND THE PRINCIPAL OR INTEREST OF WHICH IS SECURED OR TO BE DERIVED FROM ANY INTEREST IN PROPERTY USED IN A TRADE OR BUSINESS OR FROM PAYMENTS IN RESPECT OF SUCH PROPERTY.

THIS LATTER TEST, CALLED THE SECURITY INTEREST TEST, IS CLEARLY SATISFIED WHEN THE BOND SERVICE IS TO BE PAID FROM THE REVENUES OF THE PIPELINE AS PROPOSED, PROVIDED THE PIPELINE IS USED IN THE TRADE OR BUSINESS OF THE OIL COMPANIES.

THE FIRST TEST, CALLED THE TRADE OR BUSINESS TEST, IS THE CRITICAL ONE. THE PROPOSED REGULATIONS INTERPRETING THIS LANGUAGE ARE SUBJECT TO CHANGE, BUT AT PRESENT PROVIDE THAT THE TRADE OR BUSINESS TEST IS MET "IN THE CASE OF A FACILITY CONSTRUCTED, . . .OR ACQUIRED WITH THE PROCEEDS OF AN ISSUE WHICH IS OSTENSIBLY OWNED AND OPERATED BY AN EXEMPT PERSON (SUCH AS THE PROPOSED TRANS ALASKA AUTHORITY) BUT WHERE ONE OR MORE NON-EXEMPT PERSONS (SUCH AS THE OIL COMPANIES) AGREE, PURSUANT TO ONE OR MORE LONG-TERM CONTRACTS, TO TAKE, OR TO TAKE OR PAY FOR, A MAJOR PORTION (MORE THAN 25%) OF THE OUTPUT OF SUCH FACILITY (WHETHER OR NOT CONDITIONED UPON THE PRODUCTION OF SUCH OUTPUT) FOR PERIODS OF TIME WHICH ARE SUBSTANTIAL IN RELATION TO THE TERMS OF THE BONDS."

ALTHOUGH THE REGULATION SPEAKS OF OUTPUT OR PRODUCTION FROM A FACILITY, THE SAME RULE WOULD APPLY TO GUARANTEEING INPUT TO A FACILITY SUCH AS A PIPELINE ~~IN WHICH~~ Where THE REVENUE IS EARNED FROM CARRYING CRUDE OIL.

FROM DISCUSSIONS WITH PERSONS EXPERIENCED IN PUBLIC FINANCING OF PIPELINES, WE HAVE BEEN CONSISTENTLY ADVISED THAT LONG-TERM

COMMITMENTS TO SUPPLY CRUDE TO THE LINE UNDER A TAKE OR PAY THROUGHPUT AGREEMENT WILL BE NECESSARY TO SELL THE BONDS.

INDEED THE MINIMUM SHIPPING AGREEMENTS DESCRIBED BY MR. GUILDEHOUS (WHILE NOT SUFFICIENT TO SATISFY INVESTORS IN THE VIEW OF MR. GARY) IS IN MY OPINION SUFFICIENT TO SATISFY THE TRADE OR BUSINESS TEST OF SECTION 103(c) AND, THUS, TO MAKE THE PROPOSED BONDS INDUSTRIAL DEVELOPMENT BONDS NOT ENTITLED TO TAX EXEMPTION. UNDER SUCH A PLAN (~~WHICH THE TEMPLE REPRESENTATIVES SAID HAS NOT BEEN ACCEPTED BY THE STATE OR ITS FINANCIAL ADVISORS~~), THE COMPANIES WOULD BE ASKED TO MAKE A LONG-TERM CONTRACT TO GUARANTEE TO PROVIDE MORE THAN 25% OF THE CRUDE TO BE TRANSPORTED THROUGH THE LINE WHICH IS THE EQUIVALENT OF GUARANTEEING TO TAKE OR PAY FOR MORE THAN 25% OF THE TRANSPORTATION SERVICE.

MR. CADES STATED THAT THE VOLUME OF THE LINE AVAILABLE FOR ~~OTR~~ THE OWNER COMPANIES IS SUBJECT TO REDUCTION FOR OTHER USERS, ~~WHICH CHANGES THE TAKE OR PAY NATURE OF THE CONTRACT.~~ BUT, SINCE ANY ADDITIONAL USERS ARE UNLIKELY TO REDUCE THE ORIGINAL COMPANIES' COMMITMENT BELOW 25% AND SUCH USERS ARE THEMSELVES NON-EXEMPT PERSONS, I FAIL TO SEE HOW THIS WOULD ESCAPE THE DEFINITION OF INDUSTRIAL REVENUE BONDS SET FORTH IN THE REGULATIONS.

THERE IS AN EXCEPTION THAT "FACILITIES WILL NOT BE TREATED AS INDIRECTLY USED IN THE TRADES OR BUSINESSES OF NON-EXEMPT PERSONS WHERE SUCH PERSONS PURCHASE THE OUTPUT OF THE FACILITIES ON TERMS WHICH ARE CUSTOMARY IN THE INDUSTRY FOR SALE OF SUCH OUTPUT AND WHICH DO NOT HAVE THE EFFECT OF TRANSFERRING TO THEM THE BENEFITS AND BURDENS OF OWNERSHIP OF SUCH FACILITIES."

AS A SAFE HAVEN FROM THE TEST OF WHETHER THE BENEFITS AND BURDENS OF OWNERSHIP HAVE BEEN TRANSFERRED, THE REGULATIONS PROVIDE THAT THE TRADE OR BUSINESS WILL NOT BE MET IF THE OUTPUT "IS SOLD TO A SUBSTANTIAL NUMBER OF UNRELATED CUSTOMERS UNDER A RATE SCHEDULE OF GENERAL APPLICATIONS PROVIDED THAT NO SINGLE CUSTOMER PAYS ANNUALLY A DEMAND CHARGE OR GUARANTEED MINIMUM PAYMENT WHICH EXCEEDS 2-1/2% OF THE AVERAGE ANNUAL DEBT SERVICE." THE ILLUSTRATION UNDER THIS EXCEPTION DEALS WITH A FACILITY FOR SUPPLYING ELECTRIC ENERGY.

IN OUR OPINION, THE MINIMUM SHIPPING AGREEMENTS CAN HARDLY BE SAID EITHER TO BE TERMS OF SALE CUSTOMARY IN THE INDUSTRY OR NOT TO HAVE THE EFFECT OF TRANSFERRING THE BURDENS OF OWNERSHIP TO THE COMPANIES. MR. GARY HAS ALREADY EXPLAINED WHY THE BURDENS OF OWNERSHIP (IN THE FORM OF THE PLEDGE OF COMPANY CREDIT) ARE OF NECESSITY PLACED ON THE COMPANIES. EARLIER TESTIMONY BY THE ADMINISTRATION HAS STATED THAT SOME OF THE BENEFITS OF OWNERSHIP WILL BE PASSED ON TO THE COMPANIES AS WELL. THEREFORE, THE TEMPLE PLAN WILL NOT FIT WITHIN THE EXCEPTION.

THUS, IT IS OUR CONCLUSION THAT IT IS EXTREMELY UNLIKELY THAT A FAVORABLE RULING COULD BE OBTAINED FROM THE INTERNAL REVENUE SERVICE THAT INTEREST ON THESE PROPOSED BONDS WOULD BE TAX EXEMPT. ALTHOUGH RULINGS, ONCE OBTAINED AND ACTED UPON BY THE RECIPIENT, ARE SELDOM, IF EVER, RETROACTIVELY REVERSED, IT SEEMS UNLIKELY THAT CONGRESS, IN VIEW OF ITS POSITION IN 1968, WOULD NOT ACT TO NULLIFY SUCH A RULING BEFORE ANY COMMITMENT HAD BEEN MADE IN RELIANCE ON THE RULING. IN FACT, LEGISLATION WOULD PROBABLY BE

INTRODUCED AS SOON AS ANY APPLICATION FOR A REVENUE RULING BECAME KNOWN WHICH WOULD CAUSE THE IRS TO SUSPEND ACTION ON THE RULING REQUEST.

~~TWO ADDITIONAL MATTERS SHOULD BE MENTIONED.~~ IT HAS BEEN SUGGESTED THAT IF THE STATE COULD OBTAIN THE TAX BENEFITS UPON WHICH THE ADMINISTRATION'S PROJECTIONS ARE BASED, THESE BENEFITS WOULD BE PASSED ON TO THE OIL COMPANIES. THE MAGNITUDE OF ANY DIFFERENTIAL IN INTEREST RATES HAS BEEN DISCUSSED EARLIER BY ADMINISTRATION WITNESSES AS BEING QUITE SMALL OR NON-EXISTENT. BUT EVEN IF SOME TAX SAVINGS WERE PASSED ON TO THE OIL COMPANIES BY REDUCED TARIFF, WHETHER ORDERED BY THE ICC OR OTHERWISE, THE BENEFIT TO THE COMPANIES WOULD STILL BE SUBSTANTIALLY REDUCED BY THE INCREASED INCOME TAX PAYMENTS ON THE HIGHER PROFITS RESULTING FROM LOWER TRANSPORTATION COSTS.

SECONDLY, THE OWNERSHIP BILL IS DESIGNED TO PROVIDE FINANCING FOR SEVERAL FACILITIES SEPARATE FROM THE PIPELINE IN AN EFFORT TO TAKE ADVANTAGE OF CERTAIN EXEMPTIONS FROM THE INDUSTRIAL REVENUE BOND PROVISIONS OF SECTION 103(c).

WHERE AN OBLIGATION MEETS THE TESTS OF AN INDUSTRIAL DEVELOPMENT BOND, THE INTEREST MAY STILL BE EXEMPT FROM TAX IF THE PROCEEDS ARE USED FOR CERTAIN FACILITIES LISTED IN SECTION 104(c)(4). THOSE FACILITIES ARE:

"(A) RESIDENTIAL REAL PROPERTY FOR FAMILY UNITS;

(B) SPORT FACILITIES;

(C) CONVENTION OR TRADE SHOW FACILITIES;

(D) AIRPORTS, DOCKS, WHARVES, MASS COMMUTING FACILITIES, PARKING FACILITIES, OR STORAGE OR TRAINING FACILITIES DIRECTLY RELATED TO ANY OF THE FOREGOING;

(E) SEWAGE OR SOLID WASTE DISPOSAL FACILITIES OR FACILITIES FOR THE LOCAL FURNISHING OF ELECTRIC ENERGY OR GAS;

(F) AIR OR WATER POLLUTION CONTROL FACILITIES, OR

(G) FACILITIES FOR THE FURNISHING OF WATER, IF AVAILABLE ON REASONABLE DEMAND TO MEMBERS OF THE GENERAL PUBLIC."

YOU WILL NOTICE THAT SECTION 1 OF HB 570 LISTS SEVERAL OF THESE EXEMPT FACILITIES. HOWEVER, FOR MOST OF THOSE FACILITIES RELATED TO THE PIPELINE IT IS UNLIKELY THAT THE EXEMPTION WILL APPLY. THE PROPOSED REGULATIONS PROVIDE THAT "TO QUALIFY UNDER SECTION 103(c)(4) AND THIS SECTION AS AN EXEMPT FACILITY, A FACILITY MUST SERVE OR BE AVAILABLE FOR GENERAL PUBLIC USE, OR BE A PART OF A FACILITY SO USED, AS CONTRASTED WITH SIMILAR TYPES OF FACILITIES WHICH ARE CONSTRUCTED FOR THE EXCLUSIVE USE OF A LIMITED NUMBER OF NON-EXEMPT PERSONS IN THEIR TRADES OR BUSINESSES."

THE BULK OF THE FACILITIES ASSOCIATED WITH THE PIPELINE ARE FOR THE USE OF A LIMITED NUMBER OF PRIVATE COMPANIES. HOWEVER,

THIS RULE DOES NOT APPLY TO POLLUTION CONTROL FACILITIES.

IN CONCLUSION, THE REQUIREMENTS OF GUARANTEES BY THE OIL COMPANIES OF THROUGHPUT TO THE PIPELINE NECESSARY FOR SUCCESSFUL MARKETING OF STATE BONDS TO CONSTRUCT THE PIPELINE, ~~AMPLY~~ DESCRIBED BY MR. GARY, WILL MAKE THE INTEREST ON SUCH BONDS SUBJECT TO FEDERAL INCOME TAX. FURTHER, IT IS QUITE POSSIBLE THAT THE STATE'S INCOME FROM OPERATION OF THE PIPELINE WILL BE TAXED BY THE FEDERAL GOVERNMENT. THUS TO THE EXTENT THAT TAX EXEMPTION IS ESSENTIAL TO THE ATTRACTIVENESS OF THE OWNERSHIP BILL, ~~THAT~~ BILL IS UNLIKELY TO SATISFY THE STATE'S REVENUE NEEDS. IN THE MEANTIME, IT CREATES A CONTINUING CLOUD OVER THE PRIVATE FINANCES NEEDED BY THE COMPANIES IN ORDER TO PLACE THE TRANS ALASKA PIPELINE IN SERVICE ~~AS SOON AS POSSIBLE.~~

SENATE BILLS NOS. 294 AND 313

RIGHT-OF-WAY LEASING

Joseph R. Cortese
Squire, Sanders & Dempsey
Cleveland, Ohio

Senate Bills 294 and 313 present a number of serious problems and, in our opinion, they conflict with federal regulatory authority and the United States Constitution.

I. THE BASIC PREMISE OF THE BILLS IS WRONG, FOR THE STATE CANNOT USE ITS LAND CONTROL TO FORCE UNCONSTITUTIONAL RESULTS.

The basic premise of these bills is that the State, in its capacity as a landowner having control over land necessary for the pipeline, can impose terms and conditions on the pipeline proprietors that it concededly could not impose in its governmental capacity. We should state at the outset that this premise is wrong. It directly conflicts with the decisions of the United States Supreme Court. For example, in Frost v. Railroad Commission of California, 271 U.S. 583, 594 (1926), the U. S. Supreme Court held that a California statute, which sought concessions from a motor carrier as to methods of operating its business as a condition of the use of state highways, was in violation of the United States Constitution because such a requirement would constitute a taking of the carrier's property without due process. The Court said:

> "If the state may compel the surrender of one constitutional right as a condition of its favor, it may, in like manner, compel a surrender of all. It is inconceivable that guaranties embedded in the Constitution of the United States may thus be manipulated out of existence."

Likewise, the attempt of a state to regulate how an interstate telegraph company may select its customers is void even where imposed as a condition to use of the streets, for the state may not use its constitutional powers to achieve the unconstitutional result of interfering with interstate commerce.

> "It is suggested that the State gets the power from its power over the streets which it is necessary for the telegraph to cross. But if we assume that the plaintiffs in error under their present charters could be excluded from the streets, the consequence would not follow. Acts generally lawful may become unlawful when done to accomplish an unlawful end, United States v. Reading Co., 226 U.S. 324, 357, and a constitutional power cannot be used by way of condition to attain an unconstitutional result." Western Union Telegraph Co. v. Foster, 247 U.S. 105 (1918).

As the following will further show, a state may not use its control of land to prohibit, attempt to regulate, interfere with, or unduly burden interstate commerce, nor to exact waivers of constitutional rights. If the use of state lands is necessary for interstate transportation, the state cannot withhold the right-of-way, it cannot exact more than reasonable compensation for such right-of-way, and it cannot invade the field of federal regulation or unduly burden interstate commerce as a condition of making available the use of its land.

II. THE STATE OF ALASKA MAY NOT WITHHOLD THE NECESSARY RIGHT-OF-WAY FOR IT MAY NOT WITHHOLD THE MEANS OF TRANSPORTING THE OIL AND GAS IN INTERSTATE COMMERCE.

The State of Alaska through its oil and gas leases has granted to the lessees the right to develop, produce, process and market oil and gas. That oil and gas can only be marketed feasibly by means which utilize state-owned lands. Under these circumstances, the State may not withhold its lands from the lessees.

This principle follows from the commerce clause of the United States Constitution. In Oklahoma v. Kansas Natural Gas Company, 221 U.S. 229 (1911), the State of Oklahoma by statute prohibited companies, which were engaged in transporting gas out of the State of Oklahoma, from laying, constructing and operating gas pipe lines in, on, under, across or along the highways of the State. The gas company merely sought rights to cross the highways for purposes of a pipeline to get natural gas out of the state. Oklahoma argued that while the gas company had the right to engage in interstate commerce, it did not have a right to obtain right-of-way in the state for that purpose, and that the state could withhold from such foreign corporation the power of eminent domain and the right to cross highways. The Supreme Court held that the state could not withhold the right to use highway crossings to construct the pipeline, and rejected the state's contentions, saying:

"At this late day it is not necessary to cite cases to show that the right to engage in interstate commerce is not the gift of a State, and that it cannot be regulated or restrained by a State, or that a State cannot exclude from its limits a corporation engaged in such commerce. To attain these unauthorized ends is the purpose of the Oklahoma statute. The State through the statute seeks in every way to accomplish these ends, and all the powers that a State is conceived to possess are exerted and all the limitations upon such powers are attempted to be circumvented. * * * The use of the highways is forbidden to them [interstate pipeline companies] and the right of eminent domain is withheld from them, and the prohibitive strength which these provisions are supposed to carry is exhibited in the fact that the boundary of the State is a highway. If it cannot be passed without the consent of the State, commerce to and from the State is impossible. The situation is not underestimated by appellant [Oklahoma Attorney General], and he says: 'If the appellees had the right of way they might engage in interstate commerce, but their desire to engage in interstate commerce is a different thing from the means open to them to procure a right of way.' And it is further said, that 'the confusion of the right to engage in interstate commerce with the power to forcibly secure a right of way is the basis of appellees' case.'

"There is here and there a suggestion that the State not having granted such right the alternative is a grant of it by Congress. But this overlooks the affirmative force of the interstate commerce clause of the Constitution. The inaction of Congress is a declaration of freedom from state interference with the transportation of articles of legitimate interstate commerce, and this has been the answer of the courts to contentions like those made in the case at bar.

"* * * No State can by action or inaction prevent, unreasonably burden, discriminate against or directly regulate interstate commerce or the right to carry it on. And in all of these inhibited particulars the statute of Oklahoma offends."

Thus, it was held that the interstate pipeline could cross state highways notwithstanding the prohibition in the Oklahoma statute.

The same Oklahoma statute was also considered, and was held to be unconstitutional in the case of Haskell v. Cowham, 187 F. 403 (8th Cir. 1911). There, the court stated as follows:

> "No state may by means of its police power, or its proprietary power, over highways or by means of any of its other powers, erect and maintain impassable barriers against interstate commerce along its borders or through its body in the face of the grant to the nation of the power to regulate that commerce; for all the powers of the state are subordinate to this power of the nation and to its will that such commerce shall be free."

Not only would the withholding by the State of a right-of-way to the lessees constitute an undue burden on interstate commerce, but it would also constitute a deprivation of the lessees' property without due process of law. A succinct statement of this principle is found in the Haskell case cited above:

> "But an owner who by virtue of his ownership of land or of mining leases thereof has the vested right to draw by means of wells or pumps natural gas from beneath the surface is the owner of valuable property which the state cannot take from him without just compensation and state laws and acts of the officers of a state which prevent him from taking it from the land and selling it and conveying it out of the state in interstate commerce, while they permit the withdrawal and sale of such gas in intrastate commerce, necessarily violate the national Constitution (1) because they take his property without just compensation and (2) because they substantially discriminate against and directly regulate interstate commerce."

The right of the lessees of the North Slope oil and gas to transport it in interstate commerce without obstacles or burdensome conditions imposed by the State is

expressly apparent in view of the fact that the State invited them to bid competitively for and purchase such oil and gas rights from the State, including, as stated in the leases, the right to "market" such oil and gas.

The point to be emphasized in our consideration of House Bills 294 and 313 is that their factual premise is inconsistent with their legal premise. Factually, they assume that the only practical way of getting the oil out of Alaska is by a pipeline and that pipeline must run across State controlled lands. If that were not the fact there would be no point to the bills for the price and conditions they exact would be avoided by using other lands. Thus, the premise is that the pipeline owners must contract with the State for right-of-ways. On the other hand, the legal premise is that the State, through its proprietary capacity, can achieve by right-of-way contracts what it could not achieve in its governmental capacity because the contracts will be entered into, it is claimed, by voluntary bargaining. It has been claimed that a state as proprietor can legally obtain unusual contract terms because others may contract with it on its terms or forego contracts with the state. That legal theory is plainly irrelevant where interstate commerce would be thwarted and property rights lost if the private parties declined the state's terms.

Instances of the federal government asserting conditions and requirements in the exercise of its contract functions are beside the point. Those are in fact instances where private parties may forego contracts with the federal government without loss of property rights, and it can hardly be claimed that the federal government is unconstitutionally restraining or burdening interstate commerce since the Constitution places the power over such commerce in the federal government.

The very factual premise of House Bills 294 and 313 that the pipeline owners must get right-of-way from the State, makes it apparent under U.S. Supreme Court cases, that such right-of-way cannot be withheld and cannot be used by the State to achieve results which are otherwise prohibited.

III. THE STATE OF ALASKA MAY CHARGE A RENTAL FOR THE USE OF ITS LAND BUT SUCH RENTAL MUST BE REASONABLE AND CONSTITUTE NO MORE THAN JUST COMPENSATION TO THE STATE.

The State may properly charge rents for the right-of-way even when there is no other practical way to conduct the interstate commerce involved. But, the Constitution requires that such rents be reasonable and not discriminatory and bear a true relation to the actual value of the land. The leading case on this regard is St. Louis v. Western Union Telegraph Company, 148 U.S. 92 (1893), rehearing denied, 149 U.S. 465 (1893). There, the City of St. Louis imposed an annual rental of $5.00 per pole for the use of so much of its lands as were occupied by the telegraph poles of the Western Union Telegraph Company and the Company claimed such charge could not be made at all and, in any event, was excessive. The court held that a rental charge could be imposed, but that it must be reasonable in relation to the value of the land used. The Court said:

> "Indeed, it may be observed, in the line of the thoughts heretofore expressed, that this charge is one in the nature of rental; that the occupation by this interstate commerce company of the streets cannot be denied by the city; that all that it can insist upon is, in this respect, reasonable compensation for the space in the streets thus exclusively appropriated; and it follows in the nature of things that it does not lie exclusively in its power to determine what is a reasonable rental. The inquiry must be open in the courts, and it is an inquiry which must depend largely upon matters not apparent upon the face of the ordinance, but existing only in the actual state of affairs in the city."

The Court did not have sufficient evidence before it to determine whether the rental was reasonable. But, upon remanding the case, it gave clear guidance that the rental had to bear a proper relationship to the value of the land occupied.

> "The court cannot assume that such a charge is excessive, and so excessive as to make the ordinance unreasonable and void; for, as applied in certain cases, a like charge for so much appropriation of the streets may be reasonable. If within a few blocks of Wall Street, New York, the telegraph company should place on the public streets 1500 of its large telegraph poles, it would seem as though no court could declare that five dollars a pole was an excessive annual rental for the ground so exclusively ~~appropriated~~, while, on the other hand, a charge for a like number of poles in a small village, where space is abundant and land of little value, would be manifestly unreasonable, and might be so excessive as to be void."

Thus, the rental must bear a proper relationship to the value of the land occupied.

Land value is most frequently determined in eminent domain cases where just compensation is based upon the value of the land taken. It is held that land value is determined by what the owner gives up, not by what the taker gains. In United States v. Miller, 317 U.S. 369 (1943), the party whose land was being condemned argued that the land should be valued in relation to the specific purpose for which it was to be used, a railroad right-of-way. The United States Supreme Court rejected this contention, and stated as follows:

> "Since the owner is to receive no more than indemnity for his loss, his award cannot be enhanced by any gain to the taker. Thus, although the market value of the property is to be fixed with due consideration of all its available uses, its special value to the condemnor as distinguished from others who may or may not possess the power to condemn, must be excluded as an element of market value." (p. 375).

The defect of the rental formulas of Senate Bills 294 and 313 is that they bear no relationship to the value of the particular land involved, and are not limited to the value of the land itself but seek to use some measure of gross revenues or the profitability of a pipeline built with private capital. This clearly goes beyond what the Supreme Court has said could be reasonably charged, and would constitute a prohibited burden on interstate commerce. Furthermore, since these unusual charges are wholly out of keeping with the general practice in other states and in Alaska, and are largely addressed to this pipeline project, they might also be viewed as violative of the prohibitions against discrimination against interstate commerce and as constituting discriminatory taxes upon interstate commerce.

IV. OTHER PROVISIONS OF THESE BILLS ARE UNCONSTITUTIONAL.

A. Court Jurisdiction.

The Bills provide that the lessee shall agree to the jurisdiction of state courts with regard to the interpretation of the lease or resolution of disputes concerning the lease provisions. (Section .020(1) of S.B. 313 and .410 of S.B. 294.)

We are not certain of the intent of this provision. If it is only designed to insure that state courts may readily obtain personal jurisdiction over the lessee, then a provision similar to that of Section .531 (designation of service agents) in S.B. 315 would be appropriate and avoid confusion.

Similarly, if the provision is only intended to mean that the law of Alaska governs interpretation of the lease, the provision appears unnecessary, but in any event should be more clearly worded to reflect that intention.

However, if this provision is intended to require the lessee to seek relief only in state courts and to prohibit it from invoking, in appropriate circumstances, the aid of federal courts, including the removal of cases to federal court where appropriate, it is clearly unlawful. As stated by the United States Supreme Court in the case of Terral v. Burke Construction Co., 257 U.S. 529 (1922):

> "The principle established by the more recent decisions of this court is that a State may not, in imposing conditions upon the privilege upon a foreign corporation's doing business in a State, exact from it a waiver of the exercise of its constitutional right to resort to the Federal courts, or thereafter withdraw the privilege of doing business because of its exercise of such right, whether waived in advance or not."

Such requirements, if imposed by the state police power, would be unconstitutional. Even a voluntary agreement having this result would be void. Roberts v. Lexington Insurance Co., 305 F.Supp. 47 (D.C. N.C. 1969).

B. Penalty Provision.

Section .020(4) of S.B. 313 would require the lessee to agree to penalties "that the Commissioner may determine to be appropriate." It provides no standard to guide the Commissioner in the exercise of this delegated authority and would place the lessee at the mercy of the Commissioner. Such a provision is contrary to the due process requirements of the Fourteenth Amendment of the Federal Constitution.

C. Regulatory Jurisdiction.

Section .350(2) of S.B. 294 requires acceptance of the jurisdiction of the Alaska Transportation Commission (oil pipeline) or the Alaska Public Utility Commission (natural gas pipeline), and Section .020(4) of S.B. 313 requires acceptance of the jurisdiction of the Alaska Oil and Gas Transportation Board. This presents a problem similar to that raised by the court jurisdiction provision of the Bills. If it is an attempt to impose exclusive jurisdiction over the lessee, or to give the State any jurisdiction in matters which are pre-empted by federal law, it patently conflicts with the Interstate Commerce and Natural Gas Acts; and it is equally obvious that the lessee cannot give the State jurisdiction or deprive federal agencies of jurisdiction merely by agreeing with the State to do so.

A private party's agreement to jurisdiction cannot create jurisdiction that does not otherwise exist by law. An attempt by the State to gain regulatory jurisdiction by consent of the party to be regulated and thus place the State in a position to regulate that which is pre-empted by the superior law of the United States, would be ineffective. As we have seen, a state may not boot-strap itself into regulation of interstate commerce by obtaining consent to such regulation as a conditions of use of its streets, for it may not use its constitutional powers to obtain unconstitutional results. Western Union Telegraph Co. v. Foster, 247 U.S. 105 (1918). Thus, in all those areas from which the state is excluded, as previously testified by others, the state can obtain no greater participation by contract than it can by its police power.

It is equally apparent that the State cannot avoid this result in the rate-making area by forcing the pipeline owners to agree to rates before submitting them to the I.C.C. Any forced agreement to come to terms with the State on rates has implicit within it a veto power of the State over rates, and would clearly be an invasion of an area pre-empted by the federal government. State cases where municipal corporations have a function in rate-making as part of their franchising power are not applicable, for there the state law permits that function. The federal law does not permit any such primary function in the states with regard to rate-making for oil and gas pipelines engaged in interstate commerce. The federal law provides only for proper state participation as a party in the proceedings of the federal regulatory agencies, but not as a prior regulator.

D. Forfeiture.

Section .020(3) of S.B. 313 provides for forfeiture for failure to comply with any lease provision and Section .040 for failure to comply with any of the provisions of the statute or regulations of the Commissioner. Section 400 of S.B. 294 gives the Leasing Board discretion to insert such a provision in each lease. Any forfeiture because of noncompliance with unconstitutional conditions of the lease, such as those already described, would itself be a direct burden on interstate commerce.

E. The Option To Purchase.

Section 370 of S.B. 294 and Section .020(11) of S.B. 313 require the lessee to agree to grant the state an option to purchase an ownership interest in the entire facility and Section 500 of S.B. 294 and Section .069(9) of S.B. 313 so define a "pipeline facility" as to make it clear that this relates to the entire pipeline, even though most of it would not cross state lands.

One rather apparent effect of this provision would be to force agreement on a price for an interest in the pipeline and thus require the lessee to forego what would otherwise be its rights to due process and just compensation under the Alaska and United States Constitutions. There is a serious question as to whether the State could lawfully proceed to acquire the pipeline or any part thereof under its eminent domain power. It is apparent, however, that if it attempted to do so, the lessee would be entitled to require that it receive just compensation, lawfully determined and, perhaps more important, require the State to show a public necessity for the taking.

Furthermore, the forced option provision, dealing as it does with the pipeline and not the state lands, obviously and directly injects the state into the business of the pipeline contrary to federal pre-emption, and unduly burdens interstate commerce.

The apparent reason for the option requirement is the fear that the wellhead price and royalties of the state may be reduced by the imposition of excessive pipeline charges. This fear is unfounded. The pipeline's rates will be regulated by federal regulatory agencies in whose deliberations the State may fully participate.

F. The Savings Clause.

S.B. 313 purports to escape constitutional infirmities by specifying that the lease conditions be imposed only "to the extent not pre-empted by federal law." Also, the bill defines "transporation" to include activities only "to the extent that such transportation may constitutionally be subject to the provisions of this chapter." As indicated above, the application of such exceptions would leave little, if anything, of consequence in the bill. The unconstitutional matter in S.B. 313 is so pervasive that we believe it would be held unconstitutional in its entirety. The problem is that the basic premise of the bill, that the State can exact any conditions it desires by virtue of its landowner position, is constitutionally unsound.

V. CONCLUSION.

We have not attempted to deal with every provision of Senate Bills 294 and 313, and do not mean to imply that provisions not discussed would be valid. Rather, we have shown that the basic legal premise of these bills is wrong and would produce unconstitutional results in vital respects. We do not doubt the authority of the state to provide for leasing rights-of-way over the public domain for this pipeline project and others, to obtain reasonable rentals therefore, and to provide for reasonable conditions and terms relating to the protection of the State's lands and properties to the extent not inconsistent with or pre-empted by the federal authority. However, Senate Bills 294 and 313 are not proper vehicles for such purpose for they are permeated with unconstitutional provisions developed from an unsound legal premise.

SCOMM

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

McVay: The floor is open now for questions of at this time, I don't know if Mr. Donaldson wants words of introduction, o.k., the floor is open now for questions of Mr. Markham.

Rader: Mr. Markham, you mentioned that the majority published of the return was 5.6. So that we could advise ourselves of that type of thing, where does that type of information come from.

Markham: It isn't published, it would have to be derived from the information that is filed with the ICC.

Rader: The next question I had was, if my memory serves me correctly and it may not, but it seems to me that several years ago you had an expert here on from the Miller administration from the ICC who gave us, lead us to believe that certainly the Alyeska interest would be, Alaskan interest, pipeline interest would be grouped with the other interest of the pipeline companies for purposes of both calculating rates of returns and also dividedds. As I understood your answers yesterday, you believe that to be clearly erroneous.

Markham: Only half erroneous. I think there is some confusion perhaps between the percent degree and the computation that is made here and the way the commission uses the 8% return. It is undoubtedly true that for purposes of determining compliance with the ~~percent degree~~ consent decree they look at the entire financial results of the company, because of that 7% dividend. However in determining whether or not the 8% maximam allowed, under the commissions rules, have been exceeded, the commission may and I think would, in a rate case break the line down into appropriate operating divisions. I don't think there is much question on it, but what the interest of the owners in the Alaska line would be treated as a separate operating division for purposes of determining whether the 8% had been exceeded.

Rader: Do you know of any instances where...

Donaldson: The question of combining x figures and data as far as Alaska and other pipe lines of the owner companies in other States has come up a couple of times. On Markham's answer on the way the ICC would like to handle it gives you one part of the picture in response to that question. In case there was any misunderstanding of the response of the owner companies yesterday in our session, let me say again that not only would the ICC probably handle it that way but there are a good many reasons for our purposes and political requirements of Alaska why we can see that the figures for TAPS should be segregated for study and comments or whatever regulatory comments, or whatever regulatory aspects come from those numbers. We in effect, here, give you the assurance that those figures will be separately maintained. How this is done again is a question of mechanics, we can't guess today just what is the best way to do it. It was you Senator Rader, I think, that made the suggestion that possibly put it into a separate corporation. That would be one way of doing it. There are several others, I understand, so the question is not whether but simply what the best way of doing it is. I wanted to speak to it again so that no one here would have any doubt or reservations on the treatment of it.

Rader: Mr. Markham, would you analyze for me whether or not the State should ~~be concerned~~ have any concern about the fact that we would work (?) with the other operations for purposes of dividend distribution, a percent decrease. It does not occur to me ~~whether or not we have an interest, just would not have~~ or how that might effect us.

Markham: I don't really see why it should be a concern in view of the fact the ICC does not rely on the ~~consent~~ consent decree for regulatory purposes, that is the Department of Justice under the Elkins Act. As x far x as maintaining a reasonable level of rates , x on the line in Alaska ~~and~~ I am quite ~~confident~~ confident that the Commission will look at the operations of that line as if it were a separte operating

division, you will segregate the valuation, you will segregate the operating expenses and revenues and so on and determine whether or not the 8% limit, which is the one currently prescribed by the commission has been exceeded. So I don't really see why you people need to be concerned about the consent decree beyond this, that if it is another check on the companies themselves in fixing their rates, they are going to be just as certain as they can, that they are not going to exceed that limit in addition to the limitations imposed by the Commission through its regulatory process. You really have a double governmental check on the earnings level that will operate on this line.

Rader: Just one further question . Is your thought that the Alaska operation be segregated, a recent opinion of yours or do you base that on some decision you have made or decided for a similar decision has been made.

Markham: Well I mentioned yesterday that I have personally been involved in two cases in recent years involving the rates on a single line. One of many lines operated by pipeline companies. These cases didn't go to hearing, they were contested cases, but they didn't go to hearing, they were disposed of in my judgment on the basis of the financial results of that line primarily. And I see no reason why the Commission wouldn't do the same thing here, it's the realistic way to do it, it's the available way to do it, and these people are just too darn busy I think, to go out and make work for themselves, by trying to look at the entire operation of the 7 companies when the problem is only the rate here in Alaska. I could add, I can't say to any case in which they have ever undertaken to fix the rates for an undivided interest line, no there is no precedent on that. But I think that there are enough analyses in the rate decisions of the Commission so that you can be reasonably confident that they are going to do it the simplest

realistic way and that obviously is to look of the results of this one line.

Rettig: Mr. Markham or Mr. Donaldson, I believe that it was Mr. Jones yesterday that indicated that a requirement by the State for record ~~AN~~ keeping and recording, would not conflict with ICC or constitutional requirements, do I interpret that as meaning that if the State did require ~~separate~~ separate ~~recording~~ reporting , ~~for the~~ for the Alaska pipeline it would ~~present~~ present no no problems for the owners.

Donaldson: I have talked with Harry Jones about this subject; ~~the~~ actually ~~the~~ his departure was the fact ——— a friend of his was quite gravely ill.

He apologized for not being able to... the subject of our discussion, in essence it is a perfectly proper exercise of State authority to acquire information. The only limit that your suggestion might be appropriate ~~of~~ and if ~~xxxxxx~~ the requirements were so burdensome or heavy and someone was standing at their elbow, and at the time they wrote a letter or received a report, obviously it would be the kind of harrassment that nobody would intend. But it is a very broad power. The second part of your question and you talk about separate system and accounts . We're used to dividing ICC's extensive information under a well established system in the past . It would be quite burdensome to create a different type of system so that you would have to run two systems of accounts. I think probably the direction of Harry's suggestion was that if you understand how broad the information was given the ICC and there may be some supplementary information, thats fine. But not totally a different system.

Rettig: I didn't have in mind requiring the maintenance of a separate accounting system or different chart of accounts separate from that required by the ICC but merely the elements that go into it as they, it might to Alaska could certainly be

kept separately.

Donaldson: George Seymour, who will be the next witness is prepared to give you quite an example of this and what information is involved.

McVay: I think Mr. Markham and Mr. Donaldson, trust (?) requesting is that Alyeska makes money the State of course can make money, what's to keep Alyeska with its supporters who are world wide oil companies from laying on losses on Alyeska. That is what we are trying to figure out. ~~Not mentioned~~ It just that we wanted to set up burdensome accounting procedures or anything like that but how can we maintain the integrity of our own line as far as accounting is concerned. That is the... trust.

Donaldson: I can certainly understand your question, perhaps I should have extended my comment in anticipation of, the first place if you have the kind of information you have been referring to, and if this notion of burying somebody's elses burdens somewhere else was a fair charge. With the information that would be segregated as to Alaska, I think the State attorney's would be well armed and corrected promptly the type of procedures that Mr. Markham used yesterday. The first thing is to get the knowledge. To me knowlddge and power and are an effective regulatory theory in themselves.

Holm: Mr. Markham, we heard some talk about how long its going to take for the ICC to come to a conclusion, I've heard 2 and 3 years and some delays, what kind of a time frame would be involved if the state were to object to the proposed rates that had been filed with the ICC and then we objected to the rates or the rate of return of the companies or really what I'm after is what minimum time could we expect this if we were really pushed.

Markham: The minimum time would involve suspension of the rates before they ever took effect if the commission felt that the States objection to them were

well taken. Or if there were a sufficiently serious question concerning the lawfulness of the rates and this was raised before the rates became in effect but after they had been filed, remember I mentiond the other day there is a 30 day filing requirement, now if during that 30 day period the State were to raise an objection to the rates which could the commission felt was probably well taken, they could suspend the rates before they ever took effect and prevent the rates from going into effect for a period of 7 months while they conducted an investigation into the lawfulness, held a hearing and reached a final decision. Now that is the minimum time period.

Holm: So there would be some rate in effect during this period of time.

Markham: It would be the old rate.

Holm: Well there may not be an old rate. If we start out and we say look Fred, 50 cents is too high ...

Markham: If the Commission were to suspend an initial rate that would mean that the carrier could not operate it until it filed another substitute rate that the Commission felt was sufficiently reasonable on its face so that it did not suspend it. In other words the carrier could be prevented from operating until a final rate of satisfaction.

Holm: Obviously we don't want to keep them from operating but if we are going to make an objection, is it conceivable that we would arrive at that there would be a conclusion that the rate setting arrived at prior to the pumping of any oil at all.

Markham: No I don't think so. This is not an area in which the commission would be likely to issue but would amount to a declaratory order. In order to get an advance decision from the commission I think that would be the only

available procedure and I doubt that the commission would intervene.

Holm: Then as I understand it the y would file a rate and this rate would be in effect/while for a during some pumping before the ICC would have any facts upon which to make a different/or decision any decision as to whether these rates were indeed ~~legitimate~~ legitimate or proper.

Markham: Well, let me back up again. If the commission, the commission could suspend the rate and prevent it from going into effect. So that it would be in suspense until the investigation was completed. If the commission decided that the question was not/sufficiently serious to warrant suspending the rate they could nevertheless immediately start an investigation/ even before the rate had become effective and under the commission's procedures you get moving pretty rapidly in submitting evidence in these cases. In the case of a changed rate, in other words other than initial rate, the carrier has the burden of proof, the carrier has to come forward with evidence in support of that rate and the time periods allowed by the commission are pretty limited for those purposes. So you will have the machinery in operation perhaps even before the rate takes effect as far as determining ~~what the reasons~~ whether or not the rate is recent.

Holm: You ~~can~~ have been pretty well involved with these hearings, are we talking about 2 to 3 years before it's finally settled?

Markham: Ordinarily~~no~~ no. If the hearing is handled on modified procedure you are talking about months instead of years. Now it is possible that ~~the~~ if it develops into a great big investigation which you have people intervening and all sorts of interests coming in and raising ~~peripheral~~ peripheral questions it can get stretched out and the proceeding involving a year or two. But this is not the normal thing in a rate case.

McVay: Mr. Donaldson, I think wanted to add something.

Donaldson: Let me have the answer as well as, this is not a new problem. Eveny time you start a new line you've got to make some guesses to what the rates are going to be. There is a considerable amount of experience out on that guess accumulated over a big many years. And the companies don't bid by money, what the ~~ultimate~~ rate will be. Really what they are trying to do is to figure out what the probable rate will be, come as close to it as they can, not take advantage of the situation. They probably also err on the low side, you see. They try to make a good guess and if they guess wrong, not only do you have the procedures of but to the extent that there is any excess and there is a procedure I understand so the remedies are there, the important thing is the attitude of the companies attempt to follow in making a real good guess. It hasn't been a problem, you understand, it is a darn good question and I want to respond to it.

Holm: You said usually on the low side, is it to your advantage to have a low tariff. It appears that in any of the other means of transportation they usually err on the high side and have to get knocked down. Now are you saying that in the oil transportation business you err on the low side..

Markham: It is not to our advantage to have a low tariff. It is ax reflection of the respect of the regulatory authority. What you are trying to do is figure out where they come, and come as close as you can on the low side of it.

Colleta: Mr. Donaldson, based on your last three remarks you have now an anticipated tariff,..

Donaldson: No sir we don't. And the reason just in brief as Mr. Spahr referred to yesterday when he was speaking of all the unknowns. You have to know really

what the cost in the line will be. You've seen that our costs have trended up, we have had more information in delays, taken in the total, environmental requirements have been added to the construction and we just couldn't guess what ~~w~~ it will be.

Colletta: I personally couldn't accept this answer. Its a gigantic project and based on that your initial concept had to have a starting point and it has been a continuous revision as the changes have occurred. Now I'm certain that someone must be anticipating and adding these provisions, there has to be a point when you normally decide that it is no longer feasible.

Donaldson: I didn't mean to imply that we haven't worked with numbers. I was trying to express what is involved in is we don't have any great confidence in any set of the numbers we get today. The assumptions that make a great deal of varying in the tariff numbers anybody can calculate, turn on the fact of what you think the line will really cost before you ~~finish~~ it is built. Secondly when to start. Third what rate of ~~proof~~ will it have. If you have where the ~~numbers~~ numbers uses 600,000 barrels a day you run the same numbers just changing that one figure to a million 200 thougand barrels a day, you can swing from a ~~negative~~ negative wellhead price to a positive wellhead price very easily. I am ~~n~~ not trying to be evasive but there is a real problem in guessing and we try to get some field, everytime we read the mail from anybody who ~~has worked with it~~ is working on this line, and say we think you ought to build it this way, the numbers change, you 've got ~~to start~~ to go back & do it over again.

Colletta: Is it normal practice when a line is in the planning stage prior to being constructed that you anticipate its full capacity, are tariffs generally set this way, for example on the Alyeska line has a capacity of 2,000,000 barrels a day, would that number be taken into consideration ~~to~~ to establish the tariff ~~with~~ rather than

the amount of oil that [redacted] going through it.

Donaldson: Well, you're looking at your costs to begin with. When you say the line has the capacity is 2,000,000 barrels a day, it doesn;t when it starts ~~from~~ sure it's the same 48 piece of pipe but as you add pumping stations that piece of pipe becomes more efficient and can handle more volume. But Mr. Spahr ~~kthink~~ again I think was referring to yesterday was, it was our guess that the best economic risk for the companies to take was to design the line so that it could be expanded from a million two , to the two million level at the very modest instrumental additional cost. They only built it to a million two to start. If you wanted to add that other 800,000 barrels you get a very expensive expansion. We don't hang up on the 2 million figure, you are looking at what ever you have got into the line at the point. Let's say it is a million 2, and the pumping stations and facilities that that embodied , that's the cost you start to work with. Then if you only have 600,000 going through that facility you can run the computer and possibly come up with a very high tariff. It is a question as to ~~wxh~~ what your facts are not whether 2 and 2 still makes four.

Colletta: Mr. Chairman , based on that when do we change the tarrif on the line?

Colletta: ~~XXXXXXXX~~ If the tariff is set at a million 2, then 30 days ~~form~~ from now you start pushing 2 million barrels through, when do we change the tariff?

Markham: I would assume that the tariff would be fixed on the basis of the contemplated throughput for the foreseeable period and if the throughput should increase to the point where the costs~~ix~~ are brought down, the tariff would be brought down and the new tariff...

Croft: Mr. Donaldson, Mr. Spahr used the figure for the total cost of the line

as 2.3 billion dollars. I think that is the most recent public figure, is that correct?

Donaldson: I don't think he used that figure.

Croft: What figure is/the current Sohio estimate of the total cost of the project at a given capacity.

Donaldson: Ed Patton can probably give you the number on that ; I can report that last December when we met with the representatives and the administration in New York on these same subjects at quite an extensive conference. They of course asked us this same question. What's the best number. We had to tell them that was that the number that we were working with then , a 2 million line capacity/ the fr ame of reference, and on the time frame that we were looking at there, it was about 3 billion dollars. My recollection is that that did not include any factor for interest on investment capital, it did have some delay time in but again those numbers changed. The point is not what the specific number is Senator Croft but that we are all talking the same general ball park in big numbers.

Croft: Assuming the three million dollars cost, assuming Mr. Spahr's assumption that the line will be on production by mid or late 76, and 2 million barrels a day, what do you anticipate will be the tariff you will seek from the ICC under that set of circumstances..

Donaldson: I personally don't know the answer. We don't expect 2 million barrels a day.

Croft: Who does no know the answer.

McVay:As I understand the witness has answered the question...

Croft: I am asking,will they present any witnesses at these hearings that will be able to tell us your anticipated tariff under a given set of circumstances.

Donaldson: Well, we hadn't come prepared to do that; I think what we can do

this is an important thing, is to... if you would give us a set of circumstances, we can give you some estimate as to what that means. That is an assumed situation and really we didn't come prepared for that sort of thing just didnt' occur to us that it was the problem here.

Croft: You didn't think that we would be concerned about that.

Donaldson: No sir, that is not the point.

McVay: Mr. Donaldson, the Senator is concerned about that perhaps at a later date given the set of circumstances to you, then maybe you could give them a printout, in writing,

Croft: Yes, for example take the case assumptions that the administration has in its computer printouts, the 24, use your figures and your summary of the environmental impact statement that was submitted in August 1971 as far a surplus capacity, use a cost of 3 billion or 3.5 billion, in your calculation, use whatever life expectancy figure you think is reasonable, but set out the assumption and provide us with the information.

McVay: it would be initially in the interest of the operating companies to have as high a tariff as possible, is that correct? In other words going back to Mr. Holm's question, most carriers the advantage is always because of competition, that sort of thing to have the lowest tariff. But in this case, I think can see where if you have the patience to have a high tariff, because that again reflects against the wellhead price.

Donaldson: There is no guarantee that you can collect the tariff ; Sohio can make your oil unmarketable. The is no guarantee that you are going to profit from on any pipeline this is why it is not a utility and simply say because you 've got a line

and because there is oil there you can set a high tariff and expect to collect it doesn't fit with the economic facts of life. What you do when you start up a facility as I understand it is try and particularly after you get it all strained to work out all ~~the things~~ (?) so that you can use the facility and market the oil, cover your costs, service your debts and hopefully make some profit. All this sounds evasive when you try to answer ~~something~~ a question like this, it is a real guessing game until you know the facts of life are and the cost of your pipe in the ground .

Croft: Let me go back...this is ~~probably not...~~ a fundamental. the wellhead price determined by backing up from the refinery, the expenses involved in the finished product, is that correct? o.k. Now if you put a high tariff on the transportation from Prudhoe to Valdez , say, lets just use...

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

is another dollar. You've got a $2.50 product. You back it up with wellhead price you've got a zero result which means, then, that the State doesn't share.

DONALDSON: You really back it off on a market PRICE OF CRUDE OIL IN The market where your offering your oil not in your refinery product price. It's a basic mathematical assumption. .. You're not in the business to produce oil for a zero volume at the wellhead. I would guess that on the set of assumptions that the Governor was speaking to last week he came up with a calculated negative wellhead price. Nothing wrong with the mathematics ON THAT assumption. You don't do business that way. You have to figure out some way ~~to~~ PARTICULARLY IN A start up, and get her going, and I am not expert on this field, and don't presume to be. I have heard Senator Croft's questions and I think maybe we can just see if we can work it out in that TEMPORARILY

MCVEIGH: Right. Well, O.K. We'll close this up. But you can see what we're ~~concerned~~ concerned with.

DONALDSON: Sure.

MCVEIGH: All right. Are there any more questions? Senator Thomas.

THOMAS: Mr. Chairman. Just a quick one. On the matter of jurisdiction, if the State were to take some of this royalty in oil and process it right here in the State, would that not put the State back in regulatory position legally?

DONALDSON: Insofar as the oil was intrastate in its shipment to the extent that the bulk of the oil would be moving through the TAPS facility it is the STREAM of Interstate Commerce that part of the _____ would remain in the Federal jurisdiction area. To the ~~event~~ EXTENT you had an intrastate shipment, ~~there~~ THIS

is no question about it, as Harry Jones said yesterday, _____ STATE DEPARTMENT _____ DEPARTMENT regulations.

THOMAS: Then I wonder, in that case, if we were able to regulate that part, the interstate part, would that not have a great influence on the rate for the interstate EQUIPMENT ?

DONALDSON: I can't answer questions I don't know. Do you have any comment on that?

MARKHAM: There would be THIS limitation on the State's jurisdiction over even the intrastate rate. THAT IS THAT IT could not fix the rate in such a way that it resulted in a burden on the interstate movement. Specific provision in the Interstate Commerce Act dealing with this type of situation arises constantly in the railroad & MOTOR CARRIER field. The State would have initial jurisdiction, without question, to regulate the intrastate rate, but it could not do it in such a way as to impose a burden on the interstate portion of the transportation.

MCVEIGH: Mr. Huber, then Mr. Young.

HUBER: Mr. Markham, I understand that your field of expertise is the pipeline area where we are dealing with Federal Government regulations, particularly ICC. Is that correct?

MARKHAM: I denied yesterday being an expert, but let's go on from there.

HUBER: ITS YOUR AREA OF EXPERTISE I have a small question on a -- a small question on fairness of rates. ~~I WANT TO EXPLORE~~ Now (coughing) I want to explore another area that we haven't been exploring that appears to be in your expertise, and that is I wonder if you would reiterate to us the relationship with pipelines, gas and oil pipelines, which ones are required under what conditions to be common purchasing AS WELL AS common carriers. I WANT TO TRY TO GET THAT GROUND WORK LAID AT THIS TIME.

MARKHAM: You just got got completely outside any area of expertise I have. I don't know the first thing about common purchaser ARRANGEMENTS. That is

primarily in the gas pipeline field about which I know very little. Ordinarily, I would think that there could be some real constitutional problems ~~and all~~ INVOLVED in trying to turn a commentary oil pipeline also into a common purchaser. Beyond that my knowledge of the subject ~~fades~~ FAILS.

MCVEIGH: Mr. Huber, I don't want to discourage questioning, but try to limit your questions within the scope of what we're doing here. I think I don't know what "common purchaser" is, either, but I have a feeling it's a marking ~~tariff~~ TERM AND WE ARE NOW IN THE production and transmittal stage.

HUBER: Mr. Chairman, it is A TERM, NOT A MARKETING TERM, BUT IT IS A TERM OF the fairness of the method of transportation of a common carrier. This is what it amounts to. And it is beyond THE QUESTIONING but I don't want to get beyond the witnesses' expertise of the other places TO GET THIS. Are you, I wanted to find out just what area the Prudhoe pipelines, in your opinion, are required to do this. ~~We~~ YOU do agree that the Prudhoe pipeline (cough) CAN TRANSLATE a part of the Outer Continental Shelf, would be required to be a common purchaser as well as a common carrier.

MARKHAM: I couldn't agree because I simply don't know.

HUBER: ALL RIGHT One other question that's having to do with rates. And we're still trying to determine here whether the State should be owner and operator of the line. Then I understand ~~some of~~ FROM your testimony so far today, "Should the State Be the ~~Owner~~ OPERATOR of the Line?" A rate of 7%, on the total value of the line , or about 210 million dollars a year wouldn't be anything unfair FOR THE STATE REAPING THAT AMOUNT OF HARVEST OFF THE LINE IT WOULD BE ~~even~~ a fair system.

Markham: I don't think we can assume, VIS-A-VIS I think the assumption has been made, that because the ~~des~~con cent decree, which applies to the shipper, owner oil co. ah, permits 7% dividends that this would automaticaly provide both a limit and a allowable return for state operation. I don't think that you can assume that, any more than you can assume that if the question of the reasonableness

of the 8% return, which the commission fixed some years ago will reopen, as I suggested yesterday that the commission would go either up or down on it, you can make the assumption for purposes of going ?. I don't think that you can predict or I can predict or anybody else can predict, what rate of return THE COMMISSION would decide was the maximum allowable return for the state if it were TO OCCUR,

Huber: I understand that then we could be legally right at 7% if the state were running the line, but in order to be morally right we may have to drop down to something like 200 million dollars a year or about 5.6%, where you indicated was the average for the conservitives that now make up Aleyeska. A MORE REASONABLE FIGURE.

Markham: I'm afraid I didn't make myself clear, I'm not even sure that the 8% would be legally right, as you suggest, if the question were open . The ultimate decision as to weather a 7% return was reasonable for the state as prepared, would have to be made by the ICC, and I simply am not in a position to PREDICT WHETHER that they wouldsay 7% is the maximum reasonable return for the state under the circumstances. I DON'T KNOW. So I don't think that you can assume that it is even leagally permissable rate regardless of any moral questions that might be involved.

McVay: In other words there may be a difference, whether it is a privately owned pipeling or a state owned pipeline.

Markham: There could well be, There could well be. Particularily if the state relies on the fact that its exempt from income tax.

McVay: Mr. Donaldson would like to comment on that.

Donaldson: Mr. Huber, your suggesting that perhaps THE 5.6 % IS SORT OF A BENCH MARK TO FOLLOW leaves me to make 2 comments for information of this committee. 1) first is, and I'm not sure if its any question of morality. IT'S simply a reflection of what probability they've actually been able to earn in a situation where there was some risks. Obviously if there hadn't

had been a whole lot of risks it might have been closer to YOUR T/R.
Second point is, these are pipelines running through terrain where there
is a lot of experiance and its not to difficult to lay pipe. The risk terrain
here that we have is essentially more, and, ah, as investor or as A FAMILIAR
whether its the state or loner companies , there isn't a reasonable argument
higher risk ought to be rewarded to whoever steps up and does the job AND
those comments be serious discussion. and I think they add to the picture, I'M NOT SURE.

McVEIGH (SENATOR): Mr. Retting do you have any question. Neither Mr. Donaldson nor

[illegible]

Rettig: Neither Mr. Donaldson nor Mr. Markham, when this is ONCE FUNCTIONING
were going to have 7 different tariffs is that correct? Ah,

Markham: Yes, IF IT that operates as non-divided INTEREST LINE.

Rettig: Now, In responding to the request for an estimate of the tariffs
at this time, this would involve again the 7 different tariffs, would it not?
If it were possible, in attempting to do this at this time do you RUN AFOUL OF
Dept. of Justice problems in discussing these matters which may in the end,
combine themselves into a particuliar rate.

Donaldson: Let me, DON'T answer that question. I'm not sure I can either, EXCEPT TO SAY THIS,
AT STANDARD OIL OF OHIO AND BRITISH PETROLEUM,
We don't, discuss tariffs with any other mambers of our project
for just that reason. When we get down to the rate procedures, tariff questions
and this sort, we will make our independant FILINGS with the ICC. At that time
it will all be out on the table and we'll see how our work compares with any
body else's but this is a subject that we just don't do. and I'm not sure that
any such thing as a ANTI-TRUST expert, but most of the time I TAKE PART OF IT BY
I'VE BEEN PRACTICING IN CLEVELAND, ITS BEEN IN THIS FIELD AND WE STAY AWAY FROM IT
EXTRADITE. The ? defender cross questions for compatable numbers,
HIS AN INDIVIDUAL COMPANY AND, EXAMPLE
you would almost have to respond what are own ideas would be. And, ah, it is an
interesting exercise, BECAUSE given the case a set of assumptions instructions, the computer will run
and give you a number. The question is, not whether it works, but what the assumptions

and, ah, I think for (Cook) Inlet with some discussion of the company to Canada or representative (Cook), you should be clear that you will not do it.

Rettig: Thank you. Going back to the problem of using the various elements for extablishing tariffs, It was mentioned a couple of days ago, I think that it was about 3 to 4 years before the ICC got around to establishing the value in connection with the Cook Inlet pipeline Co.. Recognizing that initial cost is an element of valuation in fact ~~its progress~~ it perhaps is the only reliable one, upon the immediate completion of ~~a pipeling~~ of a pipeline. Is the matter of evaluation a difficult one at the beginning, certainly the evidence is open, its there its established upon the completion is it not? And, ah, getting around to evaluation, my ICC rediance, unimportant, is it not? It's already established.

Markham: It's my understanding that the people who are familiar with the valuation process can estimate valuation even before its determined by the commission, quite accurately. The bargin there is very small, and certainly in the case of a new pipeling, or valuation of the term, as you suggest , very largely on the initial cost on the actual investment, ah, the determination of an estimated valuation would be relatively simple, could be done quite readily and would be I would guess 97 to 98% accurate.

Rettig: Putting it another way, ~~So you undoubtably~~, immediately upon the completion of the pipeline the cost is known, is that correct?

Markham: That is correct.

Rettig: Wouldn't it be difficult to argue with that figure as the actual valuation of it? At that point.

Markham: Except conceivably for some depreciation that might have taken place on some elements during the construction period, or something of this sort. There couldn't be much arguement.

Rettig: Thank you

McVay: Senator young,

Young: I'm not sure whether I want to ask any questions or not. For they've been asked while I've been waiting to be recognized. Mr. Chairman, it's early in the morning Yesterday it was established that the intra-state are your feeders or witnesses use the grounds of the cold, etc. Now I've been trying to find an example of a pipeline similar too (or ~~27~~) thats proposed in AK, I think AKN's have a unique psychological hang-up, that they're the first ones involved in something of this magnitude. And if I remember correctly, the little 36'' pipeline from West TX to CA, thats owned and operated by the Pacific Gas and Elec. Co., as a separate owner and operator. When they established they, there must be a consorting with a, or is a climate, which either one it is. Consorting with companies that utilize this line in shipping gas and I know that you said that you didn't know anything about gas lines, and if there is a consorting group do they through with establishing new tariffs, or how does this work? Is there any corolation between the two is what I'm trying to find out?

Markham: I'm not familiar with the lines, however to some extent because one of the projects we're also working on as some of the people in the room know is the North West Project Study Group. Considering a gas line from Prudhoe down the McKinzey River to service most the U.S. and even part of Canada. From that work I've learned that gas lines normally want to operate as a contract carrier instead of a common carrier. And that the people involved in moving the gas are really approaching it from a different standpoint, they want their gas moved, as new gas reserves are found usually you have enough leaitime, so that the line can be inlarged or looped to handle the additional energy to be moved, it is a totally different world in its legal structure. The regulation of rates and tariffs and so-forth here is under a different agency, a better power of commission. And, ah, essentially it is guite a different subject than the one we have here.

If this has roused is of some interest there will be opertunity on the door opportunity I am sure to give you more information, and representatives of this study group in particuliar have planned to be in AK from time to time working (crouch) and people from the administration on some of the technical enviromental aspects as well as the financial and other aspects of this type of department. I believe certainly that it is a kind of a separate question from the budgetary aspect.

Young: There is no coralation between gaslines and the oil lines?

Donaldson: Not to my knowledge, not at this particuliar point.

McVeigh: I believe the Senator did wait a long time, judging from these questions. Do we have any more questions? Mr. Rose.

Rose: Thank you Mr. Chairman. Mr. Markham, I have to admit that to the very high praises of the ICC of/somewhat door from of the, give some comments on that matter over a NUMBER OF years from my own observations with dealing with the ICC myself, do you know of any specific example where the ICC has lowered the pipeline tariffs.

Markham: Has done what? I don't----

Rose: Do you know of any particular instance where the ICC has lowered pipeline tariffs?

Markham: The descion that has been refered to repeatedly here both in the preferred state testimony and I mentioned it yesterday, the 1940 descion, wasone in which the commission made a general investigation of tariffs throughout the crude oil industry and established 8% as the maximum allowable return for crude oil lines. Now it did not, in the initial case as I recall issue an order requiring reductions. This was just before the war. What it did was to make a tentative descion and then after the war the subject was reopened, the commission had a rehearing, they found that the carriers had reduced their rates, in response to the earlier descion and found that no further action was required then a few years later, I don't recall whether this actually resulted in a reduction, but in a case started on a complaint by the railroads, the commission

examined the allowable earnings for petroleum products and established 10% as the allowable for products. I don't recall whether there was an order actually issued requiring a reduction of the rate in that case, but certainly the establishment of those ceilings has had the effect of requiring the carriers to limit their earnings in exactly the same way the 7% consent decree has had that effect.

Rose: Does the determination of maximum allowable profits. The question was, do you know of any particular instance where the ICC has, In fact, ordered a reduction in specific tariffs.

Markham: I Would have to say, that again that the effect of the the 1941 was to cause a reduction in rates, now I don't think there was ever any order actually issued in the case.

Rose: Right, you know of any specific instance where the ICC has ever made a calling that a particular carrier has been assessing excessive profits?

Markham: The 1940 case was certainly such a case.

Rose: I thought that was a determination of how much was the maximum profits. And was there a finding that excessive profits had been assessed?

Markham: There were findings as to what profits were being made throughout the industry and some of them exceeded the 8% at that time.

Rose: And that was 42 years ago.

Markham: That was 42 years ago but its been mighty effective in controlling the earnings

Rose: 32 years ago I'm sorry, I'm getting older faster. Do you know of any instance Mr. Markham, where the ICC has ever holded a refund on the basis of .....at no time have they ever ordered a lower tariff or at that time they nave ever ordered a refund, am I right?

Markham: There has never been a reperations case brought envolving pipelines as for as I know

Rose: Are you vaguely familiar with a group known as the Corporate Accountability Research Group?

Markham: I'm afraid I'm not.

Rose: And the group

McVeigh: ~~XXXXXXXX~~ He said he didn't know Harold.

Rose: I understand, but perhaps if ~~XXXXXXXXXXX~~ indicated where the group appeared that perhaps he might remember ~~...was...haps...that.....they~~ exist.

McVeigh: This is not a seminar, lets keep that in mind.

Rose: But amyway, I'm not familiar with it ~~XXXXXX~~ frankly. HA HA HA I have been furnished and I discussed it yesterday with Mr. Collins. With the statement I have got from Mr. W. ~~G~~ C. Moore Jr. I testified before the sub committee of priorities Economy ~~Gove~~ Government Authority ~~X~~ economic committee. Jan. 11, 1972 And at that ~~X~~ Time he indicated on page 3 of that statement that ICC applications also makes it possible for pipeling ~~g~~ owners to install this regulatory rate, Etc... I assume that this individual knows ~~more~~ alot about it than I do are you familiar with that testimony sir?

Markham: I;m not familiar with ~~it~~ it I knew there was such a testimony. --- I would like to comment however on this reference ~~XXXXXXXXXX~~ to abdication. I talked about it a little bit yesterday, It seems to me that the ICC is a little bit like, ah, a parent of a large family, Some of the children are running off and getting in ~~troubel~~ trouble, some of them are fighting among themselves, some of them are falling down and hurting themselves, some of them are doing their jobs and behaving themselves. Now the 4th group of children don't require the same kind of attention ~~as~~ that the 3 other types do. A good parent I shouldn't think would spend much time slapping around the 4th ones just for the sake for exerting parental control. But I wouldn't regard that as abdocation.

Rose: Bruce Rosa the Deputy Ass. Attorney Gen. at the same hearing also indicated or stated ~~possibility~~ that there is possibility of regress for outside shippers who resort to ICC regulations. in need of ~~Anti~~ the Anti Trust Div. of the Dept. of Justice.

Markham: I would disagree with the statement regardless of who he is. I don't think there is any serious doubt about the ability of anyone to get a fair hearing if he feels that he has a complaint against shipper rates. Now, noone can guarantee that your going to get regress, but you will get a fair hearing. No one can guarantee that you are going to collect if you go to court in a law-suit but you can be sure THAT under our system of govt. of at least getting a fair hearing.

Rose: If they give you a fair trial before they hang you.

Rose: Thank you Mr. Chairman

McVeigh: Mr. Donald, did you have some thing.. I noticed (pause) You don't have to respond if you don't want to.

Donaldson: Mr. Moore, that you referred to did testify at those hearings for Senator Proxmire. He is an associate of Mr. Nader I believeand approached his investigations with a certain frame of reference we might not always agree with. The only response I want to make is one that Don Markham has already indicated. I don't view business as basically bad. The supreme court has said that there is nothing unlawful just because your co. happens to be big. Rose I think we ought ALL to agree with you Sir

Donaldson: I'm sure you do. Perhaps I ought to stop there because really that kind of question isn't material to the hearings here. I have to be able to go home and look my kids in the eye at night. These things don't worry me except as the bias comes out in some of these ???

McVeigh: Are there other questions? Thats fine Mr.

Donaldson: I wasen't referring to you personally sir. You raised a fair question and I gave you a response to Mr. Moore's ....

McVeigh: Mr Barber,

Barber: To Mr.Donaldson, While this question has been nibbled at, I am sure it is in the back of everyone's mind. Whether it has been stated clearly and concisely or not is beyond my recollection. Is there a point of no return financially when this project due to increased esclation costs will reach a [redacted]

pointwhere it isn't financially feasible to bring the north slope oil to market? By that I mean the current market prices on the west coast and the rapaidly esclating construction costs of the pipeline where it has gone from 1.5 billion to 3.5 billion in 5 months.

Donaldson: (Coast) Let me ask a couple of questions let me respond to them. On project costs , the costs haven't jumped that fast that much. There is a misunderstanding, I think perhaps I can set that straight. Last December when we went with the members of the administration and their question,of course, What do think this is going to cost?, They had a document that had been furnished by Aleyeska indicating a total cost on the information submited of about 1 billion dollars, We straightened out I think a misunderstanding that 1billion dollar ~~xxxx~~ figure really was the total cost of the project, it was not. And if we researched it very quickly for them and confirmed it . We learned that the 1 billion dollar figure was the cost of selective information that had been requested By the State at one time on certain ~~catag-ories~~ categories of cost and we've responded with information on the categories requested, but it was not the total cost of the project. Someplace along the line, the label on the document ~~xx~~ that it was only a partial ~~submittion~~ submissions had gotten lost, and I don't know where it what had happened and if it was really anybody's fault, but the idea of a 1 billion dollar figure sort of hung over us since ~~when it~~ the fact that it was only a partial ~~thing~~ trend. The costs, however, as you know ~~tend~~ have to go up as these additional requirements are laid on. Any project, I suppose, has a point of no return, happily, we are not there yet. The thing that concerns us

Donaldson: the whole thing is, the sooner we get her going the better. At the end of the testimony that we will present as industry members here, I have- been asked to give a concluding report suggesting really where we are and what the State of Alaska and what would appear to us really completed moving this along. In a sense these remarks might be presumptive, they are not meant that way, real concerned we present this, but I think after the testimony fully is laid out these ideas will become clear. Yes sir there is a xxxxx-xxxxx point.

Barber: Well, Mr. Donaldson, you missed admit there is a point so you know what the point is so I will wait with great anticipation your concluding remarks.

Donaldson: I don't know what the point is, but as costs go up and crude oil prices don't move as fast, what you can see any set of numbers is a closing at that rate. That's the thing you xx should worry at all.

Barber: Well, I can't see the point is there.

McVay: Can I ask a question. Do you estimate (semi-points) what delay costs per year. In other words, if you are used to dealing in figures inflation is 2% or 3%, the cost of living goes up 1%, ...

Donaldson: He can give you that number.

Senator Palmer: This is line with what Rep. Barber was saying, Mr. Chairm-an, for the Chair to Mr. Parker or Mr. Donaldson.

The State is not of course interested, I believe this would be correct in saying, in producing oil that has a minus or a zero well-head value. From your comments earlier, I believe this will hold true as far as the industry is concerned also. But, I suspect the points might be a little different. You might be willing to produce the oil that has a value somewhat lower than the State would be interested in producing that same oil. From the standpoint that you perhaps will be making profits from the other portions of the industrial involvement. Can you speak for that at all?

Donaldson: Yes, Sir. I can speak very much to the point of that in a pretty short answer. Each function of our business has to carry its own weight as to profitability. One merely cannot subsidize the other. This is the xxxxxxxxx way our company looks at it, I can't really

speak for all other companies, but this is so. You don't stay in a business very long if it can't pay its own way, and you can't see at least a turning point and work its way out. The idea of subsidization through a number of functional levels from the well-head to the gasoline pump in the service station is an idea that is often played with - we just don't look at it that way.

McVay: Any further questions? You gentlemen will take a ten-minute break now . Yes, Mr. Markum, you may be excused.

McVay: Mr. Seymour, before proceeding, we have been here now, this is the third day, and everyone is getting (the fourth day) understandably everyone is getting tired. It is not the Chair's intention to limit questioning; however, it is the Chair's intention to keep the questions on the point. As I said this morning, we are not here for the purpose of a seminar, we are here to find as a fact finding body, and I'd like the questions to be germain and try to stay within the field of the expert. There will be a certain amount of cross-examination permitted, but cross-examination will not be permitted, so let's , as tired as we are, try to get on with it and wind up these things as fast as we can.

Our next witness is George Seymour is the manager of the PAPT Interest pipelines for Mobile Pipeline Company, Common carrier pipeline affiliate of Mobile Oil Corporation. He has been a Director and a Vice President of Cook Inlet Pipeline Company since March, 1970 with Staff responsibility for the operations of that Company. George is a professional engineer. He has been engaged in pipeline engineering and management through Mobil for some 24 years. He will address the subject of pipeline economics and risk factors and financial report.

Seymour: Prepared STatement : This morning, or at this sitting, I just plan to speak to pipeline financial reporting. And, I'd like to review the type and format of pipeline industry financial reporting, which could very well serve the needs of the State of Alaska in connection with the TAPS project. (Go to prepared statement from here)

Seymour: Deviations: I regret that I don't have enough copies for the whole room, there is extensive reproduction required and the page numbering is not as good ~~xxxxix~~ as it should be. We have typed in because of page size problems, the page number opposite the title of the particular page.

A PAGE 2 A
Page 2: Paragraph 2 insertion: Now I might say that the pipeline companies follow the uniform system of accounts for pipeline companies, which is this booklet which is prescribed by the Interstate Commerce Commission for our use. It's a public document, available for sale from the Superintendent of Documents in Washington. This is our accounting Bible in the industry. And, you will note ~~that~~ US we review these forms that they follow very prescribed methods of accounting and each ~~idx~~ item of cost and capital investment is specifically numbered and we do not deviate in any way from this system. ~~xfxxxxxxxxx~~ (Continue prepared statement-)

PARAGRAPH 5 B
Pge 2: ~~Last page~~ PAGE 2 insertion: Again we are using a Cook Inlet Form P as an example. And, if this Form were used to report on TAPS by any of the owner companies, there would be, or could very well be additional pages completed, many more probably. Continue---
Continuation after Page 3: As to revenue the schedule could set out TAPS revenue separately and if further detail would be desired by the State, as schedule that summarized such data could be prepared. Any necessary additional operating information desired by the State could also be provided on this or a similar page. The State would also be interested in the valuation of TAPS carrier property. As you know, the Interstate Commerce Commission determines the company's original valuation and traditionally brings it down to date each year. A copy of a company's valuation report which set out valuation of property located in each State is sent to each state by the ICC. In addition, because of the magnitude of investment in TAPS we expect that the ICC will determine the valuation of tax facilities separate from the valuation of owner ~~xxxx~~ companies other carrier facilities. This information would also be provided to the State of Alaska by the

ICC. To summarize, we have reviewed schedules, or samples of schedules which could be used to report required TAPS financial and operating information to the State. The TAPS owner companies have previously stipulated it was their intent for range to provide the State with complete financial and operating statistics on TAPS. Information of the type we have just reviewed which seems to be consistent with what the TAPS owner companies have offered to furnish appears adequate to fulfill the State's total need for corporate financial and ~~operating~~ operating data. Now I realize there's a great deal of information given to you here and I'm sure you may want to review it. I think we will agree there's a good deal more data in this form than is ever presented in an annual report of a publicly held stock company. I'd be happy to answer any questions that I can.

McVey: Do you have questions for the witness?

Croft: Mr. Chairman, Mr. Seymour, I note on Section 108, page 5, that Cook Inlet pipeline is a joint stock company, not an undivided interest.

Seymour: Yes, that is correct

Croft: So its a different operation in that regard than the TAPS line would be.

Seymour: Cook Inlet's operation is certainly different from that standpoint. Yes.

Croft: Secondly, do I understand the figures correctly that the capitalization of the Cook Inlet pipeline is $4 million? That their net earnings for this particular year were in excess of $5 million?

Seymour: Yes, Sir. That is correct.

McVay: Any other questions? Thank you very much, Mr. Seymour.

Donaldson: Next witness is Edward Patton, President of Aleyeska who I am sure needs no introduction to this committee

Patton: Prepared Statement. After Page 1, Although it is not a part of my prepared statement, which will be handed out to you, I would like to comment on some remarks made by Mr. Gilderhouse the day before yesterday. In part of his testimony he eluded to the fact that it would be a basic requirement of the State in ownership of case that Alyeska agree to an executed contract calling for guaranteed construction and oper-

ating performance. This is a subject that I can address with some familiarity . As recently as 1966 when I attempted to negotiate a lump sum contract (those are the words used by the Speaker of the House) for a project at that time involving about $140 million the perspective contractors indicated their inability to accept this bid because there had not up to that time ever been a lump sum contract of that magnitude. And the perspective contractors did not have the financial resources to undertake that kind of risk. We are now talkin g about a facility costing about 20 times as much as that 1966 contract, and the State or the State's representatives are implying that we should take on this lump sum obligation and it has been said in a manner which would imply that taking this on does not require the full faith and credit of the Oil Companies. This just cannot be. For me as President of Alyska to agree to a lump sum contract, I would first have to add a contingency to the cost estimate to be sure that I had covered all of the unforeseen possibilities and the history of this project indicate there have been many. And then I would have to add a profit which NOT is now under contemplation becuase if we are going to expose the owners of Alyeska to the risks then they deserve a profit, and I might add that the fourth _____paragraph in this contract would be somet-hing that has not been seen up to now. It will have to involve environmental contengencies and prospective lawsuits in addition to the normal forces of nature, Acts of God, Acts of Government and so forth. Continue prepared Statement.

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

LAST PART OF E.L PATTON'S TESTIMONY, ON TAPE # 31

VALUES AND HAVE TAKEN THE FORM OF REVENUE MEASURES. INDEED, IF ~~THEY~~ these Bills ARE REALLY REPRESENTATIVE OF THE ATTITUDE OF THIS LEGISLATIVE BODY, I CAN ONLY FORECAST THAT BUSINESS AND INDUSTRY WILL BE DISCOURAGED FROM INVESTING IN ALASKA. SB-313, FOR EXAMPLE, WOULD ESTABLISH AN ANNUAL CHARGE OF 1/20 OF GROSS PIPELINE REVENUE PLUS $656/ACRE. WITHOUT HAVING TO ESTABLISH PRECISELY WHAT GROSS REVENUE WILL BE OR WHAT THE EXACT AMOUNT OF STATE LANDS WILL BE, THAT FORMULA EQUATES TO AN ANNUAL CHARGE OF SEVERAL THOUSAND DOLLARS PER ACRE. WHAT MAKES IT EXASPERATING IS THAT WE ALREADY HAVE A SOLID HISTORY OF FEE TITLE ACQUISITION ALONG THE R.O.W. AT A FRACTION OF THAT PER ACRE.

SB-294 IS EVEN MORE EXPENSIVE. AN EXAMPLE I HAVE SEEN RESULTED IN A RENTAL OF OVER $11,000,000/YEAR, OR BETWEEN $7,000 AND $17,000/YEAR/ACRE (DEPENDENT UPON THE ULTIMATE STATE MILEAGE). NUMBERS LIKE THESE WOULD, OF COURSE, COMMAND GREAT RESPECT IN DOWNTOWN

LOS ANGELES. OBVIOUSLY, IF ANY FORMULAS LIKE THESE PASS THE LEGISLATURE, IT WOULD BE IN OUR INTEREST TO ACQUIRE FEE TITLE TO ALL OF THE STATE MILEAGE INVOLVED.

SOMEONE HAS ADVANCED THE ARGUMENT THAT THE "LOWER 48" LEASING * FORMULAS AVERAGE OUT TO A R.O.W. COST OF ABOUT 4% OF THE COST OF AN AS-BUILT LINE, SO ALASKA SHOULD DO AT LEAST AS WELL. IT'S A RATHER WEAK ARGUMENT BECAUSE CONSTRUCTION COSTS IN THE REMOTE AREAS OF ALASKA ARE AT LEAST 2-3 TIMES THOSE OF THE "LOWER 48" ~~AVERAGE~~, WHEREAS THOSE REMOTE AREA LAND VALUES ARE PRACTICALLY NEGLIGIBLE COMPARED WITH "LOWER 48" LAND VALUES. IN EFFECT THE SB-294 FORMULA SAYS THE MORE DESOLATE AND FOREBODING LAND IS, THE MORE ONE SHOULD PAY FOR IT. I DON'T AGREE WITH THAT.

MR. CHAIRMAN, YOU HAVE ASKED ME "WHAT CAN ALASKA DO TO HELP?". I HAVE ANSWERED THAT QUESTION IN A NEGATIVE SENSE TO THIS POINT. BUT ALASKA HAS ALREADY HELPED. THE CONCERNED STATE AGENCIES HAVE CONTRIBUTED GREATLY TO THE WILDLIFE AND ENVIRONMENTAL STUDIES, AND THEY ARE WORKING TOWARD MEANINGFUL AIR AND WATER QUALITY STANDARDS. YOUR UNIVERSITY ~~HAS~~ HAVE BEEN OF IMMEASURABLE HELP IN THE SOLUTION TO MANY OF OUR PROBLEMS. I THINK THIS LEGISLATURE CAN ASSIST NOT ONLY THIS PROJECT, BUT THOSE TO COME IN THE FUTURE, BY CONTRIBUTING TO STATUTES WHICH ARE EASILY UNDERSTANDABLE, WHICH ARE EMINENTLY LOGICAL AND FAIR, AND WHICH ARE NOT SUBJECT TO CHANGE BECAUSE OF POLITICAL OR MONETARY EXPEDIENCY. NO ONE IS GOING TO MAKE MAJOR INVESTMENTS IN THIS STATE WITHOUT ASSURANCE THAT THAT INVESTMENT WILL NOT BE REGULATED OUT OF EXISTENCE.

ALL OF YOU KNOW OF OUR INTENSE FRUSTRATION. ANYTHING WHICH MIGHT RELIEVE THAT FRUSTRATION WILL BE HELPFUL. WE WANT TO GET GOING, SO WE URGE YOU -- IN FOOTBALL LANGUAGE -- TO GET OUT THERE AND BLOCK FOR US. THANK YOU.

ELP/nl
3/3/72

E. L. PATTON

* Attachment

LARGE PIPELINE RIGHT-OF-WAY LEASE RATES

STATE OWNED LANDS

(All Rates Shown Are for Single Payments for Life of Project Unless Otherwise Indicated)

	Basic Approach	Rate $ Per Acre	Rate $ Per Mile	Rate Other	Remarks
Arizona	Negotiated	10-12			10-year Period Perpetual Lease May Be Negotiated During Primary Term
California		400			Annually
Indiana	Standard Rate		3200		
Louisiana	Standard Rate		3200		
Michigan	Standard Rate		3200 320		Developed Areas Undeveloped Areas
Minnesota	Standard Rate		320		
Montana	Standard Rate		200		
New Mexico	Appraisal	15			
Texas					
General	Standard Rate		480		10-year Period
University	Standard Rate		1120		10-year Period
Washington	Negotiated	10			
Wisconsin	Standard Rate		320		
B.L.M.	Standard Rate		5		

ELP/nl
3/6/72

Mr. McVeigh: Thank you, Mr. Patton. We have questions from first Senatorial Committee, State House Affairs Committee, House Finance Committee. Mr. Croft, did you have questions? Mr. Huber?

Mr. Huber: Very short one for Mr. Patton. I think I want to refer to the, the area about the leasing bill 294 and when you mentioned about the possible interfer- ence of routings. I don't believe any member of this legislature wishes to add anything to the routing of the proposed Alyeska Pipeline. But ~~too many~~ S.B. 294 does go further than this and did you mean to apply your remarks ~~off~~ elsewhere to the gaslines and other things of the future, particularly the gas lines?

Mr. Patton: I don't want to get involved talking about gaslines because I don't know anything about them, but I think any any legislation which departs from from sound engineering considerations and that's what this legislation reads. It's inadvisable.

Mr. Huber: ~~You'd be~~ The concerned ~~with~~ news over the prolitheration of pipelines since you know the most current ~~fashions~~ plans on gas pipelines is through Canada all the way and there is some concern in ~~your~~ the State~~ment~~ using a common corridor or common corridors as much as possible. And that's the ~~only~~ reason I asked that.

Mr. McVeigh: Any further questions? Mike Miller.

Mr. Miller: Just one - - - question . We 've heard previously that the pipeline hasn't passed the two million barrels, although at the

present time, the prudent reserves don't indicate a real need for that. Could you give us an estimate/in dollars or percentage how much more Alyeska is willing to invest in the two million capacity, forty-eight inch pipeline as compared to what would have invested if they had taken into consideration only the proven reserves?

Mr. Patton: Well, you're touching on some areas that are owner responsibilities, but I'll endeavor to answer as much as I can of that question. The investment level that we are now talking about the difference between the one point two million barrels per day case and the two million barrel per day case ~~is to me~~, ~~--~~ ~~do parallel~~ precisely. So obviously for a ~~row to be~~ low cost you get a large increase in capacity, about a forty to fifty percent increase.

Mr. Miller: Thank you very much.

Mr. McVeigh: Mr. Patton, we've heard that one pipe, I believe, one point two million barrels per day is is what's being planned now for maximum production. Is that correct?

Mr. Patton: No, I don't think that is correct, Mr. Chairman. The actual situation in my contract with the owners right now is to design and procure materials but we have suspended procurement because of the recent delays that we had to okay and procure materials for the 600,000 barrels per day gauge. We had further instructions from the owners to design the one point two million gauge but not procure any material at this time. We have no instructions at all on the two million barrel gauge.

Mr. McVeigh: So then that that really the two million barrel figure is is used alot in the conversations about the pipeline, but that's, that's high then or at this stage at least unrealistic, is that right?

Mr. Patton: I don't exactly know what you mean by unrealistic because in the time trend that we're talking about we could have the the two million barrel gauge engineered and material available to build it in order to fit in with the transitor placed on it by Interior in the operation of the line. So it's not unrealistic, we could, we could be ready to go with the maximum gauge easily within the time trend that we have facing us.

Mr. McVeigh: Thank you. Any further questions?

Mr. Merdes: I have one.

Mr. McVeight: Senator Merdes.

Mr. Merdes: Mr. Patton, using your best judgment on the facts that you have before you now, when do you estimate that the pipeline, when I say when, I mean the time frame, making certain assumptions and I say this in the back grop of Senator Stevens remarks in the joint session of the legislature as to a time schedule of construction dependent on certain facts. What is your best judgment as to when construction will get undertaken, using certain assumptions?

Mr. Patton: Well, they're all assumptions. You have to recognize that. The first assumption is that the Interior Department will issue the Impact

Statement next week. That would put us into the Washington, D. C., District Court for six to eight weeks or possibly two months later. We would expect to stay in the various court houses in the Federal judicial system for the remainder of the year. Then we would hope to get the validated permit and probably begin construction about a year from now. Or April of 73. If those things happen, we would expect to finish construction, hopefully in the fall of 1975. But those are all assumptions. We've had assumptions that appear to be just as good last year, year before that, year before that. I emphasize that.

Mr. Merdes: One final question. Is there any possibility of say constructing a road with a bridge across the Yukon onto your agreement with the State Highway Department or is everything contingent upon a permit?

Mr. Patton: Well, I think everything is contingent upon the permit. If it's not, I can't see any of the owner companies laying any more of their money on the table until they have the permits. I wouldn't do it with my money.

Mr. McVeigh: Thank you.

Mr. Barber: Mr. Patton, I understand that on the North Slope there will be permitted no gas boring like there has been done in Cook Inlet. Are your time frames for your six hundred thousand barrels throughput, your one million two hundred thousand barrel throughput and the possible two million barrel throughput daily coupled with the construction of the Canadian gas line in any way?

Mr. Patton: Well, they, ~~we~~ they have a degree of freedom that gives us the maximum and that is the reinjections of the gas and that is what's planned in the early days. There's not any flaring plant.

Mr. Barber: At what point does it become engineering unfeasible to pump the gas back into the ground?

Mr. Patton: Well, I think...

Mr. Barber: In the realm of millions

Mr. Patton: I don't, I don't really know. It's the producer's job. I don't think you're talking about being engineeringly infeasible; you're talking about the economics of the thing, and I'm not priveleged of those numbers.

Mr. Barber: In other words your engineering time frames are in no way coupled with the construction of the Canadian gas line.

Mr. Patton: That is correct.

Mr. McVeigh: Any further questions? Mr. Cullate. Excuse me.

Mr. Patton: I have some points that were raised yesterday and today that I thought you were going to ask about and one of them a while ago was escalations. Do you want me to address those points?

Mr. McVeigh: If you care to, yes. We'll be with you when you're through.

Mr. Patton: Well, the escalation, now you can assume the labor and materials are going to escalate at the rate that the oil well as it off phase two, which is five and one half percert. You talk five percent of three billion dollars is one hundred fifty million dollars a year. Now historically, the so-called technical stipulations put on by Interior if escalated at three, four, five hundred million dollars a year, we would expect them to taper off as they run out of ideas on how to tighten up the security, but if you had to guess right now what the escalation would be in another year's delay, affording people another year of time to think about this, I would, I would guess that we're talking about three hundred million again. One hundred fifty of that would be in labor and materials and the other half would be in what might

likely happen as more engineers and scientists work at this project. Now, this doesn't address the cost of mine. The cost of the money is not Alyeska's problem, it's the problem of the owner. Mr. Holm, I believe it was Mr. Holm this morning, who raised the question of what is the point of no return. There are at least seven different points of no return. The point of no return was reached by the Holm Oil Company eighteen months ago. It will be reached in my opinion in separate steps by individual oil companies, depending upon their, what they think they have in the way of oil up there and what their financial resources are and what alternate investment opportunities they have to make. And because there are at least seven different numbers and they are all private numbers within the confines of one company, I mean one company, just one of the seven, to each of the seven, you can bet that none of the seven are going to tell any of the other seven what that drop-out place is. So you can't quantify that number. There certainly is one, but, or seven of them.

Mr. McVeigh: Is there anything else you want to know? Mr. Collate.

Mr. Collete: Mr. Patton, I'm alittle confused and I quite don't remember, could you possibly comment on what the contract hearing on Alyeska Pipeline Service Company is. Is it a construction contract?

Mr. Patton: Right now it's a construction contract, but there is being worked an operating contract. The intention of the owners is to have us design, construct, operate it, maintain the pipeline, as Mr. Spahr said in his opening remarks.

Mr. McVeigh: Any further questions.

Mr. Rader: Mr. Chairman.

Mr. McVeigh: Yes, Senator Rader.

Mr. Rader: Is that construction contract a fixed fee contract or a contingent fee contract or a cost plus contract or what type of contract is it?

Mr. Patton: It's a cost plus contract. Well, it's not even cost plus because we're not earning a profit, it's just straight cost. We are reimbursed with every cost to build a line.

Mr. McVeigh: Any further questions?

Mr. Rader: Would it be feasible for the State to enter into a cost plus contract with you and audit the costs as you go along?

Mr. Patton: Well, you're talking about if the State had the financial resources.

Mr. Croft: Yes, of course -- financial resources.

Mr. Patton: If the State had the financial resources and the owner companies agreed, they wanted to make Alyeska available for that, the answer is yes.

Mr. Croft: I've just been handed a copy of your remarks. I don't care to ask you about the remarks, but there's an appendix which you didn't mention in your oral testimony and it lists large pipeline right of way lease rates on State-owned lands for various states. Under the remarks section there is reference for example, in Arizona to a ten year period that a perpetual lease may be negotiated. As to Texas, general and university land remarks indicate a ten year period. There's no indication of any renewal or right

of renewal. And under the Bureau of Land Management there is no indi, there is nothing under remarks to indicate the duration. Could you explain whether the absence of remarks indicates that the period of duration is is indefinite?

Mr. Patton: Well, the parenthetical under the heading says it that all rates shown are for single payments with a life of the project unless otherwise indicated. The BLM is for the use of the life of the project. The State of Arizona regulations indicate in the regulations that the first period of the lease is only ten years, but that during the initial period, you may negotiate a perpetual lease. In the case of the Texas ten year period, there is a long, long history of never having failed to renew a lease automatically. Furthermore, there is not a great deal of State land involved in Texas, so you have the alternative of end-running the State's land. And furthermore, you are talking about relatively miner investments in those areas. You are not talking about a three billion dollar investment. I think the big difference is that you are putting up regulations, which is to reason. Posed the threads that I have mentioned and you don't yet have any corp interpretations or long history of how you are going to, are going to enforce those regulations. This is the big difference. We're talking about the State of Texas that has a fifty year history of pipelining, and is essentially a audiner.

Mr. McVeigh: Any futher questions, Mr. Patton, oh, Mr. Culetta.

Mr. Culetta: Mr. Chairman, Mr. Patton, based on the assumption, not really the assumption, the fact that you're a construction contractor and in essence e

than other

an operater, doesn't this migate the undivided interest, will, will Alyeska be responsible to ICC for the tarrif regulation or do we have seven undivided interest holders. It has been stated that there will be seven tarrif.

Mr. Patton: I have nothing to do with the tarrif or the regulations. We would simply operate the pipeline as the owner's agent.

Mr. Culetta: As the owner

Mr. Patton: The owners plural

Mr. Culetta: agent

Mr. Patton: As the owners' operating agent. We would have nothing to do with collecting the money.

Mr. Culetta: So, would I be correct then in assuming that in the event of a tarrif discrepancy, which of the company's would we file against?

Mr. Patton: Well, you're just, I'm not an expert on this. Not my area.

Mr. McVeigh: Any futher questions. Thank you, Mr. Patton.
items requested that statements be passed out in advance as to the oral testimony of your witness.

: We're, the next witness, the next witness

: We're going to get the statements now

: We're going to go through until 11:30. There will be, I understand, a (which is planned) roll call in the House at 11:00 o'clock, but there will be no counts. Members wishing to make roll call, I will have a brief pause at ten minutes to eleven so that they can leave.

: Thank you.

: Is the mike on now?

Mr. Donaldson: The next witness and the last witness to testify on the subject of regulation and right of way is Joseph Cortese, general partner in the law firm of Squire, Sanders & Dempsey in Cleveland, Ohio. Joe is specializing in the area of law concerning the powers of state and local governments, in ~~fact belongs~~ tax exempt bonds to Mansing. Later this afternoon he will again return to the witness chair to discuss with you some of the legal aspects of the state ownership. If we can defer any questions on that subject in his later testimony, we would appreciate it much. Mr. Cortese.

Mr. Cortese. Thank you. Chairman. Ladies and gentlemen of the House State Affairs and Senate Congress committees. Ladies and gentlemen of the Legislature. It is certainly my pleasure to be with you. It's taken a bit of time to get to the table, but I've been fascinated by the presentation to the committee and the questions you have, particularly alert questions of this committee. It is also my first time in Alaska, and I hope to have occasion to return, but other occasion than this. My function is to testify to the legal aspects of the right of way leasing bills, Senate Bills 294 and 313. I think it is a rather unhappy function on my part because necessarily I must give you my candid views of those bills which resolves in my advising you of my opinion that the legal undercunning of those bills are indeed faulty. I certainly don't mean to be disrespectful, but it's difficult to convey those views clearly without being direct and confine them to the point. I want

to emphasize that in expressing these legal views, I do not in any way or in any degree whatever question the sincerity and the honest effort that have gone into the drafting of these bills. I necessarily must disagree with the legal judgments. Regarding these right of way bills, Senate Bills 294 and 313, my comments will be applicable to both bills because they go to the very legal essence of the bills rather than to necessarily detailed aspects. We have heard on Tuesday as I recall from the Attorney General's office, that use a paramount, parallel metifore by the Attorney General, that the two bills are sort of engaged to be married sometime next week. That's provided, apparently, that the dowry can be negotiated. It would be premature, obviously, to try to comment on the issue of that marriage. It may be possible that the marriage won't be consummated. However, here again, asuming that any substitute bill or amended bill would be built on the essence of the two right of way leasing bills before our-your committees, I believe that the comments that I will make, you will find they're relevant also to any such amended or substitute bill. What I must say to you in the first instance is that the basic premise of these two bills is that the State in its capacity as a landowner having control over land necessary for the pipeline, can impose terms and conditions on the pipeline proprietors that it concededly could not impose in its governmental capacity. Examples, it is acknowledged that the State in its exercise of its police power, its direct regulatory capacity, could not impose regulations upon rates, upon certificates of convenience, for certificates to instruct, or on the method of rendering service of the pipeline, but it has been contended, too, this

committee and other committees of the legislature and the joint impact committee, that this regulatory function which could not be performed directly in the exercise of your police power can somehow be garnered by the exercise of your position of landowner and contractor of the use of that land. I must say to you that this basic premise is wrong. It directly conflicts with the decisions of the United States Supreme Court. For example, in the case of Frost against the Railroad Commission of California, decided in 1926. The United States Supreme Court held that a California statute, which sought concessions from a motor carrier as to methods of operating its business as a condition of the use of state highways, was in violation of the United States Constitution because such condition would constitute a taking of the carrier's property without due process. Let me quote briefly from that case as an illustrative principal. The Court said: If the state may compel the surrender of one constitutional right as a condition of its favor, it may, in like manner, compel a surrender of all. It is inconceivable that guaranties embedded in the Constitution of the United States may thus be manipulated out of existence. Likewise, the attempt of a state to regulate how an interstate telegraph company may select its customers or special services is void where even where/posed as a condition of the use of its streets, for the state may not use its constitutional powers to achieve the unconstitutional result of interfering with interstate commerce. This is the principal of the Western Union Telegraph case decided by the United States Supreme Court in 1918. Quoting from that case: It is suggested that the State gets the power that is to regulate the manner of business of this telegraph company from its power over the streets which is necessary for the telegraph to cross. But if we assume that the plaintiffs

in error under their present charters could be excluded from the streets, the consequence would not follow. Acts generally lawful may become unlawful when done to accomplish an unlawful end, and a constitutional power cannot be used by way of a condition to attain an unconstitutional result. As the following will further show, a state may not use its control of land to prohibit, attempt to regulate, interfere with, or unduly burden interstate commerce, nor to exact waivers of constitutional rights. If the use of state lands is necessary for interstate transportation, the state cannot withhold the right of way, it cannot exact more than reasonable compensation for such right of way, and it cannot invade the field of federal regulation or unduly burden interstate commerce as a condition of making available the use of its land. I must interject at this point. These conclusions I am expressing here are not so in my conclusions. Two of my partners and two of my associates

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

Mr. Cortese: This problem, also the LEGAL group of officers of the respective companies, pipeline companies and --- ----- has the problem, we are agreed on the conclusions that I expressed. The State of Alaska may not withhold the necessary right-of-way, or it may not withhold the means of transporting the oil and gas in interstate commerce. The State of Alaska through its oil and gas leases has granted to the lessees the right to develop, produce, process and market oil and gas. This is what is granted in the lease. The oil and gas can only be marketed feasibly by means which utilize state-owned lands. Under these circumstances, the State may not withhold its lands from the lessee. This principal follows from the commerce clause of the United States Constitution, as you heard in some detail by previous references the commerce clause from the Constitution, Article 1, Section 8, Clause 3 reverses exclusively to the Congress of the United States the power to regulate interstate commerce. No State may enter into the field of regulating interstate commerce.

In Oklahoma v. Kansas Natural Gas Company, decided by the United States Supreme Court in 1911 the State of Oklahoma had adopted the statutes designed to prohibit the interstate shipment of natural gas from within the State of Oklahoma to outside of the State of Oklahoma. The technique used to so prohibit such shipment was to take cognizance of the face that natural gas could ~~not~~ be shipped out of Oklahoma feasibly only by a pipeline. Certainly it could be put into tanks somehow and conveyed somehow certainly some alternative was physicially possible, but practically and economically, no it was not, this gas had to be transported out of Oklahoma by pipeline or it would not be transported at all. Taking cognizance of that, the State of Oklahoma said "No Interstate Gas Pipeline may cross a state highway. It sought thereby to use its control of that land,

those state highways, to preclude interstate shipment of natural gases.

The Attorney General, Mr. West, for the State of Oklahoma argued that the Kansas Natural Gas Company was misguided in its legal premise that Oklahoma somehow had to give it the right to cross its highways. He argued that the gas company may have a right to engage in interstate commerce, but it does not have the right to the means of engaging in interstate commerce. So obviously if the gas company had the right of way it could engage in the interstate commerce of shipping gas out of Oklahoma, but the State of Oklahoma could withhold from it, he argued, the power to cross its highways. The Supreme Court rejected that argument, concluding that "if Oklahoma had that kind of power then Oklahoma had the power to stultify interstate commerce contrary to the United States Constitution."

If I may quickly read from the opinion of the court I think you could see the cogent analysis that necessarily follows from what the State of Oklahoma sought to do. At this late date it is not necessary to ~~save~~ state cases ~~faces~~ to show that the right to engage in interstate commerce is not the gift of a state and that it cannot be regulated or restrained by a state, or that a state cannot exclude from its limits a corporation engaged in such commerce. To attain these unauthorized ends is the purpose of the Oklahoma Statute, the state through the statute seeks in every way to accomplish these ends and all the powers of the state is conceived to possess ARE ENGAGED ----------in all the limitations upon such powers are attempted to be circumvented . The use of the highways is forbidden to them, interstate pipeline companies,and the right of emminent domain are withheld from them, and the prohibitive strength which these provisions are supposed to carry is exhibited in the fact that the boundary of the State is a highway. If it cannot be passed without the consent of the state commerce to and from the State is impossible. The situation is not estimated by appellant (Oklahoma Attorney

General), and he says: 'If the appellees had the right of way they might engage in interstate commerce, but their desire to engage in interstate commerce is a different thing from the means open to them to procure a right of way.' And it is further said, that, (by the Attorney General) the confusion of the right to engage in interstate commerce with the power to forcibly secure a right of way is the basis of appellees' case.' There is here and there a suggestion by the Attorney General for the State of Oklahoma that the State not having granted such right the alternative is a grant of it by the Congress, which, of course, had not been done in the State. But this overlooks (cut) the affirmative force of the interstate commerce clause, the affirmative force of the interstate commerce clause of the Constitution. The inaction of Congress is a declaration of freedom from state interference with the transportation of articles of legitimate interstate commerce, and this has been the answer of the courts to contentions like those made in the case at bar.

The court continued, ' No State can by action or inaction prevent, unreasonably burden, discriminate against or directly regulate interstate commerce or the right to carry it on. And in all of these inhibited particulars the statute of Oklahoma offends."

Thus, it was held that the interstate pipeline could cross state highways notwithstanding the prohibition of the Oklahoma statute.

The same Oklahoma statute was also considered in the same year in a case decided just a month before the Supreme Court decision, by a seperate case Haskell v. Cowham, decided by the 8th Circuit in 1911. There, the court stated in under similar circumstances /.

"No state may by means of its police power, or its proprietary power, take

note, or its proprietary power, over highways or by means of any of its ~~other~~ powers, erect and maintain impassable barriers against interstate commerce along its borders or through its body in the face of the grant to the nation of the power to regulate interstate commerce; for all the powers of the state are subordinate to this power of the nation and to its will that such commerce shall be free."

Not only would the withholding by the State of a right of way to the lessees constitute an undue burden on interstate commerce, and I might interject here "I am not suggesting that the State is purposing to withhold the right of way I am ascerting the legal principle of the basis for other reasoning that will follow." Not only would the withholding by the State of a right of way to the lessees constitute an undue burden on interstate commerce, but it would also constitute a deprivation of the lessees' property without due process of law.

A succinct statement of this principle is found in that same Haskell case cited above: "But an owner who by virtue of his ownership of land or of mining leases thereof has the vested right to draw by means of wells and pumps natural gas from under the surface is the owner of valuable property which the state cannot take from him without just compensation and the state laws and acts of its officers which prevent him from taking it from the land and selling it and conveying it out of the state in interstate commerce, while they permit withdrawal of gas by others in intrastate commerce, necessarily violate the national Constitution (1) because they take his property without just compensation and (2) because they substantially discriminate against and directly regulate interstate commerce."

The right of the lessess of the North Slope oil and gas to transport it in interstate commerce without obstacles or burdensome conditions imposed by the State is expressly apparent in view of the fact that the State invited them to

bid competitively for and purchase of oil and gas rights from the State, including, as stated in the leases, the right to "market" such oil and gas.

The point to be emphasized in our consideration of House Bills 294 and 313 is that their factual premise is inconsistent with their legal premise. Factually, they assume that the only practical way of getting the oil out of Alaska is by a pipeline and that pipeline must run across State controlled lands. If that were not the fact there would be no point to the bills, with effect to this pipeline, for the price and conditons they exact would be avoided by the use of other lands. Thus, the premise is that the pipeline owners must contract with the State for right of ways. On the other hand, the legal premise is that the State, through its proprietary capacity, can achieve by right of way contracts what it could not achieve in its governmental capacity because, it is claimed, the contracts will be entered into by voluntary bargaining. It has been claimed that a state as proprietor can legally obtain unusual contract terms because others may contract with it on its terms or may forego contracts with the state. The ~~That~~ legal theory is plainly irrelevant where interstate commerce would be thwarted and property right lost if the private parties declined the state's terms. I want to emphasis that distinction and that conflict in the factual premise and legal premise of both these bills because as I said the factual premis is that one must have the right of way from the State in order to get this oil out of the state, and the legal premise is that the state can exact any contract terms it desires in making contracts in disposing of rights to use its land, because anyone who voluntarily enters into such contracts with the state or declines to enter into such contract with the state, that obviously is not the fact situation.

I would like to interject here, since I am sure I will get the question, whether this is manifest from the presentations that have been made to the legislature

in connection with the drafting of these bills. I do make reference, I had not intended originally to do so, but, it's apparent from the questioning that has gone on previously that substantial reliance is being based upon the 80 page memorandum of Prof. Witherspoon. I would like to briefly quote from that memorandum at page 30 on this legal premise that I referred to, on page 30 of those of you who have it before you may examine the portion that I will quote, this is the major heading on the CONSTITUTIONAL BASIS OF THE STATES POWER TO ENACT THIS LEGISTATION the sub-heading "The states power to dispose of its property and to contract" and under that the essential legal premise as stated as follows," Since the other party to this disposition or contract does not have to enter into these transactions and is perfectly free to do as it chooses it has no justifible basis to complain concerning the conditions or obligations placed upon it as part of the considerations for the state entering into the transaction, as a legal premise an expression of utter freedom. On the other hand at page 60 of the memorandum we get down to the factual premise involved, and under the heading of "The essential feature of the proposed litigation" Leverage. which is followed with four points of leverage. The quotation ~~which~~ That I direct your attention to is "by choosing to exercise it's, the states, property control and disposition power and contract power the state has chosen a method which gives it initial leverage relative to the oil and gas industries. These industries and their pipeline elements must be able to lay their pipeline over state land in order to move the crude oil and natural gas they produce in Alaska to markets outside the state. They must be able to lay their pipelines over state lands."

Instances of the Federal Government asserting conditions and requirements in ~~its~~ the exercise of its contract functions are beside the point, those are infact instances where private parties may fore go contracts with the Federal government

without ~~the~~ loss of property rights, and it can hardly be claimed that the Federal Government is unconstitutionally restraining or burdening interstate commerce since the Constitution places the power over such commerce in the Federal Government . Reference has been made to the Federal governments requirements for EEO, Equal Employment Opportunities conditions in its contracts. I have personal experience with that, in that a leading case on the subject was one that I participated in Entitled Wayner v. Cauhega County Community College. This involved a Cleveland plan a forerunner of the Philadelphia Plan. That contract and requirement was contested by a contractor who lost the bid because he would not comply with it. We defended that contract requirement of the Federal Government.

We defended it through four levels of court including the U.S. Supreme Court in a period of two and a half years . We were successful in defending it, but in defending it we had to establish that the Federal Government was not thereby forcing a discrimination against the presumed white majority. That the equal protection clause of the U.S. Constitution was not being violated by the this Federal contract requirement, I ~~say~~ site this as an example of nevertheless having to test contract requirements against Constitutional inhibitions.

The very facts ~~of~~ premise of House Bills 294 and 313 that the pipeline owners must get the right of way from the State makes it apparent under the U.S. Supreme Court Cases that such right of way cannot be withheld and cannot be used by the State to achieve results which are otherwise prohibitive .

THE STATE OF ALASKA MAY CHARGE A RENTAL FOR THE USE OF ITS LAND, QUITE OBVIOUSLY, BUT SUCH RENTAL MUST BE REASONABLE AND CONSTITUTE NO MORE THAN JUST COMPENSATION TO THE STATE.

The State may properly charge rental for the right of way, even ~~when~~ where there

is no other practical way to conduct the interstate commerce but by use of the state land, but the Constitution requires that such rents be reasonable and not discriminatory and bear a true relation to the actual value of the land. The leading case on this point is St. Louis v. Western Union Telegraph Company, 148 U.S. 93 (1893),. In that case, the City of St. Louis imposed an annual rental of $5.00 per pole, within the city, upon the telegraph company The telegraph company opposed in court that charge claiming (1) that the city could not impose any charge because of its engagement in interstate commerce and (2) that any such charge of $5.00 was excessive. The court held that a rental charge could be imposed, but that it must be reasonable in relation to the value of the land, in expressing its conclusions after careful analysis, the Court said that:

"Indeed, it may be observed, in the line of the thoughts heretofore expressed, that this charge is one in the nature of rental; that the occupation by this interstate commerce company of the streets cannot be denied by the city; that all that it can insist upon, in this respect, reasonable compensation for the space in the streets thus exclusively appropriated; and it follows in the nature of things that it does not lie exclusively in its power to determine what is a reasonable rental. The inquiry must be open in the courts, and it is an inquiry which must depend largely upon matters not apparent upon the face of the ordinance, but existing only in the actual state of affairs in the city."

The Court did not have sufficient information or evidence before it to determine whether the rental was reasonable, But, in remanding the case, it gave clear guidance that the rental had to bear a proper relationship to the value of the land occupied. To the value of the land occupied.

The Court said "The court cannot assume that such a charge is excessive,

and so excessive as to make the ordinance unreasonable and void; for, as applied in certain cases, a like charge for so much appropriation of the streets may be reasonable. If within a few blocks of Wall Street, New York, the telegraph company should place on the public streets 1500 of its large telegraph poles, it would seem as though no court could declare that five dollars a pole was an excessive annual rental for the ground so exclusively occupied;" bear in mind this was 1911, "while, on the other hand, a charge for a like number of poles in a small village, where space is abundant and land of little value, where space is abundant and land of little value, would be manifestly unreasonable, and might be so excessive as to be void."

The discenting opinion would have taken judicial notice of the fact that a $5.00 per pole charge in the city of St. Louis was not unreasonable because it said it was known to the discenting judges anyway there were many areas of St. Louis where the occupation of space by a pole was not worth $5.00 a year. But, what is important to note in this case is that the court speaks in terms of reasonable compensation in relationship to the value of the land, the raw value of the land occupied.

Thus, the rental must bear a proper relationship to the value of the land occupied.

Land value is most frequently determined in eminent domain cases where just compensation is based upon the value of the land taken. It is held that land value is determined by what the owner gives up, not by what the taker gains. In United States V. Miller, decided by the Supreme Court in 1943, the party whose land was being condemned argued that the land should be valued in

relation to the specific purpose for which it was to be used, a railroad right of way. The United States Supreme Court rejected this contention, ~~and~~ stating as follows:

"Since the owner is to receive no more than indemnity for his loss, his award cannot be enhanced by any gaining to the taker. Thus, although the market value of the property is to be fixed with due consideration of all its available uses, its special value to the condemnor, its special value to the condemnor, as distinguished from others who may or may not possess the power to condemn, must be excluded as an element of market value."

The point here is that the value of this land to be determined for purposes of reasonable rental, which is the limit of what can be charged without inhibiting or burdening interstate commerce is the value of the land to any normal person or any general user who might want to use it, and not the special, peculiar value of this particular user. I should further emphasis that in all the discussion about having the rent gauged to the profitability of the land, it is not profitability of the land that has been really talked about, what they are talking about under these bills is profitability of the pipeline. Under ~~these~~ A conditions ~~I would~~ WHERE IT IS assumed private capital will build that pipeline. The defect of the real formula of Senate bills294 and 313 is that they bear no relationship to the value of the particular land involved. And are not ~~limiting~~ limiting to the land itself, but seek to use some measure of gross revenues for the profitability of the pipeline built with private capital. This clearly goes beyond what the Supreme Court has said could be reasonably charged and would constitute a prohibitive burden on interstate commerce. Furthermore, since these unusual charges are wholly out of keeping with general practice in other states, as Mr. Patton has indicated, and in the state of Alaska as well and are largely addressed to this pipeline project they might

also be viewed as violations of the prohibitions against the discriminations against interstate commerce and as constituting discriminatory taxes upon interstate commerce. Or simply discriminatory practices to the extent that they are considerably in excess of any thing that might be gauged as reasonable relationship to the value of the land, they should be viewed as taxes, and yet there are taxes imposed on those who must pay --------.

Other provisions of the bill are unconstitutional. (a) Court Juridisction The Bill provides the lessee shall agree to the jurisdiction of the state courts with regard to the intrepretation of the lease for the resolutions concerning disputes concerning the lease. We are uncertain as to the intention of this provision. If it is merely to obtain service of process on the pipeline companies, the lessee, I suggest it is entirely unnecessary, since the pipeline company is already in this state subject to service of process and has a statutory agent. If it is intended merely to say that the law of Alaska shall govern the interpretation there is no objection to that. I submit that would be the natural thing since the lease would be entered here, but if that is the purpose more appropriate words could be used to say so, however if this provision is intended to require the lessee to seek relief only in State Courts and to prohibit it from invo king in appropriate circumstances the aid of Federal Courts including the removal of cases to Federal Courts where appropriate it is clearly unconstitutional as stated by the U.S. Supreme Court in Pearl V. Burke Construction Co. decided in 22. "The principle established by the more recent decision of this court, is that a State may not in imposing conditions upon the priviledge upon foreign corporations doing business in a state exact from it a waiver of the exercise of its constitutional right to resort to the Federal Court or thereafter withdraw the priviledge of doing business because of its exercise

of such right, whether waived in advance or not. Such requirements for waiver or use of the Federal Court ~~is~~ if imposed by the police power would be unconstitutional even a voluntary agreement having this effect would be void. Roberts case cited here, District Court, North Carolina.

We also note, and then I will summarize the rest of this, that the penalty provision of these particular Senate Bill 313 is in our view unconstitutional as saying no standard and of being contrary to the due process requirements of the Federal Constitution in that it would require the lessee to agree in advance to any penalty that the Commissioner might choose to access.

C. Is an important regulatory Jurisdiction, both of these bills which seek to require the condition of the lease, that the lesee consent to regulatory jurisdiction of some regulatory body of the State of Alaska. I would point out that as has already been testified by previous witnesses that quite obviously the regulatory area pretaining to interstate commerce is preempted by the Federal Government, whether excersized or not, and that an attempt by the State, by indirect, such as in the Western Union Case, that ~~was~~ A cited earlier Where the State of Massachusetts sought to acquire the telegraph company to render stock quotation service to whomever the State of Massachusetts said. That determination was to be made by the telegraph company was considered to be ~~Violative~~ violative to the Federal Constitution and paramount of interstate commerce even though the state sought to exercise sought to impose that . . . . .

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

Cortese (continued): . . . .b re submitting then to the ICC. Any forced agreement that comes to terms with the state on rates has implicit within it a veto power of the state over rates and would clearly be an invasion of the area preempted by the Federal government. State cases where municipal corporations have a function in rate making as part of their franchising power are not applicable for there the state law permits that function. The federal law does not permit any such primary function in the states with regard to rate making for oil and gas pipelines engaged in interstate commerce. The federal law provides only for the proper state participation as a party in the proceedings of the federal regulatory agencies but not as a prior regulator. Cases previously cited to the impact committee on this point, the Armour Packing Company Case, the Chicago Great Western Railway Case, are in applicable. There is no attempt by any state there to assert regulatory rate making functions. Surely there were rate contracts involved, contracts by shippers with the railroads, surely the court held in one case that the contract was invalid because it interfered with the regulatory power in that tariffs were raised after the contract was made and the contract rate could not stand because all rates had to be the same, could not be discriminatory, therefore, if the contract rate was forced up to the tariff rate. This works both ways and I want to, or ought to, emphasize to the court this Armour Case, excuse me, to the committee, that this Armour Case makes it clear that you can not have a long term contract on rates that is sustainable. Either minimum rates for the purpose of protecting bond holders of state bonds, and I don't mean to get into a detailed discussion of that at this point, nor maximum rates for purposes of protecting whomever the state thinks ought to be protected, because the regulatory process of the ICC will control that and not the contract. I point out in the memorandum which has been given to members of the committee that the forfeiture provisions of 313 are, in our judgement, unconstitutional, that the option, the purchase provision, of course, is forced upon the companies in order to obtain a lease of

for the right of way across state land would be an unconstitutional burden on interstate commerce. It would be a deprevation of their rights, in a sense, that it have just compensation determined in an orderly judicial process. I also point out in the memorandum that the savings clause referred to earlier of 313 to the effect that it does not operate in any area that would be preempted by the federal law and would not operate, that the bill would not operate to the extent that the transportation can not be constitutionally regulated by the state. Either leaves very little or nothing of value in the bill, but in any event, that the bill is so permeated with such provisions that it would probably be declared unconstitutional in its entirety. The problem is that the basic premise of the bill, that the state can exact any conditions it desires by virtue of its land owner position is constitutionally unsound. In conclusion, we have not attempted to deal with every provision of SB's 294 and 313, and we do not mean to imply that provisions not discussed would be valid. Rather, we have shown that the basic legal premise of these bills is wrong and would produce unconstitutional results in vital respect. We do not doubt the authority of the state to provide for the leasing of rights of way over the public demands for this pipeline project and others, to obtain reasonable rental therefore, and to provide for reasonable conditions and terms relating to the protection of the states land, and properties to the extent not inconsistent with, or preempted by federal authority, however, the state knows that SB's 294 and 313 are not proper vehicles for such purpose for they are permeated with unconstitutional provisions developed from an unsound legal premise. I should add that obviously we have found no case precisely involving the same facts. To our knowledge, this sort of legislation has never been attempted before but we have sought to bring to the attention of the committee our judicial authority which are as close in point as we were able to find. We think that they establish legal principals which are applicable and from which would probably be concluded that the basic premise of these bills is constitutional unsound.

We do not have a --- blac case but we thank the authorities present.

McVay: Let me interupt for just a moment. The House is adjourned until 1:00 so members here don't have to worry about the 11:00 session. Number two, we are to vacate at 11:30 and it is 11:12 now, again point of the rule, that I don't want to stifle any questions. It would be nice if we could get through with this witness by 11:30, attempt questions now Mr. Rose.

Rose: Mr. Cortese, did I hear you state ~~then~~ that the owners must be able to lay this pipeline across the state lands, thats, of course, for the purpose of getting it out the state to market, is that right?

Cortese: Yes sir.

Rose: I notice that you did not address yourself to the question of public ownership, in other words, of the state becoming an owner in respect to carrying which could provide the carriers and then the owners would be able to carry the products across the state. Would you care to comment up on that? sir

Cortese: Yes sir. That is a subject area that we had planned to get into this afternoon. That is, the area of state ownership, the testimony as it has already been previewed will indicate that our best judgement is that there is no practicable possibility for the state to finance and construct this pipeline, so that it is not ~~appliable~~ viable alternative. secondly. I should point out to you that in my judgement the state does not have the power to preempt or monopolize this field of activity. It is true, for example, the state may monopolize the liquor business. This is because the federal constitution, the 21st Amendment, expressly gives the power for full control over the liquor business, and in cases dealing, challenging the state and its control over the liquor business as interfering with interstate commerce the courts have indicated that (what for) the 21st Amendment the state could not so interfere with interstate commerce but by reason of the 21st amendment it may ~~with~~ in respect ~~to the~~ with liquor ~~business~~.

Rose: ^Even It is investigated that president state ownership/assuming their financial capability.

Cortese: Are there legal impedements?

Rose: Are you suggesting that there is a legal impedement in that assuming financial capability if the state ~~can~~ should do it.

Cortese: Yes, I ~~would~~ will get to that ~~effect.~~ this afternoon. If time permits

McVay: Mr. Harris.

Harris: Mr. Cortese, if the state enacted legislation, or adopted regulations seeking to secure jobs for Alaskans on this project, and this was challenged in court as unconstitutional, what, in your opinion, would be the court's decision?

Cortese: I have not examined that question and I could not give you a conclusion that would be meaningful to the committee. I suspect, however, that the question Harris had would be, in some part, does the requirement have any particular burden or accessive burden on interstate commerce. As Mr. Patton has already testified, there is no question that this would be an intention of the oil companies to maximize utilization of native ~~help~~ talent and Alaskan talent. I couldn't give you a legal conclusion on that, sir.

McVay: Mr. Barber.

Barber: Mr. Cortese, in connection with legal premises quoted by you with respect to the unconstitutionality of these two bills under question, would your premises likewise hold to a pipeline across the State of Alaska which would meet a Canadian gas line going to the continental United States?

Cortese: I hadn't thought about it previously but I can't think why not sir.

Barber: In other words, you would hold the Canadian line to be interstate commerce even if the item under discussion, the TAPS itself, is within Alaska 100%?

Cortese: Oh yes, there has been ample testimony, I think on that by Mr. Jones in particular that the flow of the product, whether its oil or gas you're speaking of course about a huge stream of oil from the north through Valdez to the lower forty eight, and that quite obviously being interstate commerce and I gather from reading Professor Witherspoon's memorandum, that at least in three places he similarly concludes that this would be interstate commerce.

Barber: In other words, you hold the Canadian line to be of the same type or synonomous with tanker operations from the port of Valdez to the lower forty eight?

Cortese: I would think so, continuous flow of commerce, regardless of the particular technique or vehicle employed.

Barber: Even when it goes over a foreign country?

Cortese: Oh yes.

McVay: It is interstate and foreign commerce.

Cortese: Thats true, the commerce clause relates to commerce among the states and with foreign countries.

McVay: Mr. Groth . . Mr. Holm.

Groth: One of the primeses of the SB 294 and 313 are that to the this leverage position and Witherspoon memorandum. You can also gain jurisdiction over the federal lands by voluntary contract. Do you concur with that?

Cortese: Even jurisdiction over the .....

Groth: The point is that portion of the pipeline, according to Mr. Witherspoon, that is on federal land. It could be, in part, regulated by the state on the basis of ~~the~~ getting voluntary agreements with the oil companies for the right to go over the state land.

Cortese: Well, I see your point. No, I do not agee with that at all. This particular feature we are talking about, fifty miles of state owned land with another ninety miles under selection that has been attentively excepted and another fifty, I believe, that has been selected and frozen there has been no action on it. Fifty, fifty, fifty

Groth: Lets assume its even two hundrend.

Cortese: Assuming that its two hundred. That The fact that the bill seeks to exert jurisdiction over eight hundred miles under a two hundred mile lease manifests its attempt at regulation rather than having anything to do with the leasing as such of state land, the utilization as such of state land, and quite clearly in my mind, displays that the bill's attempt, as is manifested by all that has been said about it, is an attempt XO boot strap the state into regulation of an interstate carrier which the U.S. Supreme Court has said repeatedly simply cannot be done.

Groth: Just one other question Mr. Chairman. Some four or five places in the 82 page memorandum, page 66, 71, 75, 76 and various other places, it is not necessary that you look in it. The concept is expressed that there is a possibility that the state now ought to go to the Department of Interior and say, Gentlemen please give us the permit so that the state would thereby gain jurisdiction over that other 600 miles for purposes of discussion. What is your view as to the likelihood ~~that~~ of the Interior, at this stage of the proceeding, consenting to such an arrangement?

Cortese: I don't think that I could express any opinion on ~~it~~ that. It has certainly been a long, long process. One would certainly hope that one does not have to start all over again. So far as likelihood on the judgements, practices of Interior on that score is concerned, I really couldn't comment in a way that would be useful to the committee.

Groth: Thank you.

McVay: Mr. Holm.

Holm: Yes, Mr. Cortese, you cited a quotation out of the lease where you said that, if I remember right, that the lessee had a right to market. Where is this quotation found, where can we get this? Is that the actual language, the right to market?

Cortese: Not right to market, I'll read it to you sir. This is the standard form of lease of the Department of Natural Resources of the State of Alaska, form #DL 1. This is the revised October 1963 version. There is also a revised April 1971 version. I think the language is the same in both. Reading from the first ~~line~~ one:

> "Born in consideration of a ~~bonus~~ cash bonus and the first year's rental, the receipt of which is hereby acknowledged, and the rentals for all discovenents and divisions herein contained on the part of the lessee to get paid, kept and performed, and subject to the conditions and reservations herein contained, lessor (that is the state) does hereby grant and lease upon the lessee (thats the oil companies)

exclusively without warranty for the sole and only purposes of (leases for the sole and only purposes of) exploration, development, production, processing and marketing of oil, gas, and associated substances produced therewith, and of installing pipeline and structures thereon to find, produce, save, store, treat, process, transport, take care of, and market all such substances and for drilling water wells and taking underground and surface water for use in its operation, for housing and boarding employees, its operation thereon, the following described tracts of land in Alaska."

Whereupon there are spaces

Holm: And you interpret that word marketing you extend that to a right to cross state lands?

Cortese: No I don't depend upon that. What I am indicating to you is that the lease itself contemplates, of course, the marketing of this oil when it is obvious that it can be marketed only by crossing the state lands, let me emphasize that the Oklahoma case had nothing to do with the state selling the natural gas because natural gas is bought privately and yet, that the owner of the natural gas, Kansas Natural Gas Company, had a right to cross state highways to get that gas out of state.

McVay: Gentlemen we have to adjourn. We will be back at 3:00.

BREAK

McVay: Ladies and gentlemen, the hearing will reconvene. Mr. Donaldson do you want to call the next witness. I think that I should say that the previous witness will return, speaking Mr. Holm of your question. He has another presentation.

Joe would you come up, Joe. I wonder if you would come up & finish the ? Mr Holm asked of you before the break would you rather wait?

Donaldson: The next witness we have to present is Mr. Raymond B. Gary, general partner in Morgan, Stanley and Company, and the Manager and Director of Morgan Stanley and Company, Inc. He has been with this investing banking firm since 1955. I might say just a further word of introduction. His investment banking firm has

dealt extensively in pipeline financing, and has raised some very very large sums of money for a variety of clients . We think he is uniquely qualified to testify on the subjects being considered by the joint committees and he will address his remarks to the finance issues on all the bills being heard here today, rather than piece meal his testimony, we thought this might save some time and . . .

Gary: Thank you. Mr. Chairman and members of the committee, we appreciate the opportunity to appear before you. Our firm shares with all of you the concern about this pipeline and any delays in its construction and/would very much would like to see come through in the interest of the state and the oil companies and in the country's national interest. There are elements of balanced payments on this oil and we are aware of that too/ . . . First a few words about Morgan Stanley. We are investment bankers in the business of underwriting and distributing securities of industrial corporations, transportation companies, finance companies, public utilities, pipelines, airlines, and governments. Since our firm was formed in 1935 we have managed or co-managed over sixty billion dollars worth of securities and that includes two billion of pipeline financings of some 56 issues for 18 pipeline companies. We've also managed the largest debt offering ever, public sale, of debt ever done - that was $1.6 billion of debentures with warrants attached for the American Telephone and Telegraph Company. We've also done the largest private financing ever done for construction projects - that was the Churchill Falls (Labrador) Corporation, its a hydroelectric project under construction now in Labrador. So you'd think that qualifies us to talk about these large sums of money. I'd like to say something about pipeline financing in general to start off with, if I may. There's two ways it's customarily been done. First is "project financing", where the pipeline assets are owned and operated in corporate form. The second is, as the case here, "undivided human interest systems".

The financing is the same, in a sense - it's a question of who's on center stage. When it's project financing the pipeline itself is on center stage and is spot-lighted by credit of the oil companies. Undivided joint interest financing, the oil companies are in center stage, but everybody recognizes the pipeline to be a part of their system. In terms of the first, project financing, the corporation is formed to construct the pipeline and operate it. The financing is secured by pledge of unconditional oil company credit in the form of completion and thru-put agreements. These represent unconditional applications of their credit. What they say is, "you'll either ship or pay" and in any event you'll pay over to the pipeline company the amount of money that will keep it in funds sufficient to meet all its obligations on their bills payable. They're effectively guaranteed. Customarily we finance 90 per cent of pipeline costs. The reason why we do that -- first, why do oil companies want to borrow 90 per cent? It's strictly a matter of consent for you to be all heard about, which dictates use of leverage because the return on equity capital is limited. The reason lendors are willing to loan 90 per cent is they have the oil company credit there and they are not taking any risk of failure on the pipeline--they're not taking a business risk, they're taking a credit risk, if you will, on the composite credit of the several shipper-owners, but they're not taking a business risk because no matter what ~~ever~~ happens they get paid, whether it breaks down or is interrupted or any event of "force majeure". There is no "force majeure" outs. I take it we all know what we mean by "force majeure" but those are events of God, they're major catastrophies--events out of the control of anybody. Nevertheless, I should also add that when you do a pipeline financing you still have to put your backstop by oil compnny credit--you still have to demonstrate to the lendors that the pipeline itself is an economic and viable operation. You prove to them first that there's enough crude in the area that the pipeline's serving to support its life. We submit an engineering report or an engineering study to show that it can satisfactorily operate and offer an

opinion of an engineer to the effect it can be built, within the cost and the time, and he looks at the other end, delivery end and where the market for the crude is and satisfy yourself that there is an adequate market for the crude when it comes out the other end. Then, in addition to all that, once the lendor is satisfied that its a viable and worthwhile investment, then he has the backstopping behind him. I might say a word here about the notion of "modified thru-put agreements". I don't know many, and in any case even for a modest sized pipeline financing that have been borne in the past, I don't believe there's ever been a case of a "modified thru-put agreement". It's not appropriate to the situation. Oil companies build pipelines to serve their own transportation needs, primarily and it's natural for a lendor to say, "Well, you're building for your own purposes- you backstop it with your own credit." It doesn't do a lendor very much good to have a mortgage on pipeline because if the oil company isn't using it, there's not much the lendor can do to get any value out of it. In fact, we don't put mortgages on pipelines very much anymore. Now, George mentioned pipeline financing, and in this case the oil companies themselves own, as you've heard at some length, undivided joint interest in the systems. They do this financing of pipelines owned in this fashion are done just as any other item in the corporate or corporations capital expenditures budget, it's done through their working capital earnings cash flow and issuance of securities which reflects their entire equity/debt mix, so that its gone through their total capital structure. The end result of the financing is that they've permitted themselves the risk of building a system and their return is a -- comes to them from the transportation income, if any, of the pipeline. This is just as real a use of credit as any other, it substitutes for other investments that an oil company might have made--other uses of its credit that it might have made and therefore we say they are entitles to get a profit. Now, let's turn to the financing of TAPS, for a moment, we're talking here about an amount of money for a project that is

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_____planned financing and the whole scheme for a period of 15 years. The project is the largest hydroelectric project in the world. It will be when it is completed - will have been - ten years in construction. The project's cost is estimated now at some $930 m-illion. The financing consisted of the combined offering both in the U. S. and Canada of the ~~qui~~ equivalent in U. S. dollars~~xxxThexeesxx~~ of $550 million in First Mortgage Bonds. In addition to that ~~wx~~ there was a bank loan of $150 million U. S. Equivalent. Jr. Financing of $100 million in the form ofgeneral mortgage bonds which are actually sub-ordinated to the first mortgage bond. And in addition there ~~would~~ will be some $150 million of retained earnings during construction period as a result of partial operation during the construction period. That financing of $550 million, the project is $900 and in order to do it we have to obtained from the largest lending institution in the Country, the largest amount of commitments they had ever made to a single man. At that stage. Since then there has been one larger, which I will come to if you are interested. Although I might say those commitments in that case were for ~~$25,000~~ $125,000 million private to Metropolitan Life and Prudential Life. The larg-est amount they had at that time in any single name would be private placement was many times larger than the nearest that had ever been done before, which was, I believe, the pipeline financing. This financing is 3 to 5 times as large depending on how you compute it, so we are already talking about straining the environment capital saving of the company here. We strained _____for Churchhill Falls. In this case its very fortunate that the oil companies happen to have chosen to do ~~it~~ an undivided joint interest form. Because it ~~is~~ possible for each of them to come to market in a discreet amounts for _____in different names and at different times through the construction period to meet their needs so that it will not be such a strain on the market as it might have been had it been done in project form and then it would come to the market for $3 billion, which is an amount which we feel may be in excess of the amount of money that can ~~may~~ be raised in a single offer. Despite the size, we think it could be done absent the~~xxxxx~~ legislation you are talking about this week. Which to our way of thinking raises some severe

impediments on the ability of oil companies to raise these amounts of monies. I think we might now turn to how this legislation affects financing and after that I'll finish up talking about the State's ability to finance this amount of money. _____ _____. I'm going to pick five areas, there are more. The basic general theme is that some of the elements in this legislation prevent threats or they put clouds over the ability of the oil companies to finance. And I might point out that to the extent you do that, or it is done, and the Interior Department has already done it/ in one respect it hurts both you and the oil companies, because anytime you put a cloud over a project, you make it less attractive for some lenders and when things get less attractive for lenders, they ask for increased interest rates. And pipelines' economics are sensitive to interest rates especially when you raise 90% of the costs. They are very sensitive./ So we're concerned about them, and we think you ought to be. The first is the limitation of the lease for five (5) years. This has been covered by a number of people before, but I'd just point out to you that customary pipeline financing, you're always able to save the lending. The pipeline has the undisputed right to use the leased right-of-way for the expected economic OR physical life of the system. And, in no event, for a period shorter than the indebtedness. Now, in this case, lenders would regard this five-year lease limitation as a major infirmity impairing the liability of the system. And, I think there is some doubt that they will lend longer than five years, in this case. Or, if they did, I think we've got to realize what might happen here. Your interest is in keeping this well head price up, but the quickest way I know of putting it down is to force the oil companies to depreciate this property in five years. You ought to be thinking in terms of a longer line, as long as possible, on this so that the term of the bonds can be stretched out which results in spreading the burden of financing over the longest possible period rather than the shortest possible period. If anybody's interested later, I might go over the affect of depreciation on these and on with the pipeline operations. We, for years, have been trying to stretch out maturities of pipeline bonds, the past thirty years which some people say is about as long as you

can go without affecting interest rates. In order to match it up with the ICC depreciation which has been getting longer and longer. . well, anyway, I guess that's enough on the lease. Loss of ownership is the next area and this is the most curious, I guess. If the prospect hanging over the oil companies that the ownership of this pipeline could be taken away from them at some time in the future almost nullifies any justification for making the investment in the first place. If an oil company's used its credit, it's foregone its use in other areas. The threat that the profit on it or control of it even would be taken away in something that would be a real cloud over this project and would make lenders shy, not shy, it would make them walk away from it. At this stage, I'd point out another area in which why this has got to be pinned down. These seven oil companies are all common carriers. Somebody tendered to them voluble to ship, they have to share their space, and, if you will, back out some of their own oil if they happen to be full, and the system goes. Proration . . .now, having built the system, if they've got to share this space with others, they're entitled to a return on that, and if lenders think that there is going to be some denial of return to the oil company, they're going to down grade its credit, and they're going to not lend. Regulation . . . I guess I don't need to cover too much. There's been alot of that this morning. I'd just point out again, this is another one of those areas where you could scare off lenders. If they think that the thing would be regulated in such a fashion that the oil companies cannot earn a profit, they are going to penalize the oil companies either in the form of a higher interest rate or/by simply not lending. They'll say, we'll lend something else. And they see opportunities all the time. So, I don't think that one needs to be covered too much anymore. Now, there's another kind of a little problem in here that is proposed by this threat of taking the pipeline away from the oil companies that has not been covered before. I might do that in alittle detail. The prospect, if you will, from the standpoint of the oil companies is that they find themselves in a position vis-a-vis with the State of Alaska, heads you win, tails I

lose. They borrow the money to finance the system, they build it, they pledge their credit, they take these enormous risks that are insurant in this situation, and then someday down the road it can get taken away from them. One of the things that they would be doing, normally do, is borrow as long a term as possible. And in the long-term bond market, and you borrow at long term, you do it from institutions who are covering long-term liabilities and investing at long terms, and they exact a penalty or redemption of penalties / if you have to pay off your bond early, say out of the proceeds paid to the oil companies by the State of Alaska and condemnations proceeding. Now in this case, just the fact that the threat's there is going to make them think about it and worry about that early redemption. The reason they do it is that they're protecting themselves against being paid off early at a time of low interest rates. They go into one of these things and they set a rate that's appropriate at the time of the credit involved and make their plans on this basis and to enjoy the income at the interest rate that, whatever's negotiated at over a long period of time. If they think they're going to get paid off early, at a time of low interest rates, they ask for this redemption penalty to guard against that contingency. Now, in this case, it's a threat to lean over, that may, even if this Legislature doesn't do it, they still read the newspapers and they see well, the State's thinking about it. Well, there are people in the State that are thinking about it. They'll say, well, it might happen. So, against it happening, they say we're going to have a big redemption premium if you pay me off early. Now, / I don't know how big that would be. It could be as high as 10% in the earlier years. Now, that's a figure to be borne in mind that if you're talking about $3.5 billion dollars worth of debt, 10% redemption premium is an additional cost of $350 million dollars, and that's substantial. It might be unnecessary. Now, finally the whole question of uncertainty is one that is terminating this whole picture, at the moment. The uncertainty of how these hearings are going to turn out, and what's going to happen on this legislation, among other things. There's one rule in finance that you learn very early, when there's

uncertainty, it adds to the cost. Now, the uncertainty here ~~delays~~ is delaying this project; it's delaying financing by companies that might be in the market now to pawn some of the expenditures they've made in the past. They can't go into the market if they don't know whether or not they're going to own these facilities. I might also say, we're in the time now, relatively better interest rates, and by that I mean better for the borrower, relatively lower interest rates than we've seen in some years, and there're a number of bankers and economists who are of the opinion that that, this present, relatively happy time is not going to last too long, that interest rates will go up, and I point out to you again that pipelines are sensitive to interest costs. Just a 1% rise in interests costs, say from 7% to 8%, or 8 to 9, by the time the financing is conducted, adds to the operating costs of the system $35 million dollars during the period which the maximum amount of debt is outstanding. And that comes back and hits you in that well head price, because, of course, a tariff must carry the burden of the debt. Now, I'd like to finish up with the abilities of the State to finance this staggering sum of money. I might point out that another thing that hasn't come out yet is that if the State does it, which we don't think it can, but it's not going to be 3-1/2 billion, it'll be more, because among other things, the State's estimates, as I understand them; there was some confusion on this, but as I understood it, it did not include interest during the construction, so that would be added to the base figure, whatever it comes out at. The State's bankers have been talking about a reserve fund of or it should be talking, I should think, two years of debt service. There is interest on interest and interest on the reserve fund because that would have to be raised. And you're possibly looking at raising as much as a billion dollars more than, in fact, the oil companies will have to raise. Well anyway....The tax exempt market is a big one, but our firm's of the opinion for this amount of money that even if it could be raised, and there are some doubts about that, but for it to be raised at all, you would have to tap every reservoir of capital in the country to the maximum extent. Now, this would include, and the biggest of those reservoirs, of course, are the life insurance companies that are

not ordinarily . . . . . life insurance companies and pension funds I should say that are not ordinarily borrowers of tax exempt securities in the first place, because they get almost no benefit from them. For that reason, the cost isn't this number that's been banged about, it's the rate at which life insurance companies loan their money to credits of this kind. Now, this theory's been advanced that one of the ways the State can secure a borrowing of this magnitude is to dedicate to its oil income, now, its prospective oil income. I'm not talking about the existing royalties and severance taxes which could not ~~afford~~ support this amount of debt. I'd only point out at this stage, that from the purposes of security or adequately securing a bond offering, the royalties and severance taxes from the North Slope at any rate are not, they're not bankable assets. There're not valuable assets to add security in a completion undertaking because their realization are completely dependent upon the completion of the pipeline. So they don't, they would add security if it were in operation and those amounts would be falling, but not much, because the back ~~stocking~~ stocking that's needed here is against those that have had some forced_____that result in shutdown of the pipeline. That's the thing that lenders worry about. They have confidence in the oil companies that they can build it technically and that they can evaluate the economics, but it's all those other events that they worry about and the reason they ask for their / back stocking, and the back stocking is, if you will, it's somebody financially capable of paying interest and debt service during periods that nobody can foresee but you still worry about - an earthquake, a shipping strike, a tanker spill that results in an injunction against operation of the pipeline, so it's shut down. Now, when it's shut down those royalties and severance taxes aren't flowing so they don't add much security to this borrowing that we're talking about. So, we reluctantly come to the conclusion that the State on the basis of its present resources cannot, CANNOT finance the construction of this pipeline. In our view, if it can be done at all, it has to have the unconditional back stocking of the oil companies, I'm not talking about a modified truth of it here, I'm talking about

the full faith and credit of the several oil companies. I might say here, at this point, the only area in which there's some disagreement in our office, there's some that think it would take the joint and several back stocking to do well. It's not a question of going to something weaker than the normal truth of the thing but it's a question of meaning perhaps something stronger. A word about the plan proposed by Temple, Barker & Slone. If that plan doesn't have a completion undertaking, it doesn't do any good to say, well, the State will pay this on a contract basis because there still isn't completion. That isn't a completion undertaking by someone financially capable of discharging that undertaking. The State doesn't have the assets to perform that and just consider, if you will, the prospect of maybe the State selling one or two issues in the tax exempt market and then that market getting exhausted. It has a way of doing that. It doesn't take too many repetitive offerings before underwriters say stop, we can't do anymore. And those are issues of 115 and 200 million dollars. There're considered gigantic in that market. And then what happens, so the pipeline's half under construction, all this money has been committed, who is going to pay the bond holder back. So that that plan effectively does involve the full courage / and faith and credit of the oil companies if you would expect that they would go ahead and still complete the project if the State failed to be able to pay. Again, it's a sort of a never, never land because it can't happen in the first place. To get people to commit to even the first issue of bonds, you've got to convince professional investors that the last issue will be sold. They've got to see the end of the tunnel. And the only basis upon which they would do partial issues would be having a completion undertaking by someone who is financially capable of doing it. If the bond market runs out of money, they can put the money up whether its out of their equity or whatever it is, on their own credit, and that's the strength that you look to to get this done. Now, that is indeed an encumbrance of the credit of the oil companies. And I might point out, there was a remark made during the day about this plan that didn't encumber the oil companies. Well, if it doesn't encumber the oil companies credit, it's no good as securities. I might just give you another few facts here, and then I'll quit. There isn't the underwriting

capital in this country to do an issue of 3-1/2 million dollars worth of borrowing. The largest bond issue ever underwriten was managed by our firm from a telephone deal last a year ago January of $500 million dollars. That's the largest underwritten deal ever done in history. It strained the capital of this country to the point and the investment bankers in this country to the point where the calendar had to be lightened around it so people could take these committments, and the next largest deal ever done was the common stock offering which we did for Standard Oil Company of New Jersey early in 69 some,/about $400 million dollars, and that one strained the capital resources of the industry. As I said before, the telephone offering that the ventures with warrants had to be done on a dealer managership basis simply because it could not be underwritten. So, again, you've got to bear that in mind when you talk likely about the State doing an issue of $3-1/2 million dollars worth of bonds. There isn't the underwriting capital around to do it. Other aspects of this plan obviously also entail very considerable delay. There's the delay of/legislation getting passed, the delay of constitutional amendments. That agreement which was talked about, that satisfactory voluntary agreement which was talked about, I don't know how long that would take to negotiate, but that would be a long time. The delay adds costs. We've seen, all of us, how the cost of this pipeline is escalated in the last three (3) years while it's been waiting for its approval in Washington and it's going to continue to do so. Construction costs in this State are recognized to be very high. Construction costs all over the world are escalating in a year. There is going to come a time when the continued delay of this thing is going to hurt, and it's going to hurt both you and the oil companies. Now, one more point. The question has also been raised and we discussed it with the State officials when they were in New York of the State's capability of raising the amount of money to take over this pipeline at some time in the future. Presumably, some time in the future after it has become a going concern and demonstrated first that it works and doesn't sink into the ground. This is very problematic. We'd think that there'd be a host of things you'd have to know. You'd have to know first if there's more crude than there is now proved. You'd have

to take a look at the economics of the system with the party involved. You'd have to look at the economics of the market on the West Coast of the United States, the technical operating experience, market conditions at the time, general levels of interest rates and all sorts of factors, and if every single one of them turned out very favorably, and I mean a variety of factors that I haven't even mentioned, and there'd been no serious mishaps. . . all of these things turned out perfectly, well, then we'd think that maybe it's almost conceivable that the State might over an extended period of time raise a substantial amount of money. I wouldn't say 3-1/2 billion, because I don't know. To do so, even then, with all those things perfect, economics beautiful, discoveries all over the place so that the system was obviously full and about to be moved and everything else favorable. I still think that the State to raise the amount of money then would have to pledge all of its royalties and severance taxes to the detriment of the State's credit for other purposes, whatever highways, or schools and hospitals. It's generally a good rule to finance, not to encumber any of your assets to the borrowing purpose, because you're detracting from the _____ of the whole, but as I say, that's terribly problematic and I don't think any bank will do the judging _____ that can be done. That's about the end. I might say that we wouldn't consider it sound. We say that in order for the State to raise the money to do this, it would have to pledge all these valuable oil income assets, but we don't think that's a very good idea for the State to do as banking and it buys alot of governments, national governments and these kinds of things simply because at the event of a forced _____ occurs then, after this stuff is hot and the pipeline does get shut down, whether its by Udall of the Interior Departm-ent the reserve becoming unproducable for one reason and another, then you have the State up to here in debt, strangling in debt without the royalties being realized and that's trouble. Now, I don't want to end on a sour note. I'll just say that I hope the State will clear away these clouds from this financing and let's all get to it.

Mr. McVeigh: Senator Rettig has some questions.

Mr. Rettig: Mr. Gary. . . . .

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Rettig:...more able to secure the unconditional throughput agreements from the oil companies and everything should run smoothly, the guarantees would never have to be called upon. What would this do to the oil companies in the event they wanted to seek financing for something else. What is this guarantee without standards from an investment standpoint?

Gary: How many years are we talking about?

Rettig: Well, we're talking about 25 years I suppect. The operation has continued smoothly for 10 years or 15 years.

Gary: This is a very interesting question and there has been a lot , we've talked about it in our office for months and we've talked about it with our oil company clients. There are a lot of people who ~~xxxx~~ say, will throughput agreements, they aren't they are operating agreements, they are shipping agreements; if you don't happen to ship for some reason you pay. And, the only time you pay out on your cash efficiency power graph in a throughput agreement is when there is something drastically wrong with the operation, either crude has dried up, it has happened to pipelines, or maybe the market has dried up or the economics of the operation have ~~decreased~~ so that the pipeline is no longer an important operation. This ~~has~~ happened in this ~~mid~~ ~~Continent~~ ~~Cont~~ area where the is drying up; production is now being sought in the Gulf Coast area, some of the smaller pipelines up there have limited economic lives so by and large in this country pipelines have been well planned and thought out, it is not very often that oil companies or, but it does happen, have to pay up on the ~~tax~~ effeciency provision of the agreements, and thats hangup enough money for the pipeline company to pay off the debt. So operating experience is then, is not then an actual drain on ~~either~~ ~~side~~. Thats fine as long as you are talking about a 50 ~~xxxx~~ or 75 million

dollar pipeline, and often several owners each own a moderate percentage of ~~dollars~~ these. I have known pipelines that has 17 owners in it, the leading owner owning only 9%. Well let me use an example to help. The pipe line that has 17 owners in it, and the whole financing is $35,000,000 and the largest interest in it, I believe is held by a subsidiary of Gulf around 9%, I don't think investors worry much about the Gulfs through-put commitment on that pipeline. This pipeline, it is so large that ~~knowone~~ anyone is going to regard the throughput agreement as any other than a guarantee of debt. They are going to think its a percentage interest of the pipeline multiplied by the 3-1/2 billion or what ever amount of debts outstanding, that would added onto the balance sheet, rating agencies will do it, certainly investors will do it, its not going to be overlooked. There is a lot of talk about off balance sheet financing if you will not being charged up. Thats not true any more. Investors know about it, they understand it rating agencies do. I've talked to both of the major rating agencies on throughput agreements and what they mean and I'm charged they represent our oil companies credit. And I've talked to both sides, and they claimed in one hand, everything is working fine, it is not really charged in that because it is an operating expense. On the other hand if it is not working so well, it is a true liability. And interestingly enough throughput agreements in a sense is stronger than a ~~guarantee~~ guarantee in that it retains its working capital commitment assured against usually they may plus the modern insures the pipeline as having enough money to meet all of the its obligations in the past.

So I think that it would be correct to say that the operating systems ~~have~~ that are proven ~~and~~ that people dont necessarily charge it out

So against each of these companies.'

You do ask the question then, are you Mr. Pipeline Borrower a major guarantor of any one elses debts? Is this a fact? You would ask this same question. Are you a guarantor

even tho it doesn"t appear in dollars and cents on the balance sheet?

I'm not sure. We'd regard it very seriously, I might say.

Thank You.

RETTIG: SENATE COMMERCE
I'm going to start with the ~~Sub College~~ Commission first. Mr. Groth did you have a question? Would you start it off?

Mr. Chairman, Mr. Gary sounds a little bit like my banker that keeps telling me not to go to building and then he goes and builds one next door. GARY: The reason I was asked to come up here was that I'm the guy ~~with~~ had all our clients but Hollowat. ~~to work~~.

But one of the matters that troubles me ~~here~~ somewhat is the apparent disagreements between two sections of intelligent gentlemen, one of them being you, and the other the people from Temple/ Barker ~~Gas~~, and Mr. Macy who is certainly from a -----

: I don't think there is any disagreement

: You seem to indicate that (if I understand your testimony) that in order for the State to build this pipeline, they would have to have the full financial credit of the oil companies. I thought Mr. GUILDERHOUSE indicated that that wouldn't be necessary.

: May I get the notes out here because I didn't hear it that way. I did not hear him say that it could be done. In fact I heard them list a bunch of assumptions and conditions, having to be satisfactory to all. And then I think they left what I heard was an implication that it might be done. Now, among the assumptions and the first one we look at is the reserves Sufficient reserves is what I look at. We have heard testimony here that is generally known that the reserves are nine and a half million ~~dollars~~ BARRELS which are not enough to support this pipeline at the projected levels that are being talked about. Implicit here is the expectation of those additional barrels will be found AND

I'm sure these oil companies would certainly have that expectation. They don't know where, how much, or with what degree of certantly or assurance that that could be done. But I'm talking ~~about~~ from standpoint of financing FROM THE STANDPOINT OF FINANCING. The oil companies ~~are~~ perfectly capable of taking that risk that they wont find those additional reserves. But a lender isn't going to take that risk. He's going to want to be backstopped ~~stopped~~ against that event not happening. That's not his business. That's putting the lender in the oil business if you make him assume that risk. Now, if the satisfaction of that first assumption or that ~~certain~~ first condition just isn't here, at the time the financing needs to be done so it has to be backstopped ~~stopped~~. Now thats true of all the ~~beautiful~~ USUAL things that you have to ~~set up for~~ SATISFY a ~~lenders~~ lenders ON,

Would you flip back in your notes to Mr. Guilderhouse's testimony which is one page before?

I understood that his fifth point was

1. Was operation pipeline sound business
2. The cost fees are various assumptions - it will cost three and
3. ~~It will~~ one-half billion It will be built and utilized.
4. That the State's credit is not adequate to sell the G.O. bonds.
5. ~~And~~ Perhaps I misunderstood that the oil companies will not be obligated to lend their full faith for credit

: Lets go back to one of the earlier ones that you said that it will be built and used. Then he talked about a shipping agreement that didn't have any teeth in it, and it didn't obligate the oil companies to pay any monies, if for instance, the proof dried up, or the line was shut down for any reason. Who's going to pay the debt then?

: Thank you. Let me hit this one a little harder, for its hard even for our oil company guys clients to understand. Sometimes when you tell them they've got to put their credit squarely behind the pipeline financing. They ~~think that just because they have~~ so-and-so look the things been operating for years and ~~they are~~ there just going to expand a little bit we say No, put it behind there. The lender doesn't take business risks. He takes credit risks but he's not going to take the risk of ~~an~~ an economic circumstance occuring that he has no control ~~over~~. He can evaluate the risk of ~~loaning~~ loaning money in various to an oil company which is a going concern ~~in various~~, different places, not just this pocket up here or that pocket down there or in the Middle East or Venzuela, or the lower forty eight or whereever it is, he looks at a credit that is dynamic in a diversified business, diversified internationally in the case of most of these oil companies, where if something goes wrong here, we have have strength there . That's what he's looking to. He's not looking to assume a business risk that he doesn't know about. He can't do anything about finding the additional reserves, that would be necessary to put this through this line

to get it up to the two million barrels a day level. When the oil company takes ~~this~~ those risks it does it because its opotomistic and hopeful, and just to round out this point, thats why they have to have the expectation of the profit.

GARY: Mr. Holms.

HOLMS: Yes, Mr. Gary. In earlier testimony (I don't know which page to flip back to) but in earlier testimony we had the supposition made that the tax exempt bonds would be a point and a half to two points less than they would be if private enterprise had to borrow this kind of money. With all the hazards of the bonding of a State that you have been talking about, could I get your idea about this because it seems that the State had predicated a lot of the differential in profit upon the point difference. What is your opinion?

GARY: Its somewhat an academic question. My firm is of the opinion , and by the way, Mr. Macey said the same thing, that you would have to tap every capitol market if this is done and he even said in an answer to a question, indicated what one would normally regard as the gap between tax exempt securities and taxable securities of corporate bonds, would be somewhat eliminated by virtue of the fact of having to sell large quantities of bonds to institutions that derive almost no benefit from the tax exempt status of the bonds, simply because they dont pay taxes. Pension funds don't pay any, Insurance company taxation is an instrumental way to 32% of major light companies. so that, I frankly don't think that you'd end up any lower than what the rate would be if you had to go to those people only. The buyers ~~XXXXXXXXX~~ ~~SBS~~ tax exempt market is a large one consisting of individuals, banks, small banks some foreign casualty companies and in the tax exempt market, a two hundred million dollar offering is gigantic. and new purpose offerings, and this is a new purpose---this isn't a hospital, or a general obligation or an airport or a ~~XXXXXXXXX~~. toll road. There's a lot of difference between this and a toll road its more powerful its not a public utility. The oil companies can't use it there's something gone wrong so toll road~~x~~ is a question of measuring traffic, sure the measurement may be out a little bit according to a traffic consultant but somebody's going to use it and it gets some use --you've hear them talk about the Chesepeke Bay Bridge so if the issue were ready to go

tomorrow, and you were asking about the difference of the first hundred million dollars worth, the first thing you would have to do is go out on an educational campa[illegible] and you'd have to take the major investing corporation you'd show them whats involved, you'd educate them, you'd go on a massive campaign to educate investors, on why this is the kind of investment they should make. Never the less, its a new venture and the first time off you have to pay for doing something new. I doubt that there would be any lower rate than what the oil companies could borrow at anyway with their credit, and I suspect that when you went to sell the first issue of bonds, you'd negotiate

you'd negotiate a rate to them appropriate to that credit, and I doubt that if you try to do any financing at a[illegible], I doubt that there would be any difference --- there would be less of a difference than occurs in the normal fluctuation of bond prices anywhere. At least you couldn't measure it.

HOLM: Then, this great advantage which we have been lead to believe is there, practically evaporates under your arguments. One other thing. It seems to me that from what you said, that if the State wanted to make a bond offering of this size that this did advantage a[illegible] ~~bonds of~~ our bonds because the private enterprise when they went, there would be seven offerings and they would all be broken down because we wouldn't go all at one time. However, wouldn't it also be true that whether or not the State went into the bond market or the private enterprise went into the bond market, there would be in fact maybe a billion thrown on the market at the offing of somebody --- maybe it comes from seven companies but there still a billion dollars being axed from the market and this is going to be a tremendous impact I know. We were told that nine hundred million from the oil lease sale dried up a lot of the money market.

GARY: Now, we're talking long term market.

HOLM: O. K. If we're talking long lease market, wouldn't the same thing be true tho, wouldn't the parallel be true whether or not the State went into it or not, or the private enterprise went into it.

GARY: I don't know how to answer that. Yes, the oil companies when they start raising their share--this will tap the market, but they have other sources. They have

internal cash flow and they will be staging it out in terms of their picture so that you won't have identifiableTAPS financing necessarily, you have Humble pipeline coming to the market for its needs whatever they are. It has the largest oil company in the world, which has an enormous cash flow so it would be melted into its normal trips to the marketplace. I guess what we're saying is --its trips to the marketplace might come a little more frequently than and in bigger size than would otherwise be the case were they not building this thing but I submit that if they were not building this, they would be making investments in other places and coming to market anyway. I might say that in this endeavor, and studying this whole problem, that we have consulted a banker, Donald who is a retired Senior Vice President of the First National City Bank and is considered by many to be the Dean of the tax exempt municipal bond market, and who is now the consultant to the power authority of New York, the New York Authority and he has had an entire career in the tax exempt market. He concurs that all of our views that I have been expressing here today and He's concerned about the size that we're talking about. Put it another way. Let me see if this will help a little bit. If the oil companies happen to have organized this in corporate form and are trying to build a market with three and a half billion dollars, or 90% of that, in the next three years --I don't know what we would say to them if they asked us to do it--I think we would probably say to them, the maximum size that you can take out of the market is not that much, you'd have to do a very substantial portion of this with the banks, in term loans if they could do it. When you get to really gigantic projects of this kind you're rubbing up against the capacity of the market to take something. Some of these major institutions have what are called "Legal Limits" and they can't go beyond a certain amount that any one bank. We had occasion to tote this up in connection with the gas line as somebody mentioned this morning and we got up to an amount short some millions of dollars of a considerable amount and assumed some takedowns over a period four years the maximum amount that they could commit on any one project.without exceeding their legal limit and we found

Entire Corporate

and it got these in other pieces

enough, to get it done we would have to tap banks, current bank loans which sometimes in some money market conditions are hard to do by an amount that would also strain a commercial bank. Let me put one more thought to you, and thats the question of legal investment. The plan that's been served up to you here, contemplates a so-called modified agreement which is really shipping does not have in it to my way of thinking sufficient security to qualify as a legal investment where-in the elements to legal investments to insurance companies are there. Now, maybe it is suitable that that might be worked out with something short of full paid in credit of the oil companies but I honestly doubt it when one considers the history of this pipeline, where the proved investor could not prudently take the risk to a satisfactory resolution of all the problems facing this pipeline in their technical producibility any thing else the politics couldn't say that the far degree of adequate security is there so that you're in a situation where you may be biggest pool even denying yourself the capitol there is so it doesn't make financial sense to me to tie both your hands behind your back and then call you out and raise an amount of money thats staggering

RETTIG: Thank you. I think at this time one point should be clarified. I believe that at no time has the State in its position declared or assumed any advantage from its ability to issue tax free bonds. Its sole advantage, if any, would be freedom from income taxation on the operation of the pipeline. For example: On page 4 of the States presentation by Commissioner Wolforth, they assume that two billion, six hundred thousand of the debt would bear an interest rate of 8% and only nine hundred million assumed to be issued on a tax free basis and that at 6 1/2 percent, so that even if that were all at a tax exempt rate the advantage would be relatively minor in that regard as opposed to freedom from Federal and State Income Taxes so the almost total advantage claimed by the State is in the area of income taxes, not in tax exempt bonds.

MC VEIGH:- I would like to ask Mr. Gary to comment on the advantage that the State would have in relationship to this Federal Income Tax. It's a good, healthy amount. I think its $168,000,000 per year. Now that strikes me, as a layman in finance as one a lot of money that the State as well as the oil companies could utilize rather than giving it to a third party like Uncle Sam. What do you say about that?

GARY: I say--sure, its for the benefit for both, obviously the Federal Income taxes ~~would~~ can not be paid. I don't happen to know what the tax profile of this pipeline is in the hands of the oil companies as they're projecting to do it but I know what a typical tax of the pipeline operation is, having worked on it. So I think the magnitude of the amounts I mentioned here are somewhat misleading. I don't know what appreciable life the ICC will assign to this pipeline. It will be critical to the economics--it will be important for the economics of this pipeline what that life is but to the extent that the taxes are saved and I suppose if that tax saving were shared with the oil companies in the form of a lower tariff; this is the state they would own it I suppose yes that would be the benefit of all I think this is a somewhat difficult area to talk about unless you know what you are comparing--I suspect that your comparing an apple and an orange here.

MC VEIGH: I think you would have to agree that its already been stated and I think fully accepted if we're under State ownership still its going to be regulated by ICCand that the rate regulations would follow and that if there was an expense which you would have under private ownership is non-existant under State ownership, that is the Federal tax bill then thats going to result in lower rates because we've got to assume that theres a fixed 7% amount that we can make whether we're State owned or privately owned and if theres an expense deducted from that then its got to show up someplace.

GARY: I don't know that that's so. That's my problem. I indicated here, with State ownership you must realize that you're saving a very substantial amount of money more than the oil companies are. For instance, they don't have to raise interest during construction because they are a going concern. If the State owns it, its a xxxxxx project and

GARY: 'project has to raise the interest earned. Project has to raise the reserve fund and it raises absolutely a greater amount of money. ~~Bowing~~ Combine that, with the interest rate that you would have to pay to attract the capital of this amount its apt to be more expensive--I don't think it would be cheaper. It might be more expensive than the amount of Federal Income Tax rating.

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TAPE 36:

Page 1:

: _____ state ownership.

: I'm not the advocate of any position of state ownership against private ownership. I'm here, I think, in the capacity to talk about an answer (??) so I have no private ~~feelings~~ opinion but I think I'm here to talk about an answer.[1] Really nothing that we've addressed ourselves to, and as I said a little bit ago , this is a comparison of an apple and an orange, and in some respect ~~fact~~ I just don't know whether it will come out cheaper or not. And again I think you can do a lot of work studying this but such substantial elements of dissimilarity/is not necessarily going to reduce itself down to a that the comparison measurable quality. I think I might emphasize again that as a practical matter I don't see how the completion problem is solved, it isn't solved for instance by the state asking some underwriters to sign a letter saying no matter what they will divide the 3-1/2 or 4-1/2 billion dollars over a specified period of time. No underwriter can do that. That amount of capital doesn't exist. To write a Letter meaning for that way so it isn't there. And you're saying, we're not going to encumber the oil _____ completion question. Well, I don't see that anybody going to loan money without a completion undertaking here. So its a little difficult to talk about, and frankly the comparison isn't valid.

: I think that answers my question.

Rose : Mr. Gary, what Indicative is the oil companies individualy can here, interest, ownership concept ~~in~~ raise the necessary money - you said the money for that particular site)??) is available in the market. Th en you indicate under the corporate arrangement, to form a single entity ~~I would~~ That would change The Picture ~~say do better~~ . One thing that I don't understand is, why couldn't the And wish you could clarify for me

entrepreneurs, the financiers in this situation do what is commonly done in the money market, and that is asking the principal in the corporation to provide the necessary back up for their own credit?

Gary : Well I'm assuming (??) the backups there.

Rose : Do you remember ~~under~~ the corporate setup, you said the money would be harder to obtain even then? Even with the same backup and the same credit?

Gary : I'm assuming its present in both cases. What I'm saying to you is that as a mode of finance , doing it in project form, ~~inx~~ rather than in 7 discreet ways, you don't have the multiplicity of names, you don't have the ~~strong~~ going concern advantage , the individual companies have the flexibility to incorporate their own.....

Rose : Thats what I mean, Sir... If you were to say, well in addition to the corporation's credit, and backup principals, ~~the~~ who are the ffs will and provide their own credit for backup. I know thats done in private (??) financing currently, ~~and then even~~ if I have and if ~~when they~~ need to make a loan, to obtain a loan, and they tell you, well your corporation isn't strong enough, and if you'll sign individually we go? Why couldn't that be done in this instance?

Gary : It would be done. It would be done. In either case its exactly the same. The full faith and credit of the oil companies are behind it, and would be required into this pipeline.

Rose : I have one other question:

Gary : Maybe I can.....there are seven owners here, there's Humble, Atlantic, Sohio, Phillips, and Mobil Etc. When I say a multiplicity of names instead of I mean the Trans Alaska Pipeline system, going to market to sell three bil lion or more dollars worth of oil, thats one name, and investors ~~working~~ looking at it have legal limits to that one name. The credit is still composite credit of the

seven oil companies, but the name on the bond is Trans Alaska Pipeline System. Its only one name. joint Humble
If they do it in undivided/interest form the/pipeline comes to market, the
~~Robot~~ mobil? comes to market, Amerada comes to market, Union comes to market,

GARY: They
Rose : You see that they may do it along all the lines of the
ROSE!
rest of their financing too. I don't think theres any difference in the
availability of_____.

Gary : Yes.

Rose : Alright, The next question that I have sir

Gary: : Witness (?) my partners to make sure they agree!

Rose: : The same one that was raised yesterday that which we had ~~the~~ some
difficulty ~~of~~ IN obtaining an answer....you ~~seemed~~ seem to be there ~~would be~~ experts in
what is going to
the field....assuming if we are.....~~the state is going into some one should~~
~~go~~ into the State in some ~~un~~ feasible arrangement, a 3-1/2 billion dollar
issue OR MORE IN EXCESS OF

Gary: ~~Oh~~, 35 hundred million dollar issue, spaced right,
Rose: RIGHT
5 MONTHS WHAT
Rose: WITH A TOTALITY OF : 3-1/2 billion - what is the total cost to the State for of the, of course, best approximation possible
underwriting these counsel fees and other fees ~~adhering~~ RELATING to it?

Gary : Can I give you the cost of the first issue? As you know,
I don't really believe it can be done; (laughter) let me give you the cost
of the first issue. ALright? Is a tax exempt following...

Rose : Well, either way....it makes no difference.....
GARY: Is it tax exempt?
Rose: Let's Assume not.

Gary Assume not: The State issues, guaranteed by ~~law~~, The oil companies contradiction of terms,

Rose : I'm sorry, I didn't think I would be quite so complicated
The state went into it and thats all.

Gary : ~~The State may as well (??) the tax limit for taxable bonds~~
AS A TAX EXEMPT OR TAXABLE BOND
Rose: Right
.....let me first talk about ~~taxes~~.....I don't get the picture of the State
TAX EXEMPT BONDS
selling a taxable bond....

Rose : Well, I thought you indicated that those bonds issued by the State would not be taxable.....I'm under the assumption that they are not.

Gary : Now, let me try to answer your question. There is confusion here somewhere. Tax exempt bonds, for new purposes, where investors have to be educated, and large size..all right, lets assume this is 100 million dollars, a large issue, for a new purpose, where you have to do very substantial education of investors, I would guess that the underwriting spread would have to be in the neighborhood of 2-1/2%, on the first issue. Now included in that underwriter's selling commission out of that, I would say, Ah, you might have to pay a selling commission of about half of the total spread, a little more than half maybe.

Rose : Is that included in the 2½?

Gary : Included in the 1.3 per cent . You have a management fee, the managing underwriter, and underwriting fee to make up rest of the 2-1/2%. I think if the thing were set up in such a fashion that .....well, lets assume the first issue is terribly successful, and the credit becomes established after this education process that goes on. Then you might expect the credit came be established and the operation became more and more proved, that the fee might decline in competitive issues. I think you should understand that the underwriting is largely a cost of sales. People don't knock on bankers' doors to buy bonds. You have to go out and sell them, and municipal bonds are sold by brokers and registered representatives and they have to make a commission, they have to go out and sell the things. As disappointing as it may sound to you, you have to work to sell bonds./ You have to pay somebody to sell them. They have to get somebody to go out and tell the story.

And thats what this underwriting expense is. I think the witness WAS I don't know what happened to him-----but anyway its....thats what it costs on tax exempt - 2-1/2%

Chairman : Thank you, Mr. Gary. I think you've answered the question. We are going to take a 10 minute break. If I can just add to what you said something that I discovered after the question was asked, that the underwriters also carry the burden of stock buying (??) the bonds if they don't sell. Isn't that right? .....Thats to be accountable too, in there?

Gary : Thats what underwriting means. THE RISK LIKE THESE OTHER RISKS WE TAKE.

Chairman : Lets take a ten minute break.

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: There were some suggestions from members of the Legislature WE'RE going to depart from a rule that we had determined we would maintain, and that is we thought it probably initially/~~xxxxxxx~~ would be inappropriate for witnesses to pose questions to witnesses. However, in this area of municipal bond financing we do have a man within the State of Alaska, he's on the staff, Commissioner of Revenue Eric Wohlforth, has agreed, for purposes of clarification, to ask some expert questions of our expert witness and we are going to call upon Mr. Wohlforth AT THIS TIME to ask some questions that have occurred to him in connection with Mr. Gary's testimony. Mr. Wohlforth, would you come up here ? There's a mike set up AT THE END OF THE TABLE

Wohlforth : Thank you very much for the opportunity, Mr. Ch airman. I am afraid the questions will not be as expert as the answers, but I'll take a crack at it anyway. The first one, as a point of information,

how many tax exempt issues has your firm underwritten, either as a manager or co-manager?

Gary : We don't....our firm ....I don't know the answer to that question. We participate in large revenue financings or often where they're large enough OR complicated enough so that we can lend some assistance. We have managed a number, again I don't know the number of municipal industrial revenue bonds, which are not unlike the activity that we are talking about here, I think we've managed the largest bonds in Lorraine County Ohio, which is backed by U. S. Steel Company. Its also an Alaskan Co.

Wohlforth : Do I understand, and I may not have this right from your earlier testimony, that lenders do not ordinarily take economic risks?

Gary : Th ey don't take business risks, if you will. Th at was said to make a formula (?????)

Wohlforth : I see. But in the case, you perhaps excluded from that consideration the total financings which are in the (default??), the one in the Chesapeake Bridge and Bay Tunnel financing, and the Virginia Turnpike high financing?

Gary : I think I also said that this pipeline isn't anything like a toll road. Among other things a toll road can be built in stages utilized in stages and generate revenues as stages are completed and hooked up. This pipeline as a project doesn't generate one penny of revenue until its complete. Its one of the things about pipelines you always have to remember, that they're worthless unless they are completed. Its not true of toll roads.

Wohlforth : Thank you. How, in your opinion, does the tendency of an ownership bill present a real threat of the loss of ownership?

Gary : Well, I think thats a legal question. Talking from a business

sense, I think what is meant was that if we're going into the market with some local bonds, and its the investors' community to worry about spending a lot of money, and not being able to enjoy a return on it, business return, if he is worried about Mobil's investment being condemned by the State, or worried about Mobil spending a lot of money that it will get a return on, then whenever you have worries in investors' minds, you are hurting finances. And if the investor is convinced for instance, if the thing works, and/the State takes it away, he's not penalized over in the marketplace. He will regard that credit being dissipated, impaired if you will. And that results in an increase in cost and it was also a narrowing of the marketp lace. When investors worry they don't buy. They say, I'll pas this one by, and get the next one.

Wohlforth : How in your opinion could the State raise the funds to condemn the pipeline?

Gary : I think I've said I don't believe the State can, without the credit of the oil companies.

Wohlforth : I see, so thats ....

Gary : I'm not trying to be negative here. We're talking about an amount of money, that represents a staggering burden. From a market standpoint I don't see the State doing it without the credit of the oil companies.

Wohlforth : What specific financing plans have any of the member companies involved in the consortium have already been postponed?

Gary : I am not at liberty to say that. I will tell you that prospects of a threat overhanging these oil companies is because of this pending legislation, and the aura of hostility that it generates has caused us to recommend to one of these companies that ...to defer financing in this current market.

and I don't say that you did
Wohlforth : Did you suggest that /...didn't you suggest in your testimony, that one or more of the member companies are now ready to finance _____on the pipeline?

Gary : I will discuss this point with clients. (??)
I think I might point out that these companies already have a fair amount of money invested in that pipe thats sitting on the ground., and those are expenditures that ~~xhax~~ ought to be funded on long term. The cost of What I'm saying is that with this cloud hanging over , its not propitious, it simply wouldn't be propitious for them to attempt to go to market and face the kind of doubts and clouds that this event is causing.

Wohlforth : I may sort of start up financing as you characterize this,/it is properly characterized as one .... ~~xixxixxx~~ and indeed you alluded to the fact that in prior testimoney references were made to the necessity of an initial funding of a reserve, and that such a reserve, is it not true and in your experience in such a reserve can hurt interest over the life of the bonds? Assuming all ~~Gaxyxxxxxxxxxxxxxx~~ goes well in effect, being tied to the final maturity issue would pay the bonds off in what would be called a 'wash'?

Gary : Oh, sure, and as time goes on of course it becomes bigger and bigger/relationship to the amount of debt outstanding/and improves the credit as time goes on, and as you say if the pipeline is successful. What I was referring to in my remarks was the fact that/money/has to be borrowed by the State to get it, there to make it a reserve, and that adds to the burden here, ∧ ~~the~~ oil companies, since they have a going concern, don't have to do, and it's adding to the cost under that scheme of doing things.
in as the debt declines that amount of that reserve also which is something that the established credit

Wohlforth : Thats all I have, Mr. Chairman. Thank you very much.

Rettig : One moment, please. I wonder if you would submit to a question, Mr. Wohlforth?

Wohlforth : Surely.

Rettig : I have a short one. In this matter of reserves for bond issue, established with the purp ose of servicing the debt in the event of a slowdown from some source, on the assumption that such reserve would be created out of monies ~~purchased~~ borrowed at 8%, presumably that money has to be available, on short notice, to service the bond deb t. Is that a proper assumption?

Wohlforth : This is correct and the trust ~~debentures~~ indentures usually provide that its maturity when ~~a~~ is no longer than 12 months, 18 months or 24 months, in governments or instrumentalities of the United States.

Rettig : Under those circumstances as they exist ~~this~~ today, it would not be possible to achieve a push with it

Wohlforth : It certainly would not, in a given year. That is cor rect.

Rettig : In some cases it would perhaps even make a drop in interest rates, short term rates, or even higher. There was a period, as we all know.

Rettig : Thank you very much, Mr. Wohlforth.

Wohlforth : Thank you mr Chairman

Chairman : Are there any questions? Senator Croft?

Croft : Could I ask Mr. Gary - has there been through the chair problem with ~~less on the~~ financing of pipelines across either Federal land or across State of Texas, either State or University Texas lands in /..where there is at least some question as to the duration of the land interest in the pipeline company?

Gary : Not that I am aware of. The State of Texas, be ing an oil state, is generally regarded as being friendly to the oil industry, AND not friendly to the extent of discrimination in favor of independent dlrs

but the State of Texas does depend upon oil for a very large portion of its State income and so it's generally regarded as always having taken steps which are conducive to the health industry. So I'm not aware of any problems which has ever arisen but I would guess that perhaps some pipliners around here may remember some.

CROFT : What about the crossing of Federal land where the interest of the carrier has been described as either ~~trifilerable (??)~~ terminable or cancellable or ~~pre~~revokable? ~~Can~~ Does that cause a problem?

Gary : I'm not aware of any problems that have ever occurred on those grounds. This is one way of tending to demisish ~~I tend to be committed to~~ my earlier testimony, ~~not~~ about this situation - ~~this~~ which is quite different from those.

CROFT : To what extent is the provision of SB 294 different in that regard?

Gary : Its different because this hearing is taking place. This hearing is evidence of some breakdown in communications between ~~your~~ the oil companies and the State, I think so that the general impression which is left with the investing public is that there is trouble there and when there is trouble that means trouble for people trying to ~~be~~ do financing.

RETTIG : Mr. Gary, I believe what the senator meant is ~~that they~~ you do have some situation in Texas that has short term right-of-way implications . Were the conditions of SB 294 to come into being we may have similar short term - I think in that case 20 years - is the maximum period. Is that correct, Senator? Is that the point you were

CROFT : Automatically ten years, there can be ~~a~~ up to twenty years, and there is provision for almost automatic renewal for additional ten year periods in SB 294, That was specifically what I was referring to.

GARY : Let me state it correctly, so it is understood. ~~The~~ WHERE THE problem LIES HERE. THE PROBLEM LIES IN THE ~~was~~, which the State has stated, that they want the limitation, namely to renegotiate terms after five years.

KETTIG : I beg your pardon - SB 294 has a minimum term of ten years, can be arranged (or raised?) at 20 years. Its the other bill thats five years.

GARY : I'm not up on these numbers.

Gary : The whole point is that the oil companies have to be able to fix their cost, to be able to say that they are making a valid judgment on the return they are liable to get. By reason of limitation of lease terms is a hint that in fact the economic groundwork is going to be changed - whatever it is, five, ten or twenty years. That represe nts an infirmity on the possibility of financing on reasonable terms.

Chairman : Are there any other questions? Mr. Huber.

Huber : Mr. Gary, we heard from you that the financing of the pipeline is actually hurt by such things as the pending legislation so my question for you - could you give a realistic percentage-wise answer/as to what relationship has a detrimental effect on availability of finances on construction of the pipeline is represented by the pending State actions in comparison with the problems on the Federal ~~land~~ level? This means the whole problem of not having t he permit issued, etc., the delays that we have .. had already with what we anticipated we might have so that we can actually ascertain what level you think in your mind , percentage-wise, you think might be in sight?

Gary : Nobody can give you an answer to that question, but I'll tell you the areas of concern - ~~the company~~ HERE AND THAT NOBODY can tell you its 1% or 5%. Areas

of concern are first delay and ~~it is only for~~ resulting from delay ~~that~~ you get escalation in cost. Also resulting from delay you may find yourself, by the time you're going to market, in a condition of market where interest rates generally are higher - they might be lower, too. The third factor is that we've created uncertainty here and/certainly in the minds of investors about the viability of this system, over a long time, simply because the general impression that's left by all this is that there are going to be troubles, perhaps,/realizing profits from this operation. Now, that is the worst. The worst kind of instrumental (??) effect because that is the thing that discourages investors, long term investors from p utting their money into it./ So, if the market shrinks, you end up paying a higher cost because you're not tapping as broad a market. In an operation of this kind you've got to get as b road a market as you can, so anything you do to penalize this finnncing is going to have an effect both on the State and on the oil companies. Its disadvantageous. With the result of higher interest cost and _____ and higher interest cost, have to be reflected in the tariff and that works its way back as you've heard many times in the last few days to the wellhead price. So I can't qualify it, but its something of serious concern.

: Mr. Gary, through the chair: in that case, what would be your opinion of the best thing we could do to maximize the good effects as of this moment?

Gary : Whats yours?

: I believe Senator_____has a question.

: We all

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Josephson: . . .If we were going to have a good investor climate for industry in Alaska, bearing in mind, this Legislature will be succeeded by another, and the next Legislature by another, and bearing in mind that we will hopefully have more than one pipeline, and series of developments and projects requiring financing, that if we were to create a good investment climate the only thing the Legislature could do, would be to adopt a permanently static public policy in which we go year by year offering no change and is that the indication that the sovereign State of Alaska has to grow, that we cannot from time to time consider public policy changes without fear, and without the constant threat of a bad investors climate? If we cannot have a permanently static policy, I wouldn't think.

Gary: I wouldn't have thought so, nor would I think that's good financial planning, but I don't know how to answer to question and I think it requires a political answer and I'm a financier. We do advise a good many national governments on financial planning but I didn't hear a financial question.

Rettig: The answer to that question may appear in some of the studies tomorrow when the State reappears in its case and perhaps some of the answers can be posed at that time. I would have to agree that the question can't be answered by, or shouldn't be expected from Mr. Gary.

Josephson: Well, Mr. Chairman, let me re-phrase it then. Are not investors sophisticated to the fact that all sovereign governments reserve certain opportunity for public policy and statutory change - that's not a unique thing her in Alaska, it applies everywhere - it governs every marketing . .

Gary: Well, I agree with that. No problem there - I agree with you.

Rettig: Are there any other question for Mr. Gary? If not we'll . . . Mr. Donaldson, apparently that concludes the . . . Senator Thomas, did you have a queation?

Thomas: No, Mr. Chairman, thank you.

Donaldson: Can Mr. Gary be excused?

Rettig: I am sure . . can anyone think of a question they might want to pose to Mr. Gary later - he will have to catch an airplane I understand.

: There were a number of them stored up the other day that haven't come today.

Gary: I am going to try and catch an airplane tonight.

Rettig: Well, thank you very much Mr. Gary. Mr. Donaldson?

Donaldson: The next witness is Tom Broussard. He's a tax specialist with the Atlantic Richfield legal department. Tom's testimony will be very short. He has a memorandum on the tax points which he has prepared for you and in view of the time element I have asked Tom to speak directly to the main points and then answer any question.

Broussard: Mr. Chairman. My name is Tom Broussard and I am a Tax Attorney in the legal department of Atlantic Richfield Company. In the last several months, together with counsel representing several other oil companies, including counsel from several law firms, we have studied the questions of federal taxation of the State of Alaska on potential profits ~~to be derived~~ that might earn from The ownership of a trans-Alaska pipeline and the separate question of the taxation of any interest received by bondholders from any bonds that might be issued by the state or a public authority for the purpose of building the pipeline. It is my opinion and that of my colleagues that it is very doubtful that either the state or its bondholders, under the bills introduced by the administration, will be exempt from federal income tax. First, considering the likelihood of the state's exemption from federal income tax on profits from the pipeline, and I gather this is the key tax exemption the state is seeking, there is no question that Congress has the constitutional power to tax the state on its income derived from business activities. The past position of the IRS up until this time has been that Congress did not intend to impose the federal income tax on a state when it was directly engaged in a business activity for the purpose of providing a public necessity or in the exercise of its police power. However, it is doubtful that the IRS will maintain that position if

asked to rule on the question of the State of Alaska operating a 3.5 billion dollar pipeline to carry oil for the benefit of a limited number of private oil companies. If the IRS did grant such a favorable ruling, where the intention of the state is, as outlined before this committee, to substitute itself for private businesses which are presently ready, able, and willing to engage in a commercial activity for the benefit of relatively few private users, and then to pass on to those companies all or a major portion of the savings from its privilege of tax exemption. Congress in my opinion is almost certain to reexamine the question of whether the privilege should be continued. The result, I believe, would be an amendment to the statute to make clear the intention of Congress that such income should not escape federal taxation. In fact, it is doubtful that congressional reaction to this proposal would be limited to this state activity alone. There was a comment before by the Chairman that the figures presented to you earlier by the state ~~did~~ do not include any benefit to be derived in the possible tax exemption on the interest received by the bondholders of any state bonds. I have had some difficulty in following the state's proposal in this regard as to what extent, if any, they expect or are planning on the benefits from tax exemption on the interest of their bonds. None the less, my memorandum has considered the possibilities that I can think of by which the state might attempt to derive that tax exemption on all or a portion of the bonds. And the memorandum attempts to consider as well as possible the different types of doing this that we could think of. ~~This~~ We resulted in a negative opinion in almost all of them, with the very rare exception and for items which were for rather small amounts, considering the magnitude of the project. None the less, I think it is important to review briefly what Congress and the Treasury have done in the area of revoking tax exemption on interest received by bondholders from certain types of bonds because I think it is indicative that what the Treasury and Congress can be expected to do in the area of tax exemptions to state income where the purposes are very

similar to those in which Congress has already acted. Now, with respect to the exemption to the income tax on bonds, the exemption is derived solely by virtue that section 103A of the Internal Revenue Code, section 103 was amended in 1968 and in the words of an Attorney Advisor in the Office of the Tax Legislative Counsel of the U.S. Treasury Department, "The increasing use of tax-exempt financing for purposes beyond those originally contemplated by Section 103 (A) has led to a series of actions by the Treasury and Congress to restrict such financing to the purposes for which the exemption was originally granted." The abuses which prompted Congress in 1968 to amend Section 103 was primarily the use by states of the tax exemption on the interest received by bondholders to finance industrial projects for the benefit of private companies. To my knowledge, the largest such project involved state bonds of less than 100 million dollars. The proposed legislation would attempt to utilize this privilege and the privilege of states' exemption on income on its own income for a project extimated at 35 times that amount with the resulting loss to the federal Treasury of amounts which have been stated previously possibly exceed 200 to 400 million dollars a year, sorry, I take that back, that is not revenue to the federal government but taxable income on which the federal income tax would be calculated. The previous concerns expressed by Congress and the Treasury that, in this area of interest on bonds that the states were creating unintended benefits for private businesses and significantly reducing the market available for municipal bonds being floated for needed governmental services are dwarfed by the magnitude of this proposal. The action by Congress to restrict that tax exemption on municipal bonds is contained in Section 103C of the Code and without going into detail on that section, the basic critical test for the purpose of these bonds is what is called the trade or business test and the proposed regulations which are not yet finalized are subject to change at any time by the Treasury, do state this as required of what it takes to satisfy the trade or business test and I quote, "In the case of a

facility constructed . . . or acquired with the proceeds of an issue which is ostensibly owned and operated by an exempt person (such as the proposed Trans Alaska Authority) but where one or more non-exempt persons (such as the oil companies) agree, pursuant to one or more long-term contracts, to take, or to take or pay for, a major portion (which is defined as more than 25%) of the output of such facility (whether or not conditioned upon the production of such output) for periods of time which are substantial in relation to the terms of the bonds." However, the regulation speaks in terms of output or production from a facility, the same rule would apply to guaranteeing input to a facility such as a pipeline where the revenue is based earned by servicing or carrying crude oil. From the discussions previously given by Mr. Gary, it appears clear that the state could not finance such an ownership commitment without commitments from the oil companies to guarantee a source of supply to the pipeline far in excess of 25% thats upon. Indeed the minimum shipping agreements which have been described by Mr. Guilderhouse (while not sufficient to satisfy investors in the view of Mr. Gary) is in my opinion sufficient to satisfy the trade or business test of Section 103C and, thus, to make the proposed bonds industrial development bonds which would not be entitled to tax exemption on their interest because, under such a plan, the companies would be asked to make a long-term contract to guarantee to provide more than 25% of the crude to be transported through the line which to me is the equivalent of guaranteeing to take or pay for more than 25% of the transportation service. Mr. Cades stated earlier that the volume of the line available to the owner companies, 7 owner companies, is subject to reduction for other users and that because of this it is different from the normal take or pay contract. However, since that commitment of the original owners is unlikely to drop below 25% of the input and since the other users are themselves going to be limited to a very few number of private oil companies, I fail to see how this ~~would~~ is going escape the definition of the industrial revenue bonds which is previously set forth in the regulations. Thus, it is our conclusion that it is extremely unlikely that a favorable ruling could be

obtained from the Internal Revenue Service that interest on these proposed bonds would be tax exempt. Although rulings, once obtained and acted upon by the recipient, are seldom, if ever, retroactively reversed by the Treasury, ~~and~~ it seems unlikely that Congress, in this instance, in view of the strong position it took in 1968 to attempt to close exactly this type of activity would not act to nullify such a ruling before any commitment had been made in reliance on the ruling. In fact, in our own experience in obtaining a ruling from the IRS, some three months after the ruling was granted, we received a call from the Treasury asking whether we had taken any adverse action as a result of this, the ruling. In that case we had concluded the transaction involved, service foreclosed in the action, but from that point on their ruling requests, similar requests, were denied by the Treasury. So, it is possible that during a period of time that even if the ruling were obtained prior to your going to market and making commitments this ruling could be reversed. Perhaps one additional matter should be mentioned. It has been suggested that if the state could obtain the tax benefits upon which the administration's projections are based, that these benefits would be passed on to the oil companies either in total, as a result of an ICC ruling, that because they were tax exempt they were not entitled to the right of a normal tax payer or in part. The magnitude of any differential in interest rates, because of any possible tax exemption has already been discussed, but assume for the moment that some tax savings could, in fact, be accomplished and could be passed on to the oil companies. The benefit which the companies would perceive would not be equal to the amount of the savings derived from tax exemption because the companies would , as a result of the reduced cost of transportation, have increased their profit in other factors, in other areas of the movement of the oil openly to market, which would result in higher income taxes as a result of the increase in income. So the net benefit to the oil companies is not in the magnitude of any tax savings which the state is seeking to obtain. In conclusion, the requirements

of guarantees of the oil companies of throughput to the pipeline necessary for successful marketing of state bonds to construct the line which have been described by Mr. Gary, would make the interest on such bonds subject to federal income tax. Further, it is quite possible that the state's income from operation of the pipeline will be taxed by the federal government. Thus to the extent that the tax exemption is essential to the attractiveness of the ownership bill to the Legislature. This bill is unlikely to satisfy the state's revenue needs, or its desire, which was expressed earlier, to have a concrete basis for future planning the revenue sources of the state. In the meantime, it continues to create a cloud over the private finances needed by the companies in order to place the Trans Alaska Pipeline in service as Mr. Gary has already stated. Before I ask for any questions as to the testimony I have just given, I would like to answer a question made by Senator Croft earlier. He asked whether there were any tax advantages to the separate interest pipeline operation as contrasted to the single entity pipeline. The answer to that question is, yes, there are tax advantages to be derived by the individual members depending on there own tax position as to to the advantages from a financing standpoint. I'll simply say that most of the companies in this case, all of the owner companies, file consolidated tax returns. If they do not own more than 80% of the stock of any subsidiary company in which they hold some stock interest, they are not entitled to take the earnings or the losses of that company on their consolidated income tax return in the year those losses or earnings are obtained. The only way they can obtain the losses in the company, and this is of major concern when you are going into a pipeline project of this magnitude, because it is quite conceivable that the losses will be there and that they'll be substantial. The only way the owner companies can get an immediate deduction and federal tax return from that is the undivided interest in the pipeline. They could not do it if there were a separate entity incorporated to operate that pipeline. As a result of this the companies have been able to take deductions for all

federal income tax returns for some costs already incurred in connection with the Alyeska Pipeline. Those costs which are not required to be capitalized for federal income tax purposes.

Rettig: Thank you Mr. Broussard. Any questions from members of the committee? Mr. Holm.

Holm: Mr. Broussard, maybe I don't know enough to ask the right question? I though I heard you say, and I can't find it in your remarks, that we were planning to pass savings on to the oil companies. Now it wasn't my understanding we were planning to pass any of these savings on to the oil companies. We were planning to use them ourselves.

Broussard: As I recall, there was a question directed to Mr. Spahr which stated, and I'll try and paraphrase it, if the state could derive benefits they intend to derive, which I see a major part being tax exemption, exemption from federal income taxes which the private companies would otherwise pay, and were able to pass some of or all of those benefits on to the companies wouldn't we be interested. Now that implies to me that the state has at least considered the possibility of trying to pass come of those advantages on to the companies. In addition to that, the Chairman stated during Mr. Gary's testimony, the proposition that perhaps 50% of these savings might be passed through to the companies. I added it additionally in my own testimony the possibility that the ICC, which has never been asked to rule on what rate of return they should allow for tax exempt owner of the pipeline. They may require that some of the ultimate savings go on to reduce tariff.

Holm: Speaking of the possibility that we would look at our competitive positon on the market and say that we'll pass the savings on for that reason, but this wouldn't necessarily put the money into the oil companies pocket. Would that change the situation?

Broussard: I'm sorry I didn't understand the question.

Holm: If we arbitrarily lowered the rate on the passing of the oil through pipeline, to put Alaskan oil in a better competitive on the world market

this wouldn't necessarily pass, there would be savings passed to someone but it would merely put Alaskan oil in a better competitive position. Would this change the situation?

Broussard: Well I'm not/ A controlling economist but to the extent that you reduce your tariff in order to put your oil in a better position on the market, I assume you not mean priced your oil at less than you could ~~possibly~~ optimately price at. So I don't see that

Holm: We would in effect be using some of the profit that we would get in these tax savings to perhaps subsidize our oil at the competitive product, but it wouldn't necessarily pass these savings on to the oil companies per se or directly would it?

Broussard: Well, I assume the state would not do so without the intention of increasing in some way its return on its own interest in the oil. Now at present, as I understand it, the state's interest in oil is not 20% of the oil. It's interest is a royalty which it has a right to take but from which I would be surprised very much if they intend to take in and a severence tax, I simply don't recall no whether they have a right to take that in but presumably you would reduce your tariff to put your oil in a better market position in order to increase some way your profit.

Holm: . . . .

Rettig: If I might, Mr. Holm, maybe I could clarify a point there with some examples. Assuming a 3 billion dollar pipeline, whether privately owned or state owned, it would be under ICC rules entitled to make a $240 million profit. The privately owned firm would have to make a profit of approximately $510 million in order to achieve a profit after tax of $240 million. Approximately $270,000.00 in income taxes would be saved and would be reflected in the tariff which would accrue to the shippers of the oil and I think this is the premise that the state's position and all of their figures so indicate. Is that correct Mr Wohlforth?

The round figures may be off but isn't that the principal inheret throughout Mr. Wohlforth?

Wohlforth: Yes it is.

Rettig: It would permit the state to deliver the oil to Valdez at a rate lower because it is not taxed, the assumption that it is not taxed. So, in effect, it would all be passed on to the shippers. Are there any other questions? Mr. Barber.

Barber: Mr. Broussard, I understand you to say that it is unlikely that the Internal Revenue Service or the Treasury Department would hold such operations as the state operated oil line tax free. Now I emphasize your word unlikely. We will never know until we put before them that question. Is that right?

Broussard: Thats true. One of the reasons that I introduced my concern about the congressional action is that I'm not all that certain that you will know, even if you do get a ruling from the Internal Revenue Service which is favorable. I think you will know when you know when-you know whether Congress does or does not act.

Rettig: Are there any other questions? Senator Rader.

Rader: Going back to Senator Croft's question on the advantages or disadvantages to the operators of a corporate structure and undivided interest and so and so forth. If each of the participating companies in TAPS set up an individual Alaska corporation which they were the subsidiary, which they were the hundred percent owner then they could pace through any losses they had could they not?

Broussard: If they set up an Alaskan corporation with a hundred percent subsidiary to hold this undivided interest rather than using existing pipeline companies. Yes that is true. Then the same result in terms of going back to the consolidated return would be accomplished.

Rader: So that wouldn't represent any tax disadvantage to the company?

Broussard: No it would not.

Rader: Thank you Mr. Chairman.

Rettig: Apparently there are no more questions. Thank you very much.

Donaldson: The next witness is Mr. George Seymour who has appeared already before this committee and his remarks at the present time will be directed to pipeline profitability.

Seymour: (prepared statement)

REMARKS OF GEORGE A. SEYMOUR
TO ALASKAN SENATE AND HOUSE COMMITTEES
ON PROPOSED ALASKAN PIPELINE LEGISLATION
WEEK OF MARCH 6, 1972

INTRODUCTION

I AM GEORGE A. SEYMOUR. I AM MANAGER OF PART-INTEREST PIPELINES FOR MOBIL PIPE LINE COMPANY, THE COMMON CARRIER PIPELINE AFFILIATE OF MOBIL OIL CORPORATION. I AM AN ENGINEER BY PROFESSION AND HAVE BEEN EMPLOYED BY MOBIL FOR TWENTY-FOUR YEARS, DURING WHICH TIME I HAVE BEEN PRIMARILY ENGAGED IN PIPELINE ENGINEERING AND MANAGEMENT. MOBIL OIL CORPORATION OPERATES COOK INLET PIPE LINE COMPANY UNDER AN AGENCY MANAGEMENT AGREEMENT. I AM A DIRECTOR OF AND HAVE BEEN A VICE-PRESIDENT OF COOK INLET PIPE LINE COMPANY SINCE MARCH, 1970, WITH STAFF RESPONSIBILITY FOR THE OPERATIONS OF THAT COMPANY.

RATIONALE OF TESTIMONY

IN RESPONSE TO YOUR INVITATION TO APPEAR AT THIS HEARING, I WOULD LIKE TO SHARE WITH YOU THAT COMPANY'S OPERATING HISTORY WHICH

Cook Inlet Pipeline

WILL, WE FEEL, UNDERSCORE THE ECONOMIC RISK INVOLVED IN THE TRANS ALASKA PIPELINE PROJECT, AND ALSO POINT UP THE SIGNIFICANT DIFFERENCES BETWEEN A COMMON CARRIER CRUDE OIL PIPELINE AND A PUBLIC UTILITY.

DESCRIPTION OF COOK INLET PIPE LINE COMPANY FACILITIES

COOK INLET PIPE LINE COMPANY WAS INCORPORATED IN MARCH, 1966. ITS STOCK IS OWNED BY ATLANTIC RICHFIELD COMPANY, 20% MARATHON OIL COMPANY, 30% MOBIL PIPE LINE COMPANY 20% AND UNION OIL COMPANY OF CALIFORNIA. 30%

THE COOK INLET PIPE LINE FACILITIES WERE COMPLETED IN THE FALL OF 1967 TO OPERATE AS A CRUDE OIL PIPELINE SYSTEM ON THE WEST SIDE OF COOK INLET, KENAI BOROUGH, ALASKA. (414 A map of the pipeline system is attached as exhibit 1) THE MAIN LINE OF THIS PIPELINE SYSTEM CONSISTS OF FORTY-TWO MILES OF TWENTY-INCH PIPE FROM GRANITE POINT TO DRIFT RIVER. A TERMINAL COMPLEX LOCATED AT DRIFT RIVER ~~CONSISTS~~ includes OF SEVEN 270,000 BARREL CRUDE OIL STORAGE TANKS, DEBALLASTING AND BALLAST WATER TREATMENT FACILITIES, LIVING QUARTERS, OFFICES AND MAINTENANCE SHOP, AND AN AIRSTRIP AND HANGAR. OIL TRANSPORTED TO THE DRIFT RIVER TERMINAL BY THE PIPELINE IS

LOADED INTO OCEANGOING TANKERS AT A LOADING PLATFORM TWO MILES OFF SHORE AND CONNECTED TO THE ONSHORE TANKAGE BY DUAL THIRTY-INCH SUBMARINE PIPELINES. THIS PIPELINE SYSTEM SERVES FIVE OFFSHORE PRODUCING FIELDS IN COOK INLET -- TRADING BAY UNIT, TRADING BAY FIELD, TEXACO NORTH TRADING BAY FIELD, ATLANTIC NORTH TRADING BAY FIELD, AND GRANITE POINT FIELD. ~~THE LOCATION OF THE PIPELINE FACILITIES AND CONNECTED PRODUCING FIELDS ARE SHOWN ON EXHIBIT I.~~

CONSTRUCTION OF FACILITIES

DESIGN AND CONSTRUCTION OF THE COOK INLET FACILITIES COMMENCED IN MARCH OF 1966. THE FIRST TANKER WAS LOADED IN NOVEMBER, 1967. THE PIPELINE, THE DRIFT RIVER TERMINAL COMPLEX AND THE TANKER LOADING PLATFORM ARE CONSTRUCTED ON LANDS ACQUIRED FROM THE STATE OF ALASKA. COOK INLET OBTAINED A RIGHT-OF-WAY PERMIT OVER STATE LANDS FOR THE PIPELINE, PURCHASED 898 ACRES OF LAND AT DRIFT RIVER FOR THE TERMINAL SITE, AND ACQUIRED A TIDELANDS LEASE ON 392 ACRES OF THE FLOOR OF COOK INLET ENCOMPASSING THE OFFSHORE TANKER LOADING PLATFORM.

PIPELINE PROJECT JUSTIFICATION

THE ECONOMIC JUSTIFICATION TO CONSTRUCT THE COOK INLET PIPE LINE SYSTEM WAS BASED UPON THE THEN ESTIMATED PROSPECTIVE DISCOVERY OF 800 MILLION BARRELS OF RECOVERABLE CRUDE OIL RESERVES IN THE AREA TO BE SERVED BY THE PIPELINE AND WHICH WOULD BE PRODUCED AND TRANSPORTED IN THE PIPELINE DURING A THIRTY-YEAR PERIOD. INITIAL COST ESTIMATES INDICATED THAT THE CONTEMPLATED PIPELINE FACILITIES COULD BE CONSTRUCTED FOR $32 MILLION. THE FACILITIES ACTUALLY COST $42 MILLION, AN INCREASE OF 31% CAUSED BY THE HIGH COST OF CONSTRUCTION IN ALASKA AND THE NEED FOR MORE STRINGENT DESIGN TO MEET ICE CONDITIONS AFFECTING THE TANKER LOADING PLATFORM.

PIPELINE THROUGHPUT

SINCE THE CONSTRUCTION OF THE COOK INLET FACILITIES, THE RESULTS OF DRILLING AND EXPLORATION IN THE AREA HAVE FALLEN FAR SHORT OF INITIAL EXPECTATIONS. MORE THAN THIRTY-FIVE DRY HOLES HAVE BEEN DRILLED WHICH, IF PRODUCTIVE, WOULD HAVE BEEN SERVED BY THE COOK INLET PIPE LINE SYSTEM. PRODUCERS' CURRENT ESTIMATES ARE

THAT RECOVERABLE CRUDE RESERVES ACCESSIBLE TO THE COOK INLET PIPE LINE SYSTEM WILL NOW BE NO MORE THAN 500 MILLION BARRELS. THIS IS 38% LESS THAN THE RECOVERABLE RESERVE ESTIMATE UTILIZED FOR PROJECT ECONOMICS. AS A RESULT, PIPELINE THROUGHPUT HAS BEEN AND IS NOW PROJECTED TO BE SUBSTANTIALLY LESS THAN ORIGINALLY ANTICIPATED AS IS SHOWN ON EXHIBIT II. UNLESS ADDITIONAL CRUDE OIL RESERVES ARE DISCOVERED IN THE AREA CONTIGUOUS TO THE COOK INLET PIPE LINE SYSTEM, IT IS HIGHLY UNLIKELY THAT THE PIPELINE CAN CONTINUE TO BE OPERATED ECONOMICALLY AT THE THROUGHPUT LEVEL NOW PROJECTED FOR 1987.

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

#38 Lee Hall

TARIFF AND FINANCIAL POLICY

THE COOK INLET TARIFF POLICY WAS INITIALLY ESTABLISHED TO SET TARIFFS rates FILED WITH THE INTERSTATE COMMERCE COMMISSION AT A LEVEL WHICH WOULD RECOVER ALL COSTS AND PROVIDE AN OWNER'S RETURN OF 7% ON I.C.C. VALUATION. UTILIZING THE ORIGINAL CRUDE OIL PRODUCTION FORECAST (ORIGINAL PROJECTION, EXHIBIT II), THE TARIFF WAS SET AT 21-CENTS PER BARREL. INITIAL PRODUCTION EXCEEDED

ADL which is redacted

EXPECTATIONS AND PRODUCERS' RE-EVALUATIONS OF RESERVES INDICATED THAT PRODUCTION WAS GOING TO EXCEED THE ORIGINAL PROJECTION, PARTICULARLY IN THE FIRST FEW YEARS. BASED ON EXPECTED INCREASED PRODUCTION AND THE ESTABLISHED TARIFF POLICY, THE TARIFF WAS REDUCED TO 16-CENTS PER BARREL IN MAY, 1968. PRODUCTION FELL BELOW FORECAST AND COOK INLET PIPE LINE COMPANY ENDED THE YEAR 1968 WITH A BOOK LOSS OF $123,000 AND A CUMULATIVE LOSS OF $1 MILLION. IN MAY, 1969, THE TARIFF WAS INCREASED TO 20-CENTS per barrel WHICH PERMITTED COOK INLET TO OVERCOME THE BOOK DEFICIT. IN APRIL, 1970, IT HAD BECOME EVIDENT THAT CONNECTED RECOVERABLE CRUDE RESERVES WOULD PROBABLY BE NO MORE THAN 500 MILLION BARRELS, AND THE OWNERS AGREED THAT COOK INLET'S FINANCIAL POLICY SHOULD PLACE EMPHASIS UPON RETIREMENT OF INDEBTEDNESS WITHIN THE LIFE EXPECTANCY INDICATED BY CURRENT ESTIMATES OF CRUDE PRODUCTION (CURRENT PROJECTION, EXHIBIT II), that is the shaded area. THE TARIFF WAS ACCORDINGLY INCREASED TO 22 1/2-CENTS EFFECTIVE JANUARY, 1971, WITH THAT RATE SCHEDULED TO REMAIN IN EFFECT UNTIL SUCH TIME (PROBABLY 1978) AS IT BECOMES NECESSARY TO FURTHER INCREASE THE TARIFF TO MAINTAIN A BREAKEVEN POSITION. THE

CURRENT COOK INLET FINANCIAL POLICY PROVIDES NO DIVIDENDS TO THE OWNERS AND ALL CASH INCOME IN EXCESS OF WORKING CAPITAL REQUIREMENTS IS UTILIZED TO RETIRE DEBT. THE GOAL OF THIS FINANCIAL POLICY IS TO GENERATE SUFFICIENT FUNDS DURING THE REMAINING ECONOMIC LIFE OF THE COOK INLET FACILITY TO REPAY THE INDEBTEDNESS INCURRED TO CONSTRUCT THE FACILITY, AND TO RETURN THE OWNERS' ORIGINAL EQUITY INVESTMENT WITH NO EARNINGS THEREON.

OIL PRODUCTION AND PIPELINE THROUGHPUT

THE ANNUAL THROUGHPUT VOLUMES OF COOK INLET SHOWN ON EXHIBIT II PARALLEL THE CLASSIC PRODUCTION CURVE OF A SINGLE OIL FIELD OR GROUP OF FIELDS DISCOVERED AT APPROXIMATELY THE SAME TIME. PRODUCTION GRADUALLY INCREASES AS FIELD DEVELOPMENT WELLS ARE DRILLED FOLLOWING A PIPELINE CONNECTION TO THE FIELD. SOMETIME AFTER ALL PRODUCTIVE WELLS DRILLED IN THE AREA ARE CONNECTED TO THE PIPELINE, PRODUCTION WILL REACH A PEAK UNLESS PRODUCTION IS OTHERWISE LIMITED FOR A PERIOD OF TIME BY PIPELINE CAPACITY, PRORATIONING OF PRODUCTION, OR RESERVOIR FACTORS. THEREAFTER, PRODUCTION WILL

GRADUALLY DECLINE OVER THE PRODUCING LIFE OF THE FIELD. UNLESS ADDITIONAL RESERVES ARE DISCOVERED IN THE AREA SERVED BY THE PIPELINE, THE THROUGHPUT OF THE PIPELINE WILL DECREASE AS THE CRUDE OIL IS PRODUCED. IN THE ABSENCE OF NEWLY DISCOVERED RESERVES, THE COMBINATION OF DECLINING THROUGHPUT VOLUMES AND INCREASING OPERATING COSTS PER BARREL WILL ULTIMATELY RESULT IN AN UNECONOMICAL PIPELINE OPERATION EVEN IF TRANSPORTATION CHARGES ARE SUBSTANTIALLY INCREASED. ULTIMATELY, PRODUCING AND PIPELINE OPERATING COSTS WILL EXCEED THE VALUE OF THE CRUDE OIL AND BOTH THE OIL FIELD AND THE PIPELINE FACILITY WILL BE ABANDONED.

CRUDE OIL PIPELINES VERSUS PUBLIC UTILITIES

A COMMON CARRIER CRUDE OIL PIPELINE FACILITY CONSTRUCTED TO TRANSPORT PRODUCTION FROM ONE OR MORE NEWLY DISCOVERED OIL FIELDS DIFFERS ~~SUBSTANTIALLY~~ considerably FROM A PUBLIC UTILITY FACILITY. A CRUDE OIL PIPELINE IS A SUBSTANTIALLY MORE RISKY BUSINESS VENTURE THAN A PUBLIC UTILITY ENTERPRISE OR EVEN OTHER TYPES OF COMMON CARRIER TRANSPORTATION OPERATIONS. A PUBLIC UTILITY FACILITY IS ORDINARILY

CONSTRUCTED TO PROVIDE A BASIC SERVICE TO A SEGMENT OF THE GENERAL PUBLIC, OR TO ALL MEMBERS OF THE GENERAL PUBLIC IN A GIVEN AREA. BECAUSE OF POPULATION GROWTH, A PUBLIC UTILITY NORMALLY HAS ASSURED GROWTH IN ITS BUSINESS FROM A FIXED BASE FOR AN INDEFINITE PERIOD OF TIME WITH VERY LITTLE LIKELIHOOD OF ULTIMATE ABANDONMENT OF ITS FACILITIES, AND WITH, TYPICALLY, PERIODIC RATE INCREASES TO MAINTAIN PROFITABILITY. ON THE OTHER HAND, A CRUDE OIL PIPELINE, PARTICULARLY IN A REMOTE PRODUCING AREA SUCH AS ALASKA, WILL BE CONSTRUCTED ONLY TO MEET A SPECIFIC NEED -- IN THIS CASE THE TRANSPORTATION OF LARGE VOLUMES OF NEWLY DISCOVERED CRUDE OIL RESERVES. CONSEQUENTLY, SUBSTANTIAL INITIAL CAPITAL INVESTMENT IN THE PIPELINE FACILITY IS REQUIRED AT ONE TIME AS CONTRASTED WITH THE MORE GRADUAL INCREMENTAL CAPITAL INVESTMENT OVER A PERIOD OF YEARS BY A PUBLIC UTILITY TO MEET THE INCREASING SERVICE DEMANDS OF A GROWING POPULATION. SUCH A CRUDE OIL PIPELINE FACILITY IS DESIGNED SOLELY TO TRANSPORT THE DISCOVERED AND PROSPECTIVE OIL RESERVES IN THE AREA IN WHICH THE PIPELINE IS CONSTRUCTED. THERE IS NO ASSURANCE THAT ADDITIONAL OIL FIELDS WILL BE DISCOVERED IN THE AREA SERVED BY THE PIPELINE OR

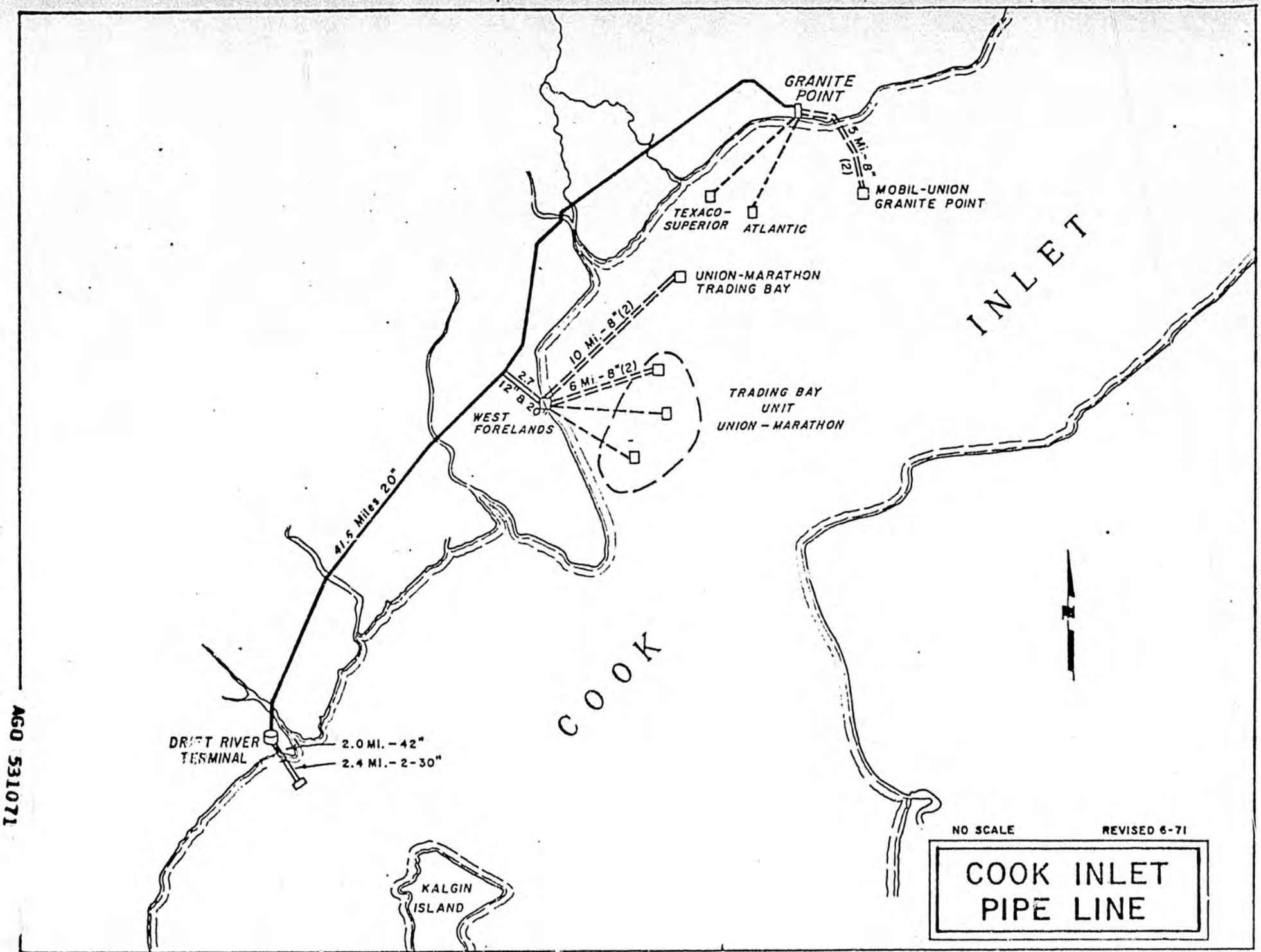
EVEN THAT THE ANTICIPATED PROSPECTIVE CRUDE OIL RESERVES WILL ULTIMATELY BE PRODUCED AND TRANSPORTED IN THE PIPELINE. THE ABANDONMENT OF THE PIPELINE FACILITY WHEN OIL RESERVES ARE DEPLETED IS A CONCRETE PROBABILITY FROM THE VERY INCEPTION OF THE PIPELINE PROJECT. THESE UNUSUAL CRUDE OIL PIPELINE RISK FACTORS RESULTING FROM THE CHANCE LOCATIONS OF UNDERGROUND OIL RESERVOIRS ARE INEVITABLE AND ACCEPTED IN THE OIL INDUSTRY. BECAUSE THESE HIGH RISK FACTORS CANNOT BE AVOIDED, CRITERIA FOR DETERMINING REASONABLE RATES OF RETURN ON OIL PIPELINE INVESTMENTS HAVE ALWAYS RECOGNIZED THAT TRADITIONAL PUBLIC UTILITY RATE-MAKING CONCEPTS CANNOT BE REALISTICALLY APPLIED TO OIL PIPELINE COMMON CARRIERS.

RECOGNITION OF RISK

THE WILLINGNESS OF OIL COMPANIES TO CONSTRUCT THE COOK INLET PIPE LINE SYSTEM WITHOUT ASSURANCE OF AN ACCEPTABLE LEVEL OF PROFITABILITY ON THE INVESTMENT IN THE FACILITY DEMONSTRATES THE ECONOMIC RISK ASSUMED IN CRUDE OIL PIPELINE INVESTMENTS BY ENTERPRISES IN THE PETROLEUM INDUSTRY. THE PARTICIPANTS IN THE

TRANS ALASKA PIPELINE SYSTEM PROJECT SIMILARLY HAVE NO ASSURANCE THAT THE PIPELINE FACILITY WILL BE A PROFITABLE INVESTMENT OVER ITS LIFE. NEVERTHELESS, THE TAPS OWNERS ARE WILLING TO ASSUME THE RISK INHERENT IN THE PROJECT. FUTURE DEVELOPMENTS WILL DETERMINE WHETHER THE TRANS ALASKA PIPELINE SYSTEM WILL BE A PROFITABLE INVESTMENT OVER THE LIFE OF THE PROJECT.

JRK-GAS/JV
MARCH 3, 1972



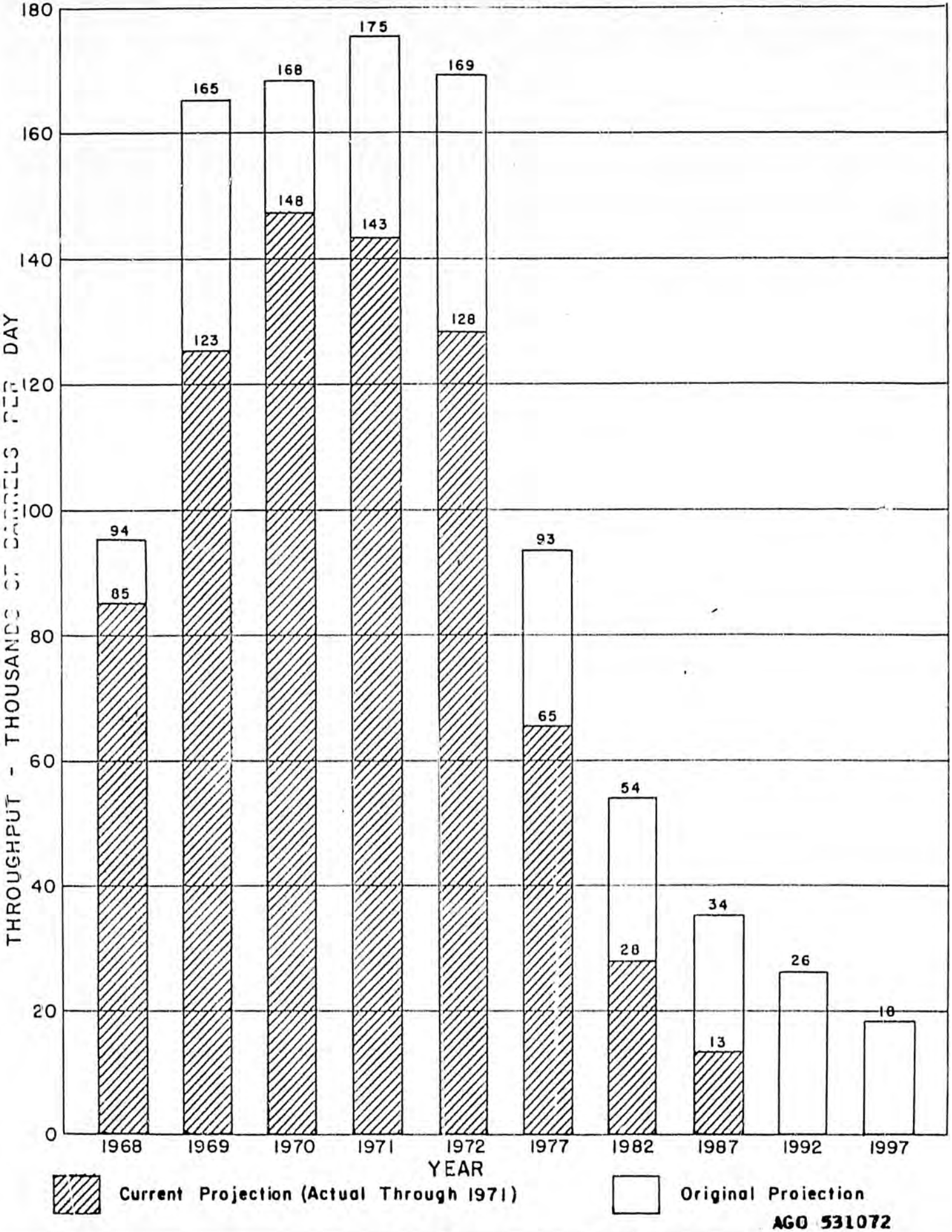
AGO 531071

EXHIBIT I

A-2291-5

COOK INLET PIPE LINE COMPANY
ANNUAL THROUGHPUT VOLUMES

EXHIBIT II



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Seymour: (statement was pre-typed)

Rettig: Are there any questions? Mr. Barber.

Barber: Mr. Seymour, in as much as the revenue with the state approves is directly determined by the transportation costs and in as much as you had to increase the profit to your pipeline company and ~~to~~ the transportation cost to keep them solvent. Does that not mean that the state of Alaska will pay the cost of that pipeline expense anyway?

Seymour: Let me say one thing we didn't increase the profit to the pipeline company, we increased income to the pipeline company so we could ~~ambertise~~ AMORTIZE the indebtness that we had. In connection with the second portion of your question, ~~undoubtly~~ UNDOUBTEDLY the increased cost of transportation, which it is to both the shippers in the pipeline who are owners of the pipeline as well as the State of Alaska ~~who~~ THOSE royalty crude oil, as you may know, is taken on an exchange arrangement by an oil company and is shipped through the pipeline. Ultimately the State of Alaska will feel the effect of this increase for transportation costs. Yes sir.

Barber: To what extent will we feel it—in percentages?

Seymour: I've indicated the range of the tariff.. it ran from 16¢ at a ~~mimuim~~ MINIMUM to 22 1/2¢ and you would have to develop the actual effect of this tariff increase on the State of Alaska's revenue from the oil that is produced in Cook Inlet from these numbers. I have not made that calculation.

Barber: It has been said that no matter what happens the State of Alaska will pay for the Trans-Alaska Pipeline. In your opinion, is that a true statement?

Seymour: I really don't quite understand your question. The State of Alaska will pay for the Trans-Alaska Pipeline?

Barber: Through the transportation cost and their prospective increases.

Seymour: Mr. Donaldson has indicated that ~~you~~ YOU'RE ~~you've~~ trying to indicate that ultimalty IT'S going to cost Alaska money to produce this black gold, THAT'S in the ground that belongs to Alaska. Is this the point you are trying to make?

Barber: No, I mean as transportation increases, the amount of money the State gets decreases. So we are going to pay for it in the long .....

Seymour: It definitely has a effect on the well head price and the taxes that are paid by the companies on the crude oil that comes out of the ground. That is correct.

Rettig: Just a little clarification on that point. The cost of the facility, the total pipeline and works, will be recovered to tariffs charges to the shippers. Is this not correct?

Seymour: Yes sir.

Rettig: Seven-eighths of the oil will be shipped by the owners, one-eighth will be owned by the state. Is this correct? So theoretical seven-eighths of the cost will be borne by the shippers other than the state. Is this not correct?

Seymour: Yes sir. Now what happens to the states crude oil you may make an arrangement as you have in Cook Inlet to have this oil taken in kind by someone rather than sold to the producers.

Rettig: So, in short, the State ultimately will pay for one-eighths, towards the recovery of the cost of the pipeline. Are there any other questions?

Croft: Do you mean to the committee? (Go ahead) Mr. Chairman, as I understand, the tariff on the Cook Inlet pipeline is presently 22 1/2 cents a barrel to transport the oil less than 42 miles. (That's correct.) Is there any comparable pipeline in United States where the transportation charge is that high? The way I figure it we lose we get to zero well head value before we get to Glenallen at that rate.

Seymour: Well first of all if you look at the post of tariff of the 22 1/2 cents, sevens cents of it is pipeline transportation and fifteen and a half cents is the terminaling and loading aboard tanker charge. The operation at the terminal is far more costly and complicated than the pipeline transportation in this case.

Croft: Could you say, in effect, you can't compare it to any other pipeline for that reason there.

Seymour: Well, now I did't say that. When and if we complete the Trans-Alaska project the ~~terminial~~ TERMINAL operation, from a stand point of complexity and operation will be a much more ~~complacated~~ COMPLICATED than the pipeline operation will be.

Croft: Considering the overall operation, do you know of any other pipeline in the United States that charges 22 1/2 cents a barrel to transport oil less than fifty miles? Do you know of any COMPARABLE TARIFF of that distance?

Seymour: I think you are again mixing--this is not just pipeline transportation I know of pipelines that certainly charge more than six cents a barrel to transport oil less than fifty miles. But you have the storage and the terminaling of the crude oil and the loading of the vessel, operation of loading facilities of which shades or distorts this picture so that you can't equate this 22 1/2 cents total simply to pipeline transportation. Do I answer your question in this matter?

Croft: Are those charges regulated by Interstate Commerce Commission as well?

Seymour: Yes, everything, the tariff is one piece of paper, which is the Cook Inlet Pipeline Tariff which lists the transportation cost from granit point to terminal at seven cents and indicates where the carrier will transfer petroleum from the carrier's tankage into the shipper's vessels at a charge of fifteen and a half cents. This is filed and approved by the Interstate Commerce Commission.

Croft: So I can understand it. Have dividends been paid to date on the Cook Inlet Pipeline?

Seymour: Dividends were paid in two years. There were none for the first two years,, then dividends for two years and there will be no more dividends under the current tariff policy.

Croft: Do you know what the total of the dividends paid the . . . .?

Seymour: Yes sir, four million dollars has been paid.

Rettig: Mr. Rose.

Rose: Mr. Seymour, thank you Mr. Chairman. Mr. Seymour as I understand your presentation concerning the Cook Inlet Pipeline. When the production projections vary then the rate is adjusted accordingly. Is that correct?

Seymour: Repeat that I didn't understand . . . . .

Rose: When the production projections vary then the tariff is adjusted accordingly?

Seymour: No, not normally, of course, we like to think that all projections are correct in this case as you see they were incorrect and you will note from the timing of the tariff changes that the tariff reduction or increases were made some time after we realized the decrease production. That is correct.

Rose: At that point you readjusted the tariff

Seymour: Yes sir

Rose: so that on the basis on the dual possession you would come out even in the end with no loss or gain.

Seymour: Thats right. Now I would like to point out that the we didn't make just one projection when first decided to look at the evaluation of Cook Inlet. We have annual forecast from the producers as to what the production we be, and they have constantly declined.

Rose: So my conclusion then and I would like you to tell me if I am right or wrong on this. Is that on that basis it can be a reasonable conclusion that a pipeline operation can be expected not to lose money in the long run but to come out even and if the original projections come out correct or nearly so. In other words, the choice would be to come out even at the end or make a profit.

Seymour: Well, of course, everyone likes to make a profit on his investment

and as we have discussed for a considerable amount of time this week. There is a profit or a dividend limitation set by the Federal Government so that we would normally arrange to set our tariffs as I indicated initially we had our policy was to cover our operating expenses, service our debt, provide a dividend payment or profit of seven per cent. Unfortunely this was not the case.

Rose: I am sorry Mr. Chairman, obvious the thrust of my question was not understood. What I am saying is that you can through revaluation of projections eliminate, for all practical purposes, the loss at the end.

Seymour: Well, yes, of course, unfortunately, if the tariff gets to the point where the cost of transportation so drastically effects the price of the crude oil you cease to transport anything. There is no profit guarantee at all.

Rose: Thank you Mr. Chairman.

Rettig: Senator Radar.

Radar: Thank you Mr. Chairman. Mr. Seymour, looking at page 40 of the ICC report, that you gave us today. It indicates there, if I understand that form and perhaps I don't, that's why I am asking you the question. That you have three million dollars in dividends in one year, 1970. (right) In view of what we've said here I don't understand how that is done or is that consistent with the .....

Seymour: Well, you see in the first three years in this operations prior to this time we had a loss in 1967, in 1968 we had a loss, in 1969 we had a did have a profit and of course these losses and this allowable is carried forwarded, and that was the way we were able to pay a 3.1 million dollars dividends in 1970. In 1969, we paid a nine hundred thousand dollar dividend.

Radar: In line with that is it customary in the pipeline business to I should be concerned that return in capital.

Seymour: Yes sir. This was, as I mentioned, the policy that was finally

established that the ~~equitity~~ EQUITY would be returned. This was done by means of dividends and that there would no future dividends in the operations.

~~Radar:~~ RADER Do you normally, this kind of situation, return your ~~equitity~~ EQUITY before your DEBT IS PAID ?

Seymour: It can be done. This is a matter of choice by the directors of the company. Now we have, also, ~~choosen~~ CHOSEN to increase our debt retirement rate, ~~So~~ so hopefully it can be retired before we run out of something to transport.

Radar: Thank you Mr. Chairman.

Rettig: Are there any other questions? Yes, Mr. Barber.

Barber: I, of course, comprehend that whatever dollars was saved in transportation, that the oil companies got 80 cents out of it, and I'll put it this way. As transportation costs increase, the return to the State of Alaska decreases. Is that not true? When it is necessary for you to increase your tariff it will ultimately mean that the State of Alaska will get less money.

Seymour: That is correct.

Barber: Now we are in agreement. Thank you.

Donaldson: May Mr. Seymour be excused.

Rettig: Yes.

Donaldson: Mr. Patton was on your list as our eleventh witness. He covered all his remarks in his appearance this morning. Mr. Cortese may resume the witness seat. Mr. Cortese will speak to the legal aspect of the state ownership and IN the conclusion will take questions on any of the subjects he has testified about.

Cortese: (Statement is prepared)

Cortese: Mr. Chairman, ladies and gentlemen of the committee, I hope I'll not be wearing out my welcome here before I'm done. This testimony relates to legal aspects of financing under HB's 569 and 570.

The legal aspects of the financing of the pipeline by the State or a state authority are important considerations, for the legal problems involved materially enlarge the seriouc doubts as to the ability of the State to provide public financing for the facility. However, as we discuss those legal problems, it should be borne in mind that even if there were no legal questions concerning state financing, a most serious, persistent and unavoidable concern is that the State simply cannot market this massive volume of financing within the time frame required. Cogent testimony has been presented on that aspect. At this point some of the legal problems will be discussed to further illustrate the sincere concerns of the producers that the State financing package being considered would cause further substantial delays and ultimately founder.

A subject of test litigation and the substantial questions involved. Let me point out that Alaska, in recent years, has undertaken bond financing in relatively novel areas, such as through the Alaska State Mortgage Association, Alaska State Development Corporation, and for the Alaska Mortgage Adjustment Plan in connection with the 1964 earthquake. In each of these instances the State has advisedly taken the basic questions of law to the Alaska Supreme Court to remove any doubt that the bonds would be valid when issued so that concerns as to legality would not further burden or thwart the marketing of the bonds. It seems most likely that such test litigation would be important with reference to House Bills 569 and 570.

Among the legal propositions which would need to be negated by such litigation are the following:

1. That the use of the state credit to finance the pipeline project is unwarranted in view of the availability of private financing, and use of state credit for such a facility in the circumstances would not serve a public purpose as required by Article IX, Section 6, of the Alaska Constitution.

2. That the State guarantee of the bonds of the Trans-Alaska Authority provided for in House Bill 569 would create a State debt contrary to Article IX, Section 8,

3. That the leasing of the pipeline by the Authority to the State as provided for in House Bill 569 would result in a State debt under Article IX, Section 8, not qualifying under the exceptions provided in Section 11.

4. That House Bill 569 would be a local or special act in violation of Article II, Section 19, Alaska Constitution.

5. That House Bill 569 involves unlawfull delegations of legislative powers to the proposed Trans-Alaska Authority and to other executive and administrative offices.

The course and outcome of such test litigation cannot be reliably predicted. Since the proposed State ownership and financing of the pipeline may be an active public issue, this might become quite different from the test litigation of the past. It is conceivable that citizens or citizen groups would intervene in the litigation, such that the scheduling of the litigation might not be that normally expected. Motions, demands for introduction of extensive testimony, and ancillary litigation, could produce extraordinary delays. It may be noted that the Alaska State Mortgage Association litigation consumed over two and one-half years. This is not rare, for bond litigation elsewhere has been quite lengthy, especially where there is involved a controversial issue, as with the Phoenix Civic Center leasing which took over 5 years, and Cincinnati and Louisiana stadiums taking a

couple of years each.

There is also the prospect of independent litigation and I would like to make reference to the non-litigation certificate requirement in bond financing.

Even if the State and its bond counsel should decide that test litigation is not necessary, the basis for adverse legal contentions is sufficiently present to indicate that others, acting independently of such determination, might nevertheless file litigation. This would pose a very serious problem in the marketing of the bonds because of the normal requirement for successful marketing that a no-litigation certificate be delivered would not be met. The no-litigation certificate is to the effect that no litigation is pending questioning the validity of the bonds, the authority under which they are issued, or the authority to provide for payment from the general or special funds committed thereto. The simple point of such a no-litigation certificate requirement is that a prospective bond purchaser does not want to buy a litigation. In this context it would appear that the pendency of such litigation would preclude giving the accepted form of certificate and thereby prevent the marketing of the bonds. I would like to point out that there are 4 types of bonds provided for in HB's 569 and 570.

1. General obligation bonds of the State, backed by the full fairth anc credit and the taxing power of the State in the normal fashion;
2. Bonds of the Trans-Alaska Authority guaranteed by the State;
3. Bonds of the Trans-Alaska Authority backed by the general credit of the State through the device of leasing the pipeline to the State with the State paying rentals from its general funds in sufficient amounts to subsidize any operating losses, pay principal and interest on the bonds and establish and maintain reserves to further secure the bonds.
4. Bonds of the Authority payable solely out of the net operating revenues of the Authority as might be generated over the life of the bonds, with the bondholders

taking the risk of any inability to pay by reason of inadequacy of revenues resulting from delays or interruption in construction, inadequacy of funds to complete the project, any interruption in operation, or changed economic circumstances.

On the public purpose question that I first mentioned and the question and the question of, is there a need for the State to use its credit. In view of the fact that private capital is ready, willing and able to finance the pipeline project, there is a substantial question whether the use and consequent burdening of the State's credit for this project would be for public purpose within the constitutional prohibition agianst use of the credit of the State for other than a public purpose. In this connection you will recall that Mr. Robert Macy, financial advisor for the Administration, pointed out that these bonds really should be backed by full faith and credit of both the oil companies and the State, and he said that in the event of some restricted committment of the credit of the oil companies were involved, nevertheless the backing of the State

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

Cortese: of the dedication of any funds of the state to a public enterprise or public ccorporation and also/would permit a mortage of any lands of the state and of any royalities , rents or other revenues before accruing from such land. The Alaska Constitution, Article IX, Section 6, provides: " No Tax shall be levied, or appropriation of public money made, or public property transferred, nor shall the public credit be used, except for public purposes" In Ault v. Alaska State Mortgage Association decided by the Alaska Supreme Court in 1969, excuse me, in 63, the court held ~~kxid~~ the financing , excuse me, the Court held that the findings and statement of public policy, public purpose in an act of the Legislature did not foreclose determination by the Court of the question of whether the act would serve a public purpose, the Supreme Court remanded the case to the Superior Court for a taking of evidence pertaining to the question, whether public purpose would be served by the act. There, the Alaska State Mortgage Association was to issue revenue bonds to provide moneys in the secondary mortgage market to stimulate housing construction. The Supreme Court said it wanted to see evidence as to the adequacy or lack of private funds in the secondary mortgage market, the effect thereon of termination of a federal program, and how the Association would reduce or eliminate adverse effects. After the case was remanded to the Superior Court and detailed testimony taken, upon a second appeal to the Supreme Court, the Supreme Court approved the program, two and one-half years later after its original decision. The Court ruled that a public purpose existed because there was a need for public financing in view of the inadequacy of private funds, as shown by the evidence, and that the program would not merely compete with private funds because the Association would make moneys available only where funancing could not be obtained from the private market. Likewise, in Dearmond v. Alaska State Development Corp., decided by the Alaska Supreme Court in 1962, the court approved a program for business development loans to be provided by the issuance of revenue bonds, only after determining that private financing was not sufficiently available for long term

development loans. In Wright V. City of Palmer, decided by Alska Supreme Court in 1970, the City's issuance of general obligation bonds to construct a plant to be leased to a manufacturer was approved upon evidence that the object and effect would be to encourage industrial development which was urgently needed because the City's , because the City's economic growth was nil, high year-round unemployment existed, jobs had been lost by the closing of mining and lumbering enterprises, there was no manufacturing in the City, and businesses were moving out of the City. The need for the City itself to take an active role in the financing was apparent. It has been held that industrial development financing serves no public purpose where the facts make it plain that private funds will provide for the project without the injection of public financing. The case where Manning v. Fiscal Court of Jefferson County decided by the highest court in Kentucky in 1966, where the Court said that " That no public purpose is served by substituting public credit for private funds. That result appears to be consistent with the approaches taken by the Alaska Supreme Court in the cases mentioned above. From an examination of the proposed statement of legislative findings and policies contained in House Bill 569, it is difficult to perceive any necessity whatever for State financing in order to achieve the objects stated, incidently the objects stated are such as, constructing the pipeline, getting it built, the consequent job development, the decrease in unemployment, economic development in general and environmental protection, all of which have been testified upon by Mr. Patton as being achieved by private financing by Alyeska and the pipeline companies. It is difficult to percieve any necissity whatever for the State financing in order to achieve the object stated especially when it is apparent that the planning, development, and expertise represented in Alyeska Pipeline Service Co. are essential to the early achevement of the pipeline project consistent with those ojectives, and in view of the substantial question s as to the practical ability of the State to finance the project. It should be borne in mind that private capital has already spent or encumbered a half billion dollars

for this pipeline, that's in addition to the bonus on the lease, and is ready, willing and able to provide the balance needed. In short, the ability to obtain the objectives through private financing and ownership presents a material question of whether the use of the State's credit for this project is unwarranted and impermissible under the Alaska Constitution. And I emphasize that I am not stating this as a policy question which it obviously also is but really as a legal constitutional question. In my memorandum before you I have a section on the State guarantee of authority bonds , the indication that that would be unconstitutional state debt, the point I make here is that a guarantee constitutes a contraction of ~~state~~ debt which can not be done without a constitutional amendment, apparently this has been recognized by presumably is why the House joint to this committee --------- the House ------the House/draft resolution was submitted/on Tuesday. Incidently I have an error in statement in the third, in the last paragraph in the last sentence which I indicate That the annual, in noting that all of the, through a guarantee all of the resources , financial resources of the State would be on the line, I noted that debt service would be apparently equivilent to the annual revenues of the State. I had miscomphrened that I had previously examined I guess I was looking at the State budget rather than the recurring State revenues which was indicated earlier in the neighborhood of $150 million. On that basis and on the basis of the reference of 20 to 30 year bonds, assuming 30 year bonds and on the basis Mr. Wohlforth's assumptions of 8 and 6 1/2 percent interest the debt service would be in the neighbor hood of$300 million which is approximately twice the current rec urring state revenues. I simply wanted to correct that for the records so as not to mislead. State rental lease commitment which is provided for on the bill. The provisions of Section 250 of House Bill 569 for the Trans-Alaska Authority to lease the project to the State and for the State to operate or sublease the project pose serious questions as to whether State debt would be unconstitutionally created thereby. Section 250 would authorize the Governor to enter into such a lease in connection with the Authority's financing of the

project, and to agree that the State would pay the Authority sufficient amounts in rentals to pay the principal and interest on the bonds, the operating and maintenance expenese of the project, and to provide or maintain reserves for debt service and operating and maintenance expenese. No limitation of amount is provided and the lease may be for any agreed term or may be unlimted in term.. Under the lease, the Governor may also commit the State to subsidize costs of the project in any amount agreed upon with the authority. No restriction is provided as to the sources of funds of the State which would be needed to pay the rentals.

The only apparent object of these provisions is to place the State in the middle so that purchasers of the Authority's bonds might view the State's credit as standing behind the bonds, and thus obtain the benefit of the State credit without a vote of the people. Such lease-type financing has been used or tried in other state and has been sustained in some and declared unsontitutional in others as creating a state debt without constitutional authorization. Still other states have adopted constitutional amendments to permit such lease financing. The validity of such financing has not been determined by the Alaska Supreme Court. The legal question is clearly presented where a unique purpose project is involved, such as this crude oil pipeline. For example the Illinois Supreme Court, in Rosemount Building Supply, Inc. V. Illinois Highway Trust Authority decided in 1970 held invalid a plan whereby the Authority would issue bonds, which the act said were not to be deemed to be obligations of the State, to finance highways, bridges and related facilities. The Authority was to pay off its bonds from its own revenues, but its principal source was to be rentals to be received from the State through leasing the projects to the State. The State was not to be committed to pay rentals except as periodically appropriated, and if rentals were not paid the Authority could undertake operation and charge tolls or lease the projects to others.

The Illinois Supreme Court had previously approved lease type of financing for various buildings, but here it distinguished those cases as involving the type of

facilities which were readily adaptable to other uses so that it could be assumed that other lessees could be found to pay sufficient sums if the State ceased to pay rentals. However, here it was apparent to the Supreme Court that while the State was not legally obligated to continue appropriations, there would be no real alternatives for use of such highway facilities. Thus, the Court concluded that an unconstitutional State debt would be created by such leasing program. Much the same can be said of the propased lease commitment of the State of Alaska in connection with the pipeline project; for if at any time the pipeline was not earning enough to cover the debt, there would be no practical way to avoid a burden on the State general fund for there would be no takers for a losing facility which has no other practical use. Thus with the vast cost, and consequent heavy debt service burden, of this single purpose facility, the type of financing involving a lease commitment by the State poses a substantial constitutional question as a contracting of State debt without complying with constitutional requirements for vote of the people. I would like to summarize the balance of this memorandum without taking an undue amount of your time. The next point is that there is a substantial question as to whether the Bill 569 constitutes a local or special law violating the constitution or prohibition against passing local or special act , acts if a general act can be made applicable. And I refer to the fact that the project that may be financed is limited to this single pipeline from the North Slope to the Prudhoe Bay area, excuse me the Valdez area. And that in similar circumstances in litigation in which my firm was involved in , in Ohio we provided for the financing of state underground parking facility. Only under the State House grounds our Supreme Court under similar constitutional provisions held that since there was a general purpose in providing parking, the general purpose might be in need of satisfaction elsewhere in the State to restrict this to a single facility was a special act in violation of the constitution. Incidently that litigation took a five year period of

time. Also, I point out that there are substantial questions of unlawful delegation of legislative powers provided for under this bill. In particular reference is made to the granting of authority of exclusive jurisdiction control and management of all pipeline facilities in the state which would be amended by amendments submitted to this committee on Monday I believe or Tuesday which change that provision giving the authority exclusive management control over those pipeline serving the source as defined by the Authority as conveying the oil or gas over a route as defined by the Authority so that the Authority is given ----------choose as it will, which in my judgement also raises substantial question of unlawful delegation of legislative powers. Also I have that the leasing provision would create an unlimited rental obligation of the State for an unlimited period of time without any particular guidelines indicating an uncontitutional delegation of legislative authority to the Governor, I also refered to the guarantee [illegible] as being so wide open and as being mandated really by the bond documents, the bond agreements made by the authority such that the Governor presumably would have to put his signature on any guarantee on any bonds that the authority or two members thereof had agreed should be guaranteed as being without any proper standards or distraints so as to constitute an unconstitutional delegation. The administration proposes striking that section from the bill, however, I suggest to you that it was not ------- as was indicated is to you that the proposed constitutional amendment would still need implimentation and that this type of provision can be looked upon as the type of implimentation that would be involved ultimately there would be certainly in that respect the serious question of unconstitutional delegation of legislative powers to the Governor. In conclusion it appears that HOuse Bills 560 and 570 raise many substantial legal problems that could keep a large number of lawyers busy for many years; and there are justifiable concerns that they would do precisely that if enacted. In view of the delays of the project already experienced, and the ecomonic cost thereby to the State, the concerns over legal problems under House Bills 569

and 570 and the further delays they can cause are important considerations for this legislature. Again if should be emphasized that, as previously testified to, even in the complete absence of any legal question, the patent inability of the State or a public cooperation of the State to successfully market such a huge volumeof bonds in the short time required, presents a direct practical and critical problem which strongly indicates that House Bills 569 and 570 are practical approaches for achievement of the objectives of the State.

Rettig: Are there any questions from members of the Committee? Other members of the Legislature? Senator Croft.

Croft: I have some questions not about his recent comments but about his earlier comments about the right of way leasing act---- concern. I'm curious as to the first two premises in your memorandum regarding right of way leases. You cited In Oklahoma v. Kansas Natural Gas Co. case, and as I understand your memorandum that case Oklahoma attempted to completely prohibit interstate commerce in gas, is that correct?

Cortese: Yes sir. Sought to conserve the gas only to Oklahoma.

Croft: Are you suggesting that that principal applies to 294 or 313, that there's an element in those bills by which interstate commerce is absolutely prohibited?

Cortese: The principal from which I cite the case as I indicated earlier was a premise from which to develope further thought on the problem and the principal for which I cited is that a State may not use its control over land to inhibit interstate commerce. Therefore, where the ultization of state land is essential for the carrying out of interstate commerce the state cannot withhold the use of that land. Then I went on to point out that the state, since the state cannot withhold it there are limits to the conditions that it can exact to making that land available. One of which was, it can ask for reasonable compensation but only reasonalble compensation in relationship to the value of the land provided.

Croft: Yes, I think even Prf. Weathersponn acknowledges there is that limitation

that you have to obtain fair value.

Cortese: He speaks in terms of fair value, he speaks in terms of the productivity of the land as I pointed out earlier it's apparent he really isn't refering to the productivity of the land, he's referring to the productivity of a pipeline that has been built with private capital and is privately owned. Which are two completely seperate thoughts and as I pointed out the considerations of the Supreme court in determining what is reasonable compensation relate to the use of the land for general purposes by anybody and not to the special purposes of the one given exotic userof that land.

Croft: Mr. Chairman, because of the importance of this question I would like to pursue it.

Rettig: Go right ahead.

Croft: Several questions arise as far as determining the fair value, you cited a case involving condemnation, I wonder if your reliance on that case is based on the premise that the State discretion with respect to the value of its land that it disposes of is idenitical to the constitutional mandate to pay fair value when it takes somebody else's land. Are you saying that those two things are identical?

Cortese: Not in isolation but in the context of a situ ation where oil reserves have been bought from the State and the only apparent way to market those reserves is by pipeline must cross state land and the only way to conduct interstate commerce is to cross that land, then I suggest to you that rental demands of that nature of the red line would appear to be and undue burdening of interstate commerce would appear to be way out of comparison with the true value of that land by any rational text.

Croft: You're not suggesting that either the Impact Committee Bill or the Administration bill distinguish between intra and inter state commerce.

Cortese: No I'm Not suggesting they disguish in verbalize but its quite apparent

in all the discussion and all the documents that we've seen that the legislation is directed at this interstate pipeline and would not be under present consideration were it not for this pipeline, that's the impression I have. Correct me if I'm wrong.

Croft: If its effect is to apply equally to inter and intra state commerce does that affect your opinion in that regard. Does the state have a wider discretion as to what it can do if it does not discriminate between intra and interstate commerce

Cortese: Quite obviously I start with the basis that this is interstate commerce that we're dealing with and that the State is therefore restricted in what it can do. Going beyond that I did mention in my comments that this unusual heavy charge for the use of this land, even as applied to intra state commerce, to a gas shipper let's say, somewhere in the state, would in my judgement be a tax and a discriminatory tax having no relationship to the land therefore taxed. A discriminatory tax because it is being imposed only on those who use state land, or need state land and therefore use state land. It wouldn't be imposed upon a pipeline that was not on state land.

Croft: You're not suggesting though that the income derived from the use of the land is not at least one of reasonable measure of the value of that land?

Cortese: From the use of the land?

Croft: Yes sir, the income that's derived from the use of the land, is that one reasonable value or method of determining the value of the land?

Cortese: What I've pointed out in reference to the U, S, Supreme Court descisions is that a proper appraisal of true value of the land along this route including that across the tundra does not properly take inconsideration the forth coming use of it by special users.

Croft: You are saying thats not constitutionaly permissible to take

Cortese: In this context of my judgement, it is not

Croft: You cannot consider the income derived from the land as a means of determining the value of the land.

Rettig: You mean the future income derived from the land?

Croft: that in effect the percentage leased is not a reasonable means at arriving at value for use of the land?

Cortese: Certainly not in this context a percentage lease I'm sure you are aware is normally used in the context of a commercial enterprise basically a retail enterprise where the lessor is renting leasing a completed facility or space in a shopping center providing a complete space and the percentage lease is employed because the lessor developer has provided a facility which itself attracts the business, walk in trade, there I can conceptualize some relationship of the value of the use of the space to the gross income. But in this kind of context I can't remotely see how a percentage lease as I understand it is relavent to streches of land across frozen tundra .

Croft: What if instead of one application to could cross state land instead of this joint venture arra ngement each of the companies were going to construct an independant line, would they have authority to say that all lines had to be constructed within one part as adjutant of its propietary power?

Cortese: I doubt as an adjutant of its propietary power, I should thing more commonly that that consideration would fit into its adjutant as a sovereign that it has some interest where development takes place particular facility in that that is a fair consideration of a matter of state local concern, however, you bear in mind the supremacy of the federal constitution and of the commerce clause, so that to the extent that that local interest of the state would so conflict as to impede, interfere with excessively burden interstate commerce, the state concern would have to give way to that degree

Croft: So that as a means of its propriety power anytime an application is made to cross state lands by an interstate carrier the state's only alternative is to obtain reasonable value and grant for right of way as far as its propriety power is concerned.

Cortese: No, not at all, if, well I'm not sure I understood, I caught the full question. Did you say if it is necessary ? for interstate commerce?

Croft: I'm saying anytime an interstate carrier applies for a right of way across state land the only alternative open to the state is to grant the permit when it obtains reasonable value,if there is ten different companies that want across state land, its a burden on interstate commerce if we deny

Cortese: No Senator Croft, what I point out in my paper, the premise the obvious premise of the bill is that this pipeline cannot be constructed without the use of state land. That's an unalterable imparative. I'm saying that in that context where it's essential to use state land where there is no pratical alternative, yes, the state must permit the use at reasonable compensation. That is in my judgement supported by the cases.

Croft: That is true whether there is one application or there is 20 applications, that they cross state land and they involve different portions, if thats the only way you can get the oil out then we have to have 20 pipelines as far as our propriety power

Cortese:..... end of tape 39..

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

Cortese: ~~And tax~~ CONTEXT that does not _____ the interstate commerce.

Croft: Well what about our authority as far the oil and gas leases are concerned. To with-hold future sales of oil and gas leases to the companies acting in interstate commerce because we don't feel that a particular kind will receive fair market value and we have that type of discretion / to say we're just not offering our land for lease to any companies for ten years until the market price is increased.

Rettig: Mr. Croft I believe that the state in its leasing act does have the right to protect any BIDS for the leasing on state land.

Croft: Yes, and I was wondering how his comments applied to that .

Rettig: If you could _____ this legislation CHANGE / we'll pursue it.

Croft: Well yes, the state might feel that this year it won't get a fair value for its land if a pipeline permit is issued across state lands and next year it will, ~~cause~~ does it has the discretion to simply say we're not disposing of our land at all this year and we're gonna wait next year until the FAIR market value is higher.

Rettig: You're referring to right away leases.

Croft: Yes I'm curious WHAT DISCRETION

Cortese: You're ~~guaying~~ CLAIMING the reserves with the right of way.

Croft: Well, I'm sure as ~~hell for as~~ HOW FAR what you see the limitation on a propriortory power goes. What are the limits, what is the discretion of the state to with-hold ~~say~~ SALE THIS of its land. And as I WONDER---

Cortese: Well, if it with the leasing of the oil that would be the easiest way to with-hold the sale of the right of way.

Croft: That wouldn't be...

Cortese: There would be no need of a pipeline if there were no oil sold up there.

Croft: And that wouldn't be a burden on interstate commerce, the fact that we withheld our part, even if .!? WAS

Cortese: If you with-held the oil

Croft: Yes

Cortese: I should think not.

Croft: ~~They're holding~~ But withholding the lease ~~here~~ is.

Cortese: Once there's property ownership in the oil which can only be used in, by putting it into interstate commerce , that's what the Oklahoma case is about.

Croft: But we don't know that it's the only way , that may be the best way to the company, ah, but I mean one of the companies have spent over forty million dollars exploring another route and has even said that it is ~~pleasable~~ FEASIBLE under certain circumstances , it's not the only route, does that have any EFFECT

Rettig: It's the only practical one apparently, ah that certainly what Professor WEINBERGER thinks, and what I assume the joint pipeline impact committee thought, Ah, that is the tenor of the bill, ah, I can't conceive that ah, you would have supposed that anyone would accept those conditions IF that there were some practical alternative.

Croft: This may be the best alternative but not the only alternative.

Cortese: Well, I pointed out that in the Oklahoma case presumably even natural gas can be shipped without pipeline. Ah, it can be tanked and ~~cartoned~~ CARTED. It's a preposterous suggestion, but it's probably physically possible. But that didn't stop the Supreme Court of the United States from telling Oklahoma they could not with-hold the right to give cross rights , ah, highway crossing rights to the pipeline.

Croft: Yes, but in that case Oklahoma had given ah, the right to cross to domestic corporations that were engaged in ~~inprospect~~ INTERSTATE commerce, but with-held it from foreign corporations engaged in interstate commerce. That's a distinction that neither the administration or the committee's BILL ~~might~~ MADE.

Rettig: We're going to have to conclude this ah, debate, ah, that's what it's becoming ah, we're going to ah continue tomorrow ah, at 8:00 ah, we are coming close to ah, at least the end is forseeable. We could ah, come back this evening or perhaps ah, hold a marathon session that we do not choose to ~~but~~, and I don;t mean to imply that because Mr. Sandooske from Marathon is going to speak tomorrow, we do have ah, at least three more speakers and we'll conclude ~~it~~ AT this time and ah, have Mr. Donaldson conclude the testimony for the industry tomorrow, following which we will have the other two speakers, ON THESE SPEAKERS there may be three and following that ah, I understand the administration wants to have some supplemental testimonies and hopefully we can conclude by noon tomorrow. 8:00 in the morning.

SCOMM

#12:5

SOHIO 5/77

HYPOTHETICAL THREE COMPANY OWNERSHIP OF PRUDHOE BAY FIELD AND TAPS
COMPARISON OF THE TAX BURDEN UNDER THE TAX STRUCTURE OF ALASKA AND THE TAX STRUCTURE
OF TEXAS, LOUISIANA, AND CALIFORNIA - 1977 THROUGH 1986 10 yrs.
(Assumes oil sells for a constant of $13.00/Bbl in California. Dollars are in millions.)

		Alaska	If Alaska had the tax structure of Texas	Louisiana	California
I.	Tax burdens under (a) existing severance, ad valorem and state income tax laws for all four states, plus (b) intangible tax in Texas, franchise taxes in Texas and Louisiana and sales and use tax in California	$5,479	$3,974	$5,863	$5,152
	Alaska's burden as a percent of the other states		138%	93%	106%
II.	Tax burdens, as in I above but assuming that Alaska passes a severance tax law which has an effective tax rate of 11.3%	6,650	3,974	5,863	5,152
	Alaska's burden as a percent of Alaska's burden under existing laws	121%			
	Alaska's burden as a percent of the other states		167%	113%	129%
III.	Tax burdens as in I above but assuming that Alaska passes the administration's franchise (income tax) bill CS HB 322	6,372	3,974	5,863	5,152
	Alaska's burden as a percent of Alaska's burden under existing laws	116%			
	Alaska's burden as a percent of the other states		160%	109%	124%
IV.	Tax burdens, as in I above but assuming that Alaska passes both a severance tax law with an effective rate of 11.3% and the administration's franchise (income tax) bill CS HB 322	7,510	3,974	5,863	5,152
	Alaska's burden as a percent of Alaska's burden under existing laws	137%			
	Alaska's burden as a percent of the other states		189%	128%	146%

AGO 531097

- SOHIO (outdates)

HYPOTHETICAL THREE COMPANY OWNERSHIP OF PRUDHOE BAY FIELD AND TAPS
COMPARISON OF THE TAX BURDEN UNDER THE TAX STRUCTURE OF ALASKA AND THE TAX STRUCTURE OF TEXAS, LOUISIANA, AND CALIFORNIA - 1977 THROUGH 1986
(Assumes oil sells for a constant $13.00/Bbl. in California. Dollars are in millions.)

	Alaska's Existing Laws	If Alaska had the tax structure of: Texas	Louisiana	California
1. Tax burden for severance tax, ad valorem tax, and state income taxes, as per "Sohio Submission Two", dated 1/21/77.	$5,479	$3,108	$5,532	$4,930
2. Tax burden, as shown in line 1 above, modified as a result of Sohio's restudy of its "Submission Two".	5,479	3,204	5,752	5,022
3. Tax burden, shown in 2 above, for severance, ad valorem, and income, plus other taxes[a/] which are included in tax structures of Texas, Louisiana and California.	5,479	3,974	5,863	5,152
4. Alaska under existing laws as percents of taxes under other tax structure:				
Taxes shown in line 1		176%	99%	111%
Taxes shown in line 2		171%	95%	109%
Taxes shown in line 3		138%	93%	106%
5. If the severance tax bill proposed by the Alaskan Senate is passed, the figures become:	$6,885[b/]	$3,974	$5,863	$5,152
Alaska's burden as a percent of other states becomes:		173%	117%	134%

a/ Includes intangibles tax of Texas, franchise tax of Texas and Louisiana and use and sales tax of California.
b/ Assuming an effective severance tax rate of 12 percent under the Senate bill.

4/25/77

AGO 531098

Explanation of Total Tax Burden: differences bt Dept Rev & Sohio figures

SOHIO THE STANDARD OIL COMPANY

MIDLAND BUILDING, CLEVELAND, OHIO 44115

RICHARD M. DONALDSON
VICE PRESIDENT
GOVERNMENT AND PUBLIC AFFAIRS

April 25, 1977

The Honorable Steve Cowper
Chairman, House Finance Committee
Alaska State Legislature
Juneau, Alaska 99811

Dear Mr. Cowper:

On April 13, I testified before your Committee and provided copies of a writing called "Sohio Submission Two". Over three months ago, I gave copies of this Submission to the Legislative Affairs Agency and to the Department of Revenue. This writing sets out our estimate of the total tax burden on the Prudhoe Bay field and on the Trans Alaska Pipeline over the next ten years under Alaska's existing laws and compares that tax burden with the burden that would exist if Alaska had the tax structure of Louisiana, California, or Texas. Our figures indicated that Alaska's burden is slightly lower than that of Louisiana, but greater than that of California or Texas.

On April 14, the Department of Revenue told your Committee that it felt the tax burden of Alaska was greater than that of Texas, but less than that of Louisiana, Wyoming, or California.

Since then, we have made a thorough review of our work, and this review confirms that we were correct in telling you that Alaska's burden is a little less than it would be under Louisiana's tax structure, but greater than it would be under the tax structure of California or Texas.

The figures shown in "Sohio Submission Two" and those provided by the Department of Revenue included severance tax, ad valorem tax, and income tax.

Questions have been raised about the inclusion of the intangibles tax of Texas, the franchise taxes of Louisiana and Texas, and the sales and use taxes of California. We studied these points, as well, and came to the following conclusions: When we include our best estimates of these other taxes, the numbers change a little bit, but the basic picture we set forth in "Sohio Submission Two" remains unchanged. Alaska still has a higher tax burden than it would have under the tax structure of California and Texas. In fact, the burden remains substantially greater than that of Texas.

We recognize that there were many basic differences between the Department of Revenue's work and ours. For example, we used a constant oil price of $13 per barrel in California, while the Department escalated the oil price to about $21 by 1985. The Department included Prudhoe gas production; we included no gas because of uncertainties as to its price and as to the start of its production. However, we believe the principal reason why the relative ranking of state tax burdens that we calculated differs from that of the Department of Revenue is the manner in which the ad valorem taxes were figured. We used ad valorem taxes which reflect actual industry experience in the three states that we examined. On the other hand, the Department calculated ad valorem figures by applying its estimate of each state's overall tax rate to a single set of assessed values for Alaskan properties, not the actual assessment experience which varies from state to state, and among the taxing jurisdictions within the states.

More specifically, when we started doing the work on "Sohio Submission Two" we considered using a system somewhat similar to that the Department has used. However, we soon gave up on that idea because we felt the results

could be misleading. There are two reasons for this. First, we felt it was not possible to select a representative tax rate or an overall assessment value for a state which would properly reflect the various assessment practices of all these independent jurisdictions (some 1,500 or so in Texas, for example). Second, we felt that a tax rate of one state, even if it could be arrived at, could not be applied to the assessment value of another state.

As a consequence, we decided to use what industry has actually experienced in paying taxes in a way that would hopefully avoid assessment and tax rate problems. In the case of the tax on property in the field, we used data assembled by the Alaska Oil and Gas Association (AOGA) for major producing states. AOGA expressed taxes actually paid as a percent of wellhead revenue. In other words, out of a dollar's worth of revenue, so many cents of the dollar were paid for ad valorem taxes on property in the field. This is a practice used by some companies in economic studies. However, before using AOGA's work, we asked ourselves whether it would be appropriate to use these percentages considering the fact that there might be a difference in wellhead value in the major producing states in the lower 48 compared to the wellhead value in Alaska. Obviously, if there were high wellhead values in these states, taxes divided by wellhead value might provide a percent that could give misleading results if applied to a different wellhead value in Alaska. We concluded that this was not a problem.

The Federal Energy Administration indicates that the average wellhead prices for domestic oil last year ranged from $7.79 to $8.60. The AOGA study represents the average prices received by the various companies, and so its data should be generally reflective of the domestic average.

In our work on "Sohio Submission Two", we used Prudhoe wellhead values ranging from $6.25 to $6.70 during 1977, the year of startup; $7.30 to $7.70 during 1978, when the producing rate was assumed to be 1.2 million barrels per day; and from $8.00 to $8.60 during 1979, and the balance of the ten-year period when production was assumed to be 1.5 million barrels per day. Results, therefore, should not be misleading.

In the case of pipeline ad valorem tax, we knew of no industry figures to which we could refer. Consequently, we made our own survey by contacting other companies and developing figures from industry experience. Here again, we tried to avoid assessments and millage rate problems as much as we could. Consequently, we took the actual taxes paid as a percent of original pipeline cost in the states of Louisiana and Texas and actual taxes paid as a percent of depreciated reproduction cost in California.

After rethinking and re-examining "Sohio Submission Two", we believe our idea of using industry experience is valid and that the manner in which we applied this experience provides the correct results. Upon reviewing our work, we detected a few errors, as one might expect, but they did not change the results we provided to you.

In summary, then, I believe the results shown in "Sohio Submission Two" are correct and hope that this confirmation will be of help. We will, of course, be glad to review our work with the Department of Revenue, if that should be desirable.

Sincerely,

Richard M. Donaldson

RMD/pmk
cc: Members of House Finance Committee
Senator John Rader
Commissioner Sterling Gallagher, Alaska Department of Revenue
Mr. Kenneth E. Showalter, Sohio

Alaska State Legislature

Senate

JUNEAU, ALASKA

4/28/77 FOR OFFICE USE ONLY

TO: Sen Rader
FR: Connie
RE: O & G Taxation - conversation with John Messenger

COMPARISON OF OVERALL TAX BURDENS

The main points of difference between the SOHIO figures and REVENUE'S data are:

1. Revenue included gas severence in the comparison; Sohio did not.
2. Revenue included Cook Inlet; Sohio only used Prudhoe
3. Revenue & Sohio calculated ad valorem taxes in different ways.

The most significant difference is number 3 (ad valorem taxes). From talking with Donaldson on Tuesday and Messenger on Wednesday, I tend to lean in support of Messenger's views.

Messenger says that Sohio's data (based on a survey by the Western Oil & Gas Association) has 2 problems:

(1) While the Sohio data does use actual property taxes paid; rather than culminating in an average mill rate (which can then be compared to Alaska's 20 mil rate), the figures are expressed in terms of "% of well-head value".

This can be misleading, unless the ratio of property value/well-head value is the same for the states compared.

Example:

State X - Averages 1$ property value / 10$ well-head value
@ 20 mill tax rate this means:
.02$ tax / 1$ property value
.002$ tax / 1$ well-head value
property tax = .002% of well-head value

Alaska - Averages 2$ property value / 10$ well-head value (hypothetical)
@ 20 mill tax rate this means:
.02$ tax / 1$ property value
.004$ tax / 1$ well-head value
property tax = .004% of well-head value

Hence, altho hypothetical Alaska and State X have the same mill rate, by translating taxation into % of well=head value, Alaska shows twice the rate of taxation as State X. (This is because Alaska has a higher property to wellhead value than does State X.)

(1)

(2) Sohio assumed Alaskan (Prudhoe) wellhead value to be $7.50. However California's average wellhead value is probably much higher (more like upper tier $11.00). Hence if property taxes are shown as % of wellhead value, rather than actual mill rates, Alaska will show a higher property tax than California, even if their mill rate is the same.

EXXON

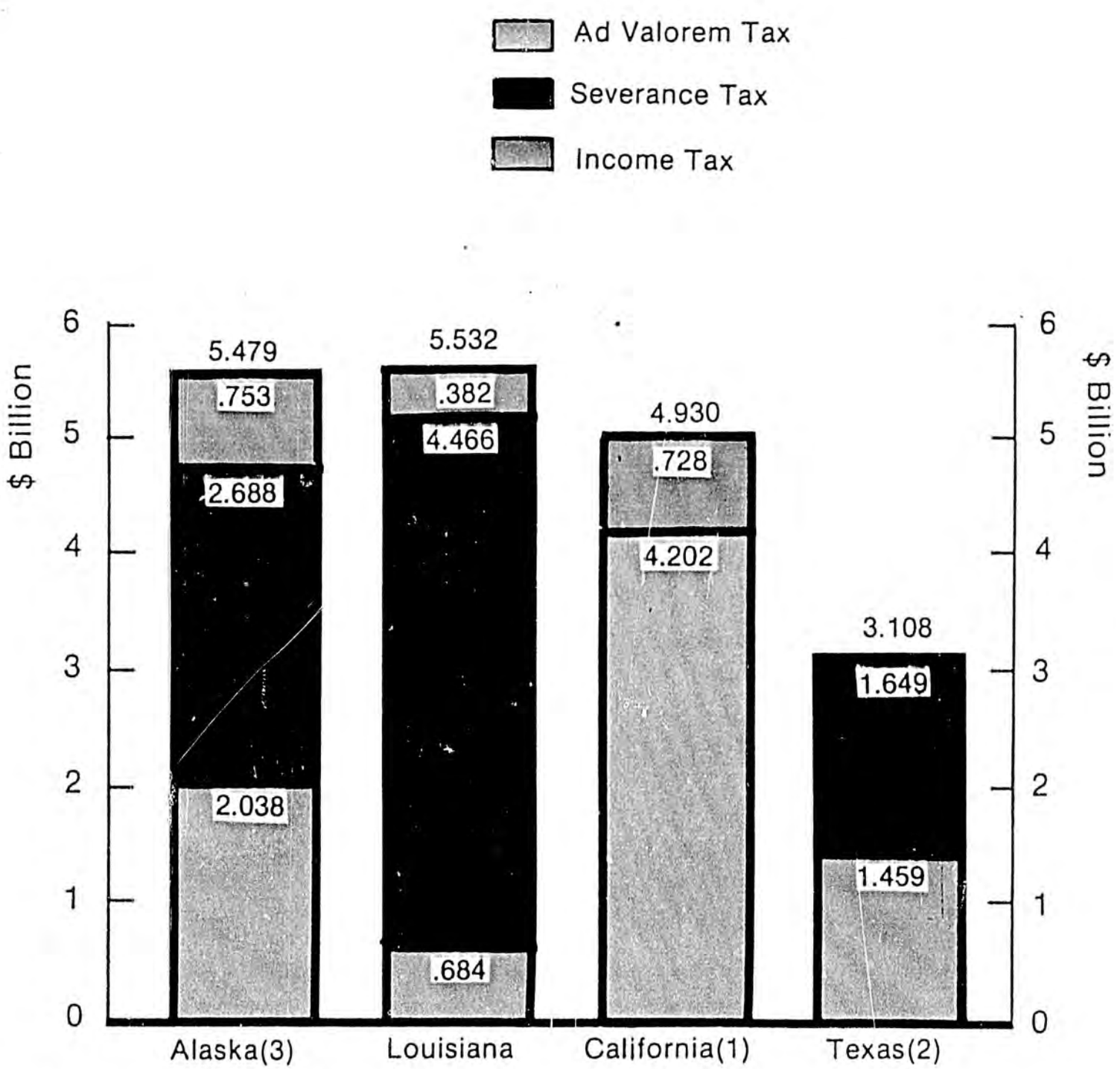
TOTAL TAX BURDEN OF ALASKA COMPARED WITH THE TAX BURDEN OF LOUISIANA, CALIFORNIA AND TEXAS

Chart 1 - Existing Laws

Chart 2 - Administration's Tax Package

Chart 3 - Legislature's Tax Package

TOTAL TAX BURDEN*



(1) California does not have severance tax

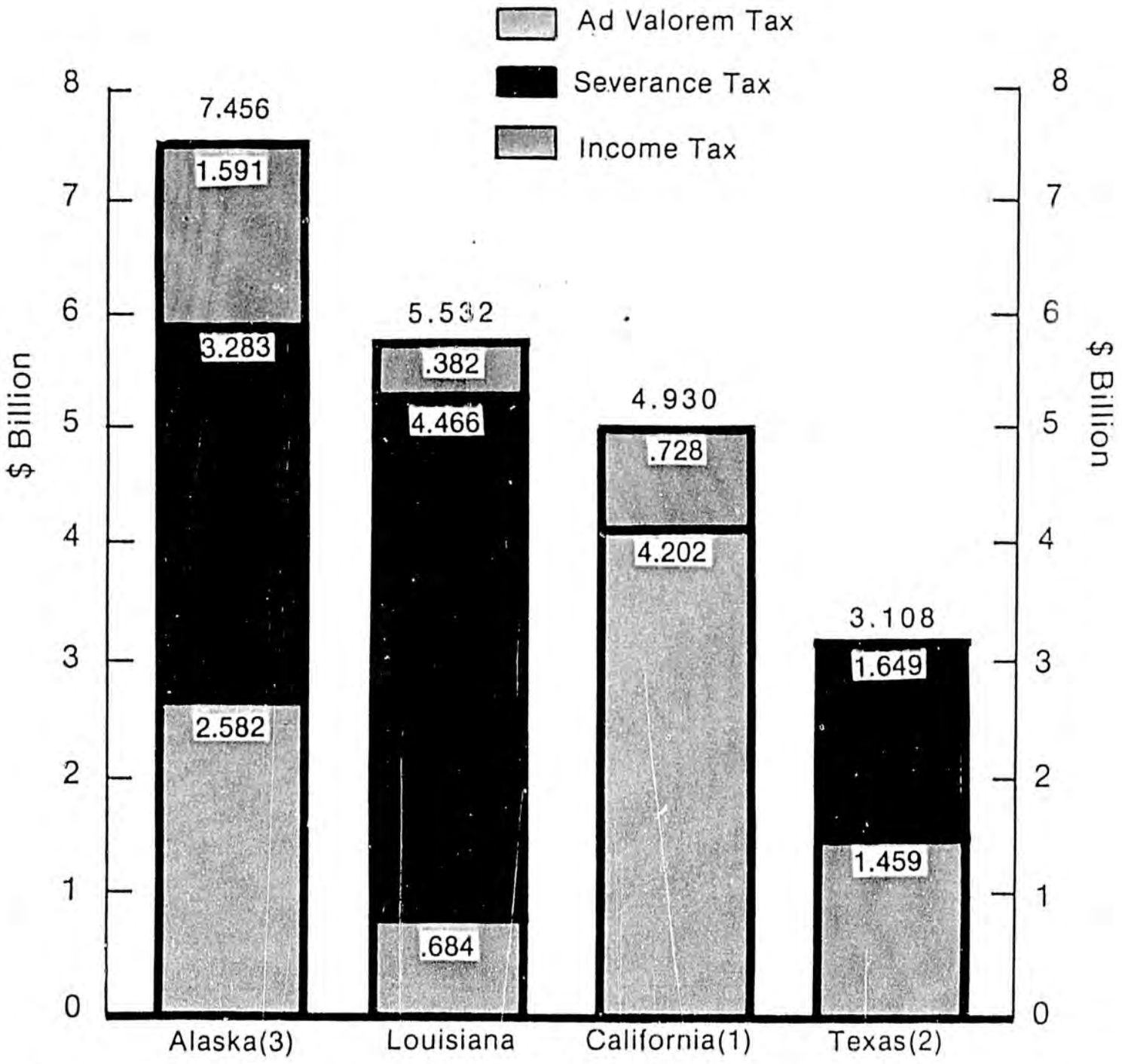
(2) Texas does not have income tax

*Sohio Hypothetical Three Company Ownership of Prudhoe Bay and Taps comparison of tax burden under the laws of Alaska, Louisiana and California - 1977 through 1986 assumes constant $13.00/Bbl. price in California - constant 1976 dollars

(3) Alaska Existing Tax Laws

AGO 531106

TOTAL TAX BURDEN*



(1) California does not have severance tax

(2) Texas does not have income tax

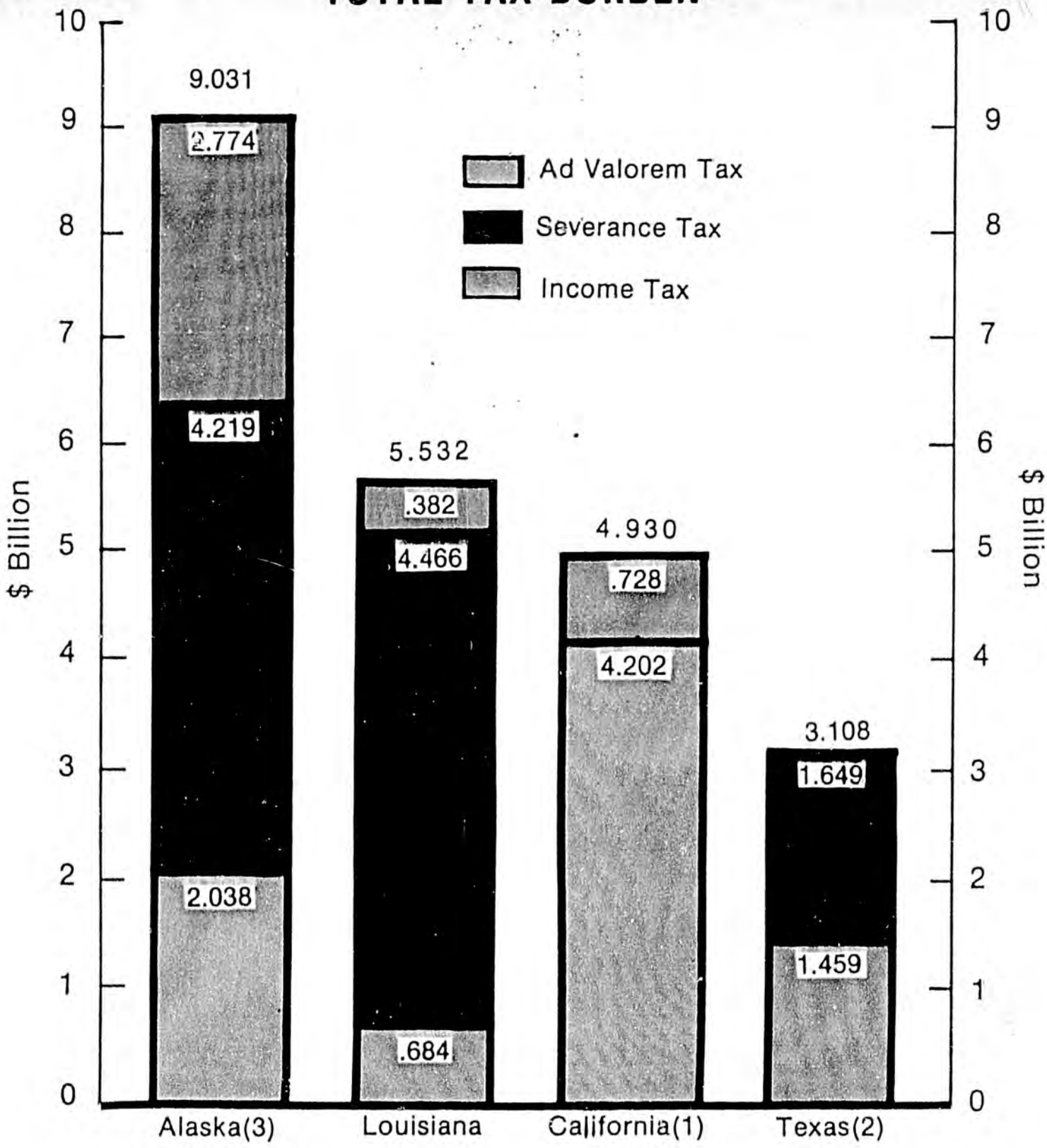
*Sohio Hypothetical Three Company Ownership of Prudhoe Bay and Taps comparison of tax burden under the laws of Alaska, Louisiana and California - 1977 through 1986 assumes constant $13.00/Bbl. price in California - constant 1976 dollars

(3) Proposed Alaska Tax Laws embodying the Administration tax package

AGO 531107

Chart 3

TOTAL TAX BURDEN*



(1) California does not have severance tax

(2) Texas does not have income tax

*Sohio Hypothetical Three Company Ownership of Prudhoe Bay and Taps comparison of tax burden under the laws of Alaska, Louisiana and California - 1977 through 1986 assumes constant $13.00/Bbl. price in California - constant 1976 dollars

(3) Proposed Alaska Tax Laws embodying the Legislature's tax package

AGO 531108

ADMIN - Dept Revenue: John Messenger

4/77

COMPARING TAX BURDENS

In the Department of Revenue's study of Alaska's oil and gas structure, it had planned to make a comprehensive comparison of Alaska's tax structure with that of other oil and gas producing states. Unfortunately with the short time available and the number of topics to be covered, it was not possible to complete this particular task in time.

due to

We have subsequently, however, been able to make a comparison of Alaska's tax burden with 7 of the major oil and gas producing states. These include Texas, Louisiana, California, Oklahoma, Wyoming, New Mexico and Kansas. In making the comparison the department has used the basic method used by Standard Oil of Ohio in its "Sohio Submission Two." That is - each state's tax structure is applied against Alaska oil and gas property,values, production and income. Accordingly, the department has taken its projections of Alaska property values, production volumes, well head values and apportioned income and applied the other state tax rates to them. In addition, like SOHIO we have not included the reserve tax payments nor the resulting reserve tax credits against severance tax.

Although we might have chosen another method in the beginning, we think that the SOHIO method is helpfull in making a basic comparison of tax burdens. A more complete analysis

would include additional taxes in the comparison with other states such as sales and use taxes, franchise taxes, special pipeline taxes and intangible taxes. For example California has a six percent sales and use tax that would apply to the sale and use of oil and gas properties in that state. Alaska on the other hand has sales taxes only at the option of the municipality and they range from two percent to five percent. Furthermore in Alaska oil and gas properties are exempt from local sales and use taxes except for the first $1,000 of each sale.

For property tax comparisons the department used property from 1977 through 1986. In some states both oil and gas hardware and reserves are taxed. In others only hardware property is taxed. Accordingly we included projections of property values for hardware and reserves separately. These values were then applied against the tax rates in other states. These property tax rates in the other states are a mixture of average assessment ratios and millage rates of the various municipalities throughout each state. The assessment ratio is the percentage of full and true value that is taxed and the millage rate is the actual percentage tax rates. Both the assessment ratio and the millage rate must be calculated to arrive at the adjusted tax rate. Since the millage rates vary from one part of a state to another, average millage rates and assessment ratios were used.

Note: Unless stated "hardware only", or "pipeline only" (excludes field hardware), property taxes include non-credited reserves taxes.

Unless noted, severance is for Oil oil & gas.
Only AK has a ¢/barrel (calls LA has $/MCF)

For severance tax comparisons the department used projections of production volumes and well head values and then applied these against the severance tax rates in other states.

no other state on a sliding scale. Severance rate used for AK was 7.8% for Prudhoe & ¢/barrel for Cook Inlet.

In the income tax comparisons the department used its projections of apportioned net income and then applied the other state tax rates to those projected incomes.

After making a comparison of all the taxes in these eight states the department found that Alaska ranked fourth behind the states of Louisiana, Wyoming, and California under existing law. Specifically the total taxes from 1977 through 1986 for Alaska totaled 7.6 billion dollars or 2.2 billion dollars below Louisiana - the highest state. Accordingly we estimate that Alaska's tax burden is not one of the highest but in the mid range of the major oil and gas producing states.

TOTAL TAXES
(1977 - 1986)

1.	Louisiana	9,896.6
2.	Wyoming	8,368.5
3.	California	8,331.9
4.	Alaska	7,680.4
5.	Texas	7,489.8
6.	Oklahoma	6,432.5
7.	New Mexico	6,181.1
8.	Kansas	6,031.2

LOUISIANA

I.	Property Tax (1977-1986)	
	Alaska Property Values (Hardware Only)	
	at 90 mills X .15 assessment ratio (adjusted millage rate - 13.5 mills)	1,762.3
II.	Severance Tax (1977-1986)	
	Alaska Production and Wellhead Values	
	at 12.5 percent - oil at 7¢ per Mcf - gas	7,905.3
III.	Income Tax (1977-1986)	
	Alaska Apportioned Income at 4 percent	228.9
TOTAL TAXES		9,896.5

WYOMING

I.	Property Tax (1977-1986)	
	Alaska Property Values (Hardward Only)	
	at 60 mills X .25 assessment ratio (adjusted millage rate - 15 mills)	1,958.2
II.	Severance Tax (1977-1986)	
	Alaska Production and Wellhead Values 10 percent at 7/8 (4 percent - local; 6 percent - state)	6,410.3
III.	Income Tax	-0-
TOTAL TAXES		8,368.5

WYOMING

I.	Property Tax (1977-1986)	
	Alaska Property Values (Hardward Only)	
	at 60 mills X .25 assessment ratio (adjusted millage rate - 15 mills)	1,958.2
II.	Severance Tax (1977-1986)	
	Alaska Production and Wellhead Values 10 percent at 7/8 (4 percent - local; 6 percent - state)	6,410.3
III.	Income Tax	-0-
TOTAL TAXES		8,368.5

CALIFORNIA

I.	Property Tax (1977-1986) ① O&G Hardware ② O&G Reserves	
	Alaska Property Values at 113 mills X .25 assessment ratio (adjusted millage rate - ~~38.5~~ 28.5 mills)	7,816.9
II.	Severance Tax	-0-
III.	Income Tax (1977-1986)	
	Alaska Apportioned Income at 9 percent	515.0
TOTAL TAXES (1977-1986)		8,331.9

ALASKA
(Existing Tax Structure)

I.	Property Tax (1977-1986)	2,610.9
II.	Severance Tax (1977-1986) ??	4,531.5
III.	Income Tax (1977-1986)	538.0
TOTAL TAXES		7,680.4

TEXAS

I.	Property Tax (1977-1986)	
	Alaska Property Tax Values at average adjusted mill rate 16 mills (12.5 mills X .30 assessment ratio) (18 mills X .60 assessment ratio) (1.45 mills)	4,427.3 ~~7,489.8~~
II.	Severance Tax (1977-1986)	
	Alaska Production and Wellhead Values at 4.6 percent - oil at 7.5 percent - gas	3,062.5
III.	Income Tax	-0-
TOTAL TAXES		7,489.8

OKLAHOMA

I.	Property Tax	
	Alaska Property Values (Pipeline Only) at 71 mills X .30 assessment ratio (adjusted millage rate - 21.3)	1,716.8
II.	Severance Tax (1977-1986)	
	Alaska Production and Wellhead Values at 7 percent on 7/8 production	4,486.7
III.	Income Tax (1977-1986)	
	Alaska Apportioned Income at 4 percent	229.0
TOTAL TAXES (1977-1986)		6,432.5

NEW MEXICO

I.	Property Tax (1977-1986)	
	Alaska Property Values (Pipeline Only)	
	at 28 mills X .33 1/3 assessment ratio (adjusted mill rate - 9.3 mills)	749.6
II.	Severance & Production Taxes (1977-1986)	
	Alaska Production and Wellhead Values at 7.95 percent on 7/8 (2.55% + 3.75% + 1.4% + .25%)	5,145.3
III.	Income Tax (1977-1986)	
	Alaska Apportioned Income at 5 percent	386.2
TOTAL TAXES		6,181.1

↑ in lieu of resources tax ↑ in lieu of field hardware

KANSAS

I.	Property Tax (1977-1986)	
	Alaska Property Values at 68 mills X .30 assessment ratio (adjusted millage rate - 20.4 mills	5,6448.8
II.	Severance Tax	-0-
III.	Income Tax (1977-1986)	
	Alaska Apportioned Income at 6.75 percent	386.4
TOTAL TAXES (1977-1986)		6,031.2

ALASKA

(Tax Structure under HB 321, 322, 323)

I.	Property Tax (1977-1986)	2,610.9
II.	Severance Tax (1977-1986)	4,877.4
III.	Income Tax (1977-1986)	2,152.0
TOTAL TAXES		9,640.3

PROJECTED PRUDHOE BAY WELLHEAD VALUE
(IN CURRENT DOLLARS PER BARREL)

YEAR (QTR)	ARABIAN 31° F.O.B. RAS TANURA	PG/US TANKER TARIFF	REFINERY PRICE	AK/US TANKER TARIFF	LOWER 48 TARIFF	TAPS TARIFF	TOTAL TARIFF	PRUDHOE BAY WELLHEAD VALUE
1977	11.56 (a)	1.65 (b)	13.21	.57 (c)	--	--	--	--
1978 (I)	11.84	1.72	13.56	.58	--	5.92 (d)	6.50	7.06
1978 (II)	11.84	1.72	13.56	.58	--	5.92	6.50	7.06
1978 (III)	12.68	1.90 (e)	14.58	.60	1.10 (f)	5.15	6.85	7.73
1978 (IV)	12.68	1.90	14.58	.60	1.10	5.15	6.85	7.73
1978	12.26	1.81	14.07	.59	.55	5.54	6.68	7.39
1979 (I)	12.68	1.98	14.66	.62	.80 (g)	5.15	6.57	8.09
1979 (II)	12.68	1.98	14.66	.62	.80	5.15	6.57	8.09
1979 (III)	13.30	1.98	15.28	.64	.80	5.09	6.53	8.75
1979 (IV)	13.30	1.98	15.28	.64	.80	5.09	6.53	8.75
1979	12.99	1.98	14.97	.63	.80	5.12	6.55	8.42
1980	13.77	2.06	15.83	.66	1.20 (h)	4.79	7.65	9.18
1981	14.60	2.14	16.74	.68	1.30	4.38	6.36	10.38
1982	15.47	2.23	17.70	.71	1.40	4.15	6.26	11.44
1983	16.40	2.32	18.72	.74	.80 (i)	3.88	5.42	13.30
1984	17.38	2.41	19.79	.77	.80	3.64	5.21	14.58
1985	19.43	2.51	20.94	.80	.81	3.45	5.06	15.88

NOTES: PROJECTED PRUDHOE BAY WELLHEAD VALUE (table on preceding page)

(a) As explained in the text preceding the table, the cost to a refiner to obtain imported replacement oil of comparable quality to Prudhoe Bay crude represents the extent to which the open market would justify the price of Prudhoe Bay oil. Saudi Arabian "Medium" crude (31° API gravity, 2.5% sulfur) serves as the benchmark from which Prudhoe Bay prices are derived. The $11.56 price represents the average price for Saudi Arabian "Medium" F.O.B. at Ras Tanura on the Persian Gulf. This average price reflects the December 1976 pricing action by Saudi Arabia. In the projection the price is assumed to rise at six percent per annum to offset U.S. and European inflation; in terms of dollars with constant value (constant buying power), the Arabian price is unchanging. In light of a developing global shortage of energy sources, particularly oil and gas, this assumption may be conservative, especially after 1985. On the other hand, assuming that the real (constant-value dollar) price increases at 3% a year yields a nominal-dollar price of $91.45 ($23.50 in real terms, as of January 1977) by the year 2000, and at that price oil as an energy source may have been significantly supplanted.

(b) Tanker transportation tariffs for the Persian Gulf to U.S. West Coast route during Fiscal Year 1976 were approximately $1.59 per barrel when computed on an average annual AFRA basis. While the current world tanker market could continue to suppress tanker tariffs in the future, tariff rates are projected to cover annual increases in variable costs. Tanker tariffs consequently are increased in this projection at an annual rate of four percent. The $0.21 per barrel import excise tax has been considered in arriving at these transportation costs.

(c) Tanker tariffs for the route between Valdez and the U.S. West Coast are computed on a weighted average basis according to port of destination and throughput volume. As in the case of foreign flag tankers, tariffs are increased 4% per annum from the composite base rate computed for operations in Fiscal Year 1978.

(d) The TAPS tariff each year will generate enough revenue to cover expenses, depreciation of the capital investment and a profit. A major determinant of the tariff is the number of barrels transported during the year. The more barrels, the lower the tariff can be in order to produce the necessary annual income.

Annual average throughput for TAPS is projected as follows (in millions of barrels per day): FY 78 - 0.94; FY 79 - 1.3; FY 80 - 1.53; FY 81 - 1.6; FY 82 - 1.7; FY 83 - 1.78; FY 84 - 1.88; FY 85 - 1.9. These rates reflect production in addition to that of the main Prudhoe Bay reservoir. TAPS tariffs are calculated on the basis of the pipeline's operating year, which is assumed to be the calendar year. The low average throughput expected during the 1977 operating year (i.e., the first two quarters of FY 78) is the reason for the high initial tariff. Some have predicted that the initial tariff will be a "break even" tariff, and on that basis it could be as low as $4.13. A tariff based on the average throughput during the first year of operation (which will correspond to the State's fiscal year but which would end in the middle of the pipeline's second operating year) would be about $4.85. The tariff projection is made on the basis of the entire pipeline, not on the basis of the financial situation of the eight individual companies that own it. Capital costs for the 1.2 million-barrel-a-day capacity are estimated at $9.45 billion, including capitalized interest. Expansion of TAPS capacity to 2 million barrels a day is assumed to cost an additional $995 million. All tariff projections assume that interest on debt financing for the pipeline will be recognized as an allowable expense in setting the tariff.

(e) Beginning in early 1978 (calendar year), the expected West Coast crude oil surplus is expected to develop. The surplus oil is assumed to go to the Gulf of Mexico area. Accordingly, the tanker tariffs are those for the trade between the Persian Gulf and the Gulf of Mexico. The tariffs are projected from the average AFRA basis during Fiscal Year 1976 and escalated at four percent per annum. Again, the 21 cent excise tax on imports is recognized.

(f) The "Lower 48 Tariff" here is the extra tankering costs assumed for moving the oil via the Panama Canal to the Gulf of Mexico. It is assumed that this is done on a temporary basis while one or more pipelines are built eastward across the Rocky Mountains from the West Coast.

(g) This is the projected tariff for a pipeline of 500,000 barrels a day capacity. The SOHIO pipeline has been used as the basis for the projection. Total cost for this capacity are estimated at $500 million.

(h) It is assumed that the West Coast surplus continues to develop beyond the initial pipeline capacity (500,000 barrels per day) to move it eastward. While additional capacity is coming on line (expansion of the first pipeline or construction of a second line), tankers are again employed to transport oil to the Gulf of Mexico area.

(i) At this point additional pipeline capacity becomes available to transport the entire surplus out of the West Coast area.

PROPERTY TAX VALUE PROJECTIONS
(Millions)

	FY 77	FY 78	FY 79	FY 80	FY 81	FY 82	FY 83	FY 84	FY 85	FY 86	TOTAL
HARDWARE VALUATION											
Prudhoe Bay Area Hardware Value	1,884	2,473	2,788	3,054	3,646	4,380	5,507	6,323	7,212	7,308	44,575
Cook Inlet Area Hardware Value	461	459	456	452	445	433	416	395	370	338	4,225
Other Areas Hardware Value	114	114	114	114	114	114	114	114	114	114	1,140
Trans-Alaska Pipeline Value	6,121	7,344	7,587	7,829	8,066	8,300	8,526	8,743	8,948	9,139	80,603
GRAND TOTAL	8,580	10,390	10,945	11,449	12,271	13,227	14,563	15,575	16,644	16,899	130,543
RESERVES VALUATION											
Prudhoe Bay Area Reserves Value	13,500.0	16,021.0	16,778.0	17,471.0	16,848.0	15,775.0	14,209.0	12,672.0	11,080.0	9,446.0	143,800.0
Cook Inlet Area Reserves Value	371.5	351.8	290.6	234.3	219.8	206.5	194.6	180.7	164.5	149.0	2,363.3
GRAND TOTAL	13,871.5	16,372.8	17,068.6	17,705.3	17,067.8	15,981.5	14,403.6	12,852.7	11,244.5	9,595.0	146,163.3

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STATE OF ALASKA
THE LEGISLATURE
LEGISLATIVE AFFAIRS AGENCY

POUCH Y - STATE CAPITOL
JUNEAU, ALASKA 99811
907-465-3800

MEMORANDUM

April 12, 1977

SUBJECT: Rate of Return Analysis on North Slope Operations and Comparison of Alaskan Oil Tax Rates With Other States (W.O. #4017)

TO: The Honorable John Rader

FROM: Richard G. Haggart
Research Analyst

This memorandum is in response to your request that we analyze recent oil industry testimony before the Joint House-Senate Resource Committee hearings on oil taxation. Specifically, you requested that we examine:

1. Competing statements and claims regarding rates of return that will be, or may be, earned on North Slope operations, in terms of overall accuracy and the appropriateness of underlying assumptions.

2. Whether the relative tax collection rates developed by Exxon and Standard Oil of Ohio for Alaska and other oil producing states accurately reflect current and proposed law.

Because of the complex nature of the issues involved and your need for a timely response because of the Finance Committee hearings on oil taxation beginning April 12, 1977, we have not been able to respond to your request in as full and complete a manner as we would prefer. Consequently, this memorandum includes only the following items:

1. A general discussion of discounted cash flow rate of return analysis and the major issues affecting such analysis, in terms of North Slope operations, and which cause significant variations among different forecasts of rates of return.

2. An appendix in which the specific rates of return cited by Exxon in their testimony of March 24, 1977, are examined for technical and methodological accuracy.

3. A brief analysis, performed in conjunction with the Department of Revenue, regarding the accuracy of Exxon's and Standard Oil of Ohio's statements regarding relative tax rates among oil producing states.

A fourth part of the memorandum is still in preparation and will be submitted to you by the end of April. In part four, we plan to develop a cash flow earnings model of Prudhoe Bay and the pipeline and examine the resulting rate of return from a variety of viewpoints. It is hoped that this analysis will help relieve some of the current confusion surrounding the issue of North Slope profitability and rate of return analysis.

RGH:jm
Attachment

Rate of Return Analysis

The operative concept in modern rate of return analysis is that of the "discounted cash flow". Although there are other and generally older measures of the rate of return (including the "pay-back" method, "accounting return", and a variety of returns on book financial measures), there is general agreement that some form of discounted cash flow or discounted rate of return analysis is the superior method. The essential difference between discounted cash flow analysis and any other method is that DCF analysis takes into account the concept of the "time value of money"--in essence, taking cognizance of the fact that a dollar received today is worth more than a dollar received next year. How much more is, of course, what DCF analysis is all about.

Clearly, in this memorandum, it is not possible to survey all aspects of discounted cash-flow analysis. However, the testimony which has been received by the legislature regarding "Prudhoe Bay rates of return" center around the following major differences of opinion:

1. The amount of money invested in the project. As will be discussed subsequently, it also may be relevant to determine an appropriate definition of "the project", and to note the proportion of borrowed funds to equity funds (debt versus stockholder interests) and in what area of the overall project such investments fall.
2. The relative cost of the investment--either in the form of direct costs, such as interest, or in opportunity costs;

i.e., how much money could have been earned had not the investment money been tied up in a half-built pipeline.

3. The magnitude, timing and duration of the cash flows from the project--how much oil will be pumped, what price will be received for that oil and over what time period this will all occur.

4. Finally, what costs, including taxes, should be deducted from the cash flows described in #3 above to arrive at a net cash flow figure for each year of production.

Obviously, given the variability of the items listed above, disagreements as to the "real" rate of return are not hard to imagine.

The primary source of disagreement among those testifying before the legislature (whether in 1976 or in 1977) has been regarding the level of investment to consider and whether to include assets financed by debt as well as those financed by equity. The basic and still unresolved questions before the legislature are:

1. Should the pipeline itself be considered separately from the Prudhoe Bay fields, or should the project be considered jointly, when making rate of return calculations?

2. Should the rate of return, whether calculated on an aggregated or disaggregated basis, be a return on net worth (stockholders' equity) or to total invested capital (which includes debt financing)?

In our judgment, differences on these questions account for 90 percent of the differentials among rate of return analyses which have been furnished to the State of Alaska.

TABLE I

FINANCIAL STRUCTURE OF PRUDHOE BAY AND TRANS-ALASKA PIPELINE
JULY 1, 1977
($ Billion)

Project	Debt(%)	Equity(%)	Total(%)
Prudhoe Bay*	$1.48 (40%)	$2.22 (60%)	$ 3.7 (100%)
TAPS	$7.06 (85%)	$1.24 (15%)	$ 8.3 (100%)
Total	$7.93 (66%)	$4.07 (34%)	$12.0 (100%)

* The debt equity ratio of Prudhoe Bay investments is set arbitrarily at 40/60.

TABLE II

HYPOTHETICAL CASH FLOW ANALYSIS
PRUDHOE BAY AND TRANS-ALASKA PIPELINE SYSTEM, 1978-2005

FY Year	Net Cash Flow Prudhoe Wellhead	Net Cash Flow TAPS Pipeline	Net Cash Flow Total Project
1978	$ 894	$600	$1494
1979	$ 920	$600	$1520
1980	$1661	$600	$2261
1981	$1869	$600	$2469
1982	$1869	$600	$2469
1983	$1869	$600	$2469
1984	$1869	$600	$2469
1985	$1869	$600	$2469
1986	$1774	$600	$2374
1987	$1687	$600	$2287
1988	$1518	$600	$2118
1989	$1365	$600	$1965
1990	$1229	$600	$1829
1991	$1105	$600	$1705
1992	$ 939	$600	$1539
1993	$ 800	$600	$1400
1994	$ 679	$600	$1279
1995	$ 579	$600	$1179
1996	$ 491	$600	$1091
1997	$ 393	$600	$ 993
1998	$ 312	$600	$ 912
1999	$ 237	$600	$ 837
2000	$ 185	$600	$ 785
2001	$ 124	$600	$ 724
2002	$ 85	$600	$ 685
2003	$ 59	$600	$ 659
2004	$ 42	$600	$ 642
2005	$ 29	$600	$ 629

It cannot be stressed too heavily that the rates of return calculated using the investment levels in Table I and the hypothetical cash flows in Table II are not the Legislative Affairs Agency's estimates of North Slope rates of return. They are, instead, illustrative models which demonstrate the possible variation in rate of return calculations, using the same data base. The investments are, of course, relatively accurate representations of investment-to-date in various parts of the project, as reported by the owner companies. The cash flows, however, are largely hypothetical and are not the result of any rigorous analysis--nor are they intended to be.

Briefly, the assumptions that went into developing Table II are as follows:

1. Net after-tax value of oil was considered to be $3.25 per barrel at the wellhead.
2. Pipeline net after-tax profits were assumed to be $600 million annually regardless of throughput levels (approximately a 7% return on $8.3 billion invested in the pipeline).
3. Production was assumed to begin in 1977, peak at 1.8 million barrels per day in 1981 and begin declining from that level in 1986. Production ceased in 2005 at a level of less than 30,000 bbl/d.

Using the data in Tables I and II, the following internal rates of return were calculated:

TABLE III

HYPOTHETICAL RATE OF RETURN VARIANCE CALCULATIONS[1]

	Internal Rate of Return (DCF Rate of Return)
Prudhoe Bay:	
Equity:	57.1%
Total:	36.0%
TAPS System:	
Equity:	48.2%
Total:	5.7%
Total System:	
Equity:	46.8%
Total:	16.3%

* Calculated from data contained in Tables I and II of this report.

As can be seen from Table III, the first major difference emerges if the pipeline is excluded from investment and rate of return calculations. Since about 69¢ of each dollar of capital invested in North Slope operations has gone to pipeline construction, and yet produces only about one-third of total cash flows, the net effect of excluding the pipeline is clearly to increase the rate of return on Prudhoe Bay production alone. Thus, excluding the pipeline from the overall calculation increases the DCF rate of return on "Prudhoe Bay" from about 16% over the life of the project to a 36% rate of return.

An even more dramatic change occurs if the return to only the equity investment is considered--here the DCF rate of return rises from 16% on all capital to over 48% if only equity is considered. Finally, the greatest returns are achieved when the two projects are considered

separately, and earnings are only attributed to equity interests. The pipeline project's rate of return to equity investment is almost 50% (compared to about 5.7% return on total invested capital), while Prudhoe Bay itself generates a return in excess of 57% if equity alone is considered.

Clearly, these differences are dramatic. They are also so wide-ranging that reconciling them becomes difficult, although not impossible. The following sections discuss some of the major economic and policy issues that cause the different rate of return results and the appropriateness of such differences in terms of the State of Alaska's viewpoint and that of the companies.

Excluding the Pipeline From DCF Rate of Return Analysis

The question of whether or not the pipeline and its associated earnings should be included in the calculation of the North Slope rate of return seems, on balance, to favor exclusion. On the one hand, the federal government limits the return on common carrier pipelines--to include such common carriers with more profitable ventures, so the reasoning goes, simply makes no sense, since by federal law (and court decisions) separate investment, financing and profit decisions must be made for such a project. Thus, to include the TAPS in a rate of return analysis artificially lowers the overall rate by including a regulated, capital intensive project in the determination. Further weight to this proposition is provided if the projects are viewed as engaging in a series of discrete, arms-length transactions, instead of the intra-company transactions of vertically integrated corporations. Thus, if the pipeline

were owned by General Motors Corporation, for example, the question of Prudhoe Bay versus pipeline rates of return would never arise--instead, tax and regulatory decisions would be made separately in view of their effects on the owner/operators of the oil field and upon the owner/operator of the pipeline. Only in the most general sense would decisions be reached on the basis of aggregate effects on the two areas (i.e., if you taxed the oil production out of existence, you would also "affect" the pipeline owner).

A final point is that any increased tax burden imposed by the state can be passed through the pipeline system in the form of higher rates. Consequently, any tax increase by Alaska will reduce the overall rate of return for companies operating in the state but will not necessarily reduce the return earned on the pipeline alone (and would not reduce the return, provided the owner/operators make tariff decisions on the basis of arms-length transactions). Thus, inclusion of the pipeline and its rate of return could provide a potentially misleading picture of the impact of taxes upon North Slope rate of return.

In defense of the concept of aggregated rates of return, it is clear such a view is appropriate from the company's as well as investor's viewpoints. After all, Exxon or Sohio cannot sell stock in Prudhoe Bay production and exclude the pipeline--or any other part of their operation. Likewise, investors purchase a piece of the total Exxon or Sohio pie--not just the highly profitable portions.

On balance, however, it seems appropriate for the state to consider the project in its component parts in terms of developing tax policy. A proper understanding of the financial and economic effects of imposing

an ad valorem wellhead tax, versus an ad valorem hardware tax, versus an aggregated francise tax, can hardly be achieved in any other fashion. Simultaneously, however, some credence should be given to corporate sector pleadings regarding the necessity for maintaining an overall rate of return that is competitive with industry standards--in short, the two standards are not irrevocably opposed, but should be used where appropriate.

Exclusion of Debt in Calculating Rate of Return

Another major area of contention in developing rate of return analyses regards the questions of including debt in determining a return on investment. The weight of the evidence here also seems to lie on the side of exclusion--but with a major caveat which will be discussed below.

The opponents of including debt in the rate of return calculation point out that debt requires no return other than the interest payment which was negotiated at the time of the bank loan or the issuance of the bonds or debentures. Therefore, to attribute income from operations to borrowed money is, in the view of some, an entirely spurious method of calculating the proper rate of return--on a par with attributing income to non-existent stockholders.

In our judgment, this view is marginally correct. Debt is a useful and necessary financing tool for any large corporation which, if properly used, can provide an important impetus to earnings via financial leverage. However, simply assigning a "return" to debt upon which payment has already been made (since almost all rate of return calculations are made after payment of interest and taxes) is too simplistic and is probably incorrect.

As was stated initially, however, there is a caveat to this conclusion--and that is that debt does require some return greater than the simple amount of principal and interest due. This is because securities markets view maintenance of a "safety margin" of sufficient earnings to cover "fixed charges" as a matter of some importance--and if that margin is eroded or is non-existent a firm's access to the capital market will be constrained, via higher rates or otherwise. Consequently, a firm may argue persuasively that consideration of the interest and principal requirements alone and assigning no further rate of return requirement to debt obligations is fallacious--the firm must indeed earn some return on invested debt over and above interest and principal requirements if it is not to suffer real financial impacts. The amount of such required return is, of course, debatable. One of the commonest measures used by financial analysts in determining the financial soundness of a firm is the "times interest earned" measure. This simply records the ratio of a firm's pre-tax and pre-fixed charge income to total fixed charges and provides some relative measure of that firm's ability to meet its fixed obligations and avoid insolvency. Naturally, there is no "good" or "bad" times interest earned ratio--analysts can only look to corporate history or to the performance of other companies in the same industry group for a relative measure of a firm's performance in this area. It seems likely that such an analysis would be appropriate when considering the tax impact on firms operating in Alaska, at least to the extent of determining whether Alaskan operations and debt coverage ratios are, or are not, in line with general industry practice.

Federal Taxes: Paid or Not?

One of the areas where industry seems on the shakiest ground is in attributing fully taxed status to Alaska income. It takes little effort to examine the corporate financial statements of the firms operating in Alaska and find that they are paying tax rates well below the nominal federal rate of 48%. A more complex question involves determining what a proper tax deduction might be for determining the actual value of future cash flows from North Slope operations--this will vary from firm to firm and, naturally, makes analysis even more difficult.

At least a minimum approach to this problem would be applying the major tax reduction effects of the Investment Tax Credit (ITC) to the nominal rate on income earned in Alaska. A further step might be the limitation, in terms of analysis, of the corporate income tax rate to the highest rate reported by any one company operating in the state, above a certain size. Thus, the analysis of rate of return would turn up an estimate that could be stated as "a rate of return equal to or greater than" some percentage rate--since the rate of return would be pegged to the most highly taxed company in the jurisdiction, and all other companies would earn relatively higher rates due to their lower tax burden. We do not suggest that these approaches are entirely appropriate or that they are the only ones which could be utilized in attempting to reconcile rate of return analysis of nominal with effective federal tax rates. A more thorough analysis of this problem will be contained in our forthcoming rate of return analysis of Prudhoe Bay operations.

Non-Prudhoe Bay Exploration and Lease Costs

Another issue which has received some attention is the question of whether unsuccessful lease costs by non-Prudhoe Bay (or other unsuccessful) companies in Alaska should be viewed as a part of the total "investment" on which a rate of return for Prudhoe Bay should be calculated. Clearly, this type of analysis is inappropriate from a strict financial standpoint. There is no relationship between the monies spent by two competing companies, one of which is eventually successful and the other of which is not--attributing the failed investment to the successful company results in nothing more than a paper exercise, since the company that actually spent the money--and lost it--is no better off than before. Who is better off (at least in terms of this analysis--since a lower rate of return may mean a lower tax rate) is the company that was successful anyway.

There is, however, an economically based argument (as distinct from the purely financial and accounting position on this issue) favoring inclusion of unsuccessful lease costs in the overall investment base for rate of return determination. And that is simply that Alaska, from an economic standpoint, should be viewed as a unit. Thus, investments, losses, and gains should be viewed in terms of the political and geographic unit, and only secondarily in terms of the corporate entities which operate there. Thus, rate of return on the project would tend to translate into rate of return in Alaska--and Alaska's tax policy could then be set accordingly.

It is not obvious, however, that this line of reasoning results in an appropriate view of Alaskan economic activity. The result of such an

approach remains that successful companies' rate of returns tend to be artifically lowered, while the rate of return of unsuccessful companies remains negative. The problem in the approach is that it attempts a "balancing" of interest in the interest of fairness--to compensate in the rate of return calculation for the risk factor associated with unsuccessful business ventures. This would be a workable approach if investment in Alaska were a closed universe. However, the universe of investment decisions is international--and the company that lost heavily in Alaska may gain heavily elsewhere. Thus, to the degree that Alaska provides additional compensation to the successful company (by attributing a lower rate of return and thus a lower tax rate), a misallocation of resources has taken place--since that company's overall return will be higher than it otherwise would have been in a competitive environment. In the final analysis, the key distinction between the two methods of calculating rate of return may lie in whether one wishes to view the rate of return of companies actually operating in the state, or to look at the rate of return on Alaskan operations in an abstract sense (Gregg K. Erickson, Director of Research, has additional and, in some instances, somewhat differing views regarding the treatment of unsuccessful lease costs. These will be provided you in the near future as an addendum to this discussion). In any event, the decision to exclude or include such unsuccessful lease costs has a reasonably substantial impact on the rate of return calculation result.

Considering Prudhoe Bay alone, inclusion of approximately $900 million in unsuccessful lease costs in the investment base (a rough estimate of the current level of losses on unsuccessful leases, whether

or not abandoned) would lower the return on Prudhoe Bay operations, as calculated in Table III, from 36.6% to about 30%. For the field and pipeline together, the rate of return would decline from 16.3% to about 14.9%, if such costs were included.

Comparability of State Tax Rates

At the request of the House Finance Committee, we have conducted a joint effort with the Department of Revenue to determine the accuracy of industry statements regarding Alaska's relative tax position among the states. The specific area we were asked to analyze was that of severance taxation, while the Department of Revenue handled ad valorem and income taxes.

In our judgment, the application of the severance taxes of Louisiana, Texas and California to the income stream described by Sohio's Submission Two was accurate within acceptable limits--i.e., our calculations varied only about 3% from those submitted to the committee. Although we have not yet seen the formal analysis of the Department of Revenue (scheduled to be submitted in the form of testimony to the House Finance Committee on April 14, 1977) we have been informed verbally that:

1. The income tax estimates made by Sohio appear to be reasonably accurate.
2. There are major differences between the Department of Revenue's estimate of ad valorem tax liabilities among the various states and those contained in Submission Two.

According to the Department, their analysis shows Alaska to be 4th or 5th ranking in terms of ad valorem tax liability, instead of 1st or 2nd.

The absolute magnitude of the differences are not available from the Department at this writing.

APPENDIX A

Accuracy of Exxon Testimony Before Joint House-Senate Resource Committee

As part of their testimony to the Joint House-Senate Resource Committee, Exxon submitted an exhibit listing rate of return estimates prepared by five different sources. The range of these estimates was 11% to 18%, and they were submitted in support of the company's contention that rates of return on Alaska operations were not out of line with overall industry rates of return--which were cited as being 12.4% average return to net worth (an accounting measure of profitability that is not directly comparable to DCF return analysis). Following are our discussions of each estimate submitted by Exxon, in terms of the general issues covered in the body of the memorandum:

Estimate 1. L. F. Rothschild & Co., Securities Analyst, New York, N.Y., Investment report prepared December, 1975. Rate of return estimate: 18%.

The rate of return cited in the Rothschild study is not a DCF calculation but, instead, is simple accounting profit relative to invested capital in one year of operations--they calculated net profits to be approximately $600 million on TAPS operations and $1.2 billion annually on Prudhoe Bay crude oil production. Properly speaking, Rothschild did not present these figures as a "rate of return" but rather as "profit potential" at production levels of 1.5 million bb/d and Los Angeles sales prices of $11.00. There is no direct relationship between this sort of analysis and a DCF rate of return calculation.

Estimates 2 & 3. Both Exxon and the Standard Oil Company of Ohio indicated that their internal discussions had resulted in a rate of return of 15% and between 14% and 16% respectively for the project as a whole.

We are in no position to analyze the rates of return submitted by Exxon and Sohio, since no underlying assumptions were provided. Although we have requested such information in the past from the companies, no results have been forthcoming. The primary reason that has been cited is difficulty with Securities and Exchange Commission rules regarding corporate disclosures that would tend to forecast earnings. In any event, the returns were calculated on the basis of the entire project, debt as well as equity and, consequently, no matter how derived, are subject to the same limitations discussed in the main body of the memorandum. The similarity between the companies' average rate of return of 15% and the 16% average DCF rate of return calculated in our hypothetical earnings example in the attached memorandum is largely coincidental.

Estimate 4. Drexel Burnham & Company of New York, New York, performed an extensive analysis of North Slope earnings and profit potential in April, 1976. The rate of return cited by Exxon from this study was 17%.

The Exxon citation was correct, as far as it went. The 17% return figure was only one of several possible DCF returns cited by Drexel Burnham and covered the entire field and pipeline operation. Drexel Burnham also estimated, however, that return on the Prudhoe Bay field alone was 27% on a DCF return basis at a price of $13 per barrel in Los Angeles. Returns at lower prices of $11 per barrel went down to 23% return on the field and 14% for the project as a whole.

Estimate 5. The lowest rate of return cited by the Exxon testimony was that derived for the Federal Energy Administration by Mortada International (a consulting firm) in November, 1976.

The Mortada study, performed under contract to the Federal Energy Administration, had somewhat contradictory conclusions from the standpoint of the industry. On the one hand, the Mortada study indicated that a DCF rate of return of 11% to 13% was a proper measure of total project returns for North Slope operations--supporting the industry position that rates of return were in line with other oil industry returns. Simultaneously, however, Mortada suggested regulating the price of North Slope oil at Valdez in the range of $11.50 to $12.40 per barrel, indicating that such prices would approximately insure such a return and would also provide sufficient incentive for development of the more expensive Kuparik-Lisburne formations. The former conclusion was greeted more enthusiastically than was the latter.

Mortada arrived at its lower rate of return conclusions via a variety of assumptions not made by other analysts. First, of course, the return was calculated on the project as a whole, rather than on the component parts. Second, total costs dating back to 1964 for all North Slope exploration were included in the investment base for purposes of calculating rate of return. These costs were also adjusted upward to 1976 dollars (all returns were stated in "real" or constant dollars) and further multiplied by a "risk factor" to reflect the incidence of unsuccessful exploration efforts.

Of all the Mortada conclusions, the inclusion of the "risk multiplier" and its method of application is probably the most controversial. No other analysis provided to the committees, or in our files, includes

such a method. Nonetheless, there is some underlying soundness in the concept that prior exploration costs should be somehow taken into account when considering the rate of return question. In our analysis, however, Mortada's approach to solving this problem was not particularly convincing.

Specifically, Mortada assumed that all prior North Slope expenditures represented one exploration "effort" and that the discovery of Prudhoe Bay was the result. By Mortada's reasoning, however, some accounting must be made for the "failed" exploratory efforts which by definition are more numerous than successful exploration efforts which result in Prudhoe Bay-type finds. To do this, they examined the success rate of exploratory ventures generally and determined that a reasonable estimate was one successful commercial discovery out of every seven tries. Consequently, while Prudhoe was a success, there were implied in that success six failures of approximately the same magnitude--consequently, an after-tax factor (since failures are deductible) to account for these hypothetical failures was applied to arrive at the "true" rate of return for Prudhoe Bay.

The problem with such reasoning is similar to that which was discussed in the section dealing with unsuccessful lease costs--attributing extra costs to the project, which in fact were not incurred in Alaska by the operating companies, is simply a paper exercise. Even worse, these costs (unlike the lease costs) were not even incurred--or deemed to have been incurred--in Alaska. The fact that the company may have unsuccessful exploration efforts around the world which will drag down its rate of return overall doesn't necessarily mean that the cost of such efforts should be rolled into Alaskan investments. Alaska, of course, can only tax those profits or activities occurring within its jurisdiction.

Since it cannot tax extra-jurisdictional profits (i.e., attribute an oil company's success somewhere else in the world back to Alaska for tax purposes), it seems to make little sense to carry unsuccessful investments back to Alaska for tax purposes either. This does not mean, of course, that some general provision for deductibility of Alaskan exploration and development efforts is inappropriate--the results of such deductions would simply reflect the real risk of looking for oil in Alaska and not hypothetical considerations of international exploration efforts.

Without the risk adjustment factor used by Mortada (which increased the investment base on Prudhoe Bay by about $900 million), the DCF rate of return calculated was 14.6%--still somewhat lower than calculated by other observers. One reason for the difference was their use of an unusually high Alaska-U.S. west coast transportation factor--$1.33 per barrel. This is compared with a more generally used figure of about $0.75 per barrel. Other possible differences emerge in the area of the TAPS tariff since their precise methodology in determining company profitability on the TAPS was not included in the report, nor was any discrete per/barrel cash flow by year of production provided.

4/15/77

Tax Hearings

Yesterday morning Dept Revenue testified that using Wainwright raw data, Revenue projected a 26.3% rate-of-return, while Wainwright used that data and got a 19.1%.

At that time Dept Revenue could not explain the difference. So SOHIO called the author in New York during lunch and presented a tape of the conversation to Finance committee that afternoon. It said: (Leibman)

(1) Difference was because Wainwright used a "real rate" which unlike the "nominal rate" (used by Rev.) does not account for inflation. Investors use the "real rate".

(2) Wainwright used a modified Governor tax package for its projections, because it wanted to use a "worst case". And it was more important to use 2 cases for Fed pricing and 2 cases for tariff as these have much greater effects than a tax change. Wainwright wanted to be "conservative in developing earnings estimates".

(3) Leibman said there are some "legitimate problems" in Alaska's tax structure; however, "on balance it is more than adequate given the State's fiscal outlook".

(4) Prudhoe Bay will have a "marginal" return on investment.

(5) Main problems with Gov's taxes:

a. ¢/barrel floor is based on "deemed market value" and the industry is caught between a fed/state conflict.

b. property tax should not be extended to LNG, etc.

c. economic value assessment is bad -- it should remain on historic costs rather than replacement costs.

NOTE: Tom Williams talked with Leibman too -- and apparently, the Administration no longer supports its 26.5% figure -- though I am not sure.

ADMIN

Dept Revenue
Tom Williams

4/77

CASH FLOW EFFECTS ON PRUDHOE BAY
DUE TO ADMINISTRATION'S TAX PROPOSALS
(Based on April 1, 1977 Report by
Wainright Securities Inc.)

($ millions)

Year	Production Tax	Property Tax	Franchise Tax	Total	Total after Federal Income Taxes
1977	-13	100	-25	62	32
1978	-43	0	-173	-216	-112
1979	-37	0	-184	-221	-115
1980	-140	0	-255	-395	-205
1981	-198	0	-302	-500	-260
1982	-135	0	-316	-451	-235
1983	-137	0	-330	-467	-243
1984	-143	0	-351	-494	-257
1985	-150	0	-379	-529	-275
1986	-159	0	-414	-573	-298
1987	-161	0	-425	-586	-305
1988	-155	0	-417	-572	-297
1989	-148	0	-411	-559	-291
1990	-137	0	-404	-541	-281
1991	-128	0	-396	-524	-272
1992	-103	0	-358	-461	-240
1993	-82	0	-326	-408	-212
1994	-66	0	-296	-362	-188
1995	-47	0	-269	-316	-164
1996	-37	0	-242	-279	-145
1997	-27	0	-221	-248	-129
1998	-15	0	-197	-212	-110
1999	-5	0	-170	-175	-91
2000	14	0	-145	-131	-68
2001	21	0	-129	-108	-56
2002	31	0	-111	-80	-42
2003	39	0	-98	-59	-31
2004	48	0	-83	-35	-18
2005	52	0	-74	-22	-11

AGO 531150 B.

PROJECTED CASH FLOWS FOR PRUDHOE BAY
UNDER PRESENT TAXES AND ADMINISTRATION'S PROPOSALS
(Based on April 1, 1977 Report by
Wainright Securities Inc.)

($ millions)

Year	Cash Flow under Present Taxes	Effects of Proposals	Cash Flow under Proposed Taxes
1959	-2	0	-2
1960	-1	0	-1
1961	-1	0	-1
1962	-7	0	-7
1963	-14	0	-14
1964	-19	0	-19
1965	-19	0	-19
1966	-4	0	-4
1967	-8	0	-8
1968	-9	0	-9
1969	-395	0	-395
1970	-69	0	-69
1971	-40	0	-40
1972	-19	0	-19
1973	-24	0	-24
1974	-145	0	-145
1975	-723	0	-723
1976	-1174	0	-1174
1977	-279	32	-247
1978	1359	-112	1247
1979	1528	-115	1413
1980	1907	-205	1702
1981	1933	-260	1673
1982	2119	-235	1884
1983	2512	-243	2269
1984	2757	-257	2500
1985	3420	-275	3145
1986	4131	-298	3833
1987	4094	-305	3789
1988	3928	-297	3631
1989	3811	-291	3520
1990	3654	-281	3373
1991	3516	-272	3244
1992	3185	-240	2945
1993	2867	-212	2655
1994	2585	-188	2397
1995	2343	-164	2179
1996	2084	-145	1939
1997	1946	-129	1817
1998	1754	-110	1644
1999	1508	-91	1417
2000	1300	-68	1232
2001	1169	-56	1113
2002	1024	-42	982
2003	915	-31	884
2004	791	-18	773
2005	707	-11	696

RATES OF RETURN (ON DCF BASIS)
FOR PRUDHOE BAY UNDER PRESENT TAXES
AND ADMINISTRATION'S PROPOSALS

Discount Rate (%)	Discounted Value of Cash Flow Under: Present Taxes	Proposed Taxes
10	3071	2762
12	1749	1560
14	997	880
16	564	490
18	313	265
20	166	136
22	81	61
24	31	18
26	3	-6
28	-12	-18
30	-20	-25

The DCF rate of return is that discount factor which yields a discounted value of zero for a given cash flow. For the Prudhoe Bay cash flow under the present tax structure, it is clear from the above table that the DCF rate of return is between 26% (which yields a discounted value of 3) and 28% (which gives a value of -12). By means of computer analysis, the actual rate of return for Prudhoe Bay under the present tax regime is 26.3%.

As also can be seen from the table, the DCF rate of return under the proposed taxes lies between 24% (discounted value of 18) and 26% (discounted value of -6). Again using a computer to narrow the range, the DCF rate of return under the proposals is found to be 25.4%.

THE IMPACT ON THE DCF RATE OF RETURN DUE TO THE TAX IS ONLY 0.9% (25.4% versus 26.3%). The effects on the DCF rate of return due to field productivity, development expense, time needed for development, and wellhead price are each much more important than this tax effect.

Wainwright error of 19.1% is wrong in Appen B.

ADMIN

TABLE 1. COOK INLET NATURAL GAS
SEVERANCE TAX PROJECTIONS
BY FISCAL YEAR AND TAX SCENARIO

Fiscal Year	Sales (Bcf/Y)	Average Price ($/Mcf)	PRODUCTION TAXES Existing ($/MM)	Existing (Rate)	Proposed ($/MM)	Proposed (Rate)
1977	147.6	$.400	2.08	4%	2.08	4.0%
1978	166.4	$.400	2.33	4%	9.32	15.9%
1979	198.5	$.400	2.78	4%	11.78	17.0%
1980	257.5	$.419	3.78	4%	16.20	18.0%
1981	312.0	$.444	4.85	4%	20.81	19.1%
1982	333.3	$.464	5.41	4%	23.56	20.2%
1983	338.9	$.474	5.62	4%	25.40	21.4%
1984	344.9	$.485	5.85	4%	27.41	22.7%
1985	351.3	$.494	6.08	4%	29.58	24.1%

TABLE 2. PRUDHOE BAY NATURAL GAS
SEVERANCE TAX PROJECTIONS
BY FISCAL YEAR AND TAX SCENARIO

Fiscal Year	Sales (Bcf/Y)	Average Price ($/Mcf)	PRODUCTION TAXES Existing ($/MM)	Existing (Rate)	Proposed ($/MM)	Proposed (Rate)
1977	2.78	$.30	.029	4%	.029	4.0%
1978	3.92	$.30	.039	4%	.219	21.3%
1979	5.13	$.30	.053	4%	.305	22.6%
1980	5.87	$.30	.063	4%	.369	23.9%
1981	28.03	$.424	.416	4%	1.870	18.0%
1982	42.96	$.495	.744	4%	3.037	16.3%
1983	777.42	$.731	19.879	4%	58.263	11.7%
1984	828.58	$.833	24.145	4%	65.823	10.9%
1985	868.70	$.883	26.847	4%	73.123	10.9%

TABLE 2A. PRUDHOE BAY NATURAL GAS
SEVERANCE TAX PROJECTIONS
BY FISCAL YEAR AND TAX SCENARIO

Fiscal Year	Sales ($/Mcf)	Average Price ($/Mcf)	PRODUCTION TAXES Existing ($MM)	Existing (Eff.Rate)	Proposed ($MM)	Proposed (Eff.Rate)
1977	2.78	$.30	.029	4%	.029	4.0%
1978	3.92	$.64	.088	4%	.233	10.6%
1979	5.13	$.68	.122	4%	.305	10.0%
1980	5.87	$.72	.148	4%	.370	10.0%
1981	28.03	$.76	.746	4%	1.864	10.0%
1982	42.96	$.81	1.218	4%	3.045	10.0%
1983	777.42	$.85	23.128	4%	58.263	10.1%
1984	828.58	$.90	26.100	4%	65.823	10.1%
1985	868.70	$.96	29.188	4%	73.146	10.0%

Table 3

COOK INLET BASIN
Residential, Power Plant, and Commercial
Natural Gas Demand Projections
by end use and by year, 1977-1985
(in Bcf/Year)

Calendar Year	Chugach Electric Beluga Plant	City of Kenai	ALASKA PIPELINE COMPANY					Total Demand
			Electric Power	Military	Residential	General Service Small	General Service Large	
1977	11.28(a)	.40	11.16(b)	5.89(b)	6.51(b)	3.10(b)	4.34(b)	42.68
1978	12.86	.42	11.59	5.89	7.03	3.35	4.69	45.83
1979	13.37	.44	12.02	5.89	7.59	3.62	5.06	47.95
1980	14.85	.46	12.42	5.89	8.20	3.91	5.47	51.20
1981	16.45	.48	12.81	5.89	8.86	4.22	5.90	54.61
1982	18.26	.50	13.16	5.89	9.57	4.56	6.38	58.29
1983	19.57	.53	13.51	5.89	10.33	4.92	6.89	61.64
1984	19.77	.56	13.81	5.89	11.16	5.32	7.44	63.95
1985	19.77	.59	14.09	5.89	12.05	5.74	8.03	66.16

a. Power System Study, 1976 by Tippett and Gee, Consulting Engineers for Chugach Electric Association forecasts demand for the Beluga plant for the years 1977-1984.

b. Data supplied by Alaska Pipeline Company projects 1977 APC system demand at 31.0 Bcf: 36% used in Chugach and Anchorage Municipal electric power plants, 19% supplied to the military, 21% sold to residential consumers, 10% delivered to small commercial users, 14% sold to large (1200 Mcf per year) commercial users. Total system demand for APC 1977-1982 is expected to grow at 5% per year with nonpower usage increasing at a rate of 8% per annum.

Table 4

ESTIMATED TOTAL COOK INLET NATURAL GAS PRODUCTION AND RESIDENTIAL DEMAND BY UTILITY AND BY YEAR, 1977-1985
(in Bcf/Year and Percentage)

Calendar Year	Total Cook Inlet Sales	Volumes (%) Sold to or for Residential End Users			
		Alaska Pipeline Company	Chugach Electric Association	Anchorage MPL	City of Kenai
1977	157.0 (100%)	6.5 (4%)	6.8 (4%)	3.4 (2%)	.4 (.3%)
1978	172.5 (100%)	7.0 (4%)	7.7 (4%)	3.5 (2%)	.4 (.2%)
1979	228.0 (100%)	7.6 (3%)	8.0 (4%)	3.6 (2%)	.4 (.2%)
1980	284.8 (100%)	8.2 (3%)	8.9 (3%)	3.8 (2%)	.5 (.2%)
1981	322.7 (100%)	8.9 (3%)	9.9 (3%)	3.8 (1%)	.5 (.2%)
1982	335.0 (100%)	9.6 (3%)	11.0 (3%)	3.9 (1%)	.5 (.1%)
1983	342.0 (100%)	10.3 (3%)	11.7 (3%)	4.0 (1%)	.5 (.1%)
1984	348.0 (100%)	11.2 (3%)	11.9 (3%)	4.1 (1%)	.6 (.2%)
1985	355.0 (100%)	12.1 (3%)	11.9 (3%)	4.2 (1%)	.6 (.2%)

Assumptions:

1. 60% of volumes sold to Alaska Pipeline Company are in turn sold to residential consumers.
2. 60% of volumes sold to Chugach Electric Association are in turn used to supply power to residential consumers.
3. 30% of volumes sold to Anchorage Municiple Power and Light are in turn used to supply power to residential consumers.
4. 100% of volumes sold to City of Kenai are used to supply power to residential consumers.

Table 5

ESTIMATED DIRECT ECONOMIC IMPACT OF
NATURAL GAS SEVERANCE TAXES ON
AN AVERAGE ANCHORAGE RESIDENCE
($ per residence per year)

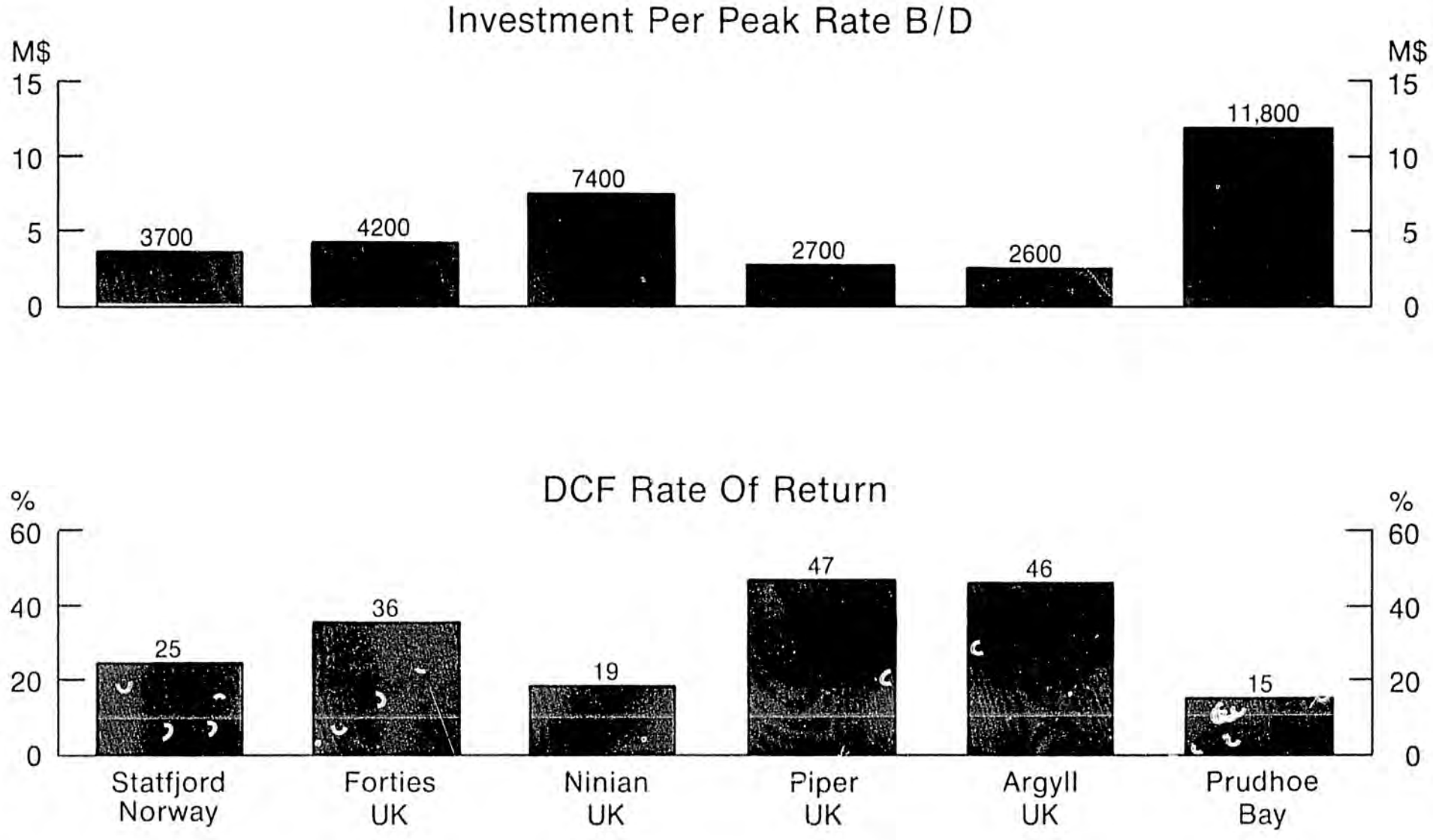
Calendar Year	Anchorage Natural Gas 1			Chugach Electric Association 2		
	Residential Customers	Existing Taxes	Proposed Taxes	Residential Customers	Existing Taxes	Proposed Taxes
1976	29,200	-	-	31,000	-	-
1977	31,500	$2.89	$ 7.49	33,200	$2.87	$ 7.44
1978	34,000	$3.04	$12.59	35,500	$3.21	$13.27
1979	36,800	$2.97	$13.34	38,000	$2.88	$12.92
1980	39,700	$3.13	$13.42	40,600	$3.32	$14.24
1981	42,900	$3.30	$14.26	43,500	$3,62	$15.65
1982	46,300	$3.41	$15.15	46,500	$3.89	$17.29
1983	50,000	$3.43	$15.90	49,800	$3.92	$18.14
1984	54,000	$3.52	$17.99	53,300	$3.79	$18.28

1. The average Anchorage Natural Gas residential billing for calendar year 1976 was $377.42 (226 Mcf @ $1.67 per MMBtu). Thus, existing and proposed severance taxes have a direct impact to the residential consumer of 1% and 2% respectively.

2. The average Chugach Electric Association residential customer paid $310.96 during calendar year 1976 (11,960 Kwh @ .026 per Kwh). Thus, existing and proposed severance taxes have a direct impact to the residential consumer of 1% and 2% respectively. At present Chugach Electric Association has a pending 15% rate increase which is being heard by the Alaska Public Utilities Commission. This rate increase dwarfs the effect of severance taxes.

Prudhoe Bay — North Sea Comparison

EXXON



AGO 531158

Alaska State Legislature

Senate

JUNEAU, ALASKA

4/15/77

TO: Sen Rader
FR: Connie
RE: Finance ~~Tax Hearings~~
Wed morning witness - Dr. Joseph Kemp
Professor of Economics
University of Aberdeen, Scotland

The following summarizes Dr. Kemp's major points:

Morality Arguments - Just as in AK, Britain issued "licenses" for oil exploration & development at 12½% royalty. Britain still has this royalty, but has increased its taxes to obtain profitibility of finds.

Kemp argues that there is no morality argument. A government taxes on taxable capacity; and no government surrenders its sovereign right to tax.

Note: All govt oil revenues going into Genrl Fund to pay back deficits & to use as collateral for getting loans. None is being saved.

Taxation in Britain - Prior to oil discoveries, Britain simply used a 12½% royalty and 52% corporate income tax.
In 1974 govt negotiated with companies and in Feb 1975 offered a new tax package. That package kept the royalty and income tax the same; however it instituted a new "petroleum revenue tax" which was credited against income tax, of 45 %.
The corporate income tax remained ineffective with its foreign tax credits, etc, so this new PRT tax was designed.
The effective rate of the PRT is somewhat less than 45% because X amount of production is free of tax to help independent or marginal operations. PRT applied on a field by field basis and did not allow tax allowanaces from outside (foregin credits).

NOTE: I see 2 things this tax package allows which AK currently doesn't to aid the industry:

(1) Kemp said that UK remits royalties on marginal fields (tho AK statutes allow it, I don't think its ever been used to establish a dependable policy)

(2) Kemp mentioned (and Showalter confirmed) that UK allows companies to recover their capital before any taxes imposed. So companies allowed to expense outlays rather than capitalize them and amortize them thru time. Front-end recovery of $.

PARTICIPATION BY GOVT

Britain recently completed 5th round of "licensing" (leasing) in North Sea. This round the govt required that the British national Oil Company participate in each license by holding 51% of the share. Kemp states that companies dislike participation more than dislike taxation. (So as long as Alaska only taxes, we aren't hitting them that hard.) I questioned Kemp afterwards as to how the profits are shared & how that effects rate of return, and he stated that "Participation" does not mean profit sharing -- just simply the government having a say in how oil is produced. Companies dislike this because they are forced to disclose all info to govt and govenrment controls timing of development and production decisions.

As a policy matter, apparently Britain is allowing companies to develop as quickly as possible; whereas Norway is holding back development.

GOVERNMENT TAKE

Britain - with 12½% royalty and 52 % corporate income and 45% PRT (credited against income tax), Kemp says that the Government take is between 60 - 70 % of total profits.

Norway - With a 50.8% corporate income tax and a 25% special income tax (with no generous allowances like the UK PRT has), the Government take is between 65 - 75% of profits.

US - Wainwright chart on page 36 shows a 54% govt take (state, fed, local) and 46 % oil company take. for Prudhoe Bay. Tanzer shows 37% company take under State's present tax structure (63% govt take)

RATE OF RETURN

Britain North Sea - If price of oil keeps up with inflation rate of return for the several fields will range from 20% for the least profitable to 40% for the most. If oil price doesn't keep up with inflation, range will be 13 - 40 %.

What's Needed - Chairman of Dutch Shell said needed 15% ROR in North Sea due to high risks. Chairman of Gulf said needed as much as 25%, for North Sea. First City Bank shows average US rate = 11-12%.

NOTE: Britain's tax package allows a 40% rate of return on the most profitable fields. Even tho it can be argued that on-shore Alaska is less risky than North Sea; no one can say Prudhoe shouldn't be viewed here as a "most profitable field".

[redacted]

NET INCOME

1. Concur with Zeifman's suggestions for additions to prefacatory language?

2. If Federal OCS Lands Act Amendments pass with a state revenue-sharing provision, would you still urge passage of a franchise tax?

3.

Wainwright estimates DCF rates of return for Prudhoe (assuming effective 9.4 state tax plus using Governor's severence package) of :

10.6 for line (assuming ICC bases on equity)
19.1 for field
15.7 if combine field and line

Wainwright then says (p35)

"Relative to DCF rate of return objectives of 20 -25% set by many companies for exploration and production ventures, and actual rates of return for some of the larger North Sea fields far in excess of that, a real rate of return of just under 16% for the largest oil field ever gound in North America provides an interesting perspective on the question of economic rents."

Drexel Burnam estimates rate of returns as:

10% for TAPS
23-27% for field (if 11.00 of 13.00 market price)
14 - 17 % combined field and line

Tanzer estimates rate of return on field alone (using Drexel Burnham figures, but showing an effective state income tax rate of 2.5 and including tax credits accumulated to date) as 29% for companies.

Note: In terms of rate of return, the big question is whether or not to include the pipeline. Someone should ask Kemp whether the figures he cited for rates of return in the North Sea included pipeline transportation costs & profits to share.

VARIOUS RATE of RETURN ESTIMATES
PRUDHOE BAY FIELD

L. F. Rothschild & Co., Securities Analyst New York, NY Report Prepared December, 1975	18%
Standard Oil of Ohio Testimony Before State of Alaska Joint Senate/House Resources Committee March, 1976	14-16%
Exxon Company, USA Testimony Before State of Alaska Joint Senate/ House Resources Committee March, 1976	15%
Drexel Burnham & Co., Securities Analyst, New York, NY Report Prepared April, 1976	17%
Mortada International, Consultant Firm, Dallas, TX. Study Prepared for the Federal Energy Administration November, 1976	11-13%

AGO 531163

EXHIBIT 1

NORTH SLOPE ECONOMICS
DATA SOURCES & MAJOR DATA ITEMS

A. Data Sources:

1. Field Economics

   a. Future production rates, investments, operating costs and oil well head prices: State of Alaska's reserves tax study, February 9,1976.

   b. Gas prices and cost of gas gathering and conditioning expenses: From February 1977 advance submission to Canadian NEB by Mr. Radford Shantz, Foster Associates and producer testimony.

   c. Historical investments: Sohio/BP Trans Alaska Pipeline Finance, Inc. Prospectus, December 4, 1974; The Standard Oil Company (Ohio) Prospectus, December 2, 1976; City of Valdez, Marine Revenue Bonds Preliminary Official Statement, January 27, 1977.

2. TAPS Economics

   a. Total cost: Alyeska announcements.

   b. TAPS will be regulated. Tariffs allowed under ICC rules result in DCF returns from 12% to 14%.

3. Tanker Economics: Consultant reports to FEA, November 1976 (Mortada Study). 10% Return on Investment.

B. Major Data Items:

1. Tanker Investment: $1,760MM

2. TAPS Investment - for 1.2 MMB/D: $7,700MM
   - for 1.6 MMB/D: $8,375MM

3. Field Investment - initial: $3,610MM
   - ultimate: $9,280MM

4. Oil Production - Reserves: 8.2 Billion Bbl
   - Peak Rate: 1.6 MMB/D

5. Gas Sales - First Year: 1983
   - Rate: 2.0 Bcf/D

6. Wellhead Prices - Oil: 1978 $6.67)
   1980 $7.28) average: $7.77/Bbl
   1985 $8.03)

   Gas: All Years $0.852/Mcf
   ($0.071/MMBtu) (Separator Outlet)

NORTH SLOPE ECONOMICS
INTEGRATED RATE OF RETURN

	Investment MM$	DCF Rate of Return
Field & Bonus	10,180	17.6
TAPS	8,375	12.0
Tankers	1,760	10.0
Total	20,315	14.5*

* Based on the investment weighting technique using total capital employed.

AGO 531165

EXHIBIT 3

NORTH SLOPE ECONOMICS
DIVISION OF PRUDHOE BAY FIELD LEVEL INCOME

LIFE OF FIELD BASED ON CONSTANT 1976 DOLLARS

		1976 Outlook MM$	%
Wellhead Value (8/8):	Oil	63,343	
	Gas	14,927	
	Total	78,270	
Field Investments		-9,280	
Field Operating Costs		-6,640	
Field Level Income		62,350	
State: Royalty		9,784	
Bonus		900	
Production Tax		4,082	
Ad Valorem Tax		1,857	
Income Tax		2,626	
Total		19,249	31
Federal Government		20,073	32
Oil Companies		23,028	37
		62,350	100

AGO 531166

EXHIBIT 4

STATE OF ALASKA
THE LEGISLATURE

LEGISLATIVE AFFAIRS AGENCY

POUCH Y - STATE CAPITOL
JUNEAU, ALASKA 99811
907-465-3800

MEMORANDUM

April 12, 1977

SUBJECT: Rate of Return Analysis on North Slope Operations and Comparison of Alaskan Oil Tax Rates With Other States (W.O. #4017)

TO: The Honorable John Rader

FROM: Richard G. Haggart
Research Analyst

This memorandum is in response to your request that we analyze recent oil industry testimony before the Joint House-Senate Resource Committee hearings on oil taxation. Specifically, you requested that we examine:

1. Competing statements and claims regarding rates of return that will be, or may be, earned on North Slope operations, in terms of overall accuracy and the appropriateness of underlying assumptions.

2. Whether the relative tax collection rates developed by Exxon and Standard Oil of Ohio for Alaska and other oil producing states accurately reflect current and proposed law.

Because of the complex nature of the issues involved and your need for a timely response because of the Finance Committee hearings on oil taxation beginning April 12, 1977, we have not been able to respond to your request in as full and complete a manner as we would prefer. Consequently, this memorandum includes only the following items:

1. A general discussion of discounted cash flow rate of return analysis and the major issues affecting such analysis, in terms of North Slope operations, and which cause significant variations among different forecasts of rates of return.

2. An appendix in which the specific rates of return cited by Exxon in their testimony of March 24, 1977, are examined for technical and methodological accuracy.

3. A brief analysis, performed in conjunction with the Department of Revenue, regarding the accuracy of Exxon's and Standard Oil of Ohio's statements regarding relative tax rates among oil producing states.

A fourth part of the memorandum is still in preparation and will be submitted to you by the end of April. In part four, we plan to develop a cash flow earnings model of Prudhoe Bay and the pipeline and examine the resulting rate of return from a variety of viewpoints. It is hoped that this analysis will help relieve some of the current confusion surrounding the issue of North Slope profitability and rate of return analysis.

RGH:jm
Attachment

or not abandoned) would lower the return on Prudhoe Bay operations, as calculated in Table III, from 36.6% to about 30%. For the field and pipeline together, the rate of return would decline from 16.3% to about 14.9%, if such costs were included.

Comparability of State Tax Rates

At the request of the House Finance Committee, we have conducted a joint effort with the Department of Revenue to determine the accuracy of industry statements regarding Alaska's relative tax position among the states. The specific area we were asked to analyze was that of severance taxation, while the Department of Revenue handled ad valorem and income taxes.

In our judgment, the application of the severance taxes of Louisiana, Texas and California to the income stream described by Sohio's Submission Two was accurate within acceptable limits--i.e., our calculations varied only about 3% from those submitted to the committee. Although we have not yet seen the formal analysis of the Department of Revenue (scheduled to be submitted in the form of testimony to the House Finance Committee on April 14, 1977) we have been informed verbally that:

1. The income tax estimates made by Sohio appear to be reasonably accurate.
2. There are major differences between the Department of Revenue's estimate of ad valorem tax liabilities among the various states and those contained in Submission Two.

According to the Department, their analysis shows Alaska to be 4th or 5th ranking in terms of ad valorem tax liability, instead of 1st or 2nd.

The absolute magnitude of the differences are not available from the Department at this writing.

Alaska State Legislature

Senate

JUNEAU, ALASKA

Reference the "Prudhoe Profits" files for rate-of-return estimates by:

Wainwright Securities
Drexel-Burnham
Mortada (for FEA)

AGO 531171

S 10

SCOMM

#12:7

Fr: "Approaches to Corporate Income Taxation of Oil Industry Operations in Alaska"
by. W.J. Levy Assoc.
Dec. 1976

Back/Forth Income Tax Credit

41. If a Net Proceeds Tax is considered as an alternative whereby the State is able to get a more appropriate approximation of taxable income than via apportionment, some sort of back/forth credit versus corporate income tax would be necessary.

42. One possibility, that Net Proceeds Tax liability may be taken as credit against corporate income tax liability.

Does this raise questions as to the State's commitments under the Multistate Tax Compact? If not, it could be a relatively simple alternative.

Alternatively, Alaska may consider to exempt from Net Proceeds Tax liability any company that opts for direct and separate reporting for purposes of corporate income tax, and that enters gross proceeds (as defined for Net Proceeds Tax purposes) as the relevant basis for determination of taxable income.

Overlapping Exposures — Multiple Taxation

43. In whatever way Alaska may choose to identify and subject to taxation higher taxable income for petroleum operations than is gotten from the apportionment formula, overlapping exposure of corporate income to state taxes would be implied.

Simply put. If Alaska gets less than appropriate taxable income via apportionment formula, other states get more. If Alaska opts for a more reasonable alternative for itself, other states will still use the apportionment formula. And thereby, other states will be taxing as allocated income some part of what Alaska separately had identified as income generated by Alaskan operations.

double taxation

44. If all states were to go completely separate routes, each uniquely chosen to maximize that state's taxable income and income tax revenues, the premise of the Multistate Tax Compact would obviously be undercut.

45. Alaska's concern is to avoid gross inequity in the identification of taxable income subject to its tax regime. But it cannot with impunity ignore the fact that taxable income in Alaska is inextricably intertwined with interstate business, Federal law and Federal policy. The issue is probably not so much in what direction Alaska should go, but how far. And if there is no magic formula, as in most legislative affairs, then reason would have to rule.

46. Further, if a Net Proceeds Tax is considered, there should be simultaneous consideration of the range of extant taxes imposed on the oil industry in Alaska. In particular, the battery of ad valorem taxes -- on reserves and property -- ought to be reviewed with reference both to administration, purpose, and revenue.

Tax Rates

47. Hereto, we have considered a Net Proceeds Tax as one alternative approach to taxation of oil producing income that might otherwise be inadequately allocated as taxable income in Alaska. This assumes that a Net Proceeds Tax rate would be the same as the State's corporate income tax rate -- even though the effective rate of taxation could presumably be higher under a Net Proceeds Tax because it arrives at a higher calculation of taxable income than via the apportionment formula.

48. From a company's standpoint, a Net Proceeds Tax would in principle, and whatever the tax rate, subject the petroleum producing industry to a separate category of taxation compared with that imposed on other corporate enterprise in Alaska.

5/77

EXTRACTION FACTOR PROBS.

SOHIO EXAMPLE

TABLE A

I. Allocation of Taxable Income Under Established Multistate Compact	Property	Payroll	Business Volume (Sales)		Allocation
Alaska	70%	5%	10%	=	28%
	(70% + 5% + 10%) / 3				
All Other States Combined	30%	95%	90%	=	72%
	(30% + 95% + 90%) / 3				
Total Income Taxed					100%

II. Allocation of Taxable In Court Under CSHB 322 in Alaska and Under Multistate Tax Compact in other States	Property	Payroll	Business Volume (Extraction Factor)		Allocation
Alaska	70%	5%	99%	=	58%
	(70% + 5% + 99%) / 3				
All Other States Combined	30%	95%	90%	=	72%
	(30% + 95% + 90%) / 3				
Total Income Taxed					130%*

* This example indicates that 30% of Sohio's income would be double taxed.

AGO 531174

SOHIO EXAMPLE

TABLE B

If all of Sohio's business were in Alaska and all of its income were represented by the box below, all of its income would be taxed at 9.4% under present law.

ALASKA

100% of Income	X	9.4%

Since a substantial part of Sohio's business will be in Alaska and a substantial part of it will be elsewhere, the present law of Alaska taxes the part of it that is attributable to Alaska at 9.4% and the other states tax the part attributable to them at their rates of taxation. Using the allocation from Part I of Table A:

ALASKA			ALL OTHER STATES		
28% of Income	X	9.4%	72% of Income	X	Other States Tax Rates

Alaska would receive 9.4% of the Company's Alaska income. While this might represent 2.5% to 3.0% of the company's total income, these lower percentages are not very meaningful, except that they reflect the fact that when a company does business in more than one state, each of the states will generally tax the share of the income attributable to that state.

BOOK INCOME PROBLEMS UNION

EXAMPLE II

ALASKA H.B. 322
USING HIGHER OF BOOK OR TAXABLE INCOME
TAXES RECOVERY OF CAPITAL

Alaska House Bill No. 322 proposes to base Alaska taxable income on the higher of taxable income as defined in AS 43.20.011(e) (adjusted federal taxable income), or book net income determined without regard to any taxes on, or measured by, net income.

Since the tax is based on the higher of taxable income or book net income before income taxes, it appears that all Alaska oil and gas producers (including native corporations) will effectively be prevented from fully recovering their capital investment for Alaska income tax purposes and will therefore be taxed on phantom income. Consider the attached simplified example which clearly shows that only $76,000 of a $100,000 capital expenditure would be recovered through the depreciation deduction allowed by the proposed law. The taxpayer would lose as a tax deduction 24% of the cost of a capital expenditure necessary to produce income and would be taxed on $24,000 of non-existent income.

EXAMPLE: Company X is in the business of producing oil and gas. It owns machinery which it purchased for $100,000 on January 1, 19A, for use in its producing operations. Production income is $50,000 per year and the machinery has an expected useful life of five years. Depreciation and income using tax and book methods are as follows:

	Tax			Books		
Year	Revenue	Depreciation (DDB/SYD)	Taxable Income	Revenue	Depreciation (S/L)	Net Income
19A	$50,000	$40,000	$10,000	$50,000	$20,000	$30,000
19B	50,000	24,000	26,000	50,000	20,000	30,000
19C	50,000	18,000	32,000	50,000	20,000	30,000
19D	50,000	12,000	38,000	50,000	20,000	30,000
19E	50,000	6,000	44,000	50,000	20,000	30,000
	Total	$100,000	$150,000		$100,000	$150,000

Since the Alaska bill requires that the higher of taxable income or book income before taxes be used as the tax base, the Alaska income and related depreciation for each year are as follows:

Year	Tax/Books	Depreciation	Alaska Taxable Income
19A	Books	$20,000	$30,000
19B	Books	20,000	30,000
19C	Tax	18,000	32,000
19D	Tax	12,000	38,000
19E	Tax	6,000	44,000
	Total	$76,000	$174,000
Real Net Income			150,000
Phantom Net Income subjec to 9.4% tax			$ 24,000

EXTRACTION FACTOR PROBLEMS UNION

EXAMPLE I

ALASKA H.B. 322
USING EXTRACTION FACTOR ATTRIBUTES ONE-THIRD
OF NON-PRODUCING INCOME TO PRODUCING OPERATION

Alaska House Bill No. 322 proposed to substitute an extraction factor for the sales factor in the Alaska apportionment formula. This substitution can result in an attribution of as much as one-third of all "downstream" income (i.e., income from transportation, refining, marketing, etc.) or non-producing income to Alaska, and can cause this one-third "overlap" of downstream income to be taxed twice. Consider the following simplified example:

Assume that a producer of oil and gas in Alaska with upstream operations wants to expand into California with downstream operations. Sales, payroll, and property would be as shown below. Further assume that all production is in Alaska.

			Existing Law Apportionment Factors	
	Alaska	California	Alaska	California
Sales	$50,000	$50,000	50/100 = .5	50/100 = .5
Payroll	$20,000	$20,000	20/40 = .5	20/40 = .5
Property	$30,000	$30,000	30/60 = .5	30/60 = .5
			1.5 ÷ 3 = .5	1.5 ÷ 3 = .5

Assuming taxable income of $40,000, each state would have taxable income attributed to it of $20,000 ($40,000 x .5 apportionment factor) under the uniform formu and there is no overlapping taxation.

Now assume that an extraction factor is substituted for the sales factor in Alaska, while all other amounts remain the same:

Alaska

	Data	Apportionment Factors
Extraction	10,000 Units	10/10 = 1.0
Payroll	$20,000	20/40 = .5
Property	$30,000	20/60 = .5
		2.0 ÷ 3 = .66667

This will have no effect on the California apportionment factor which remains at .5 since California still abides by the uniform rules. Since total taxable income is still $40,000, Alaska has attributed income of $26,667 ($40,000 x .66667), while California's attributed income remains at $20,000. Thus, substitution of an extraction factor results in the attribution of one-third of the California downstream income to Alaska, and a $6,667 "overlap" of income which is taxed twice. In effect, the Alaska producer would be paying one-third more income tax on his California operations than would his competitors in that state. This added burden could even block his expansion plans completely.

BOOK INCOME PROBLEMS INDUSTRY

Can the Oil and Gas Corporate Franchise Tax Proposal by the Administration of the State of Alaska result in duplicative taxation?

A. Proposed Law

The law would define net income as the higher of (1) taxable income for federal income tax purposes or (2) net income reported to a company's shareholders without regard to any tax on net income.

B. Illustrative Case

Assume a company invests $2,000 in a project having a life of 5 years. The company elects to write off the $2,000 for federal income tax purposes using the so called sum-of-the-years-digits (SOYD)*/ method of rapid depreciation. For its financial reporting purposes the company writes off the investment in equal amounts each year of its life.

Results would be as follows using the indicated revenues and expenses:

		Year 1	Year 2	Year 3	Year 4	Year 5	Total
1.	Revenue	$1,000	$1,000	$1,000	$1,000	$1,000	$5,000
2.	Expenses	200	200	200	200	200	1,000
3.	Net	800	800	800	800	800	4,000
4.	Tax Depreciation	666	534	400	266	134	2,000
5.	Federal Taxable	134	266	400	534	666	2,000
6.	Financial Depreciation	400	400	400	400	400	2,000
7.	Financial Income, Before Tax	400	400	400	400	400	2,000
8.	Taxable by Alaska	400	400	400	534	666	2,400

C. Results

The amount subject to federal taxes over the life of the project is $2,000, and the financial net income before tax is also $2,000. However, the amount subject to Alaskan taxes would be $2,400, or 20% more than the amount subject to federal taxes. Effectively then the 9.4% tax rate would be 11.28%.

*/ Under the SOYD method a project with a 5 year life would have depreciation equal to the following percents of the total investment for each year, respectively: 33.3%, 26.7%, 20.0%, 13.3% and 6.7%.

SCOMM

#12:8

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

EXECON
3/16/77
BEGIN RUN

PRUDHOE BAY -- PUBLIC DATA, 18.03 PER BBL, ST INC TAX IS APPORTIONED

AGO 531182 F+

EXICON DATA RECORD IMAGES

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AGO 531183

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    DEPLETION KEY                 -   0
    CALCULATING ECO LIMIT         -  NO
    BOOK ECONOMICS                -  NO

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    COMMODITIES                   -   2
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     INTEREST              WORKING-   1.0000
                           NET    -   0.8750
                           COST   -   1.0000
                           EXPENSE-   1.0000
     OVERHEAD
      INVESTMENT(INCL.D.H.CST)-   0.0
      DIRECT OPNG EXPENSE     -   0.0
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PRUDHOE BAY -- PUBLIC DATA, $8.03 PER BBL, ST INC TAX IS APPORTIONED

CASE 500 ZONE PRODUCTION SCHEDULES (GROSS VALUES)

PRO-JECT	YEAR CAL-ENDAR	ZONE 1 MAIN PROD OIL MBBL /YR	ZONE 1 ASSOC PROD	ZONE 2 MAIN PROD GAS BCF/YR	ZONE 2 ASSOC PROD	ZONE 3 MAIN PROD AD [illegible] MDOLS/YR	ZONE 3 ASSOC PROD
1	1969	0.0	0.0	0.0	0.0	0.0	0.0
2	1970	0.0	0.0	0.0	0.0	0.0	0.0
3	1971	0.0	0.0	0.0	0.0	0.0	0.0
4	1972	0.0	0.0	0.0	0.0	0.0	0.0
5	1973	0.0	0.0	0.0	0.0	0.0	0.0
6	1974	0.0	0.0	0.0	0.0	10.000	0.0
7	1975	0.0	0.0	0.0	0.0	26.000	0.0
8	1976	0.0	0.0	0.0	0.0	273.000	0.0
9	1977	146.000	0.0	0.0	0.0	313.000	0.0
10	1978	438.000	0.0	0.0	0.0	64.000	0.0
11	1979	438.000	0.0	0.0	0.0	67.000	0.0
12	1980	573.000	0.0	0.0	0.0	71.000	0.0
13	1981	573.000	0.0	0.0	0.0	79.000	0.0
14	1982	573.000	0.0	0.0	0.0	84.000	0.0
15	1983	573.000	0.0	0.730	0.0	88.000	0.0
16	1984	573.000	0.0	0.730	0.0	87.000	0.0
17	1985	573.000	0.0	0.730	0.0	83.000	0.0
18	1986	548.000	0.0	0.730	0.0	73.000	0.0
19	1987	521.000	0.0	0.730	0.0	64.000	0.0
20	1988	460.000	0.0	0.730	0.0	56.000	0.0
21	1989	394.000	0.0	0.730	0.0	50.000	0.0
22	1990	336.000	0.0	0.730	0.0	47.000	0.0
23	1991	262.000	0.0	0.730	0.0	43.000	0.0
24	1992	204.000	0.0	0.730	0.0	40.000	0.0
25	1993	159.000	0.0	0.730	0.0	37.000	0.0
26	1994	124.000	0.0	0.730	0.0	34.000	0.0
27	1995	97.000	0.0	0.730	0.0	30.000	0.0
28	1996	91.000	0.0	0.730	0.0	27.000	0.0
29	1997	82.000	0.0	0.730	0.0	24.000	0.0
30	1998	74.000	0.0	0.730	0.0	21.000	0.0
31	1999	67.000	0.0	0.730	0.0	18.000	0.0
32	2000	60.000	0.0	0.730	0.0	15.000	0.0
33	2001	54.000	0.0	0.730	0.0	12.000	0.0
34	2002	48.000	0.0	0.730	0.0	9.000	0.0
35	2003	43.000	0.0	0.730	0.0	6.000	0.0
36	2004	39.000	0.0	0.730	0.0	3.000	0.0
37	2005	35.000	0.0	0.730	0.0	3.000	0.0
38	2006	0.0	0.0	0.730	0.0	0.0	0.0
	TOTALS	8157.00	0.0	17.52	0.0	1857.00	0.0

YEAR	ZONE 4 MAIN PROD	ZONE 4 ASSOC PROD

ADL 531185

PRO-JECT	CAL-ENDAR	INC TAX MDOLS/YR	
1	1969	0.0	0.0
2	1970	0.0	0.0
3	1971	0.0	0.0
4	1972	0.0	0.0
5	1973	0.0	0.0
6	1974	0.0	0.0
7	1975	0.0	0.0
8	1976	0.0	0.0
9	1977	31.100	0.0
10	1978	43.000	0.0
11	1979	47.900	0.0
12	1980	57.900	0.0
13	1981	67.400	0.0
14	1982	76.400	0.0
15	1983	86.900	0.0
16	1984	95.600	0.0
17	1985	103.700	0.0
18	1986	106.300	0.0
19	1987	108.000	0.0
20	1988	109.000	0.0
21	1989	109.000	0.0
22	1990	109.000	0.0
23	1991	109.000	0.0
24	1992	109.000	0.0
25	1993	109.000	0.0
26	1994	109.000	0.0
27	1995	109.000	0.0
28	1996	106.000	0.0
29	1997	103.000	0.0
30	1998	100.000	0.0
31	1999	95.000	0.0
32	2000	90.000	0.0
33	2001	85.000	0.0
34	2002	80.000	0.0
35	2003	75.000	0.0
36	2004	70.000	0.0
37	2005	65.000	0.0
38	2006	60.000	0.0
TOTALS		2625.40	0.0

AGO 531186

PRUDHOE BAY -- PUBLIC DATA, $8.03 PER BBL, ST INC TAX IS APPORTIONED

CASE 500 PROJECT INTEREST FACTORS (FRACTIONS)

YEAR PRO-JECT	YEAR CAL-ENDAR	PROD/REVNUE W.I.	PROD/REVNUE N.I.	INVEST W.I.	EXPENSE W.I.	CARRY/TRADE OPTION (FRACTIONS) INVEST RECOV-ERY	CARRY/TRADE OPTION (FRACTIONS) MARGIN ALLOC-ATED	PRODUCTION OPTION CUM PROD
1	1969	1.0000	0.8750	1.0000	1.0000			

AGO 531187

PRUDHOE BAY -- PUBLIC DATA. $8.03 PER BBL. ST INC TAX IS APPORTIONED

CASE 500 INVESTMENTS (GROSS VALUES)

CAL-ENDAR YEAR	TYPE INVEST	INVEST CATGY	AMOUNT M$	SER-VICE YEAR	*****SALVAGE***** YEAR	AMOUNT M$	PER-CENT	PCT .TAX CREDIT	DEPRECIATION TYPE	LIFE YRS	PCT DCL BAL	INVEST OVHD RATE $/$
1969	TANG-N	DRILL	37.0	1977	0	0.0	0.0	7.0	GDLN			
1970	TANG-N	DRILL	56.0	1977	0	0.0	0.0	7.0	GDLN			
1971	TANG-N	DRILL	76.0	1977	0	0.0	0.0	7.0	GDLN			
1972	TANG-N	DRILL	31.0	1977	0	0.0	0.0	7.0	GDLN			
1973	TANG-N	DRILL	59.0	1977	0	0.0	0.0	7.0	GDLN			
1974	TANG-N	DRILL	227.0	1977	0	0.0	0.0	7.0	GDLN			
1975	TANG-N	DRILL	809.0	1977	0	0.0	0.0	10.0	GDLN			
1976	TANG-N	DRILL	1183.0	1977	0	0.0	0.0	10.0	GDLN			
1977	TANG-N	DRILL	512.0	1977	0	0.0	0.0	7.0	GDLN			
1978	TANG-N	DRILL	377.0	1978	0	0.0	0.0	7.0	GDLN			
1979	TANG-N	DRILL	346.0	1979	0	0.0	0.0	7.0	GDLN			
1980	TANG-N	DRILL	461.0	1980	0	0.0	0.0	7.0	GDLN			
1981	TANG-N	DRILL	670.0	1981	0	0.0	0.0	7.0	GDLN			
1982	TANG-N	DRILL	627.0	1982	0	0.0	0.0	7.0	GDLN			
1983	TANG-N	DRILL	629.0	1983	0	0.0	0.0	7.0	GDLN			
1984	TANG-N	DRILL	497.0	1984	0	0.0	0.0	7.0	GDLN			
1985	TANG-N	DRILL	343.0	1985	0	0.0	0.0	7.0	GDLN			
1986	TANG-N	DRILL	129.0	1986	0	0.0	0.0	7.0	GDLN			
1988	TANG-N	DRILL	300.0	1988	0	0.0	0.0	7.0	GDLN			
1990	TANG-N	DRILL	300.0	1990	0	0.0	0.0	7.0	GDLN			
1991	TANG-N	DRILL	191.0	1991	0	0.0	0.0	7.0	GDLN			
1993	TANG-N	DRILL	81.0	1993	0	0.0	0.0	7.0	GDLN			
1969	INTANG	DRILL	48.0	1977								
1970	INTANG	DRILL	64.0	1977								
1971	INTANG	DRILL	38.0	1977								
1972	INTANG	DRILL	5.0	1977								
1973	INTANG	DRILL	10.0	1977								
1974	INTANG	DRILL	37.0	1977								
1975	INTANG	DRILL	132.0	1977								
1976	INTANG	DRILL	192.0	1977								
1977	INTANG	DRILL	90.0	1977								
1978	INTANG	DRILL	90.0	1978								
1979	INTANG	DRILL	90.0	1979								
1980	INTANG	DRILL	90.0	1980								
1981	INTANG	DRILL	90.0	1981								
1982	INTANG	DRILL	90.0	1982								
1983	INTANG	DRILL	88.0	1983								
1984	INTANG	DRILL	82.0	1984								
1985	INTANG	DRILL	82.0	1985								
1986	INTANG	DRILL	21.0	1986								

TOTAL TANGIBLE (NEW) INVESTMENT	(M$)	7941.0
TOTAL TANGIBLE (USED) INVESTMENT	(M$)	0.0
TOTAL SALVAGE	(M$)	0.0
TOTAL INTANGIBLE INVESTMENT	(M$)	1339.0

AGO 531188

PROPERTY PURCHASES/SURRENDERS

CALENDAR YEAR	LEASEHOLD BONUS M$	LEASEHOLD G&G M$	EQUIPMENT M$
INITIAL	0.0	0.0	0.0
1969	900.0	0.0	0.0
1977	-225.0	0.0	0.0

AGO 531189

PRUDHOE BAY -- PUBLIC DATA, $8.03 PER BBL, ST INC TAX IS APPORTIONED

CASE 500 LOCAL TAXES, TARIFF

AD VALOREM TAX

NONE

PRODUCTION TAX

OIL YEAR	PROD $/$	GAS YEAR	PROD $/$
1969	0.037	1969	0.040
1981	0.047	0	0.0
1982	0.075	0	0.0
1985	0.073	0	0.0
1990	0.070	0	0.0
1995	0.065	0	0.0

* SPECIAL CHARGE SCHEDULE *

OIL/CONDENS. TARIFF

GAS/G.LIQ. SEVERANCE

NONE

AGO 531190

PRUDHOE BAY -- PUBLIC DATA, $8.03 PER BBL, ST INC TAX IS APPORTIONED

CASE 500 PRODUCT PRICE SCHEDULE

PROJECT YEAR	CALENDAR YEAR	OIL $/BBL	GAS $/MCF	AD VAL $/DOLS	INC TAX $/DOLS
1	1969	6.450	0.852	-1.143	-1.143
10	1978	6.670	0.852	-1.143	-1.143
11	1979	7.280	0.852	-1.143	-1.143
13	1981	7.780	0.852	-1.143	-1.143
17	1985	8.030	0.852	-1.143	-1.143

AGO 531191

PRUDHOE BAY -- PUBLIC DATA, $8.03 PER BBL, ST INC TAX IS APPORTIONED

CASE 500 DIRECT EXPENSE FACTORS

NONE

FIXED AND NON-RECURRING EXPENSE

CALENDAR YEAR	M$
1976	44.0
1977	129.0
1978	133.0
1979	145.0
1980	149.0
1981	240.0
1982	252.0
1983	248.0
1984	261.0
1985	318.0
1986	321.0
1987	319.0
1988	323.0
1989	313.0
1990	308.0
1991	297.0
1992	286.0
1993	280.0
1994	271.0
1995	270.0
1996	235.0
1997	233.0
1998	234.0
1999	232.0
2000	232.0
2001	114.0
2002	111.0
2003	108.0
2004	106.0
2005	104.0
2006	24.0

AGO 531192

PRUDHOE BAY -- PUBLIC DATA, $8.03 PER BBL, ST INC TAX IS APPORTIONED

CASE 500 YEARLY ANALYSIS OF NET INCOME AND PRODUCTION

		OIL			GAS		
PROJECT	YEAR CAL-ENDAR	W.I. PROD MBBL /YR	N.I. PROD MBBL /YR	NET INCOME M$/YR	W.I. PROD MMMCF/YR	N.I. PROD MMMCF/YR	NET INCOME M$/YR
1	1969	0.0	0.0	0.0	0.0	0.0	0.0
2	1970	0.0	0.0	0.0	0.0	0.0	0.0
3	1971	0.0	0.0	0.0	0.0	0.0	0.0
4	1972	0.0	0.0	0.0	0.0	0.0	0.0
5	1973	0.0	0.0	0.0	0.0	0.0	0.0
6	1974	0.0	0.0	0.0	0.0	0.0	0.0
7	1975	0.0	0.0	0.0	0.0	0.0	0.0
8	1976	0.0	0.0	0.0	0.0	0.0	0.0
9	1977	146.0	127.7	824.0	0.0	0.0	0.0
10	1978	438.0	383.2	2556.3	0.0	0.0	0.0
11	1979	438.0	383.2	2790.1	0.0	0.0	0.0
12	1980	573.0	501.4	3650.0	0.0	0.0	0.0
13	1981	573.0	501.4	3900.7	0.0	0.0	0.0
14	1982	573.0	501.4	3900.7	0.0	0.0	0.0
15	1983	573.0	501.4	3900.7	0.7	0.6	544.2
16	1984	573.0	501.4	3900.7	0.7	0.6	544.2
17	1985	573.0	501.4	4026.0	0.7	0.6	544.2
18	1986	548.0	479.5	3850.4	0.7	0.6	544.2
19	1987	521.0	455.9	3660.7	0.7	0.6	544.2
20	1988	460.0	402.5	3232.1	0.7	0.6	544.2
21	1989	394.0	344.7	2768.3	0.7	0.6	544.2
22	1990	336.0	294.0	2360.8	0.7	0.6	544.2
23	1991	262.0	229.2	1840.9	0.7	0.6	544.2
24	1992	204.0	178.5	1433.4	0.7	0.6	544.2
25	1993	159.0	139.1	1117.2	0.7	0.6	544.2
26	1994	124.0	108.5	871.3	0.7	0.6	544.2
27	1995	97.0	84.9	681.5	0.7	0.6	544.2
28	1996	91.0	79.6	639.4	0.7	0.6	544.2
29	1997	82.0	71.7	576.2	0.7	0.6	544.2
30	1998	74.0	64.7	519.9	0.7	0.6	544.2
31	1999	66.0	57.7	463.7	0.7	0.6	544.2
32	2000	60.0	52.5	421.6	0.7	0.6	544.2
33	2001	54.0	47.2	379.4	0.7	0.6	544.2
34	2002	48.0	42.0	337.3	0.7	0.6	544.2
35	2003	43.0	37.6	302.1	0.7	0.6	544.2
36	2004	39.0	34.1	274.0	0.7	0.6	544.2
37	2005	35.0	30.6	245.9	0.7	0.6	544.2
38	2006	0.0	0.0	0.0	0.7	0.6	544.2
TOTALS		8156.9	7137.3	55425.1	17.5	15.3	13061.1

		AD VAL			INC TAX			
PROJECT	YEAR CAL-ENDAR	W.I. PROD	N.I. PROD	NET INCOME	W.I. PROD	N.I. PROD	NET INCOME	TOTAL INCOME

JECT	ENDAR	MDOLS/YR	MDOLS/YR	M$/YR	MDOLS/YR	MDOLS/YR	M$/YR	M$/YR
1	1969	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2	1970	0.0	0.0	0.0	0.0	0.0	0.0	0.0
3	1971	0.0	0.0	0.0	0.0	0.0	0.0	0.0
4	1972	0.0	0.0	0.0	0.0	0.0	0.0	0.0
5	1973	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6	1974	10.0	8.7	-10.0	0.0	0.0	0.0	-10.0
7	1975	26.0	22.7	-26.0	0.0	0.0	0.0	-26.0
8	1976	273.0	238.9	-273.0	0.0	0.0	0.0	-273.0
9	1977	313.0	272.9	-313.0	31.1	27.2	-31.1	479.8
10	1978	64.0	56.0	-64.0	43.0	37.6	-43.0	2449.3
11	1979	67.0	58.6	-67.0	47.9	41.9	-47.9	2675.1
12	1980	71.0	62.1	-71.0	57.9	50.7	-57.9	3521.1
13	1981	79.0	69.1	-79.0	67.4	59.0	-67.4	3754.3
14	1982	84.0	73.5	-84.0	76.4	66.8	-76.4	3740.3
15	1983	88.0	77.0	-88.0	86.9	76.0	-86.9	4270.0
16	1984	87.0	76.1	-87.0	95.8	83.8	-95.8	4262.1
17	1985	83.0	72.6	-83.0	103.7	90.7	-103.7	4383.5
18	1986	73.0	63.9	-73.0	106.3	93.0	-106.3	4215.3
19	1987	64.0	56.0	-64.0	108.0	94.5	-108.0	4032.9
20	1988	56.0	49.0	-56.0	109.0	95.4	-109.0	3611.3
21	1989	50.0	43.7	-50.0	109.0	95.4	-109.0	3153.5
22	1990	47.0	41.1	-47.0	109.0	95.4	-109.0	2749.0
23	1991	43.0	37.6	-43.0	109.0	95.4	-109.0	2233.1
24	1992	40.0	35.0	-40.0	109.0	95.4	-109.0	1828.6
25	1993	37.0	32.4	-37.0	109.0	95.4	-109.0	1515.4
26	1994	34.0	29.7	-34.0	109.0	95.4	-109.0	1272.5
27	1995	30.0	26.2	-30.0	109.0	95.4	-109.0	1066.7
28	1996	27.0	23.6	-27.0	106.0	92.7	-106.0	1050.6
29	1997	24.0	21.0	-24.0	103.0	90.1	-103.0	993.4
30	1998	21.0	18.4	-21.0	100.0	87.5	-100.0	943.1
31	1999	18.0	15.7	-18.0	95.0	83.1	-95.0	894.9
32	2000	15.0	13.1	-15.0	90.0	78.7	-90.0	860.8
33	2001	12.0	10.5	-12.0	85.0	74.4	-85.0	826.6
34	2002	9.0	7.9	-9.0	80.0	70.0	-80.0	792.5
35	2003	6.0	5.2	-6.0	75.0	65.6	-75.0	765.3
36	2004	3.0	2.6	-3.0	70.0	61.2	-70.0	745.2
37	2005	3.0	2.6	-3.0	65.0	56.9	-65.0	722.1
38	2006	0.0	0.0	0.0	60.0	52.5	-60.0	484.2
TOTALS		1857.0	1624.9	-1857.2	2625.4	2297.2	-2625.7	64003.3

A60 531194

PRUDHOE BAY -- PUBLIC DATA. $8.03 PER BBL. ST INC TAX IS APPORTIONED

CASE 500 YEARLY ANALYSIS OF NET EXPENSES

PROJECT YEAR	CALENDAR YEAR	DIRECT EXPENSE M$/YR	ESCALATION RATE FACTOR	ESCALATED DIRECT EXPENSE M$/YR	PROD/ ~~AD VAL.~~ TAXES, ~~TARIFF~~ M$/YR	INDIRECT EXPENSE M$/YR	TOTAL EXPENSE M$/YR
8	1976	44.0	1.000	44.0	0.0	0.0	44.0
9	1977	129.0	1.000	129.0	20.9	0.0	150.9
10	1978	133.0	1.000	133.0	95.9	0.0	228.9
11	1979	145.0	1.000	145.0	104.6	0.0	249.6
12	1980	149.0	1.000	149.0	136.9	0.0	285.9
13	1981	240.0	1.000	240.0	184.9	0.0	424.9
14	1982	252.0	1.000	252.0	292.6	0.0	544.6
15	1983	248.0	1.000	248.0	314.3	0.0	562.3
16	1984	261.0	1.000	261.0	314.3	0.0	575.3
17	1985	318.0	1.000	318.0	315.7	0.0	633.7
18	1986	321.0	1.000	321.0	302.8	0.0	623.8
19	1987	319.0	1.000	319.0	289.0	0.0	608.0
20	1988	323.0	1.000	323.0	257.7	0.0	580.7
21	1989	313.0	1.000	313.0	223.9	0.0	536.9
22	1990	308.0	1.000	308.0	187.0	0.0	495.0
23	1991	297.0	1.000	297.0	150.6	0.0	447.6
24	1992	286.0	1.000	286.0	122.1	0.0	408.1
25	1993	280.0	1.000	280.0	100.0	0.0	380.0
26	1994	271.0	1.000	271.0	82.8	0.0	353.8
27	1995	270.0	1.000	270.0	66.1	0.0	336.1
28	1996	235.0	1.000	235.0	63.3	0.0	298.3
29	1997	233.0	1.000	233.0	59.2	0.0	292.2
30	1998	234.0	1.000	234.0	55.6	0.0	289.6
31	1999	232.0	1.000	232.0	51.9	0.0	283.9
32	2000	232.0	1.000	232.0	49.2	0.0	281.2
33	2001	114.0	1.000	114.0	46.4	0.0	160.4
34	2002	111.0	1.000	111.0	43.7	0.0	154.7
35	2003	108.0	1.000	108.0	41.4	0.0	149.4
36	2004	106.0	1.000	106.0	39.6	0.0	145.6
37	2005	104.0	1.000	104.0	37.8	0.0	141.8
38	2006	24.0	1.000	24.0	21.8	0.0	45.8
TOTALS		6639.9		6639.9	4081.8	0.0	10721.8

AGO 531195

PRUDHOE BAY -- PUBLIC DATA, $8.03 PER BBL, ST INC TAX IS APPORTIONED

CASE 500 YEARLY ANALYSIS OF INVESTMENTS AND SALVAGE (NET VALUES)

PROJECT YEAR	CALENDAR YEAR	TANG M$	INTANG M$	SALVG M$
0	1968	0.0	0.0	
1	1969	37.0	48.0	0.0
2	1970	56.0	64.0	0.0
3	1971	76.0	38.0	0.0
4	1972	31.0	5.0	0.0
5	1973	59.0	10.0	0.0
6	1974	227.0	37.0	0.0
7	1975	809.0	132.0	0.0
8	1976	1183.0	192.0	0.0
9	1977	512.0	90.0	0.0
10	1978	377.0	90.0	0.0
11	1979	345.0	90.0	0.0
12	1980	461.0	90.0	0.0
13	1981	670.0	90.0	0.0
14	1982	627.0	90.0	0.0
15	1983	629.0	88.0	0.0
16	1984	497.0	82.0	0.0
17	1985	343.0	82.0	0.0
18	1986	129.0	21.0	0.0
20	1988	300.0	0.0	0.0
22	1990	300.0	0.0	0.0
23	1991	191.0	0.0	0.0
25	1993	81.0	0.0	0.0
TOTALS		7941.0	1339.0	0.0

AGO 531196

PRUDHOE BAY -- PUBLIC DATA, $8.02 PER BBL, ST INC TAX IS APPORTIONED

CASE 500 YEARLY ANALYSIS OF DEPLETION ALLOWANCE

YEAR PRO-JECT	YEAR CAL-ENDAR	COST DPLTN M$/YR	STATUTORY DEPLETION 0.500*INCOME FOR LIMITATION M$/YR	PERCENT M$/YR	ALLOW DPLTN M$/YR	
1	1969	0.0	0.0	0.0	0.0	C
2	1970	0.0	0.0	0.0	0.0	C
3	1971	0.0	0.0	0.0	0.0	C
4	1972	0.0	0.0	0.0	0.0	C
5	1973	0.0	0.0	0.0	0.0	C
6	1974	0.0	0.0	0.0	0.0	C
7	1975	0.0	0.0	0.0	0.0	C
8	1976	0.0	0.0	0.0	0.0	C
9	1977	12.1	0.0	0.0	12.1	C
10	1978	36.2	0.0	0.0	36.2	C
11	1979	36.2	0.0	0.0	36.2	C
12	1980	47.4	0.0	0.0	47.4	C
13	1981	47.4	0.0	0.0	47.4	C
14	1982	47.4	0.0	0.0	47.4	C
15	1983	47.4	0.0	0.0	47.4	C
16	1984	47.4	0.0	0.0	47.4	C
17	1985	47.4	0.0	0.0	47.4	C
18	1986	45.3	0.0	0.0	45.3	C
19	1987	43.1	0.0	0.0	43.1	C
20	1988	38.1	0.0	0.0	38.1	C
21	1989	32.6	0.0	0.0	32.6	C
22	1990	27.8	0.0	0.0	27.8	C
23	1991	21.7	0.0	0.0	21.7	C
24	1992	16.9	0.0	0.0	16.9	C
25	1993	13.2	0.0	0.0	13.2	C
26	1994	10.3	0.0	0.0	10.3	C
27	1995	6.0	0.0	0.0	6.0	C
28	1996	7.5	0.0	0.0	7.5	C
29	1997	6.8	0.0	0.0	6.8	C
30	1998	6.1	0.0	0.0	6.1	C
31	1999	5.5	0.0	0.0	5.5	C
32	2000	5.0	0.0	0.0	5.0	C
33	2001	4.5	0.0	0.0	4.5	C
34	2002	4.0	0.0	0.0	4.0	C
35	2003	3.6	0.0	0.0	3.6	C
36	2004	3.2	0.0	0.0	3.2	C
37	2005	2.9	0.0	0.0	2.9	C
38	2006	0.0	0.0	0.0	0.0	C

AGO 531197

PRUDHOE BAY -- PUBLIC DATA, $8.03 PER BBL, ST INC TAX IS APPORTIONED

CASE 500

YEARLY ANALYSIS OF INCOME TAX

YEAR PRO-JECT	YEAR CAL-ENDAR	NET INCOME M$/YR	TOTAL EXPENSE M$/YR	DEPREC M$/YR	DEPLETION ALLOW M$/YR		INTANG INVEST M$/YR	TAX CREDIT M$/YR	INCOME TAX M$/YR
0	1968		0.0				0.0		0.0
1	1969	0.0	0.0	0.0	0.0	G	48.0	0.0	-23.0
2	1970	0.0	0.0	0.0	0.0	G	64.0	0.0	-30.7
3	1971	0.0	0.0	0.0	0.0	G	38.0	0.0	-18.2
4	1972	0.0	0.0	0.0	0.0	G	5.0	0.0	-2.4
5	1973	0.0	0.0	0.0	0.0	G	10.0	0.0	-4.8
6	1974	-10.0	0.0	0.0	0.0	G	37.0	0.0	-22.6
7	1975	-26.0	0.0	0.0	0.0	G	132.0	0.0	-75.8
8	1976	-273.0	44.0	0.0	0.0	G	192.0	0.0	-244.3
9	1977	479.8	159.9	271.8	12.1	C	315.0	269.1	-403.0
10	1978	2449.3	228.9	528.5	36.2	C	90.0	26.4	725.1
11	1979	2675.1	249.6	516.3	36.2	C	90.0	24.2	831.6
12	1980	3521.1	285.9	530.5	47.4	C	90.0	32.3	1200.1
13	1981	3754.3	424.9	567.3	47.4	C	90.0	46.9	1213.0
14	1982	3740.3	544.6	607.8	47.4	C	90.0	43.9	1132.3
15	1983	4270.0	562.3	633.5	47.4	C	88.0	44.0	1360.6
16	1984	4262.1	575.3	638.4	47.4	C	82.0	34.8	1366.3
17	1985	4383.5	633.7	610.1	47.4	C	82.0	24.0	1421.0
18	1986	4215.3	623.8	544.6	45.3	C	21.0	9.0	1421.6
19	1987	4032.9	608.0	447.9	43.1	C	0.0	0.0	1408.3
20	1988	3611.3	580.7	368.8	38.1	C	0.0	21.0	1238.4
21	1989	3153.5	536.9	308.2	32.6	C	0.0	0.0	1092.4
22	1990	2749.0	495.0	270.4	27.8	C	0.0	21.0	917.8
23	1991	2233.1	447.6	253.1	21.7	C	0.0	13.4	711.7
24	1992	1628.6	408.1	209.2	16.9	C	0.0	0.0	573.3
25	1993	1515.4	380.0	165.0	13.2	C	0.0	5.7	453.8
26	1994	1272.5	353.8	130.8	10.3	C	0.0	0.0	373.3
27	1995	1086.7	336.1	98.0	8.0	C	0.0	0.0	309.4
28	1996	1050.6	298.3	74.3	7.5	C	0.0	0.0	321.8
29	1997	993.4	292.2	56.9	6.8	C	0.0	0.0	306.0
30	1998	945.1	289.6	42.9	6.1	C	0.0	0.0	290.2
31	1999	894.9	283.9	30.0	5.5	C	0.0	0.0	276.3
32	2000	860.8	281.2	19.2	5.0	C	0.0	0.0	266.6
33	2001	826.6	160.4	10.7	4.5	C	0.0	0.0	312.5
34	2002	792.5	154.7	4.4	4.0	C	0.0	0.0	302.1
35	2003	765.3	149.4	1.8	3.6	C	0.0	0.0	293.1
36	2004	745.2	145.6	0.6	3.2	C	0.0	0.0	286.0
37	2005	722.1	141.8	0.0	2.9	C	0.0	0.0	277.2
38	2006	464.2	45.8	0.0	0.0	G	0.0	0.0	210.5
TOTALS		64003.3	10721.8	7941.0	675.0		1564.0	615.6	20073.0

(PROPERTY SURRENDER AMOUNTS ARE INCLUDED IN THE INTANGIBLE INVESTMENT VALUES)

A60 53198

PRUDHOE BAY -- PUBLIC DATA, $8.03 PER BBL, ST INC TAX IS APPORTIONED

CASE 500

YEARLY ANALYSIS OF NET CASH FLOW

YEAR PRO-JECT	YEAR CAL-ENDAR	NET INCOME M$/YR	TOTAL EXPENSE M$/YR	INTANG INVEST M$/YR	TANG INVEST (-)SLVG M$/YR	LEASE -HOLD INVEST M$/YR	FED INCOME TAX M$/YR	NET CASH FLOW M$/YR	CUM CASH FLOW M$/YR
1	1969	0.0	0.0	48.0	37.0	900.0	-23.0	-962.0	-962.0
2	1970	0.0	0.0	64.0	56.0	0.0	-30.7	-89.3	-1051.2
3	1971	0.0	0.0	38.0	76.0	0.0	-18.2	-95.8	-1147.0
4	1972	0.0	0.0	5.0	31.0	0.0	-2.4	-33.6	-1180.6
5	1973	0.0	0.0	10.0	59.0	0.0	-4.8	-64.2	-1244.8
6	1974	-10.0	0.0	37.0	227.0	0.0	-22.6	-251.4	-1496.2
7	1975	-26.0	0.0	132.0	809.0	0.0	-75.8	-891.2	-2387.4
8	1976	-273.0	44.0	192.0	1183.0	0.0	-244.3	-1447.7	-3835.1
9	1977	479.8	159.9	90.0	512.0	0.0	-403.0	120.9	-3714.2
10	1978	2449.3	228.9	90.0	377.0	0.0	729.1	1028.3	-2685.9
11	1979	2675.1	249.6	90.0	346.9	0.0	831.6	1157.9	-1528.0
12	1980	3521.1	285.9	90.0	461.0	0.0	1200.1	1484.2	-43.8
13	1981	3754.3	424.9	90.0	670.0	0.0	1213.0	1356.4	1312.6
14	1982	3740.3	544.6	90.0	627.0	0.0	1132.3	1346.4	2659.0
15	1983	4270.0	562.3	88.0	629.0	0.0	1366.6	1624.1	4283.1
16	1984	4262.1	575.3	82.0	497.0	0.0	1366.3	1741.4	6024.5
17	1985	4383.5	633.7	82.0	343.0	0.0	1421.0	1903.9	7928.4
18	1986	4219.3	623.6	21.0	129.0	0.0	1421.6	2019.8	9948.2
19	1987	4032.0	606.0	0.0	0.0	0.0	1408.2	2016.6	11964.8
20	1988	3611.3	580.7	0.0	300.0	0.0	1238.4	1492.2	13457.0
21	1989	3153.5	536.9	0.0	0.0	0.0	1092.4	1524.3	14981.3
22	1990	2749.0	495.0	0.0	300.0	0.0	917.8	1036.2	16017.5
23	1991	2235.1	447.6	0.0	191.0	0.0	711.7	882.7	16900.2
24	1992	1828.6	408.1	0.0	0.0	0.0	573.3	847.2	17747.4
25	1993	1515.4	380.0	0.0	81.0	0.0	453.8	600.6	18347.9
26	1994	1272.5	353.8	0.0	0.0	0.0	373.2	545.4	18893.4
27	1995	1086.7	336.1	0.0	0.0	0.0	309.4	441.2	19334.6
28	1996	1050.6	298.3	0.0	0.0	0.0	321.8	430.5	19765.1
29	1997	993.4	292.2	0.0	0.0	0.0	306.0	395.1	20160.2
30	1998	943.1	289.6	0.0	0.0	0.0	290.2	363.4	20523.6
31	1999	894.9	283.9	0.0	0.0	0.0	276.3	334.7	20858.3
32	2000	860.8	281.2	0.0	0.0	0.0	266.6	313.0	21171.3
33	2001	826.6	160.4	0.0	0.0	0.0	312.5	353.7	21525.0
34	2002	792.5	154.7	0.0	0.0	0.0	302.1	335.7	21860.7
35	2003	765.3	149.4	0.0	0.0	0.0	293.1	322.9	22183.6
36	2004	745.2	145.6	0.0	0.0	0.0	286.0	313.7	22497.2
37	2005	722.1	141.8	0.0	0.0	0.0	277.2	303.2	22800.4
38	2006	464.2	45.8	0.0	0.0	0.0	210.5	228.0	23028.4
TOTALS		64003.3	10721.8	1339.0	7941.0	900.0	20073.0	23028.4	

AGO 53199

PRUDHOE BAY -- PUBLIC DATA, $8.03 PER BBL, ST INC TAX IS APPORTIONED

CASE 500

PRESENT VALUE PROFILE

DISCOUNT RATE PERCENT	PRESENT VALUE PROFIT-M$	DISCOUNT RATE PERCENT	PRESENT VALUE PROFIT-M$
0.	23026.4	1.	18631.0
2.	15112.9	3.	12280.9
4.	9987.8	5.	8121.1
6.	6593.6	7.	5337.9
8.	4301.4	9.	3442.5
10.	2726.1	12.	1633.3
14.	863.2	15.	566.8
16.	516.7	18.	-73.5
20.	-353.1	30.	-921.7
40.	-995.5	50.	-962.8
60.	-911.8	70.	-863.1
80.	-821.0	90.	-785.1
100.	-754.3		

INVESTMENT YARDSTICKS

PAYOUT PERIOD = 12.03 YEARS

INVESTOR'S RATE OF RETURN = 17.57 PERCENT

RATIO, UNDISCOUNTED PROFIT TO INITIAL INVESTMENT (PFIT)=0.0

PVP AT 25.00 PERCENT =-753.025 PVPI NOT CALCULATED

AGO 531200

PRUDHOE BAY -- PUBLIC DATA, $8.03 PER BBL, ST INC TAX IS APPORTIONED

CASE 500 ABBREVIATED RESULT TABLE

PROJECT INITIATION DATE = 1/69
DATE OF FIRST PRODUCTION = 1/74

PRODUCTION/REVENUE

	W.I. PROD	N.I. PROD	N.I. REVENUE M$
OIL (MBO)	8156.9	7137.3	55425.1
GAS (BCF)	17.520	15.330	13061.090
AD VAL (MDOLS)	1857.0	1624.9	-1857.2
INC TAX (MDOLS)	2625.4	2297.2	-2625.7

SUMMARY RESULTS (M$)

TOTAL INCOME	TOTAL EXPENSE	TOTAL INVEST	TOTAL TAX	NET INCOME
64003.3	10721.8	10179.9	20073.0	23028.4

INVESTMENT YARDSTICKS

PAYOUT PERIOD = 12.03 YEARS

INVESTOR'S RATE OF RETURN = 17.57 PERCENT

RATIO, UNDISCOUNTED PROFIT TO INITIAL INVESTMENT (DFIT)=0.0

PVP AT 25.00 PERCENT =-753.025 PVPI NOT CALCULATED

AGO 531201

PRUDHOE BAY -- PUBLIC DATA, $8.03 PER BBL, ST INC TAX IS APPORTIONED

CASE 500 SUMMARY RESULT TABLE

PROJECT INITIATION DATE = 1/69
DATE OF FIRST PRODUCTION = 1/74

PRODUCTION/REVENUE

	W.I. PROD	N.I. PROD	N.I. REVENUE M$
OIL (MBO)	8156.9	7137.3	55425.1
GAS (BCF)	17.520	15.330	13061.090
AD VAL (MDOLS)	1857.0	1624.9	-1857.2
INC TAX (MDOLS)	2625.4	2297.2	-2625.7

PROJECT INTEREST FACTORS (FRACTIONS)

PRO- JECT	CAL- ENDAR	PROD/REVNUE W.I.	PROD/REVNUE N.I.	INVEST W.I.	EXPENSE W.I.
1	1969	1.0000	0.6750	1.0000	1.0000

SUMMARY ECONOMICS (M$)

REVENUE	64003.3
INVESTMENT	
TANGIBLE	7941.0
INTANGIBLE	1339.0
LEASEHOLD	900.0
DRY HOLE	0.0
SALVAGE	0.0
TOTAL	10179.9
EXPENSE	
DIRECT	6639.9
PROD/AD VALOREM TAXES, TARIFF	4081.8
INDIRECT	0.0
TOTAL	10721.8
BFIT PROFIT	43101.6
INCOME TAX	20073.0
NET PROFIT	23028.4

INVESTMENT YARDSTICKS

PAYOUT PERIOD = 12.03 YEARS

INVESTOR'S RATE OF RETURN = 17.57 PERCENT

RATIO, UNDISCOUNTED PROFIT TO INITIAL INVESTMENT (BFIT)=0.0

PVP AT 25.00 PERCENT =-753.025 PVPI NOT CALCULATED

AGO 531202

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

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EXXON 1977
calculations

PRUDHOE BAY PROJECT ECONOMICS
GENERATED FROM PUBLICLY AVAILABLE DATA

Page

Computer Output: Field Economics

AGO 531203

NORTH SLOPE ECONOMICS CONSTRUCTED FROM PUBLICLY AVAILABLE DATA
MAJOR SOURCES OF DATA AND DATA ITEMS

A. Data Sources:

1. Field Economics

   a. Future production rates, investments, operating costs and oil wellhead prices: State of Alaska's reserves tax study, February 9, 1976, with all data deescalated to 1976 dollars.

   b. Gas prices: Price at pipeline inlet of $1.46/MMBtu from February 1977 advance submission to Canadian NEB by Mr. Radford Shantz, Foster Associates. Cost of Service expense for gas gathering-conditioning of $0.75/MMBtu is based on producer testimony that the cost of service would be about 1/3 of combined gathering-conditioning-transportation costs of service.

   c. Historical investments:
      Sohio/BP Trans Alaska Pipeline Finance, Inc. Prospectus, December 4, 1974;
      The Standard Oil Company (Ohio) Prospectus, December 2, 1976;
      City of Valdez, Alaska, % Marine Revenue Bonds (ARCO Pipe Line Company Project) Preliminary Official Statement, January 27, 1977.

2. TAPS Economics

   a. Total cost: Alyeska announcements.

   b. TAPS will be a regulated concern. Tariffs allowed under ICC rules result in DCF returns from 12 to 14%.

3. Tanker Economics: Consultant reports to FEA, November 1976 (Mortada Study).

   10% Return on Investment

NORTH SLOPE ECONOMICS CONSTRUCTED FROM PUBLICLY AVAILABLE DATA
MAJOR SOURCES OF DATA AND DATA ITEMS (Continued)

B. Major Data Items:

1. Tanker Investment: $1,760MM

2. TAPS Investment - for 1.2 MMB/D: $7,700MM
   - for 1.6 MMB/D: $8,375MM

3. Field Investment - initial: $3,610MM
   - ultimate: $9,280MM

4. Oil Production - Reserves: 8.2 Billion Bbl
   - Peak Rate: 1.6 MMB/D

5. Gas Sales - First Year: 1983
   - Rate: 2.0 Bcf/D

6. Wellhead Prices - Oil: 1978 $6.67
   1980 $7.28
   1985 $8.03
   Average $7.77/Bbl

   Gas: All Years $0.852/Mcf ($0.071/MMBtu) (Separator Outlet)

C. Integrated DCF Rate of Return: 14.5%

AGO 531205

PUBLIC DATA CASE
INTEGRATED RATE OF RETURN
(Investment Weighting Technique)

	Investment MM$	DCF Rate of Return*
Field & Bonus	10,180	17.6
TAPS	8,375	12.0
Tankers	1,760	10.0
Total	20,315	14.5

Investment Capital

* Total Capital Employed Basis

AGO 531206

PUBLIC DATA CASE
DIVISION OF PRUDHOE BAY FIELD LEVEL INCOME

		1976 Outlook MM$	1976 Outlook %	1969 Outlook %
Wellhead Value (8/8):	Oil	63,343		
	Gas	14,927		
	Total	78,270		
Field Investments		-9,280		
Field Operating Costs		-6,640		
Field Level Income		62,350		
State: Royalty		9,784		
Bonus		900		
Production Tax		4,082		
Ad Valorem Tax		1,857		
Income Tax		2,626		
Total		19,249	31	23
Federal Government		20,073	32	25
Oil Companies		23,028	37	52
		62,350	100	100

AGO 531207

PUBLIC DATA CASE
WELLHEAD PRICES
1967 CONSTANT DOLLAR BASIS
$/Bbl

Year	Wellhead Price Used In Reserves Tax Study	Reference Price Escalation (a)	Constant Dollar Wellhead Price (a)
1976			
1977	7.58	1.13	6.45
1978	8.52	0.72	6.67
1979	10.00	0.87	7.28
1980	10.42	0.42	7.28
1981	11.35	0.43	7.78
1982	11.35	-0-	7.78
1983	11.35	-0-	7.78
1984	11.35	-0-	7.78
1985	12.05	0.45	8.03

(a) Reference price of $11.28/Bbl on West Coast.

AGO 531208

GAS SALES

Price = $0.71/MMBtu

Initiation Date = 1983 (Technical Considerations, Prudhoe Bay Operating Plan, October, 1976)

Gas Sales Rate - 2.0 Bcf/D (Reserves Tax Study)

Reserves - 25.4 Tcf (De Golyer and Mac Naughton)

Since Reserves Tax Study only goes to 2006, will produce 2.0 X 365 X 10^{-3} X 24Yrs = 17.5 Tcf of 1200 Btu hydrocarbon gas.

GAS VALUE

Value at Pipe Line Inlet = $1.46/MMBtu. Radford Schantz, Foster Associates Advance testimony filed w/Can. NEB 2/77.

Cost of service expense for gas conditioning based on producer evidence presented to FPC = $0.75/MMBtu.

Wellhead price = $1.46 - 0.75 = $0.71/MMBtu (Sep. Outlet) or 0.852/Mcf at 1200Btu/cu. ft.

Note: Pritchard & Abbot include gas sales expenses but no revenue as the gas is not subject to the reserves tax.

AGO 531209

PUBLIC DATA CASE

FIELD EXPENSES; PRODUCTION TAX ON OIL

MM$

Year	Reserves Tax Study Escalated Op. Expenses	Escalation Factor	Constant 1976 Dollar Expenses	Gross Prod'n MM Bbl	No. Producing Wells	B/D/ Well	Gross Oil Prod'n Tax %	Well-head Price $/B	MM$ Gross Prod'n Tax Value	Net Prod'n Tax Value	Net Prod'n Tax %	Alternate Price Case: Well-head Price $/B	Alternate Price Case: MM$ Gross Prod'n Tax Value	Alternate Price Case: Net Prod'n Tax Value	Alternate Price Case: Net Prod'n Tax %
1976	44	1.000	44												
77	138	1.070	129	146	166	5000	7.5	6.45	61.8	30.9	3.75	8.17	78.4	39.2	3.75
78	152	1.145	133	438	209	5742	7.5	6.67	191.8	95.9	3.75	8.39	241.2	120.6	3.75
79	178	1.225	145	438	252	4762	7.5	7.28	209.2	104.6	3.75	9.00	258.6	129.3	3.75
1980	195	1.311	149	573	295	5321	7.5	7.28	273.8	136.8	3.75	9.00	338.4	169.2	3.75
81	337	1.403	240	573	313	5015	7.5	7.78	292.5	184.7	4.74	9.50	357.2	339.5	7.13
82	378	1.501	252	573	356	4409	7.5								
83	398	1.606	248	573	399	3934									
84	448	1.718	261	573	441	3560									
85	585	1.838	318	573	481	3264	7.3								
86	590	1.838	321	548	520										
87	586	1.838	319	521	530										
88	594	1.838	323	460	505										
89	575	1.838	313	394	455										
1990	566	1.838	308	336	414	2223	7.0								
91	546	1.838	297	262	376										
92	526	1.838	286	204	316										
93	515	1.838	280	159	265										
94	498	1.838	271	124	212										
95	496	1.838	270	97	170	1560	6.5								
96	432	1.838	235	91	163										
97	438	1.838	233	82	153										
98	430	1.838	234	74	144										
99	427	1.838	232	66	134										
2000	427	1.838	232	60	127	1294	6.3								
01	210	1.838	114	54	119										
02	204	1.838	111	48	110										
03	199	1.838	108	43	103										
04	195	1.838	106	39	97	1100									
05	191	1.838	104	35	95	1000									
06	44	1.838	24												

Reserves Tax Total = $476MM

AGO 531210

PUBLIC DATA CASE
HISTORICAL FIELD CAPITAL EXPENDITURES
MM$

Year	BP/ SOHIO(d)	ARCO(e)	Exxon(f)	Others Est. (a)	Total	IDC & Dry Holes(c)	Tangible
1969	40	nil	nil	45	85	48	37
1970	60	nil	nil	60	120	64	56
1971	60	13	13	28	114	38	76
1972	26	5	5	-	36	5	31
1973	61	4	4	-	69	10	59
1974	134	65	65	-	264	37	227
1975	411	265	265	-	941	132	809
1976					1375 (b)	192	1183
				133	3004	526	2478

(a) World Oil, 12/69, shows 9 completed wells, 9 rigs running, and 2 rigs waiting on freeze-up in addition to ARCO and BP activity. Assume 2 wells per rig as follows with 75% dry holes:

Year	No. Wells	$\overline{M}$$ Cost Per Well	$\overline{M}$$ Total Cost	$\overline{M}$$ Tangible	$\overline{M}$$ Dry Holes & IDC
1969	9	5	45	3	42
1970	15	4	60	4	56
1971	7	4	28	2	26

(b) Reserves Tax Study

(c) Reserves Tax Study shows 116 producing and 10 injection wells drilled thru 1976. Assume 8 additional (5%) dry holes by Sohio/BP and ARCO. Intangibles and dry holes are then:

3\overline{M}$/Well X 70% X 176 successful wells = 370\overline{M}$
3\overline{M}$/Well X 100% X 8 dry holes = 24$\overline{M}$
$394M

or 14% of the $2,871$\overline{M}$ spent thru 1976 by Exxon, ARCO and BP/Sohio.

(continued on next page)

(d) Sohio/BP Trans Alaska Pipeline Finance, Inc. Prospectus, December 4, 1974. The Standard Oil Company (Ohio) Prospectus, December 2, 1976.

(e) City of Valdez, Alaska, % Marine Revenue Bonds (ARCO Pipe Line Company Project) Preliminary Official Statement, January 27, 1977.

(f) Assumed identical to ARCO.

PUBLIC DATA CASE
HISTORICAL AND PROJECTED FIELD CAPEX AND AD VAL TAX
1976 CONSTANT DOLLARS
MM$

Year	No. Producing Wells	No. Inject. Wells	No. Wells Drilled	Intang. Drilling Costs (a)	Total Capex With Inflation (b)	Inflation Factor	Total Capex 1976 Dollars (c)	Intang. & Dry Holes	Tangible Invest-ment	Cumulative Tang. Invest-ment	Depreci-ation (d)	Accum. Depr.	Ad Val Tax (e)
1969					85		85	48	37				
1970					120		120	64	56				
71					114		114	38	76				
72					36		36	5	31				
73					69		69	10	59				
74					264		264	37	227	486			10
75					941		941	132	809	1295			26
76	138	10(gas)			1375	1.000	1375	192	1183	2478			273
77	166		43	90	644	1.070	602	90	512	2990			313
78	209		43	90	535	1.145	467	90	377	3367	160	160	64
79	252		43	90	534	1.225	436	90	346	3713	182	342	67
1980	295		43	90	722	1.311	551	90	461	4174	266	608	71
81	313	25(wtr)	43	90	1067	1.403	760	90	670	4844	306	914	79
82	356		43	90	1076	1.501	717	90	627	5471	370	1284	84
83	399		42	88	1151	1.606	717	88	629	6100	436	1720	88
84	441		40	82	995	1.718	579	82	497	6597	510	2230	87
85	481		39	82	781	1.838	425	82	343	6940	577	2807	83
86	520		10	21	276	1.838	150	21	129	7069	602	3409	73
87	530		0		276	1.838	150		150	7219	595	4004	64
88					276	1.838	150		150	7369	552	4556	56
89					276	1.838	150		150	7519	450	5006	50
1990					276	1.838	150		150	7669	335	5341	47
91					200	1.838	109		109	7778	300	5641	43
92					150	1.838	82		82	7860	200	5841	40
93					100	1.838	54		54	7914	200	6041	37
94					50	1.838	27		27	7941	200	6241	34
95											200	6441	30
96+											150/yr		
							9280	1339	7941				

(a) 70% of $3.0MM well cost.
(b) 1976 forward from Reserves Tax Study, 2/76.
(c) Historical not inflated.
(d) Unit of production.
(e) Includes reserves tax of $223MM in 1976 and $253M in 1977.

AGO 531213

CHASE GROUP OF PETROLEUM COMPANIES (29 in 1975)

		1970	1971	1972	1973	1974	1975	Trendline Growth %/Yr.
Crude Oil Supplies, MB/D		28,862	31,647	33,320	35,223	34,066	28,835	None
Net Income Before Inc. Tax		12,012	15,943	17,417	26,980	49,507	39,640	28
Property, Plant & Equip:	Net	64,550	71,740	75,097	79,613	91,169	99,027	9
	Reserves	53,061	58,562	60,530	64,060	69,219	68,716	
	Total	117,611	130,302	135,627	143,673	160,388	167,743	7

Assumptions for future predictions:

1. Field employees factor is Prudhoe production over worldwide oil supplies times 5. (a)
2. Future growth after accounting for inflation.
   a. Crude oil: 2%/yr.
   b. Net income before taxes: 5%/yr.
   c. Gross P, P & E: 4.0%/yr. thru 1980; 5%/yr. 1980-85; 6%/yr. 1986+.

(a) Recognizes that oil is handled four times (production, transportation, refining, and distribution) and that refining and distribution/marketing are employee intensive steps.

AGO 531214

PUBLIC DATA CASE
FIELD BOOK DEPRECIATION
MM$

Investment Year	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	Total
Investment	2,990	377	346	461	670	627	629	497	343	129	150	
Beginning Reserve (a)	8,157	7,573	7,135	6,562	5,989	5,416	4,843	4,270	3,697	3,149	2,626	
Depreciation:												
1978	160	-	-	-	-	-	-	-	-	-	-	160
1979	160	22	-	-	-	-	-	-	-	-	-	182
1980	210	28	28	-	-	-	-	-	-	-	-	266
1981	210	28	28	40	-	-	-	-	-	-	-	306
1982	210	28	28	40	64	-	-	-	-	-	-	370
1983	210	28	28	40	64	66	-	-	-	-	-	436
1984	210	28	28	40	64	66	74	-	-	-	-	510
1985	210	28	28	40	64	66	74	67	-	-	-	577
1986	201	27	26	38	61	63	71	64	51	-	-	602
1987	191	26	25	37	58	60	68	61	48	21	-	595
1988	169	23	22	32	51	53	60	54	43	19	26	552
1989 (b)												450
1990												335
1991												300
1992												200
1993												200
1994												200
1995												200
1996-2006												150/yr.

a) MM Bbl

b) Simplicity assumptions used past 1989.

AGO 531215

PUBLIC DATA CASE
STATE INCOME TAX

Year	Property Factor (a) Gross PPE, Bil. $ World Wide	P B Field	Gross PPE Factor	Employees Factor Crude Oil, MMB/D World Wide	P B Field	P B Factor	Average 3 Point Factor (b)	Bil. $ World-wide Net Income Before Income Taxes	AK Income Tax (c)
1976	174.4	- (d)	-	29.4	-	-	-	41.6	- (d)
1977	181.4	3.65	0.0201	30.0	0.4	0.0027	.0076	43.6	31.1
1978	188.6	4.18	0.0222	30.6	1.2	0.0078	.0100	45.8	43.0
1979	196.2	4.72	0.0240	31.2	1.2	0.0077	.0106	48.1	47.9
1980	204.0	5.44	0.0267	31.8	1.57	0.0099	.0122	50.5	57.9
1981	212.2	6.51	0.0307	32.4	1.57	0.0097	.0135	53.1	67.4
1982	220.7	7.58	0.0343	33.1	1.57	0.0095	.0146	55.7	76.4
1983	230.0	8.73	0.0380	33.7	1.57	0.0093	.0158	58.5	86.9
1984	238.7	9.73	0.0408	34.4	1.57	0.0091	.0166	61.4	95.8
1985	248.2	10.51	0.0423	35.1	1.57	0.0089	.0171	64.5	103.7
1986	258.2	10.78	0.0418	35.8	1.50	0.0084	.0167	67.7	106.3
1987	271.1	11.06	0.0408	36.5	1.43	0.0078	.0162	71.1	108.3
1988	284.7	11.34	0.0398	37.2	1.26	0.0068	.0155	74.7	108.8
1989	298.9	11.61	0.0388	38.0	1.08	0.0057	.0148	78.4	109.0
1990	313.8	11.89	0.0379	38.8	0.92	0.0047	.0142	82.3	109.8

(a) Under UDITPA rules, property factor is based on original cost.
(b) Sales factor assumed to be zero.
(c) 9.4% rate.
(d) Property factor does not include incomplete construction.

Note: After 1990 assume level taxation 1991-95, then decline 3%/yr. as world-wide investment grows.

AGO 531216

PUBLIC DATA CASE
TANKERS

Source: The Determination of Equitable Pricing Levels for North Slope Alaskan Crude Oil, November, 1976; Prepared for Office of Regulatory Programs, Federal Energy Administration under Contract No. CR-06-60824-00 (Mortada Study)

1. Required tanker capacity: 4.5 MMDWT assuming West Coast disposition for 2.0 MMB/D.

2. Average vessel size: 115 MDWT.

3. Average cost: $450/DWT plus $40/DWT interest during construction.

4. Roundtrip Valdez - Long Beach = 14.5 days including turn around at both ends of 1.5 days each.

5. Dry docking every two years = 30 days.

6. Weather and repair = 20 days/year.

7. Barrels hauled per year:

   115 MDWT X 6.4 Bbl/Ton = 736 MBbls/trip
   Average operating time = 365 - 15-20 = 330 days/year
   Trips/year = 330 ÷ 14.5 = 22.8
   MMBbls/Year = 22.8 X 736 X 10^{-3} = 16.78 (46 MB/D Avg.)

8. Investment Costs:

Year	Investment for MB/D	No. Vessels Req.	MM DWT	MM$ Investment
1976	828	18	2.07	932
1977	372	8	0.92	414
1978				
1979	370	8	0.92	414
				1760

9. Assumed DCF Return: 10%

AGO 531217

STATE OF ALASKA

JAY S. HAMMOND, Governor

DEPARTMENT OF REVENUE

PETROLEUM REVENUE DIVISION

509 W. THIRD AVENUE -- ANCHORAGE 99501

February 9, 1976

Mr. R. H. Underwood
Manager, Alaska Taxes
Atlantic Richfield Company
P.O. Box 360
Anchorage, Alaska 99510

Proposed Assessment for Reserves Tax (AS 43.58) on Proven Reserves of Oil in the Prudhoe (Sadlerochit) Oil Pool, North Slope Borough, Alaska

Dear Mr. Underwood:

An appraisal of the market value as of January 1, 1976 of the oil reserves of the Prudhoe (Sadlerochit) Oil Pool has been made for this Division by Pritchard & Abbott, Valuation Engineers of Fort Worth, Texas. This appraisal does not extend to the gas reserves of this reservoir because, in the absence of an initial transmission facility, the gas reserves are exempt from the reserves tax. Enclosed is a copy of the appraisal, which includes a statement of underlying assumptions and a calculation sheet showing how the appraised market value was derived.

Before developing their present projections of capital and operating costs and of the methods by which the pool will be developed, produced and eventually depleted, Pritchard & Abbott engineers have met on several occasions with the proposed unit operators and their partners. During these discussions Pritchard & Abbott indicated their thinking as to their projections, and on some points comments or criticism was offered by the operators. While we found this very useful, I should point out that the projections in the appraisal remain the work of Pritchard & Abbott, and not the operators or their partners.

Pritchard & Abbott have also received well logs and other physical data. The confidentiality of proprietary or statutorily confidential information has been, and will continue to be, strictly maintained. Based on this information, Pritchard & Abbott are preparing a "break out" of the market value by property. While the results of this task are not ready for distribution at this time, I have been informed that properties within the proposed unit that were rendered by Atlantic Richfield Company on behalf of itself and others do not represent more than 39.96 percent of the market value for the entire Prudhoe (Sadlerochit) Oil Pool, or not more than $4,711,000,000. This value includes the value as of January 1, 1976 of any production equipment needed for unit operations that was on those properties on that date. To avoid taxing this production

equipment twice, its assessed value for AS 43.56 would be subtracted from the market value of these properties in determining the value of the oil reserves for purposes of the reserves tax.

The reserves tax is unique not only for its temporary nature and its complex system of credits back and forth with the production tax, but also because of its unprecedented magnitude when applied to Prudhoe Bay. Because of this, and to administer the tax fairly and equitably, we are soliciting the review and comments of you, and all other operators and interest-owners in the Prudhoe (Sadlerochit) Oil Pool who wish to make them, before we reach any final decision as to the assessment of the Prudhoe properties. Mr. Gerald D. Heier, State Petroleum Property Assessor, and I will be available at the Division office in Anchorage through February 27, 1976 for discussions about the tax. For the convenience of companies headquartered outside Alaska, Mr. Heier and I will conduct a meeting on Wednesday, March 3, 1976 at the offices of Pritchard & Abbott, 200 Seminary South Building, Fort Worth, Texas, beginning at 9:00 o'clock in the morning (local time). We invite you and any other representatives of Atlantic Richfield Company, or any of the interests on whose behalf you rendered Prudhoe properties, to attend this meeting to discuss the reserves tax. We will remain available in Fort Worth for discussions with smaller groups or individuals through Friday afternoon, March 5, 1976. Written comments received at the Division office in Anchorage by the close of business on March 5, 1976 will also be given full consideration. After that time the record will be closed for our purposes, and we will prepare assessment notices for the reserves tax on the basis of our decisions made in light of this record.

Naturally the provisions for appeals in AS 43.58 and the regulations will remain available to any taxpayer challenging the assessment in his assessment notice.

Please call or write if you have any questions.

Yours very truly,

Thomas K. Williams
Director
Petroleum Revenue Division
Department of Revenue
State of Alaska

Enclosure

TKW:dh

cc: Mr. Gerald D. Heier, Anchorage

Pritchard & Abbott, Fort Worth, Texas

Exxon Company, U.S.A.

Page 7 of 7

Please Land Attorney's Rule Copies Pool

211

February 6, 1976

Mr. Thomas K. Williams, Director
Petroleum Revenue Division
Department of Revenue
State of Alaska
509 West Third Avenue
Anchorage, Alaska 99501

Dear Sir:

The Prudhoe Bay, Sadlerochit Pool has been appraised to determine the market value of remaining oil reserves under unitized conditions. It is my opinion that the market value as of January 1, 1976 is:

$ 11,790,000,000
Eleven Billion Seven Hundred Ninety Million Dollars

In addition to the present worth calculations, I am including a summary of the basic projections used to develope and deplete the oil reserves.

Yours truly,

Malcolm Jarrell, P.E.
Pritchard & Abbott Valuation Engineers

MJ:jr

Enclosures

Page 1 of 7

PRUDHOE BAY SADLEROCHIT POOL
PROJECTIONS as of 1-1-76

Development & Depletion

Well Development

The total number of producing wells drilled is based generally on 160 acre spacing per oil well, in the area where the oil column is 200 feet or more. In areas of thinner oil column, the density may vary to 320 acres per well. The magnitude and time frame for well development is,

A. Four (4) rigs continuously working for 12 years,
B. Each rig completes up to ten (10) wells per year,
C. Ten (10) gas injection wells drilled by 1977,
D. Twenty-five (25) water injection wells drilled by 1981,
E. Five hundred thirty (530) producing wells drilled by 1988.

Oil Production

A. Production begins by mid-1977 at an average rate of .8 MMB/D.
B. Production increases to an average rate of 1.2 MMB/D in 1978 & 1979.
C. Production increases to an average rate of 1.57 MMB/D (98% of 1.6 MMB/D) in 1980 & remains constant through 1985.
D. Production decline starts in 1986 and continues through 2005.

Water Production

A. Becomes significant by 1983 and increases to approximately 75% of total fluid production by 1996.
B. Water production in excess of 75% total fluid per well is one basis of plugging wells.

Gas Production

A. Gas/oil production ratio is 730 SCF/Bbl.
B. Shrinkage & fuel consideration is 8% of gross with remaining gas injected through 1980.
C. *Gas sales start in 1981 at a rate of 730 BCF/yr.

Water Injection

A. Source water injection starts in 1981 at a rate of 2250 MB/D and continues through 2000.
   1. Source water requirements based on injection rate of 2250 MB/D minus (-) produced water.
B. Produced water is injected through 2005.

Development & Depletion (cont'd)

Gas Injection

A. Produced gas injected through 1980.
B. *Produced gas sold or used after 1980.

Workovers

A. Begin in 1978 and increase to approximately 20% of the producing wells per year.
B. Plugging operation begins in 1938 and continue through 2006.

*Gas and/or condensate sales is not considered as economic factor in market value calculations.

Expenditures

Capital

A. Capital expenditures for the completion, addition and expansion of production facilities is projected to be approximately 85% of the total through 1985.
B. The average cost to drill & complete a well is $3 MM.

Operating

A.	Basic facility operations	$ 85 M/yr.
B.	Basic artificial lift facility operation	$ 45 M/yr.
C.	Well operation	$ 75 M/yr./well
D.	Well workover	$ 400 M/well
E.	Plug & Abandon wells (Net after salvage)	$ 250 M/well
F.	Gas handling & injection	9¢/SMCF
G.	Water handling and injection (1) source	14¢/bbl
	(2) produced	11¢/bbl
H.	Special allowance in 1976 & 1977 for 'start-up' training of personnel, etc.	

*All Capital and Operating expenses is inflated at 7% per year through 1985.

Severence Tax (Production Tax)

A. Based on State of Alaska % formula
i.e., up to 300 B/D/W = 3% of gross wellhead income
next 700 B/D/W = 6% " " " "
next 1000 B/D/W = 8% " " " "

Ad Valorem Tax

A. Estimated tax from A.S. 43.58 (Reserve) + A.S. 43.56 (Property) for 1976 & 1977.
B. Estimated tax from A.S. 43.56 (Property) after 1977.

YEAR	PRICE @ W.H. $/Bbl	NO. OF WELLS PRODUCING	PRODUCTION 8/8 GROSS MM Bbls	INCOME 7/8 GROSS MM $
1976		138		
77	7.58	166	146	968
78	8.52	209	438	3265
79	10.00	252	438	3832
80	10.42	295	573	5224
81	11.35	313	573	5691
82	11.35	356	573	5691
83	11.35	399	573	5691
84	11.35	441	573	5691
1985	12.05	481	573	6042
86		520	548	5778
87		530	521	5493
88		505	460	4850
89		455	394	4154
1990		414	336	3543
91		376	262	2762
92		316	204	2151
93		265	159	1676
94		212	124	1307
1995		170	97	1023
96		163	91	959
97		153	82	865
98		144	74	780
99		134	66	696
2000		127	60	633
01		119	54	569
02		110	48	506
03		103	43	453
04		97	39	411
2005		95	35	369
06				
TOTALS			8,157	81,073

No price increase after 1985

Page 4 of 7

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RUDHOE BAY - SADLEROCHIT POOL
PRESENT WORTH CALCULATIONS
(as of 1-1-76)

EXPENDITURES					INCOME	P.W.
CAPITAL MM $	OPERATING MM $	SEV. TAX MM $	A.V. TAX MM $	TOTAL MM $	7/8 NET MM $	@ 18% MM $
1375	44	1	235	1655	(-1655)	(-1524)
644	138	(73) 37	302	1121	(- 153)	(- 119)
535	152	(248) 124	41	852	2413	1595
534	178	(288) 144	47	903	2929	1641
722	195	(395) 210	54	1181	4043	1920
1057	337	429	63	1896	3795	1527
1076	378	426	78	1958	3733	1273
1151	398	422	93	2064	3627	1048
995	448	418	109	1970	3721	911
781	585	441	119	1926	4116	854
276	590	416	126	1408	4370	769
276	585	393	131	1385	4107	612
276	594	343	135	1348	3502	442
276	575	292	139	1282	2872	307
276	566	247	142	1231	2312	210
200	546	188	144	1078	1684	129
150	526	144	143	963	1188	77
100	515	111	142	868	808	45
50	493	86	141	775	532	25
-0-	496	67	137	700	323	13
	432	62	133	627	332	11
	428	56	126	610	255	7
	430	50	118	598	182	4
	427	44	108	579	117	2
	427	39	96	562	71	1
	210	35	83	328	241	4
	204	31	69	304	202	3
	199	27	55	281	172	2
	195	24	39	258	153	1
	191	21	23	235	134	1
	44		3	47	(- 47)	(- 1)
10,760	11,532	5,328	3,374	30,994	50,079	11,790

Page 597

15.1
6.0
9.1

11,790
50.16
677.4

11,790
x .02
235

SCOMM

#12:9

RADER

THE DETERMINATION OF EQUITABLE PRICING LEVELS FOR NORTH SLOPE ALASKAN CRUDE OIL

NOVEMBER 1976

Prepared for Office of Regulatory Programs

FEDERAL ENERGY ADMINISTRATION

under Contract No. CR-00-50824-00

This report was prepared under contract to the Federal Energy Administration (FEA) and does not necessarily state or reflect the views, opinions, or policies of the FEA or the Federal Government.

TABLE OF CONTENTS

Three field development plans were analyzed.

Case I: Only Prudhoe Oil Pool (consisting of Sadlerochit, Sag River and Shublik formations) is developed. Field is put on production in mid-1977. Production rate reaches 1.5 MMB/D by early 1979 and is held at that rate until mid-1986, and then declines. Gas sales begin in 1983 at 2 BCF/D.

TAPS' capacity expands to 1.5 MMB/D.

Case II: Field development plans include lower reserve estimates of Kuparuk and Lisburne Oil Pools. TAPS' capacity expands to next level of 2 MMB/D.

Prudhoe Oil Pool is produced at 1.6 MMB/D. Contributions of Kuparuk and Lisburne Oil Pools bring production rate to 1.77 MMB/D. Production rate peaks in 1986 and then declines.

Case III: Field development plans include upper reserve estimates of Kuparuk and Lisburne Oil Pools. TAPS' capacity and Prudhoe Oil Pool production rate are unchanged from Case II.

Contribution of Kuparuk and Lisburne Oil Pools brings rate of production to 1.915 MMB/D. Production rate peaks in 1986 and then declines.

Methodology and Results

1. Develop production rate forecast for each case.

2. Estimate investment in field and costs of operation for each development plan.

3. Estimate investment in TAPS and costs of TAPS' operation for 1.2, 1.5 and 2.0 MMB/D capacity.

4. Determine average transhipment costs from Valdez to West Coast ports. Cost of transshipment including terminal handling is 76 ¢/B.

5. Establish ceiling price (in 1976 dollars) at Valdez, based on price of comparable Saudi Arabian crude to West Coast refinery exclusive of entitlements.

	$/B	
Price of Saudi Arabian crude FOB Ras Tanura	11.51	12.64
Transshipment to West Coast	1.33	
Import Fee	.21	
Terminal Handling	.10	
	13.15	
	- .76	
Ceiling price at Valdez	12.39	13.54

6. Compute tariff rate by year for each case. Average tariff rate for first 10 years of pipeline service:

Case I	4.50 $/B
Case II	4.30 $/B
Case III	4.20 $/B

- Each TAPS owner has different experience with debt-to-equity ratio and interest rates. Each owner may set a different tariff.
- ICC and Justice Department rulings set the ceiling on tariff rate. An owner can set tariff below ceiling, but Justice Department will not knowingly condone destructive competition. This still leaves a wide latitude for each owner to set a different tariff.
- Owner may set the tariff rate annually (unsmoothed) or smooth the rate over several years.

7. Compute total operating costs of TAPS by year for each case to include:
   - Cost of operations (in 1976 dollars)
   - Ad valorem taxes
   - State of Alaska corporate income tax
   - Federal corporate income tax
8. Compute ceiling well head price by year for each case. This is equal to ceiling price at Valdez minus tariff.

   Use well head price to compute total field operating costs, including
   - Cost of operations (in 1976 dollars)
   - Ad valorem tax
   - Royalty and payments to Alaska Native Fund
   - Severance tax
   - State of Alaska corporate income tax
   - Federal corporate income tax

9. Compute annual gross revenue generated at Valdez at constant 1976 dollars plus revenue for gas sales in the field at 53 ¢/MCF (before conditioning to pipeline quality).

10. Adjust pre-1976 expenditures to 1976 dollars.

By expressing pre-1976 investments and post-1976 investments and revenues in 1976 dollars, the uncertainty associated with forecasting the future rate of inflation is circumvented. The resulting rate of return is referred to as "real rate of return". Price levels thus determined need to be adjusted quarterly to reflect effects of inflation.

11. Compute DCF, after tax, real rate of return on total investment in TAPS and Prudhoe Bay Field using items 7, 8, 9 and 10 above.

12. Analyze sensitivity of rate of return to price at Valdez by changing it by one dollar increments. Repeat items 8 to 11 above.

13. Analyze sensitivity of rate of return to risk multiplier "R", where $R = 1 + .5 (S - 1)$, and S = inverse of success ratio. Multiply total industry's expenditures on North Slope from 1959 until field discovery in 1968 by risk multiplier. The relationship between R and S assumes the unsuccessful exploratory ventures are expensed for federal income tax purposes.

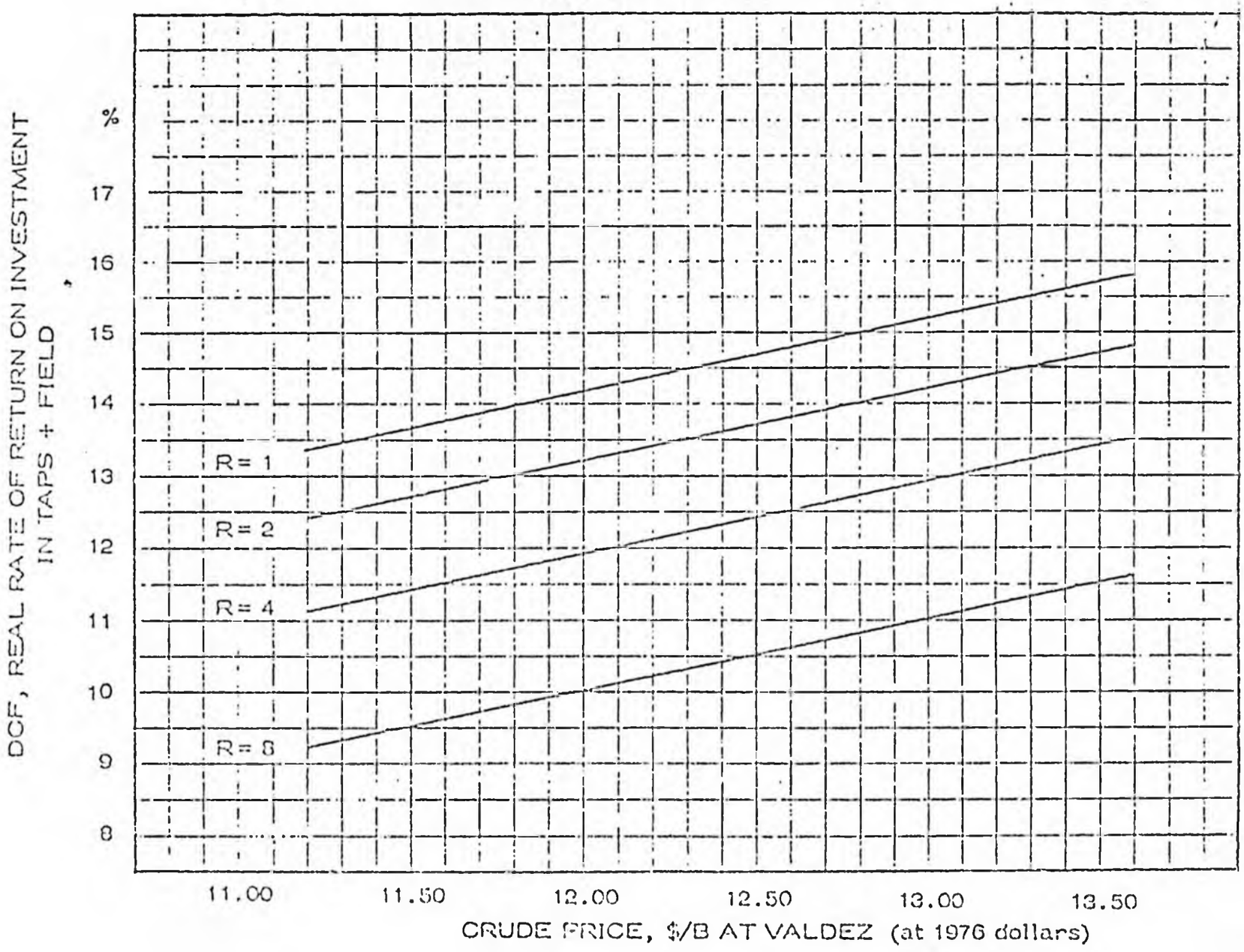
14. Analyze sensitivity of rate of return to uncertainty in tariff determination

15. Analyze sensitivity of rate of return to variation in rate of throughput by comparing rates of return for Cases I, II, and III.

RELATIONSHIP BETWEEN

RATES OF RETURN, RISK MULTIPLIER "R"

AND CRUDE PRICES



AGO 5311232

Conclusions

- Rate of return is relatively insensitive to the rate of throughput. The increased cost of developing and operating the speculative and less productive reserves in the Lisburne and Kuparuk Oil Pools is substantially offset by the economy resulting from increasing TAPS' capacity from 1.5 to 2.0 MMB/D.
- The uncertainty in tariff determination has little effect on the rate of return. An increase in tariff shifts the tax obligation to TAPS from the field, and vice versa. Since the field taxable income is more heavily taxed, a lowering of tariff increases the total tax obligation but does not affect the rate of return significantly.
- A change of 1 $/B in the price of crude at Valdez results in a net change in after tax revenue to the owners of 38 ¢/B. It also results in a 1% change in the rate of return.
- The risk multiplier has a dramatic effect on the rate of return. For Case I, with Valdez price of 12.40 $/B:

Risk Multiplier	Rate of Return %
1	14.6
2	13.6
4	12.3
8	10.4

A risk multiplier of 3 to 4.5 (equivalent to success ratio of 1 in 7) is suggested. For this range of risk multiplier and an after tax, DCF, real rate of return of 12%, the price range at Valdez would be

. 11.50 to 12.40 $/B.

Comparable well head price range would be:

Case I	7.00 - 7.90
Case II	7.20 - 8.10
Case III	7.30 - 8.20

Recommendations

- Equitable prices of Prudhoe Bay crude at Valdez fall between 11.50 and 12.40 $/B (1976 dollars), to be adjusted quarterly for inflation.
- Pricing at Valdez provides a built-in incentive for developing the speculative Kuparuk and Lisburne Oil Pools.
- Pricing at Valdez circumvents the uncertainty in tariff rates.
- Equitable prices of Prudhoe Bay crude at the well head for Case I fall in the range of 7.00 to 7.90 $/B (1976 dollars), to be adjusted quarterly for inflation.
- This study did not address itself to the implications on pricing of any surplus of crude on the West Coast.

I. Relationship Between Prices at West Coast Ports, Valdez and Well Head

The major components of the total system required to bring the Prudhoe Bay crude to the West Coast refineries are:

1. The Prudhoe Bay Field System
2. The Trans Alaska Pipeline System
3. The Transshipment System which transports the crude from Valdez to West Coast ports.

The price of Prudhoe Bay crude on the West Coast is equal to the price at Valdez plus the cost of transshipment. Similarly, the price at Valdez equals the well head price plus the pipeline tariff.

Cost of Transshipment

The cost of transshipment per barrel is equal to the sum of the operating costs per barrel plus the capital charges per barrel required for depreciating the cost of the tanker over its life after allowing a 10% rate of return on investment. The transshipment cost is very sensitive to tanker size and to the length of the voyage from Valdez to the West Coast port. A detailed analysis and presentation of the costs of transshipment as a function of tanker size and length of voyage is presented in Chapter III.

To arrive at a representative transshipment cost to be used for relating the price at Valdez to the price at the West Coast, an average tanker size of 115 MDWT (which is the average size of tanker in the Valdez to West Coast fleet) was used. Furthermore, the length of the voyage was averaged

out by arbitrarily assuming that one-third of the Valdez to West Coast crude oil trade goes to Puget Sound and two-thirds to Long Beach.*

Pipeline Tariff

The price of Prudhoe Bay crude at Valdez represents an important point of departure. The pipeline tariff for moving Prudhoe Bay crude from the field to Valdez is computed according to a set of rulings established by the ICC and the Justice Department. The tariff thus calculated represents a ceiling which cannot be exceeded by the owners. The form of ownership of the trans-Alaska pipeline is one of undivided joint interest and permits each owner to post a separate tariff. The owners will probably post different tariffs for several reasons.

1. The actual interest paid on borrowed capital is recognized by the ICC as a component in the tariff computation. Interest charges vary from owner to owner, depending on the interest rate on the pipeline debt, and debt to equity ratio.
2. The ownership in the pipeline is not the same as the ownership in the field reserves.

The Justice Dept. will not knowingly permit destructive competition through tariffs that fail to cover expenses. That still leaves considerable room for variation in the tariffs posted by the different pipeline owners.

For this reason, the price of crude at Valdez and a rate of return based on the combined investment in the field and pipeline system take on an added significance. The trans-Alaska pipeline tariff is computed for the average owner according to the rules and regulations prescribed by the ICC

* This assumption is examined in greater detail on page III-12.

and the Justice Department. The computed tariff is used to arrive at well head price which is the basis for computing:

1. Severance tax
2. State royalty
3. Payments to Alaska Native Fund
4. State and federal corporate income taxes.

II. Rates of Return

The rates of return computed in this study are discounted cash flow, after tax (both state and federal) real rates of return on total investment. Therefore for TAPS, the rate of return computation takes into account the entire capital investment in the pipeline (i.e. not limited to owners' equity). Similarly, therefore, it does not recognize construction interest, which is included in the ICC valuation base for tariff determination.

Predicting the future rate of inflation over the life of the project is subject to a high degree of uncertainty. On the other hand, reasonably reliable predictions can be made of the field producing potential, rates of throughput and operating and investment costs in terms of 1976 dollars. Therefore it is more meaningful to project all future costs and revenues in terms of 1976 dollars and to express all pre-investments also in terms of 1976 dollars. The resulting cash flow yields a real rate of return as distinguished from a nominal rate of return when discounted to determine a zero present worth. The price of oil thus determined is expressed in 1976 dollars and should be adjusted periodically after the fact to reflect the effects of inflation. Table I-1 was used to express pre-1976 investments in 1976 dollars.

Chapter II

QUALITY AND CHARACTERISTICS OF PRUDHOE BAY ALASKAN CRUDE OIL

Introduction

The Prudhoe Bay Field consists of three principal hydrocarbon accumulations. These are the Kuparuk, the Prudhoe and the Lisburne Oil Pools, in order of increasing depth. The Prudhoe Oil Pool is the principal hydrocarbon accumulation in the Prudhoe Bay Field. It ranges in depth from approximately 8,700 feet to 9,300 feet and contains the majority of known proven reserves in the field. The pool is made up of the Sag River, Shublik and Sadlerochit formations. The productive intervals in this pool vary in gross thickness from approximately 20 to 600 feet. The Sadlerochit formation contains most of the reserves in the Prudhoe Oil Pool.

Current development plans focus on the Prudhoe Oil Pool only. To date, no formal plans have been announced by the field operators for the development of the Kuparuk and Lisburne reservoirs. Crude oil from the Prudhoe Oil Pool will be the only crude oil going through the pipeline for the first three years of operation.

Extensive analyses were performed on two crude samples from the Prudhoe Oil Pool. One sample was obtained from ARCO's Sag River State #1 (the Sadlerochit formation) and was analyzed by the Bureau of Mines. The other sample was also a Sadlerochit crude obtained from ARCO's Drill Site #1 and analyzed by ARCO.

Chapter III

TRANSSHIPMENT COSTS BETWEEN VALDEZ AND WEST COAST PORTS

Introduction

The principal market for North Slope Alaskan crude oil will be the West Coast of the United States because export exchange and swap arrangements of domestic crude oil for foreign crudes are barred by law. A number of questions arise about the ability of the West Coast market to absorb the entire production from Prudhoe Bay. Current estimates indicate that in 1978 the West Coast market will have a surplus of 300 to 600 MB/D. The surplus in 1982 may be as high as 600 to 800 MB/D.

The disposition of the surplus crude which will be available in the West Coast market has been analyzed by other studies and falls outside the scope of this assignment.

For the purpose of this study, the principal destination of the Prudhoe Bay Alaskan crude oil will be Puget Sound, San Francisco and the Los Angeles-Long Beach area even though significant amounts of North Slope Alaskan crude oil may find its way to the Gulf Coast.

United States Preference Trade Act

U.S. laws restrict the use of non-U.S. flag vessels in certain trades. For example, pursuant to Section 2 of the Shipping Act of 1916, cargoes transported by sea from one U.S. port to another must be carried in unsubsidized vessels of U.S. registry. These vessels must be owned by U.S. citizens and must have been built in the U.S. Furthermore, the

Merchant Marine Act of 1920 (the Jones Act) requires that cargo transported between domestic ports be in ships built and registered in the U.S. and manned with U.S. crews. The Jones Act further stipulates that companies with more than 25% foreign ownership are not considered to be U.S. companies for purposes of the Act.

Tanker Requirements and Availability

The U.S. tanker capacity which is required to deliver 2 MMB/D of North Slope production will range from 4.5 MMDWT to approximately 6 MMDWT, depending upon the disposition of Alaskan crude oil among the various regions of the U.S. The 4.5 MMDWT assumes that the North Slope production will be shipped to West Coast ports.

Given the dual considerations of economics of scale and port limitations, the preferred tanker sizes for North Slope oil trade are anticipated to range from about 50 MDWT to shallow draft 165 MDWT tankers. Unsubsidized tankers falling within this classification will reach approximately 4.5 MMDWT by 1979-1980. Of the 4.5 MMDWT, 3.2 MMDWT will be owned or controlled by North Slope oil companies who will lease rather than own their tankers for most of the tanker life. The remainder 1.3 MMDWT is owned by independent ship owners. Based on present commitments and tankers on order, enough tanker capacity will be available to transport the North Slope Alaskan crude oil to West Coast ports.

The tanker size distribution of the North Slope oil companies is presented in Table III-1.

Table III-1

TANKER SIZE DISTRIBUTION
FOR
TANKERS OWNED OR CONTROLLED BY
NORTH SLOPE OIL COMPANIES

Number of Tankers	Size of Tankers MDWT	Status	Total Capacity MDWT
2	188	on firm order	376
4	165	on firm order	660
2	150	on firm order	300
1	150	on option	150
1	129	delivered	129
3	120	delivered	360
2	118	on firm order	236
1	118	on short term charter	118
2	81	delivered	162
2	81	on short term charter	162
3	75	delivered	225
4	70	delivered	280
1	52	delivered	52
			3,210
Independent Shipowners			1,300

The average size of tankers in the above distribution is estimated to be 115 MDWT.

Tanker Charter Rates

Tanker charter rates are highly competitive. Prevailing market rates for time and voyage charters are subject to fluctuations from time to time depending on market conditions and supply and demand situation. Although long-term charter rates (usually defined as charters for periods in excess of three years) are also subject to supply and demand, the variations are generally not as extreme as the short-term market rates. Accordingly, the long-term market rates tend to be less volatile. Nevertheless, they also fluctuate from time to time and hence are not suitable as a basis for determining the cost of transshipment. For the purpose of this analysis, the cost of transshipment will be computed by:

- depreciating the cost of the tanker over its useful life after allowing a rate of return on the investment, plus
- the cost of operating the tanker.

Cost of Transshipment from Valdez to West Coast Ports

The cost of transshipment from Valdez to West Coast ports consists of capital charges related to tanker construction plus applicable marine operating costs.

A. Cost of Tanker Construction

The cost of large crude carriers built in American shipyards has risen from around 200 $/DWT in 1970 to over 500 $/DWT on current orders. This cost does not include interest during construction which averages under 10% of the cost of construction.

Tankers which were built before the recent rapid rise in construction costs will have a distinct competitive advantage. The average construction cost for the entire Valdez to West Coast fleet is estimated to be 450 $/DWT plus 40 $/DWT for interest during construction. To arrive at transportation costs in ¢/B, the construction costs are depreciated over the life of the tanker, assuming several rates of return (for sensitivity purposes) and taking into account the length of the voyage between Valdez and various West Coast ports.

The following assumptions were used to compute the annual revenues and hence the capital charges per barrel required to yield various rates of return on the invested capital in tanker construction:

- Investment tax credit = 10%.
- For federal income tax purposes, tanker is depreciated over 14.5 years using double declining balance.
- Tanker life is 25 years.
- Federal income tax is 48%.

The computed capital charges are shown in Tables III-2 and III-3.

Chapter IV

TRANS ALASKA PIPELINE SYSTEM

Basic Facts

The trans-Alaska pipeline is just over 801 miles in length, of which about 375 miles will be buried and the remainder will be elevated. Current plans call for an initial capacity of 600 MB/D when the line is first completed in mid-1977, increasing to an ultimate capacity of 2 MMB/D in three stages. In the first stage, line capacity will be boosted to 1.2 MMB/D by late '77 or early '78. The capacity will be further boosted to 1.5 MMB/D in '79. Boosting the capacity further to 2 MMB/D must be coordinated with the development of speculative reserves (see Field Development Plans). Some estimates indicate that the pipeline via "looping", which employs added pipe and pump stations at various points along the line where the grade requires it, could handle 2.5 MMB/D. The Valdez terminal will have a ship-loading capacity of 80 to 110 MB/H, and can accommodate tankers of 195 MDWT. For a line capacity of 1.2 MMB/D, the storage capacity will be met through 18 tanks with 510 MB capacity each. Four berths will be required for the 1.2 MMB/D throughput, with a fifth berth to be added upon the increase in line capacity.

Trans Alaska Pipeline Ownership

Company	% of line owned
SOHIO Pipe Line Company	33.34
BP Pipelines, Inc.	15.84
ARCO Pipeline Company	21.00
Exxon Pipeline Company	20.00
Mobil Alaska Pipeline Company	5.00
Union Alaska Pipeline Company	1.66
Phillips Petroleum Company	1.66
Amerada Hess Corporation	1.50

TAPS Agreement

Duration of initial team: 30 years

Form of ownership: undivided joint interest

Transfer of ownership:

- permissible for cash
- partners have first purchase rights

Expansion from 1.2 MMB/D to 2.0 MMB/D

- any participant may propose
- other participants may acquire proportionate share or decline
- each partner has option to acquire share for 2 years after expansion

Construction Costs

The estimated costs of pipeline construction for 1.2 MMB/D design capacity is 7.7 billion dollars. This estimate includes the construction costs for the Valdez terminal, the fuel line, pump stations, and pumping plants. The estimated construction costs by year of expenditure and by cost item are shown in Tables IV-1 and IV-2.

Table IV-1

ESTIMATED CONSTRUCTION COSTS OF TRANS ALASKA PIPELINE SYSTEM BY YEAR OF EXPENDITURE

(For 1.2 MMB/D Design Capacity)

Year	Expenditures MM$
1969	35
1970	180
1971	109
1972	49
1973	47
1974	857
1975	2,772
1976	2,698
1977	765
1978	188
Total	7,700

Table IV-2

TRANS ALASKA PIPELINE SYSTEM

CONSTRUCTION COSTS

(MM $)

	Estimated Costs for 1.2 MMB/D (Design Capacity)
1. Alyeska Corporate	940.0
2. Bechtel - General	127.0
3. Pipeline - General	696.1
4. Pipeline Sections	1,353.6
5. Fuel Line	26.1
6. Mainline Pipe & other Permanent Materials	753.1
7. Pipeline & Roads - General	1,696.3
8. Roads - General	20.2
9. Roads	114.0
10. Yukon River Crossing	20.6
11. Fluor	171.2
12. Stations and Terminal - General	.1
13. Stations - General	14.8
14. Pump Stations	618.3
15. Topping Plants	21.1
16. Gate Valves	30.1
17. Mainline Refrigeration	5.0
18. Terminal - General	354.4
19. Terminal	738.0
Total Estimated Construction Costs	$ 7,700.0

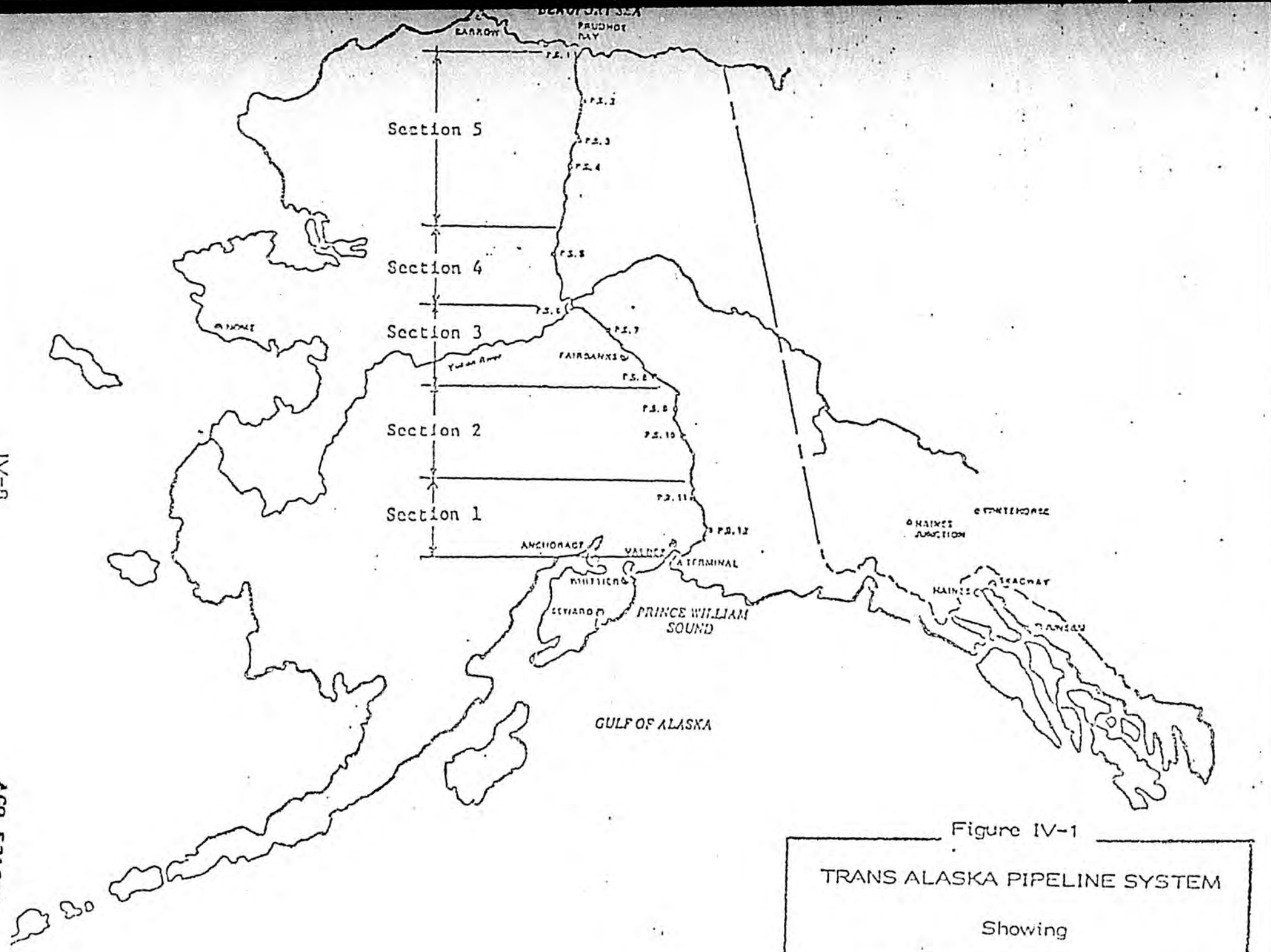


Figure IV-1

TRANS ALASKA PIPELINE SYSTEM

Showing

Pump Stations and Line Sections

Tariff Computation

The Prudhoe Bay Field development plans presented in this report identify three possible alternatives. Each alternative results in a different rate of production and throughput for the pipeline. Consequently, the computed tariff rates are different for each development plan. The tariffs were computed for each case for the years 1977 - 1994 according to the ICC and Justice Department guidelines as outlined in the Assumptions. After 1994, and due to the rapid decline in the field production rate, the computed tariff would have to be increased sharply to yield to the owners 7% on the valuation of the pipeline. It was therefore assumed that by 1994, either new fields would have been discovered or the owners would accept less than the 7% allowed by the ICC. From 1995 on, the tariff was increased at 10 ¢/B annually. This assumption has little effect on the recommended crude price, since the rate of return is computed on the investment in the field and pipeline. The three cases for which the tariff was computed are summarized below.

Case 1: Field development in this case is limited to Prudhoe Oil Pool. The field production rate was limited to 1.5 MMB/D and held at that rate through 1985, after which it begins to decline. The pipeline capacity was expanded in 1979 from 1.2 MMB/D to 1.5 MMB/D. The cost of the expansion was estimated at 520 MM$ plus 50 MM$ for construction interest. This brings the total estimated cost of the pipeline for 1.5 MMB/D capacity to 8,220 MM$ plus 1,350 MM$ for construction interest. The tariff for Case 1 in 1976 dollars varies between 3.45 and 5.40 $/B.

Case II: Field development in this case includes a lower estimate of the reserves of the Kuparuk and Lisburne Oil Pools. The rate of throughput for the pipeline increases to 1.77 MMB/D and is held through 1985, after which it begins to decline. It was necessary, therefore, to increase the pipeline capacity to the next level of 2 MMB/D. The estimated cost for increasing the pipeline capacity from 1.5 to 2.0 MMB/D is 500 MM$ plus 50 MM$ for construction interest. The total cost of the line is estimated to be 8,720 MM$ plus 1,400 MM$ for construction interest. The increase in throughput for this case outweighs the increase in cost required to increase the line capacity. Therefore, it results in a lower tariff than in Case I. The tariff for Case II in 1976 dollars varies between 3.10 and 5.60 $/B.

Case III: The field development in this case includes the upper estimate of the reserves of the Kuparuk and Lisburne Oil Pools. The rate of throughput for the pipeline increases to 1.915 MMB/D and is held through 1985, after which it begins to decline. This case requires no additional investment in TAPS over Case II. However, because of the increased rate of throughput the tariff in 1976 dollars varies between 2.90 and 5.60 $/B.

TRANS ALASKA PIPELINE SYSTEM

ASSUMPTIONS FOR TARIFF COMPUTATION
(All Costs in Billion Dollars)

1.	Cost of construction for 1.2 MMB/D design capacity	= 7.70
2.	Construction interest for (1) above	= 1.30
3.	Cost of expansion to 1.5 MMB/D	= .52
4.	Construction interest for (3) above	= .05
5.	Operating costs	= .274 $/B
6.	State of Alaska corporate income tax	= 9.4 %
7.	State of Alaska ad valorem tax based on economic value of pipeline	= 2 %
8.	Debt to capital ratio	= .85
9.	Interest on debt	= 9.0 %/annum
10.	Debt is retired in equal installments over a 25-year period.	
11.	For rate determination, pipeline depreciation is normalized (i.e. straight line) over 26.5 years. Federal and state income taxes allowed in rate determination are based on normalized depreciation. [Reference: ICC Docket No. 35533; William Bros. Pipeline Co., October 10, 1975]	
12.	The ICC valuation base declines at 6% per annum.	
13.	The maximum profit permitted on the ICC valuation base is 7% per annum.	
14.	For actual federal income tax, the line is depreciated using double declining balance over 17.5 years.	
15.	Federal corporate income tax	= 48%
16.	Investment tax credit	= 10%

Table IV-3

TRANS ALASKA PIPELINE SYSTEM

COMPUTED TARIFF AND PIPELINE ECONOMICS

CASE I: LINE CAPACITY 1.5 MMB/D
(Field Development Limited to Prudhoe Oil Pool)

Year	Throughput MB/D	Throughput MMB/Y	Tariff ¢/B	Gross Revenue MM$	Operating Costs MM$	State Taxes Ad Valorem MM$	State Taxes Corporate MM$	Federal Income Tax MM$	Capital Investment MM$
1969									35
70									180
71									109
72									49
73									47
74									858
75									2772
76									2098
77	600	146	540	788	40	53			765
78	1200	438	540	2365	120	115	53		188
79	1400	511	485	2478	140	108	69		520
1980	1500	548	435	2384	150	102	73	104	
81	1500	548	415	2274	150	98	73	329	
82	1500	548	395	2165	150	90	73	337	
83	1500	548	380	2082	150	84	74	344	
84	1500	548	365	2000	150	79	75	347	
85	1500	548	345	1891	150	75	73	336	
86	1400	513	345	1781	142	70	72	334	
87	1305	476	330	1717	131	60	71	329	
88	1210	442	365	1613	121	62	70	322	
89	1110	405	380	1539	111	58	70	323	
1990	1034	377	385	1455	104	55	68	314	
91	952	347	395	1375	95	51	67	309	
92	870	319	410	1304	87	48	66	304	
93	801	292	420	1231	80	45	64	296	
94	732	267	430	1148	74	43	61	284	

Pre-1976 costs expressed in actual dollars (i.e., money of the day).
Post-1976 costs and revenues expressed in 1976 dollars.

Table IV-4

TRANS ALASKA PIPELINE SYSTEM

COMPUTED TARIFF AND PIPELINE ECONOMICS

CASE II: LINE CAPACITY 2.0 MMB/D
(Field Development Includes Lower Estimate of Kuparuk and Lisburne Pools)

Year	Throughput MB/D	Throughput MMB/Y	Tariff ¢/B	Gross Revenue MM$	Operating Costs MM$	State Taxes Ad Valorem MM$	State Taxes Corporate MM$	Federal Income Tax MM$	Capital Investment MM$
1969									35
70									180
71									109
72									49
73									47
74									853
75									2772
76									2998
77	800	146	560	818	40	53			765
78	1200	438	560	2453	120	115	56		709
79	1500	548	475	2603	150	122	73		500
1980	1600	594	430	2511	160	125	74	61	
81	1720	628	385	2418	172	117	77	357	
82	1750	642	360	2315	176	110	78	359	
83	1770	646	340	2200	176	104	77	354	
84	1770	646	325	2100	177	98	76	353	
85	1770	646	310	2006	177	92	76	350	
86	1655	604	315	1903	166	86	78	349	
87	1535	560	325	1823	154	81	75	345	
88	1435	524	330	1729	144	76	74	344	
89	1325	484	340	1621	133	72	74	341	
1990	1234	450	345	1556	123	67	72	334	
91	1142	417	350	1460	114	63	70	322	
92	1040	380	365	1387	104	59	69	319	
93	956	349	375	1309	96	56	67	312	
94	872	318	383	1183	87	53	62	286	

Pre-1976 costs expressed in actual dollars (i.e., money of the day).
Post-1976 costs and revenues expressed in 1976 dollars.

Table IV-5

TRANS ALASKA PIPELINE SYSTEM

COMPUTED TARIFF AND PIPELINE ECONOMICS

CASE III: LINE CAPACITY 2.0 MMB/D
(Field Development Includes Upper Estimate of Kuparuk and Lisburne Pools)

Year	Throughput MB/D	Throughput MMB/Y	Tariff ¢/B	Gross Revenue MM$	Operating Costs MM$	State Taxes Ad Valorem MM$	State Taxes Corporate MM$	Federal Income Tax MM$	Capital Investment MM$
1969									35
70									150
71									100
72									49
73									47
74									558
75									2772
76									2093
77	800	146	550	818	40	53			765
78	1200	438	560	2453	120	115	56		708
79	1500	548	475	2603	156	122	73		500
1980	1600	584	430	2511	173	125	74	61	
81	1704	655	370	2424	179	117	77	356	
82	1859	679	340	2309	186	110	76	352	
83	1859	679	325	2207	186	104	76	353	
84	1915	699	305	2135	192	98	78	351	
85	1915	699	290	2030	192	92	76	354	
86	1800	657	290	1941	180	86	76	350	
87	1677	612	300	1839	168	81	74	341	
88	1574	575	300	1725	157	76	73	336	
89	1458	532	310	1652	146	72	73	334	
1990	1357	495	315	1562	136	67	72	331	
91	1259	460	320	1472	126	63	70	322	
92	1145	418	330	1379	114	59	67	312	
93	1052	384	340	1306	105	56	66	306	
94	958	350	355	1243	96	53	66	305	

Pre-1976 costs expressed in actual dollars (i.e., money of the day).
Post-1976 costs and revenues expressed in 1976 dollars.

Gross Revenue = throughput X tariff.

Operating Costs are based on the estimated manpower required to operate and maintain the line. Alyeska and TAPS owners are still in the process of developing an operating budget for TAPS and could not confirm or infirm our estimate.

State Corporate Income Tax = .094 of taxable income from the pipeline. Discussions with Alaska Department of Revenue indicate that the State of Alaska applies allocation and apportionment in multi-state taxation. The application of multi-state taxation would require estimating total corporate income by pipeline owner from all activities and allocating it back to each activity based on certain allocation formulas. This approach could not be followed here because it would be unrealistic to estimate the future corporate income of each TAPS owner for the entire life of the project.

Tables IV-3, IV-4, and IV-5 present the computation of the tariff, gross revenue, operating costs, State of Alaska ad valorem and corporate income taxes, federal income tax and capital investment. These results were merged with the results of calculations from Prudhoe Bay and used to calculate a rate of return on the investment in the field and pipeline.

A communication received from a North Slope owner shortly before going to print estimates the operating costs at 25 ¢/B higher than our estimate. Since TAPS' operating costs are passed in toto to the tariff, and since this

change increases the real rate of return on the investments in TAPS and the field by 6 basis points only, it was possible to account for this change without repeating the entire computation and analysis.

Average Tariff for First 10 Years of Pipeline Operation

	$/B
Case I	4.50
Case II	4.30
Case III	4.20

Effects of Inflation on Pipeline Tariff

Inflation impacts the tariff in three ways:

- The valuation base at any given time is affected by the rate of inflation, which determines the replacement cost of the line.
- The interest charges on the debt are also affected by the rate of inflation. Portions of the debt will be refinanced at maturity at interest rates which depend on the rate of inflation.
- The future operating costs of the line will also depend on the rate of inflation and will directly impact the tariff.

Pipeline Tariffs in 1987 at 7% Inflation

	$/B
Case I	4.80
Case II	4.35
Case III	4.05

Chapter V

PRUDHOE BAY FIELD

RESERVES AND DEVELOPMENT PLANS

Introduction

The Prudhoe Bay Oil Field is located on the flat-lying coastal plain of the Alaskan North Slope about 120 miles north of the Brooks Range (see Figure V-1). The North Slope is 600 miles long from the Canadian border to the Chukchi Sea and up to 200 miles wide from the Brooks Range to the Arctic Ocean. At the western part of the North Slope is National Petroleum Reserve #4, and the eastern part of the Slope is occupied by the National Wildlife Refuge. The area between NPR #4 and the Wildlife Refuge has been actively explored since the late 1950's. This effort culminated in the discovery of Prudhoe Bay Field in 1968.

In the Prudhoe Bay Field area, basement is encountered at 12,000 feet. Overlying the basement rock are sequences of sedimentary rocks. In ascending order, the recognized formations are: the Kekiktuk conglomerate, Kayak shale, Itkilyarriak formation, and the Lisburne group carbonates, which contain the Lisburne Oil Pool, the lowest defined pool in the Field. Overlying these are the Sadlerochit formation, Shublik formation, and Sag River sandstone, which together contain the most important oil pool in the Prudhoe Bay Field, officially designated as the Prudhoe Oil Pool. The Kingak shale occurs next. The youngest unit in the lower sequence is the Kuparuk River sands, containing the shallowest defined oil pool in the Field. The Lisburne Oil Pool extends east of the Prudhoe Oil

Pool, and the shallower Kuparuk Oil Pool extends over a broad area to the west of the Prudhoe Oil Pool.

Following the discovery of Prudhoe Bay Field in 1968, the State of Alaska held a lease sale and received just over 900 million dollars in lease bonuses. Of that amount, 361 million dollars were spent on the area currently encompassing the Kuparuk River Oil Pool, the Prudhoe Oil Pool and the Lisburne Oil Pool as defined by the Division of Oil and Gas, Department of Natural Resources, State of Alaska (see Figure V-2).

Step-out drilling proceeded to delineate the limits of the Field. As of December 1975, 88 production wells had been drilled in Prudhoe Oil Pool, 55 of which are located on the west side operated by BP and 33 of which are located on the east side operated by ARCO. To satisfy initial crude oil supply demands for the trans-Alaska pipeline, current activity in Prudhoe Bay is directed toward development of this reservoir. Under State of Alaska regulations, the entire Prudhoe Bay Field will be developed as a unit and not by individual companies holding leases to avoid duplication of facilities and to ensure maximum efficient production with maximum environmental protection.

Prudhoe Bay Field Reserves

1. Prudhoe Oil Pool

The Prudhoe Oil Pool has been studied and reported on by the State of Alaska, Department of Natural Resources, Division of Oil and Gas; and by the Federal Energy Administration in a study dated December 31, 1974. The oil and gas reserves in the Prudhoe Oil Pool are summarized in Table V-1 based on discussions with the field operators and after reviewing the above-mentioned studies.

Table V-1

PRUDHOE OIL POOL

OIL AND GAS RESERVES

	Stock Tank Oil & Condensate MMMB	Solution Gas TCF	Gas Cap Gas TCF
Hydrocarbons, In Place*	22.9	13.9	26.6
Recoverable**	9.0 to 9.2	8.0	18.6
% Recovery	39 to 40	58	70

Initial average producing GOR = 750 CF/B

Gas contains 12.0% CO_2

* State of Alaska - Division of Oil & Gas

** Various sources

(Recoverable oil includes .5 MMMB of condensate.)

2. Kuparuk and Lisburne Oil Pools

In contrast to the Prudhoe Oil Pool, no engineering studies have been released on the Kuparuk and Lisburne Oil Pools. In fact, little information other than the press releases concerning the results of well tests is available on these oil pools. Therefore our estimate of reserves in the Kuparuk and Lisburne Oil Pools must be classified as speculative.

Speculative recoverable reserves from other reservoirs in the Prudhoe Bay area including secondary recovery are in the order of 1.3 to 2.1 billion barrels. Most of these reserves occur in the Kuparuk sand reservoirs to the west of the large Sadlerochit sand reservoir and in the Lisburne lime reservoirs which lie primarily under the gas cap of the large Sadlerochit reservoir.

Based upon announced well tests, it could be postulated that the Kuparuk sands are from 20 feet to 60 feet thick and the area could be three to five townships. The oil is in the 21° to 23° API gravity and the gas-oil ratio is in the order of 300 to 400 SCF/B. Using an average porosity of 23% and a normal water saturation of 25% and formation volume factor of 1.19, there would be 1125 stock tank barrels of oil in place per acre foot.

To maximize recovery, artificial recovery methods using waterflood or waterflood plus CO_2 injection would have to be started at the same time as production. A total recovery from the Kuparuk sand reservoirs could be postulated to be in the range of 630 to 1360 MMB of stock tank oil. Tests indicate that wells have a producing capacity in the 1000 to 2500 B/D rate.

Announced tests of Lisburne lime wells have indicated thicker net

Table V-4

Summary of Speculative Reserve Estimates

	Kuparuk MMBbls	Lisburne MMBbls	Total MMBbls
Lower Estimate w/artificial recovery	826	469	1295
Higher Estimate w/artificial recovery	1358	714	2072

Development Plans for Prudhoe Bay Field

1. Prudhoe Oil Pool

As of December 1975, 55 wells have been drilled in the area operated by BP and 33 wells have been drilled in the area operated by ARCO. Current development plans indicate that a total of about 130 producing wells will have been drilled and fully equipped for production by midyear 1977 (start-up date for the Alyeska Pipeline). It is anticipated that these wells will produce 1,200,000 BOPD (producing capacity will be slightly larger). These wells will be drilled in that part of the field where there is approximately 200 feet of oil column in the Sadlerochit sand. Completions will be made in that part of the sand to minimize water production and the production of gas from the gas cap. Initially the well spacing will be 320 acres per well.

It is planned that by midyear 1978 enough additional wells (approximately 70) will have been drilled so that the east side of the field (ARCO-operated) will have a producing capacity of 960,000 BOPD and the west side (BP-operated) will have a capacity of 900,000 BOPD for a total of 1,860,000 BOPD. The total of producing oil wells in the field at this time will be approximately 200.

By mid-1979 and no later than January 1, 1980 additional wells will be drilled to attempt to bring the productive capacity of the field to 2,000,000 BOPD. However, the field will be produced at a rate of 1,500,000 to 1,600,000 BOPD in order to maintain a flat rate to the pipeline for several years (estimated 7-plus). As in the operations of most

fields, where the water drive is not 100 per cent effective in maintaining reservoir pressure, well productivity should start to decline during this 7-plus year period and gas-oil ratios should start increasing. Ultimately 500 or more oil wells may be required in the oil column, reducing the well spacing to 160 acres per well or less. This will be required for optimum recovery of oil and gas and prudent operation of the oil pipeline.

Initially all gas produced along with the oil will be reinjected in the gas cap of the reservoir and will continue until a gas pipeline is constructed to the Prudhoe Bay Field. The earliest date forecasted for completion of an Alaskan gas transportation system (and this would require the highest priority for material and supplies) would be mid-1981. A more likely date would be mid-1982 or later.

Due to the characteristics of the sediments and the problem of heavy oil at the base of the sand in certain areas, the oil rim is only open to the aquifer in 50 to 70 per cent of the field. (See description of lower zone on page 13, June 1974, State of Alaska - Division of Oil and Gas, Report on in place volumetric determination of reservoir fluids, Sadlerochit formation, Prudhoe Bay Field.) In all probability then, water injection into the reservoir will not be necessary until mid-1982, i.e. when gas sales would be started and only in quantities equal to the reservoir voidage resulting from producing the gas cap.

PRUDHOE BAY FIELD

PRUDHOE OIL POOL

DEVELOPMENT AND PRODUCTION PLANS

ASSUMPTIONS:

1. Alyeska Pipeline will start operations 7-1-77.

   (a) Initial rate will be 300,000 BPD.

   (b) After 9-1-77 the rate will be increased to 600,000 BPD.

   (c) After 10-1-77 the rate will be increased to 1,200,000 BPD.

   (d) After 1-1-79 the rate will be increased to 1,500,000 BPD. Sufficient rigs (probably 4 or more) must be operated to maintain this rate until 1985.

   (e) After 1-1-80 the rate may be increased to 1,900,000 BPD. (This is speculative and will be dependent upon added production from Kuparuk sand reservoir and the Lisburne lime reservoir.)

2. The productive capacity of the Prudhoe Oil Pool (crude oil and condensate)

   (a) More than 120 oil producing wells will have been completed by 7-1-77, sufficient gas injection wells will have been completed and gas injection facilities installed.

   (b) Gas sales will have been started on 1-1-83 at the rate of 2.0 billion cubic feet per day. Gas from the gas cap will produce 30 barrels of condensate per million cubic feet of reservoir gas.

(c) It will be necessary to drill sufficient gas wells in the gas cap to have a deliverability in excess of one billion cubic feet per day in order to have 2.0 billion cubic feet per day available for the gas pipeline by 1-1-83.

(d) Pressure maintenance by water injection starts 1981-82.

PRUDHOE BAY FIELD

COSTS, WELL HEAD PRICES, AND ALASKA NATIVE FUND

Finding Costs

The finding costs of Prudhoe Bay Field consist of two types:

1. Expenditures on exploratory drilling, lease bonuses and rentals, geological and geophysical activity from the inception of industry activity on the North Slope in 1959 until the field discovery by Prudhoe Bay State #1 and confirmation by Sag River State #1 in 1968. Industry's expenditures on the North Slope (specifically the area between NPR #4 and the Wildlife Refuge) were estimated from the Joint Association Survey's annual publications and are presented in Table VI-1.

It can be stated that exploration ventures, especially of the type analyzed here, i.e. in virgin basins, do not usually result in discoveries. Hence, successful exploratory ventures should carry the cost of unsuccessful exploratory effort. A "risk multiplier R" can be defined such that if "S" exploratory ventures result in one commercial discovery, then the exploratory costs of the successful venture should be weighted by the risk multiplier "R" to account for the cost of the other ventures. However, the quantification of this argument presents some difficulties. For if "S" represents the inverse of the success ratio in exploration activity, then "R" should take into account the Internal Revenue Code which permits the explorationist to write off the cost of the unsuccessful ventures. Thus, $R = 1 + .5 (S - 1)$; i.e. a success ratio of one in seven results in a risk multiplier "R" of 4.

Another approach, in lieu of the risk multiplier, would be to interpret the computed rate of return in terms of the nature of the exploratory venture. Thus, exploratory activity in a virgin basin should yield a higher rate of return than exploratory effort in a mature basin where the probability of success is comparatively high.

There is still an alternate approach, however, which could be used in this case. Specifically, the transaction between Sohio and British Petroleum which involved about half of the reserves of Prudhoe Bay could be analyzed to establish the value assigned to the undeveloped reserves by the participants in the transaction.

Table VI-1, which presents our estimate of the industry's expenditures on the North Slope from 1959 until discovery of Prudhoe Bay, was not modified to reflect a risk multiplier and the numbers in it are "money of the day" and have not been converted to 1976 dollars.

2. In 1969 after the discovery of Prudhoe Bay Field, the State of Alaska held a lease sale and received over 900 MM$ in lease bonuses. Of that amount, 361 MM$ were spent on the area covered by the Kuparuk, Prudhoe and Lisburne Oil Pools as defined by the State of Alaska, Division of Oil and Gas. This 361 MM$ is included in Table VI-1 as part of Prudhoe Bay finding costs. However, it cannot be considered as a risk investment and does not receive a risk multiplier since it was made after field discovery.

Well Head Prices and Gross Revenue

The ceiling on Prudhoe Bay crude is set by the price of Saudi Arabian crude on the West Coast market. The price of Saudi crude to a West Coast refiner, exclusive of entitlements, consists of:

	$/B
Arabian crude (FOB Ras Tanura)	11.51
Tanker tariff to Long Beach	1.33
Crude import fees	.21
Terminal charges	.10
	13.15
Average transshipment and terminal charges from Valdez to West Coast	.76
Ceiling price of Prudhoe Bay crude at Valdez	12.39

Based on the ceiling price of Prudhoe Bay crude at Valdez and on the average pipeline tariff during the first 10 years of service, the ceiling well head price in 1976 dollars for the first 10 years of production averages 7.90 $/B for Case I, 8.10 $/B for Case II, and 8.20 $/B for Case III. The nominal ceiling price of Prudhoe Bay crude at the well head and at Valdez is to be adjusted quarterly to reflect the effects of the rate of inflation on crude prices.

The determination of equitable prices for Prudhoe Bay crude at Valdez is sensitive to the risk multiplier applied to industry's expenditures on the North Slope from 1959 until discovery of Prudhoe Bay in 1968 (see

Chapter VII). A risk multiplier of between 3.0 and 4.5 is consistent with industry's expenses in wildcat activities during the mid-1960's. For a risk multiplier of 3 and a crude price of 11.50 $/B at Valdez, the DCF, after tax, real rate of return on the investments in Prudhoe Bay Field and in TAPS is equal to 12%. Similarly, for a risk multiplier of 4.5 and a crude price of 12.40 $/B at Valdez, the DCF, after tax, real rate of return on the investments in Prudhoe Bay Field and TAPS is equal to 12%. An equitable price for Prudhoe Bay crude at Valdez in 1976 dollars falls in the range of 11.50 to 12.40 $/B. Based on the price at Valdez, equitable prices at the well head are as follows:

Case I (only Prudhoe Oil Pool is developed)	7.00 - 7.90 $/B
Case II (Prudhoe Oil Pool + lower estimate of Kuparuk and Lisburne)	7.20 - 8.10 $/B
Case III (Prudhoe Oil Pool + upper estimate of Kuparuk and Lisburne)	7.30 - 8.20 $/B

The prices are in 1976 dollars and are to be adjusted for inflation to yield 12% return.

Projections of ceiling well head prices and gross revenue in 1976 dollars for Cases I, II, and III are presented in Tables VI-5, VI-6, and VI-7. The gross revenue projections include revenue from gas sales starting in 1983. The well head price of gas before CO_2 removal is assumed to be .53 $/MCF in 1976 money.

PRUDHOE BAY FIELD

WELL HEAD PRICE, ROYALTY AND TAX PAYMENTS

CASE 1: Field Development Limited to Prudhoe Oil Pool

Year	Well Head Price $/B	Alaska Native Fund Payment MM$	State Royalty MM$	Severance Tax MM$	Ad Valorem Tax MM$	Corporate income tax	
						State MM$	Federal MM$
77	6.99	20	107	68	42	16	
78	6.99	61	321	206	54	168	536
79	7.54	77	405	258	61	226	1010
80	8.04	88	463	293	67	265	1182
81	8.24	90	474	298	75	260	1135
82	8.44	92	486	304	87	263	1153
83	8.59	72	565	332	97	296	1309
84	8.74		647	334	108	301	1335
85	8.94		661	338	117	308	1398
86	8.94		627	317	121	299	1382
87	8.79		571	283	113	270	1248
88	8.74		531	260	105	253	1171
89	8.59		483	235	98	230	1063
90	8.54		451	221	91	214	992
91	8.44		414	203	84	197	911
92	8.29		378	185	78	179	827
93	8.19		344	171	73	161	746
94	8.09		312	157	68	145	670
95	7.99		280	142	63	127	589
96	7.89		247	127	59	113	521
97	7.79		222	113	55	99	457
98	7.69		195	99	51	84	389
99	7.59		168	84	47	69	319
2000	7.49		145	72	44	56	260
01	7.39		122	60	41	44	202
02	7.29		104	51	38	33	153

Post-1976 costs and revenues expressed in 1976 dollars.

Table VI-6

PRUDHOE BAY FIELD

WELL HEAD PRICE, ROYALTY AND TAX PAYMENTS

CASE II: Field Development Includes Prudhoe Oil Pool + Lower Estimate for Kuparuk and Lisburne Pools

Year	Well Head Price $/B	Alaska Native Fund Payment MM$	State Royalty MM$	Severance Tax MM$	Ad Valorem Tax MM$	Corporate income tax State MM$	Corporate income tax Federal MM$
77	6.79	20	104	65	42	14	
78	6.79	50	312	198	54	140	352
79	7.64	84	440	277	70	222	939
80	8.09	94	496	309	86	252	1060
81	8.54	107	563	347	105	279	1166
82	8.79	113	593	360	128	289	1223
83	8.99	23	756	390	148	327	1409
84	9.14		791	392	166	350	1548
85	9.29		803	395	177	359	1618
86	9.24		751	363	181	339	1557
87	9.14		693	331	180	312	1442
88	9.09		649	308	168	295	1365
89	8.99		597	284	156	272	1258
90	8.94		556	265	145	254	1176
91	8.89		517	246	135	237	1098
92	8.74		468	226	125	214	991
93	8.64		427	207	117	194	897
94	8.54		386	188	109	174	809
95	8.44		345	169	101	153	708
96	8.34		308	151	94	137	633
97	8.24		276	136	87	121	558
98	8.14		245	121	81	104	480
99	8.04		212	105	76	86	398
2000	7.94		185	92	70	71	331
01	7.84		157	78	65	68	316
02	7.74		137	68	61	57	265

Post-1976 costs and revenues expressed in 1976 dollars.

Table VI-7

PRUDHOE BAY FIELD

WELL HEAD PRICE, ROYALTY AND TAX PAYMENTS

CASE III: Field Development Includes Prudhoe Oil Pool + Upper Estimate for Kuparuk and Lisburne Pools

Year	Well Head Price $/B	Alaska Native Fund Payment MM$	State Royalty MM$	Severance Tax MM$	Ad Valorem Tax MM$	Corporate income tax State MM$	Corporate income tax Federal MM$
77	6.79	20	104	65	42	13	
78	6.79	59	312	198	54	127	260
79	7.64	84	440	275	75	203	821
80	8.09	94	496	306	98	228	917
81	8.69	114	598	366	124	276	1116
82	8.99	122	641	385	153	292	1207
83	9.14	7	825	411	179	324	1365
84	9.34		872	427	204	374	1654
85	9.49		885	428	213	386	1735
86	9.49		836	397	219	369	1686
87	9.39		775	363	219	341	1578
88	9.39		731	341	203	327	1514
89	9.29		674	315	189	302	1399
90	9.24		628	294	176	283	1308
91	9.19		585	273	164	265	1225
92	9.09		531	247	152	240	1109
93	8.99		484	224	142	217	1005
94	8.84		436	202	132	194	897
95	8.74		390	180	122	170	786
96	8.64		347	160	114	151	700
97	8.54		314	144	106	134	622
98	8.44		277	127	98	115	533
99	8.34		241	110	92	96	442
2000	8.24		211	96	85	80	369
01	8.14		182	82	79	75	349
02	8.04		158	71	74	63	291

Post-1976 costs and revenues expressed in 1976 dollars.

Royalty Payments and The Native Claims Settlement Act

Under Public Law 92-203 of December 18, 1971, "Native Claims Settlement Act":

Section 6(a) There is hereby established in the United States Treasury an Alaska Native Fund into which the following monies shall be deposited:

1. ...

2. ...

3. $500,000,000 pursuant to the revenue sharing provision of Section 9.

Section 9(b) ....the State shall pay into the Alaska Native Fund from the royalties, rentals, and bonuses hereafter received by the State, a royalty of 2 per centum upon the gross value of such minerals produced or removed from such lands.

Thus, of the royalty of 12.5% received by the State of Alaska, 2% will be paid into the Alaska Native Fund established in the United States Treasury until the total paid in the Fund amounts to $500,000,000. The payments due the Alaska Native Fund and the State of Alaska royalty are presented year by year in Tables VI-5, VI-6, and VI-7. In all three development plans, the payments in the Alaska Native Fund will be completed before the end of 1983. In fact, the payments into the Fund will probably be completed before the end of 1982 since they will be made in nominal dollars instead of 1976 dollars.

State of Alaska Severance and Ad Valorem Taxes

The State of Alaska receives severance tax on a percentage of gross value at the well head (less royalty) or on a per barrel basis, whichever is higher. For Prudhoe Bay Field at the well head prices under consideration, the percentage severance tax applies and is computed according to the following table:

Average Production Rate per Well B/D	Severance Tax %
0 - 300	5
301 - 1000	6
over 1000	8

The ad valorem tax is equal to 2% on capital investment in exploration and production properties assessed on replacement costs less depreciation, and is shown in Tables VI-5, VI-6, and VI-7.

State of Alaska and Federal Corporate Income Tax

Tax rates of 9.4% and 48% were used for the State and Federal corporate income taxes, respectively.

Chapter VII

PRICING CONSIDERATIONS

DCF, AFTER TAX, REAL RATE OF RETURN

AND SENSITIVITY ANALYSES

Effect of Throughput on Rates of Return

Three alternate field development plans were considered:

Case I: Development plans were limited to Prudhoe Oil Pool and TAPS' throughput capacity to 1.5 MMB/D. The pipeline operates at capacity for nearly seven years.

Case II: Development plans were expanded to include lower estimate of reserves and producing capacity of Kuparuk and Lisburne Oil Pools. TAPS' throughput capacity increases to the next level of 2 MMB/D. Rate of throughput for TAPS increases to 1.77 MMB/D. In this Case, Prudhoe Oil Pool is produced at rates up to 1.6 MMB/D instead of 1.5 MMB/D as in Case I.

Case III: Development plans include upper estimate of reserves and producing capacity of Kuparuk and Lisburne Oil Pools. TAPS' throughput capacity is 2 MMB/D. Rate of throughput for TAPS increases to 1.915 MMB/D. Prudhoe Oil Pool is produced as in Case II.

The estimated development costs of the speculative Kuparuk and Lisburne Oil Pools are considerable higher than Prudhoe Oil Pool. On the other hand, the estimated incremental investment required to increase TAPS' capacity to accommodate the production from the Kuparuk and Lisburne Oil Pools is modest compared with the initial investment required for the

1.5 MMB/D of TAPS' throughput capacity. As a result, the real rate of return on the investments in the field and pipeline is relatively insensitive to the rates of throughput. In fact, based on a price of 12.40 $/B at Valdez (1976 $'s) and risk multiplier of one, the after tax real rate of return on the investments in the field plus pipeline for Cases I, II, and III averages 14.2% and varies by less than $\pm$ 40 basis points between the Cases.

Effects of TAPS' Tariff

Some uncertainty surrounds the tariff determination, expecially for the first few years of line operation. Moreover, the form of TAPS' ownership, i.e. undivided joint interest, allows each owner to post a separate tariff. Furthermore, an owner can either post an annual unsmoothed tariff or a smoothed tariff covering more than one year. Using Valdez as the pricing point for Prudhoe Bay crude circumvents the effects of uncertainty in tariff on the price of Prudhoe Bay crude to a West Coast refiner.

The effects of uncertainty in the tariff on the rate of return to the owners is small. Everything else being equal, a higher tariff results in higher state and federal income taxes on the pipeline operation and, simultaneously, lower well head price and hence lower royalty, severance tax, and state and federal corporate income taxes on field operations. In general, since the field's taxable income is more heavily taxed than the pipeline, one would expect a higher rate of return on the combined investment in the field and pipeline as a result of posting a higher tariff and shifting income from the field to the pipeline. However, actual computations indicate that such an increase in the rate of return is not significant.

Effects of Crude Prices at Valdez on Rates of Return

The incremental effective tax rate which includes royalty, severance tax, state and federal corporate income tax is 62%. Thus, a price increase of 1 $/B at Valdez results in a net after tax income to the owners of 38 ¢/B. An increase in price of 1 $/B at Valdez results in a 1% increase in the after tax real rate of return. Similarly, a drop in price of 1 $/B results in a decline of a little more than 1% in the after tax real rate of return. (See Figure VII-1.)

Effects of Risk Multiplier

The risk concept as used in decisions involving exploratory activity expresses the geologist's subjective a priori judgment on the probability of success. When properly formulated, it should take the form of a frequency distribution function representing the probability of all possible outcomes. However, when applied after a discovery is made, it becomes an accounting procedure, such that successful exploratory ventures carry the costs of the unsuccessful ones. Since unsuccessful ventures can be expensed for federal income tax purposes, a risk multiplier "R" is defined such that $R = 1 + .5 (S - 1)$ where S is the inverse of the success ratio.

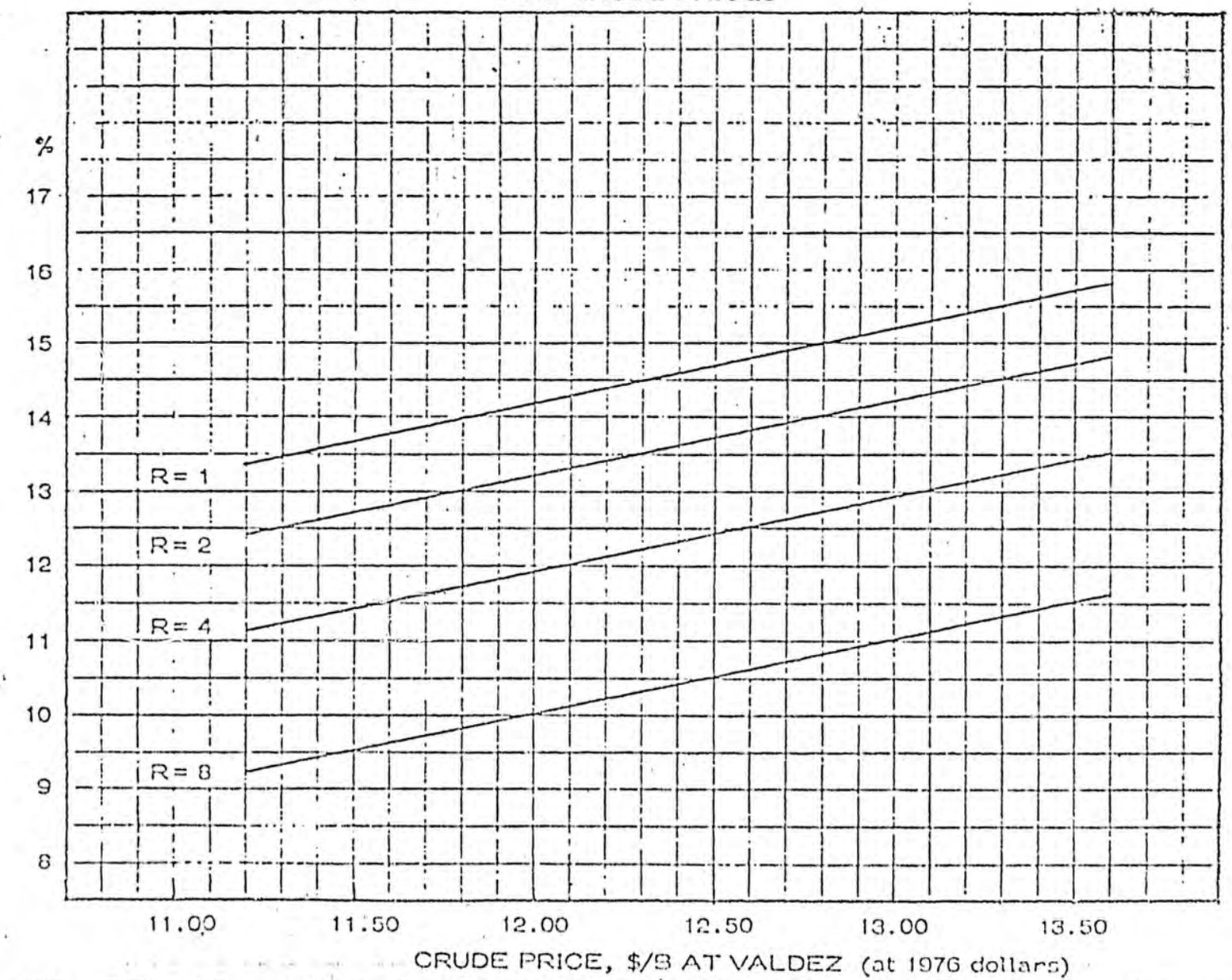
The risk multiplier thus defined has a significant effect on the rate of return. For the base case, i.e. Case I, applying a risk multiplier of 4 (i.e. a success ratio of 1 in 7) to industry's expenditures on the North Slope from 1959 to the discovery of Prudhoe Bay in 1968 reduces the after tax real rate of return on the investments in the field plus TAPS from 14.6% to 12.8%. A risk multiplier of 8 (success ratio of 1 in 15) reduces the rate

Figure VII-1

RELATIONSHIP BETWEEN

RATES OF RETURN, RISK MULTIPLIER "R"

AND CRUDE PRICES



of return to 18.4%.

A risk multiplier in the range of 3 to 4.5 is suggested.

- Industry's activity on the North Slope was preceded by an intensive exploration program carried out by the Navy on NPR #4 from 1944 to 1953 which contributed significantly to the geological knowledge of the North Slope.
- The exploratory program of the early sixties may still yield new discoveries in the North Slope.

Hence, a crude price at Valdez in the range of 11.50 to 12.40 $/B in 1976 dollars yields a DCF, after tax real rate of return of 12% on investments in TAPS plus the field.

Pricing Considerations in EPCA

Section 401, Part A of Title IV of Public Law 94-163, "Energy Policy and Conservation Act" (EPCA) stipulates that adjustments as production incentives can be made only on "... a finding by the President that such adjustment is likely to provide positive incentive for the discovery or development of high cost and high risk properties (including ... properties located north of the Arctic Circle...)". That section further provides that if the maximum average first sale price which has been adjusted to provide production incentives has the effect of reducing ceiling prices permitted for crude oil produced in the remainder of the U.S. to levels which result in less production of such crude oil, he may submit to the Congress an amendment to the regulations which:

"(a) excludes up to 2 million barrels per day of crude oil production transported through the trans-Alaskan pipeline from the computation of the maximum weighted average first sale price... and (b) established ceiling price ... for the first sale of crude oil production (referred to in (a) above) such that the actual weighted average first sale price for such production will not exceed the highest actual weighted first sale price permitted under the regulations for significant volumes of any other classification of domestic crude oil."

In view of the above, certain pricing alternatives are suggested.

1. Pricing at Valdez

The benefits of a strategy based on crude pricing at Valdez are:

a. It insulates the consumer in the lower 48 from the uncertainty in tariff determination.

b. It provides a built-in incentive for the owners of Prudhoe Bay to develop the speculative and more expensive reserves in Prudhoe Bay Field, since the improved economy resulting from the increased rate of throughput in TAPS should contribute to offsetting the significantly higher costs of developing and operating the Kuparuk and Lisburne Oil Pools.

A regulation based on a weighted average sales price of 12.40 $/B at Valdez equates the costs of Prudhoe Bay and Saudi Arabian crudes (exclusive of entitlements) to a West Coast refiner. A price at Valdez falling between 11.50 and 12.40 $/B provides an equitable rate of return to the owners of Prudhoe Bay Field and TAPS.

2. Pricing at the Well Head

Under present tariff expectations, a well head price between 7.00 and 7.90 $/B in 1976 dollars, to be adjusted quarterly for inflation, would be equivalent to a Valdez price of 11.50 to 12.40 $/B.

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WAINWRIGHT SECURITIES INC.

BARLOW

INDUSTRY REVIEW

April 1, 1977

PETROLEUM INDUSTRY

North Slope Oil and Gas

Introduction

Realization of the enormous economic value represented by the multi-billion-barrel petroleum reserves on Alaska's North Slope is an investor paradox: even as the much-anticipated startup of Prudhoe Bay output draws increasingly near, the uncertainties of systematically attempting to assess project economics and attendant company earnings benefits have become magnified. In particular, the pricing and disposition of North Slope oil, (1) the determination of pipeline tariffs (and earnings), (2) and the State of Alaska's intentions regarding oil and gas taxation (3) all remain key unknowns even at this late stage. Because important decisions affecting these and other vital issues bearing on Prudhoe Bay economics will probably be made in 1977, this *Industry Review* provides an overall perspective on these issues' status and how they might be expected to unfold in coming months, and also outlines a model for analyzing North Slope integrated earnings – and the sensitivity thereof – under conditions of uncertainty.

Summary and Conclusions

In essence, the results of this analysis can be summarized with seven major observations.

(1) Construction Status. Despite a number of concerns that developed in 1976 regarding the integrity of the pipeline welding and other aspects of this massive construction project, essentially on-time completion of the entire system appears reasonably well assured. While some remedial tasks and final inspections remain, the correction of all of the shortcomings that were the focus of intense investor and public attention last year appears to be proceeding well. Accordingly, actual pipeline fill should begin early in the third quarter with the first tanker shipments from Valdez at a 600,000 b/d rate due in late August. The 1.2 million b/d capacity of the transportation system should be reached by year-end.

(2) West Coast Supply/Demand. Virtually all knowledgable and interested observers agree that, with a buildup of Prudhoe Bay production to 1.2 million b/d, a substantial surplus of domestic crude oil will develop in P.A.D. District V. Projections of the excess generally range from 300,000-600,000 b/d, reflecting differing expectations for refined product demand growth, other West Coast production, and the level of crude oil and refined product imports. At this juncture, U.S.-Flag vessels operating via the Panama Canal will probably be the principal means of alleviating the West Coast surplus, pending the availability of one or more proposed pipeline systems to transport the oil eastward out of P.A.D. District V. Augmentation of the existing U.S.-Flag fleet with vessels currently under construction and with subsidized U.S.-built vessels now operating in foreign service should provide sufficient capacity to handle the anticipated surplus over the short term. For political reasons, it appears that the alternative of exchanging North Slope oil with Japan for Middle East imports to the Gulf Coast and eastern U.S. ports will become an option only if the surplus becomes so large that it forces a shutting in of Prudhoe Bay production.

(3) Crude Oil Pricing Policy. The pricing of North Slope oil will be decided by the FEA (subject to approval by Congress) via a rulemaking proceeding that is now underway. At recent public hearings on the matter, the FEA received comments on a variety of proposals, ranging from allowing Alaskan oil to compete freely with imported oil in the U.S. marketplace to imposing a controlled price related to the upper tier price of a comparable West Coast crude grade. Pending the Carter Administration's North Slope pricing recommendation to Congress (which is due by April 15, 1977), the reasonable possibilities for North Slope pricing probably range from an upper tier landed West Coast price (adjusted for possible benefits from including Prudhoe Bay oil in the U.S. composite calculation) to a price competitive with imported oil. On this basis, our analysis of a number of the subtleties involved in applying the provisions of the *Energy Policy and Conservation Act (EPCA)* to the pricing of North Slope oil suggests a possible range of landed prices in Long Beach in early 1978 of $11.79 to $13.90 per barrel.

Finally, a review of the FEA's recent Notice of Inquiry suggests that the agency fully realizes the need to reconcile its entitlements treatment of North Slope oil with its findings as to the desired price level.

(4) Alaskan Taxation. In what has seemingly become an annual event, the Alaskan legislature is deliberating on yet another set of oil and gas tax proposals, raising anew the question of whether the oil industry and investors can reasonably expect a fair, workable, and, most importantly, stable tax regime to ultimately emerge in Alaska. While little support appears to exist for the radical excess value (windfall) tax of a year ago, a consensus has apparently formed on the necessity for a major overhaul of the state's production tax and corporate income tax. At this juncture, with hearings having just taken place and the possibility that

substantial legislative revision of the tax initiatives will follow, it is somewhat premature to gauge their impact on North Slope earnings. Moreover, with legislative leaders showing every intention of sticking with a mid-April adjournment date for the current session, it is conceivable that little in the way of new petroleum taxes will be enacted this year. This is particularly true given the integral relationship of the pricing of North Slope oil and the level of the TAPS tariff themselves major unknowns to the taxation question.

(5) Pipeline Tariff Determination. Recent regulatory developments in the pipeline industry (i.e., the ICC's decision in the Williams Brothers Pipe Line Company rate case) have (a) provided new insights into the Commission's current regulatory procedures, and (b) raised major questions about the appropriateness of conventional industry and ICC practices regarding the setting of pipeline tariffs. In all likelihood, resolution of the considerable uncertainty surrounding the tariff-setting process for TAPS will be an extended affair, the outcome of which appears to rest on the convergence of a major rate case involving the State of Alaska, and Ex Parte No. 308, the ICC's own rulemaking proceeding. Our review of the complex issues involved here, especially the ICC's ratemaking approach in the WBPL rate case, points towards an eventual tariff structure for TAPS that probably will be lower than has generally been anticipated by (a) the oil companies, (b) the investment community, and (c) the FEA. This conclusion is particularly noteworthy because of the importance of the level of the TAPS tariff in the overall economics of North Slope oil.

(6) Production Economics. The focal point of this *Industry Review* is a computer model the writers have developed for analyzing North Slope integrated earnings. Among other things, the model takes into account the effect of different markets of destination on the profitability of North Slope oil. Table 1 summarizes projections for 1980 unit producing profits by market under two basic price cases.

Table 1

Unit Producing Profits by Market of Destination – 1980
($ Per barrel)

Market	Crude Oil Price	
	Case I	Case II
Japan	$3.32	
Puget Sound	3.59	$3.02
San Francisco	3.51	2.88
L.A./Long Beach	3.53	2.93
Houston	3.10	2.35
Chicago	3.45	2.60

Case I: World price.
Case II: Controlled upper tier price.

(7) Company Earnings. Finally, Table 2 presents our earnings expectations for each of the major reserve owners in the Prudhoe Bay field for selected years under specified price and pipeline tariff assumptions.

Table 2

North Slope Earnings
Modified ICC Basis Tariff Treatment – 10% Return on Valuation ? (equity or total inv.
(In millions except per share)

	1977		1978		1979		1980	
	Case I	Case II	Case I	Case II	Case I	Case II	Case I	Case II
Arco								
Total	$184.1	$160.8	$301.0	$236.4	$343.2	$291.3	$447.8	$379.0
Per share	$1.59	$1.39	$2.60	$2.04	$2.96	$2.52	$3.87	$3.27
BP								
Total	$ 65.9	$37.0	$522.5	$446.2	$473.7	$394.7	$624.8	$518.9
Per share	$ 0.17	$0.10	$1.35	$1.16	$1.23	$1.02	$1.62	$1.34
Exxon								
Total	$178.4	$154.3	$287.2	$219.0	$331.8	$274.8	$432.0	$359.1
Per share	$0.40	$0.34	$0.64	$0.49	$0.74	$0.61	$0.96	$0.80
Mobil								
Total	$ 31.6	$ 29.3	$ 38.9	$ 32.5	$ 43.4	$ 38.5	$ 54.7	$ 48.5
Per share	$0.30	$0.28	$0.37	$0.31	$0.41	$0.36	$0.52	$0.46
Phillips								
Total	$ 16.4	$ 14.0	$ 30.0	$ 23.2	$ 34.0	$ 28.5	$ 44.3	$ 37.4
Per share	0.21	$0.18	$0.39	$0.30	$0.44	$0.37	$0.58	$0.49
Socal								
Total	$ 3.6	$ 2.6	$ 9.9	$ 7.3	$ 11.3	$ 9.2	$ 14.9	$ 12.3
Per share	$0.02	$0.02	$0.06	$0.04	$0.07	$0.05	$0.09	$0.07
Sohio								
Total	$218.3	$122.6	$895.6	$748.3	$793.6	$641.2	$972.9	$795.3
Per share	$5.34	$3.00	$14.88	$12.43	$13.16	$10.63	$15.90	$13.00

Case I: World price.
Case II: Upper tier controlled price.

TABLE OF CONTENTS

(See Index of Tables, Charts, and Maps on following page)

INDEX OF TABLES, CHARTS, AND MAPS

Taps Construction and Field Development Progress

In contrast to so many other aspects of the North Slope project which have been characterized by little or no lessening of uncertainties as the date of scheduled startup approaches, essentially on-time completion of the 1.2 million b/d pipeline system and Prudhoe Bay field complex has become progressively more assured with each passing month.

Pipeline Construction. Notwithstanding the series of press accounts in mid-1976 which strongly suggested the possibility of further delays in completing the project due to welding and management problems, additional support for such a pessimistic view has not materialized. All but 27 of the 3,955 incidents of faulty girth welds or inadequate and/or fraudulent records of same have been corrected and it appears that these few remaining problems can be corrected in the spring. Meanwhile, yet another audit of the X-ray inspection procedures for girth welds is being conducted by a Chicago accounting firm as a follow-up measure to the earlier review by Arthur Anderson and Company. Results of this audit are due by early spring. In a separate but related matter, Congressional accusations that there are also substantial shortcomings in the double jointing welding that was performed under controlled shop conditions appear to be largely without merit.* The final independent check involving all welding is being conducted in conjunction with the "as built" survey, which is a reconciliation by a third party contractor of the system's final physical configuration with the specifications required by state and Federal inspectors. This task is now about 50% complete and at last report has not uncovered any major new discrepancies. Accordingly, the welding aspects of the project seem to be under control, subject to the findings of the ongoing audit and the completed "as built" survey.

As of late February 1977, the pipeline itself was 98.0% complete. Aside from cleaning up and performing the final backfilling, grading, and revegetation along the pipeline route, the other tasks that are still incomplete include (1) insulating some 45 miles of pipe, (2) hydrostatic testing of the remaining 160 miles of the system, and (3) miscellaneous tasks related to completion of the initial group of pump stations (Numbers 1,3,4,8, and 10).** The insulating task is not critical to an on-time completion of the initial system. Also, the final phase of hydrostatic testing, which is a critical path in the completion of the initial system, will begin as soon as permitted by the Interior Department inspectors. Finally, the pump stations were 95% complete as of early February 1977, and are only slightly behind plan. In an effort to simplify its management functions and to consolidate efforts to complete the remaining tasks as much as possible, Alyeska has awarded contracts to only two contractors for the 1977 season to complete the above tasks.

** Alyeska has been unable to match X-rays for 10 welds out of a total of some 41,753.*

*** In addition, pump stations Numbers 6,9, and 12 will be brought on later in 1977 to reach throughput of 1.2 million b/d by November 1, 1977.*

Finally, it should be noted that Alyeska has a total of some 1,900 "noncompliance reports" (NCR's) outstanding in this project which also will ultimately need to be resolved. These involve various faults or deviations from the specifications for the system which have been uncovered by either the state or Federal inspectors. The degree of seriousness of these items varies widely, ranging from either waiverable or readily correctable problems with inadequate animal crossings to more serious faults such as insufficient burial depths at some river crossings for the pipeline. At this stage, both the state and Federal inspectors believe that there are no outstanding NCR's involving questions of the integrity of the pipeline. While the diffuse nature of these problems makes it very difficult to draw a meaningful overall conclusion, our recent reviews of the situation with both Federal and state authorities suggests the identified problems are manageable and unlikely to result in a major slippage in the completion date for the initial system.

Valdez Terminal. Again, as of late February, the terminal facilities were 86% complete or about six percentage points behind plan, which strongly suggests that this part of the project remains the critical path for the entire system. The most important single task at Valdez has been construction of the electrical power station. At this point, the power plant is being brought onstream in stages, with the first of three boilers now firing up and the other two due to follow shortly. Regarding the two tanker berths required for initial loading, berth number 4 is now complete and berth number 5 should be completed on or about May 1, only slightly behind target. As to other important elements of the terminal project, hydrostatic testing of all the major fluid piping systems has been completed, and 17 of the 18 tanks required through Phase I have been finished and checked. Basically, all that remains are (1) completion of berth number 3, (2) repair of some relatively minor damage resulting from an accident involving the 18th storage tank, (3) startup and final testing of the terminal control system, and (4) final grading, clean-up, and demobilization. Current plans call for completion of all of tasks (2) and (3) by June and tasks (1) and (4) (which are not critical) by September. Accordingly, the terminal should probably be ready to accept crude oil by late spring.

Expansion to 1.6 Million b/d. Until 1976, Sohio and other TAPS participants had indicated that expansion of the pipeline's capacity from 1.2 to 1.6 million b/d would proceed as rapidly as physically possible. Since that time, however, there has been ample incentive for North Slope reserve holders not to proceed as quickly with plans for full exploitation of the main (Sadlerochit) reservoir's potential. Such incentive has come from the likelihood of a West Coast surplus of crude oil in 1978-1979 together with some uncertainty about exports as an alternative (even on a temporary basis), and the imponderable of U.S. pricing policy for Prudhoe oil. In addition, while it may be only a technicality that could be readily modified, the present TAPS ownership agreement provides that the system must be operated at the 1.2 million b/d capacity level for nine months before any member can propose a further expansion.*

Once a decision to expand is made, one full winter will be required for installation of the refrigerated foundation at pump station number two. Since it now appears that the decision point has already passed for achieving 1.6 million b/d of pipeline capacity in 1979, our best estimate for the onstream date of this new capacity is late 1980.

** From Sohio's standpoint, the apparent benefit of higher production from such a proposal is at least partly offset by the likelihood that its TAPS ownership interest would be increased (with a meaningful negative cash flow effect initially) and by the marketing problems that the additional oil will present prior to the availability of pipeline outlets.*

Costs. The Prudhoe Bay project has had so many significant boosts in the estimates of its total development costs that there is little or no credibility in Alyeska's most recent indication that construction is now proceeding well within the $7.7 billion budget and that the last of the increases may already have been seen. Nevertheless, Alyeska's experience with labor productivity and other factors over the past two years should probably contribute to a modest increase in the final construction cost number.

Moreover, if there is a final overrun in the net cost of the 1.2 million b/d system, it could be offset by the proceeds obtained from sale of the surplus equipment used in its construction. The equipment's original book value totaled about $800 million. If the resale value of this hardware is 30%-40%, a cost adjustment on the order of $240-$320 million would result.

As to the cost of expanding the pipeline's throughput from 1.2 to 1.6 million b/d, Alyeska is adhering to its estimate revision of $675 million made some 12 months ago. In this case, we are optimistic that this estimate will be only moderately exceeded (i.e., approximately $700 million) due to certain cost savings associated with design changes in the system. Specifically, tankage requirements at Valdez have been reduced from 32 to 22; a fifth loading berth has been eliminated; and plans for a cooling system for the oil at Valdez have been dropped. In regard to a further expansion of TAPS to 2.0 million b/d, the only official guidance is the estimate of $855 million to do so in one step. However, this estimate was formulated in 1975 and has not been updated. Accordingly, it appears that this figure is too low.

Field Development. Development of the main Prudhoe Bay reservoir itself remains on schedule. A total of 119 wells have now been drilled. Of these, enough have been completed to comfortably provide 600,000 b/d of production when the pipeline becomes available. In addition, BP and Arco/Exxon have each nearly completed two gathering centers (flow stations). Accordingly, the availability of 1.2 million b/d of productive capacity by November 1977 appears reasonably well assured. Finally, both BP and Arco/Exxon are proceeding with construction of their third gathering center (flow station) with completion planned for 1978, once again making completion of pipeline activities the critical path in expanding the system's output.

West Coast Supply/Demand – 1978 and Beyond

This section updates a previous analysis of the long-term outlook for West Coast petroleum supply and demand which appeared in our *Industry Review – North Slope Oil and Gas* of May 1975. In addition, it provides a basis for viewing the possible profit implications for various North Slope producers of a likely West Coast crude surplus which is examined later in this report.

In recent months, considerable attention has been focused on the outlook for West Coast supply/demand after the startup of North Slope production. As a starting point for reviewing supply/demand balances, Table 3 summarizes historical District V product demand, refining, and crude production data.

Table 3

P.A.D. District V Supply/Demand
(Thousands of b/d)

	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	12 Months Ending October 1976
Product demand	1,562	1,666	1,741	1,863	1,945	1,952	2,031	2,159	2,324	2,192	2,211	2,336
Crude runs	1,362	1,392	1,452	1,567	1,658	1,676	1,742	1,858	1,976	1,869	1,937	2,032
Crude production	899	986	1,073	1,217	1,238	1,254	1,203	1,150	1,122	1,081	1,076	1,061
Net crude deficit	463	406	379	350	420	422	539	708	854	788	861	971

Source: Bureau of Mines data.

As the above data shows, P.A.D. District V has long been crude short. From 1965-1970, the deficit remained relatively stable as increases in local production approximately matched both the growth in demand for refined products and the overall rise in crude oil runs. Thereafter, and until late 1973, the shortfall widened substantially; during the period, District V production declined while demand for refined products continued to grow. Following a drastic curtailment in demand due to the economic recession in the aftermath of the Arab oil embargo, the 1975 crude shortfall improved only slightly from the 1973 level. For the most recent 12-month period for which data is available, however, it appears that resumed growth in demand for refined products and essentially flat District V production are translating into a renewed expansion of the West Coast crude deficit.

Virtually all of the deficits in Table 3 have been filled by imported crude oil. Table 4 provides a breakdown of these foreign sources and shows changes that have occurred in the mix since the upheaval of October 1973. In general, it can be seen that Canadian imports have been declining steadily (on both a relative and absolute basis, reflecting that country's policy of increased domestic utilization of its own production). Three other major sources (Indonesia, Saudi Arabia, and the United Arab Emirates) have all grown by significant percentages since 1974. Of these areas, Indonesia has experienced the largest absolute increase in shipments to District V. This trend reflects the particular appropriateness of the low-sulfur characteristics of Indonesian oil for the West Coast market. As discussed later, these factors are likely to dictate a continuing role for Indonesian oil in West Coast refineries, even after major new supplies of Alaskan oil become available.

(See Table 4 on following page)

Table 4

Imports of Foreign Crude and Refined Products
(Thousands of b/d)

	1973	1974	1975	12 Mos. Ending October 1976
Canada	241.7	188.9	163.6	116.0
Equador	44.0	39.0	52.7	40.4
Indonesia	188.7	249.5	295.3	438.2
Iran	37.7	139.2	105.2	116.4
Saudi Arabia	231.6	95.4	95.6	175.6
United Arab Emirates	30.7	23.5	49.9	73.6
Other	35.9	40.4	89.3	114.5+
Total crude	810.3	775.9	851.6	1,074.7
Refined products	59.6	51.4	30.8	25.8
Total crude and refined products	869.9	827.3	882.4	1,100.5

Source: Bureau of Mines data.

Until the Arab oil embargo, it was generally expected that a growth rate in West Coast demand for liquid hydrocarbons somewhat above an estimated 4.5%-5.0% for the overall U.S., combined with projected declines in existing Californian and Alaskan production, would result in sufficient growth of the crude deficit from the level shown in Table 3 so as to enable Prudhoe Bay output to be fully absorbed in the region by simply backing out imports of comparable quality foreign oil. However, as discussed in our May 1975 *Industry Review*, the sharp crude price increases after 1973 necessitated a complete revision of projections to reflect both the supply and demand elasticity effects of rising hydrocarbon prices on West Coast balances over the intermediate and longer term. In essence, our earlier analysis pointed to a P.A.D. District V crude oil surplus in 1980 on the order of 685,000 b/d under assumptions of (1) a modest 2% growth in product demand and (2) North Slope output of 2.0 million b/d. Now with the benefit of the additional information gained during the past 20 months, it is evident that a number of the key assumptions underlying West Coast supply/demand analyses have once again undergone further significant change. On the one hand, it is apparent that something less than 2.0 million b/d of North Slope output is currently assured from existing Sadlerochit, Kuparuk, and Lisburne reserves. Alternatively, a better capability now exists for estimating the effects of higher prices on refined product demand growth and on production prospects for remaining P.A.D. District V output ex Prudhoe Bay.

A number of new and updated West Coast supply/demand analyses completed by various companies and Government agencies concerned with the situation have recently been published by the Senate Interior Committee (now the Energy and Natural Resources Committee).* In general, these projections reflect more optimistic assessments of District V production prospects as a result of (1) the opening of production from the Naval Petroleum Reserve at Elk Hills, (2) improved economics for enhanced recovery projects (principally thermal methods), and (3) renewed offshore development activities. Also, it is important to note that virtually all of these analyses incorporate relatively conservative demand growth expectations, which average 3%-4% annually for all products. Among the various refined products, residual and other fuel oils are expected to grow considerably faster due to expected shortages of natural gas supplies projected for West Coast electric utilities.** Table 5 provides a summary of the net crude oil surpluses projected in each of these analyses.

Table 5

Projected P.A.D. District V Surplus Through 1985
(Thousands of b/d)

	1977	1978	1979	1980	1981	1982	1983	1984	1985
FEA		600		900-1,100					700-1,300
Arco		400	400	400	400	550	600	650	700
Exxon	200	600	500	700	600	600	800	900	1,000
Kitimat	(815)	(199)	68	359	523	638	553	518	434
Sohio		300-600				600-800			
Socal	300	350	600					750	
Union Oil	250	550	550						

( ) *Denotes deficit.*

Source: U.S. Senate Interior Committee.

**Summary of responses to joint committee questionnaire on Potential Problems Associated with the Delivery of Crude Oil from Alaska's North Slope, Committee on Interior and Insular Affairs, November 1976.*

***Reflecting the growing need of West Coast utilities such as Pacific Lighting, The Pace Company, consultant to Sohio, has projected that 1980 District V residual fuel consumption will increase 26% above the 1977 level versus only a 12% gain in consumption of all petroleum products. In our view, this projection may prove too conservative because of undue optimism about a flattening of the decline of natural gas supplies prior to 1980 in response to higher prices.*

In view of the numerous variables which affect the West Coast supply/demand balance (i.e., the rate of buildup in Prudhoe Bay production, the rate of growth in product demand, the average decline rate of existing production, and the possible magnitude of new P.A.D District V production ex the North Slope, to name a few), clearly the nature of the problem is anything but deterministic. In fact, the relatively wide range of estimated deficits shown in Table 5 can be attributed to various combinations of fairly small differences in assumptions applied to the large base figures for overall supply and demand. This phenomenon of compounding of small differences is better demonstrated by the data and assumptions underlying individual forecasts which are summarized in Appendix A. Given the nature of the situation, it is not our intention to offer yet another refinement of projections of future West Coast supply/demand balances into the early 1980's. Rather the approach here has been to present the above conclusions by various knowledgeable and interested parties along with some additional observations in order to identify and focus on a "base case" expectation for a likely West Coast crude surplus.

Our review of the assumptions and analyses associated with the forecasts shown in Table 5 indicates that Socal's projections provide a credible and useful set of conclusions upon which to build a "base case" for examining the economics of North Slope crude oil movements. In particular, as a major West Coast crude oil producer, the company presumably has good firsthand knowledge of the factors affecting trends in both existing and new production in the region. Similarly, as a long-established refiner-marketer in District V, Socal probably has the best insight into likely future trends in demand for key refined products. In this connection, Socal's current refinery expansion program assures that it will have the ability to be the largest West Coast processor of North Slope oil and a dominant supplier of fuel oils to a burgeoning market of utilities converting over from natural gas.

As a point of reference then, the assumptions upon which Socal's analysis rests are outlined below.

(1) Overall refined product demand growth will average slightly under 3 1/2% during 1976-1985, with demand for low-sulfur fuel oils growing quite rapidly and demand for gasoline being slow to 1980 and flat from 1980 to 1985.

(2) District V refining capacity will expand at a more moderate rate than is currently suggested by FEA projections* as shown below.

	FEA Estimates	Socal Estimates
	(Thousands of b/d)	
1980	2,938	2,786
1979	2,906	2,756
1978	2,874	2,739
1977	2,835	2,709
1976	2,588	2,305

*See the FEA's Trends in Refinery Capacity and Utilization, June 1976.

(3) P.A.D. District V crude oil production – ex Prudhoe Bay – will remain approximately unchanged at 1,050,000 b/d during 1978-1980. This level includes estimated contributions of 200,000-270,000 b/d from Elk Hills and 50,000-80,000 b/d from new fields and projects offshore California (Carpenteria, Dos Cuadras, Santa Clara, Santa Ynez).

(4) Prudhoe Bay production will begin at 600,000 b/d in mid-1977, build up to 1.2 million b/d within one year, and expand further to 1.5-1.6 million b/d by 1980.

Although the projections above are stated in terms of "crude barrel balances," it is important to note that the post-1977 West Coast supply problem in reality will be much more complicated due to differences in quality considerations between North Slope oils and the various other crudes it will be competing against in the marketplace. To provide additional perspective on the question of differing product yields and specifications, Table 6 compares some of the salient characteristics of Prudhoe Bay oil with representative Saudi, California, and Indonesian crude oils.

Table 6

Distillation Yields
Prudhoe Bay vs. Other Crudes

	Prudhoe Bay	Saudi Arabian	Coastal California	Indonesian (Minas)	Indonesian (Ataka)
Light straight run gasoline	3.1%	8.2%	3.2%	3.2%	7.0%
Reformer feed	15.5	10.4	19.3	6.1	33.0
Jet fuel	9.4	17.1	9.4	9.8	21.0
Diesel cut	12.6	12.0	11.0	12.4	20.0
Gasoil	36.3	32.2	32.6	43.5	16.0
Residuum	21.7	16.0	22.5	24.4	1.0
API gravity	27.4°	34.0°	27.8°	35.3°	43.2°
Sulfur content	0.95%	1.8%	1.5%	0.07%	0.07%

Source: Oil and Gas Journal.

Given the higher product cuts at the low end of the barrel for Prudhoe vs. the other oils, it is apparent that the displacement of either Saudi or California oil beyond certain levels now anticipated in the plants of West Coast refineries will tend to skew the product mix from District V refineries toward meaningfully greater quantities of heavy gasoil and residual products – unless additional cracking facilities are installed to expand West Coast capacity for handling Prudhoe Bay crudes.* Conversely, if North Slope oil displaces low-sulfur Indonesian imports (which are predominantly Minas crude), substantial new facilities would

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**The following results of an FEA survey provide perhaps the best publicly available indication of the ability of District V refiners to handle North Slope oil, considering only those conversions and expansions now under way:*

be required to reduce the sulfur content of products, particularly heavy fuel oil, to enable refiners to supply a product that meets current specifications of local air pollution authorities. Because of the major capital investment required in both of these cases, these options for alleviating a surplus of North Slope oil are only long-term alternatives which are very much subject to as yet undecided Federal policies on the pricing and entitlements treatment of North Slope oils vis-à-vis other sources.

Footnote continued from previous page:

1978 Potential Distribution of North Slope and Foreign Imports in P.A.D. V

Refinery (a)	1975 Capacity MB/D	1978 Alaska North Slope	1978 Foreign Imports	1975 Imports (b)	1975 Sweet Imports
Los Angeles					
Union	108	0- 50	10- 20	45	8
Arco ✓	182	70-100	30- 50	65	32
Socal	230	130-190	50- 90	150	141
Shell	96	20- 35	5- 10	21	3
Mobil	124	25- 30	8- 10	14	8
Gulf	52	10- 25	10- 15	20	5
Douglass	47	5- 25	5- 10	11	6
Texas	75	15- 20	15- 20	15	16
Powerine	44	0- 5	10- 15	20	10
Subtotal	958	275-480	143-240	361	229
San Francisco					
Exxon ✓	88	70- 74	0- 5	45	3
Socal	190	120-176	30- 42	50	24
Shell	100	30- 40	0- 5	21	2
Toscopetro	110	0- 30	15- 20	33	1
Union	111	0- 19	0- 15	N/A	N/A
Subtotal	599	220-339	45- 87	149	30
Puget Sound					
Arco ✓	96	96- 98	--	94	43
Mobil	71	10- 35	70	48	48
Shell	91	0- 15	70	71	63
Texaco	78	0- 2	70	76	59
Subtotal	336	106-150	210	289	213
Grand total	1,893	601-969	398-537	799	472

(a) Includes only those refineries likely to utilize North Slope crude.

(b) Port of Entry only. These are incomplete crude quality reports but very close to total foreign imports reports which are proprietary.

N/A Not available.

Source: Summary of responses to joint committee questionnaire on Potential Problems Associated with the Delivery of Crude Oil from Alaska's North Slope.

For the shorter term, based on the considerations just outlined, Union Oil, another company with excellent perspective on the situation, has questioned whether projections by some of the other interested parties sufficiently recognize the product yield characteristics of North Slope oil relative to (1) the crudes it will be seeking to displace and (2) the particular needs of the West Coast market. The company points out that the introduction of relatively low gravity (27°) North Slope oil into a market that already is being supplied with substantial quantities of locally produced heavy oil is likely to cause some dislocations. In fact, notwithstanding the previously mentioned expectations of soaring electric utility demand for fuel oils as a result of shrinking natural gas supplies, Union representatives believe the West Coast refining of North Slope crude could exacerbate an already difficult situation by providing even greater quantities of fuel oils with sulfur contents that are unacceptably high for major portions of the West Coast market.* If the present entitlements disincentives and restrictions on exports of residual fuel oil (and on exports of heavy California crudes) are continued, Union believes that a significant surplus of this product will develop by late decade, with additional adverse effects on the demand for Prudhoe Bay and/or comparable quality California heavy crude oils. Chart 1 summarizes the company's projections of this surplus.

Socal generally agrees with Union's analysis, though its degree of concern seems to be somewhat more muted, perhaps reflecting the company's unusually strong capability of processing and marketing the output from these crudes. In any case, both concur that the above considerations dictate a continuing role for certain minimum levels of imported crude under the present and likely 1978-1980 configuration of West Coast refineries. Socal's 1978-1980 projections assume industry utilization of some 400,000-600,000 b/d of imports, consisting primarily of Indonesian crude with some Saudi oil also being used to meet lube oil requirements.

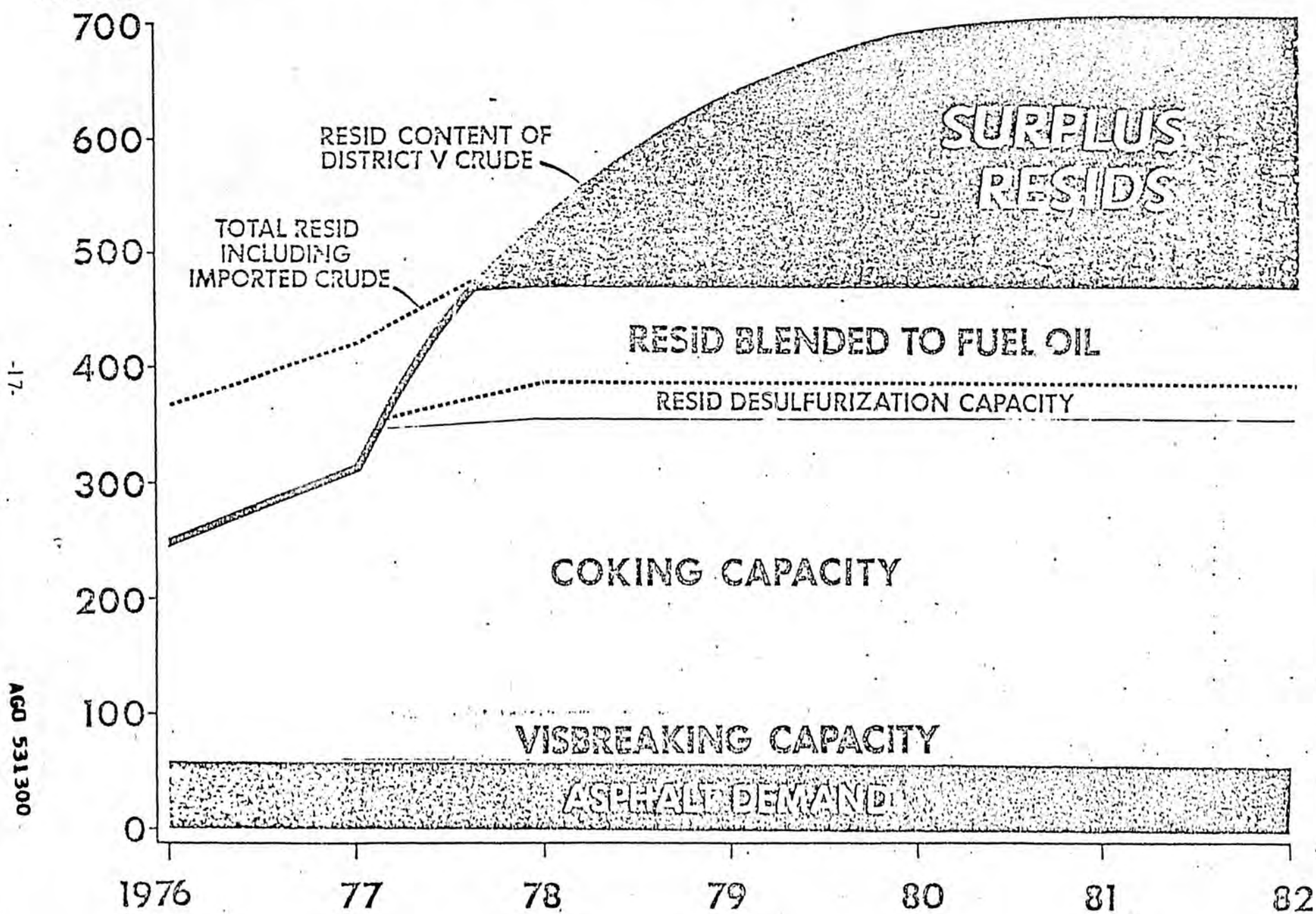
Having reviewed some of the physical constraints on the consumption of North Slope oil in District V, it is necessary to note that certain economic factors will also have a direct bearing on the plans of refiners to handle this oil, especially the pricing and entitlements treatment of North Slope output, both of which will be discussed in more detail later.

(See Chart I on following page)

Without desulfurization, North Slope crude, which has a 0.95% sulfur content, yields residual fuel with 1.75% sulfur. The inappropriateness of such a fuel for California needs is well emphasized by the recent agreement between the State Air Resources Board and Socal Edison, whereby the utility will begin immediate conversion of all 40 of its oil-fired electric generating plants in the South Coast Air Basin to burn 0.25% sulfur instead of 0.5% sulfur fuel oil.

CHART I

DISTRICT V
RESID PRODUCTION vs. PROCESSING CAPACITY



Source: Exxon Company, U.S.A.

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PETROLEUM INDUSTRY

At this juncture, there are still no definitive answers to the questions posed by Union and other West Coast refiners. However, given the situation's obvious uncertainties, *it is clear that, in formulating various scenarios for disposition of Prudhoe Bay crude oil, some allowance should be made for the possibility of even higher levels of required movements of North Slope crude out of District V than might otherwise be suggested by strict calculation of barrel balances.** Having now added this caveat to the "base case" expectation that the West Coast crude surplus will approximate 300,000 b/d for 1978 and 350,000 b/d for 1979, it is helpful to review the various means of moving such excess Alaskan oil to other markets. The major alternatives are outlined on page 19, along with some indication of the potential volumes involved and the time frames within which they could become effective.

For additional perspective, Map I generally outlines the routes of the various proposals listed and provides indications of the expected transportation costs associated with each.

A few other observations about the various alternatives listed below are in order. As to the interim means available for handling excess North Slope oil, the practicalities and politics of the situation are likely to dictate the use of a combination of measures. Initially, the bulk of the excesses likely will be moved by unsubsidized *Jones Act* U.S.-Flag vessels through the Panama Canal, with perhaps some relatively small quantities also moving via a reversed Four Corners pipeline and rail tank cars, economics permitting. Several observers have concluded that there will probably be enough flexibility in the U.S.-Flag fleet to accommodate the expected West Coast surplus with certain adjustments. Sohio's analyses indicate that sufficient unsubsidized U.S.-Flag capacity will exist to move about 250,000 b/d of crude oil through the Panama Canal beginning in late 1977 over and above the tanker requirements for North Slope oil consumed on the West Coast. This estimate is reasonably in line with those of the Overseas Shipholding Group, Inc. (OSG) (an independent U.S.-Flag operator with a meaningful amount of Alaskan-suited tanker capacity) and the Maritime Administration (MARAD), which has recently conducted a detailed analysis of the availability of tanker transportation at the request of the FEA. With the completion of ships still under construction, these observers also generally agree that U.S.-Flag vessels available for Panama Canal movements would rise to approximately 400,000 b/d in 1979.

As the MARAD and OSG analyses point out, it is impossible to be completely definitive as to tanker capacity for Panama Canal movements since there may be significant tradeoffs with various transportation configurations. For example, while generally the Canal can only accommodate fully-loaded vessels of up to 60,000 dwt, certain of OSG's specially designed 90,000 dwt vessels can traverse it partly loaded. Thus, tanker capacity through the Canal

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**In fact, in developing a preliminary marketing model for the distribution of North Slope oil in the early years (see Table 16) we have used the midpoint of the FEA data on refiner's indications of possible North Slope crude runs in each West Coast refinery adjusted for a small expansion of Exxon's capacity at San Francisco. This approach suggests 1978, 1979, and 1980 movements of North Slope crude out of P.A.D. District V might approximate 395,000 b/d, 395,000 b/d, and 613,000 b/d, respectively.*

Interim Solutions		Indicated Volume (b/d)	Available
(1)	U.S.-Flag tanker shipments to P.A.D. Districts I-IV via the Panama Canal.	250,000 325,000 400,000	1977 1978 1979
(2)	Transshipment eastward out of P.A.D. District V via railroad tank cars.	40,000-50,000	1978
(3)	Four Corners pipeline.	30,000-40,000	1977-1978
(4)	Exchanges of crude oil with Canada and Mexico.	Uncertain and limited.	1978
(5)	Export to Japan via foreign-flag tankers.	Essentially unlimited by physical capacity considerations.	1977
(6)	Shutting in excess North Slope production	? N/A	N/A

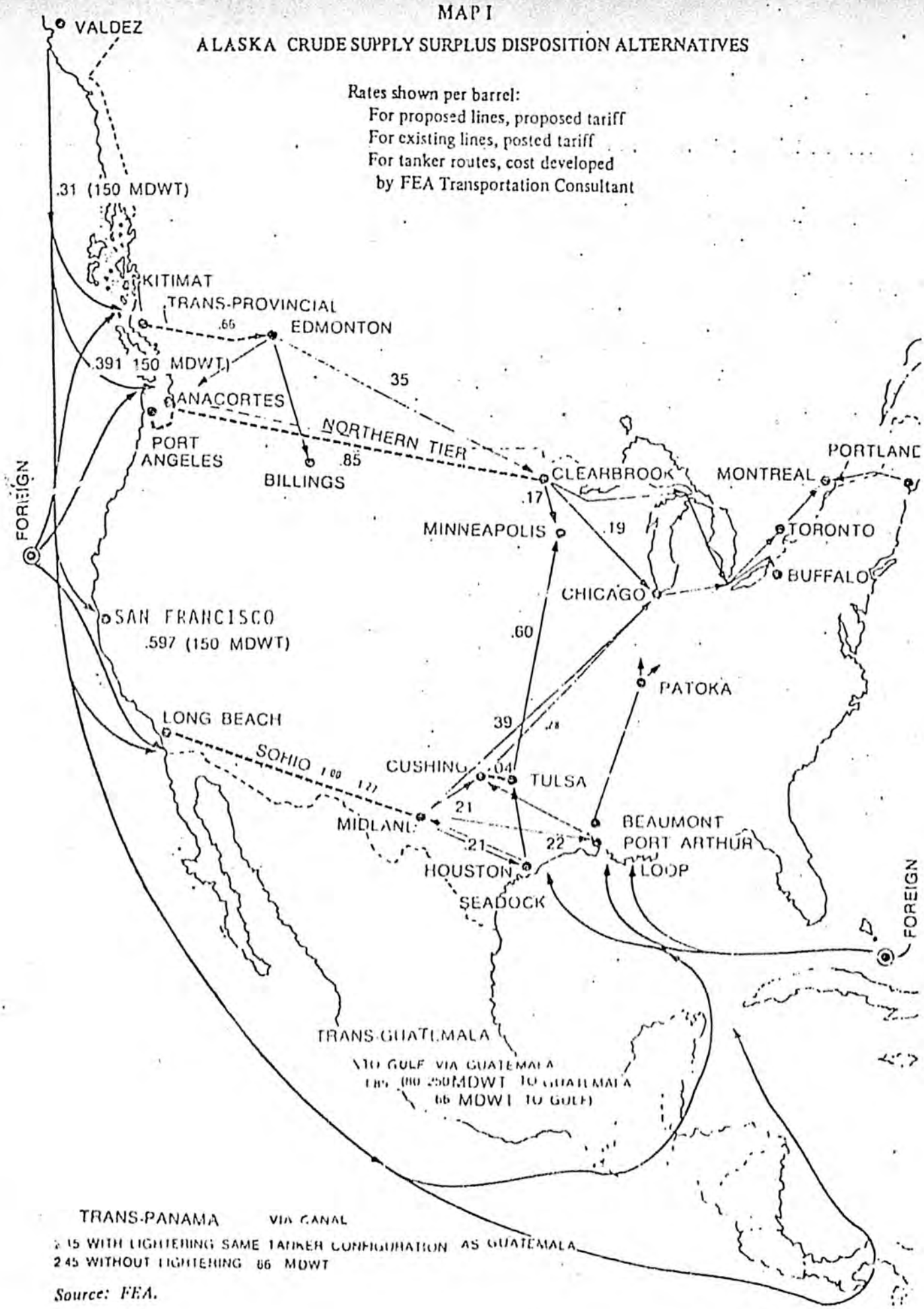
Longer Term Solutions			
(1)	Sohio and Exxon's LATEX pipeline from Long Beach to Midland, Texas.	500,000 1,000,000	1980 1982 (Phase II)
(2)	Northern Tier Pipeline system from Port Angeles, Washington to Clearbrook Minnesota.	600,000 800,000-1,200,000	Post-1980 (Phase I) Post-1980 (Phases II-III)
(3)	Trans-Provincial Pipeline system from Kitimat, B.C., tieing into existing pipelines at Edmonton, Alberta, Canada.	300,000 350,000 430,000 650,000	April 1979 1980 1982 Ultimate
(4)	Reversal of Trans Mountain Pipeline.	165,000 350,000	Late 1978 (yo-yo) 1980 (full reversal)
(5)	Central American pipeline system across Guatemala.	600,000 1,200,000-1,600,000	?
(6)	Retrofitting existing District V and/or Northern Tier refineries to run additional North Slope oil.	–	Post-1980

N/A Not Applicable.

(See Map I on following page)

MAP I

ALASKA CRUDE SUPPLY SURPLUS DISPOSITION ALTERNATIVES



Source: FEA.

AGO 531303

could depend on whether such vessels are actually used in this mode or are shuttled fully-loaded to the Canal's western terminus where the oil could be lightered to handy-sized tankers (50,000 dwt and smaller). Since there is some uncertainty as to the exact amount of waste or inefficiency associated with each particular mode, final predictions of volumes should not be viewed as deterministic.

Thus, in view of the magnitude of the possible surplus already outlined and allowing for less than optimal utilization of nominal *Jones Act* capacity,* the West Coast excesses could probably build up to the point where there will be a need for either (1) additional Panama Canal shipments using subsidized U.S.-built vessels now operating in foreign service (subject to the obtaining of appropriate *Jones Act* waivers), or (2) exchange of North Slope oil or comparable California oils with Japan or Canada using either U.S.-or foreign-flag vessels in return for oil delivered to other U.S. destinations (P.A.D. Districts I-IV).

As to the first option, studies by both independent shipowners and the Maritime Administration indicate that numerous possibilities exist for returning U.S.-Flag tankers now in subsidized international service to domestic operation. One such study points to the need for 900,000-1,000,000 tons of such vessels to handle a surplus on the order of 500,000 b/d. The use of these vessels would require waivers under the *Jones Act* which most observers believe would be readily obtainable.** Beyond compliance with these legal provisions, the principal factor controlling the return of such vessels to domestic service will be the availability of attractive tanker rates. However, at the $1.75 per barrel charge for movement from Long Beach to Houston contemplated (in the discussion on production economics which follows), the adequacy of the return to the shipowners will probably not be a problem.

Regarding the second option of handling West Coast excesses beyond those that can be transported by *Jones Act* ships, an exchange of oil with another country offers the possibility of certain savings in transportation costs in the case where North Slope oil is priced based on the value of equivalent imported crude. For example, Table 7 shows that the Valdez netbacks associated with North Slope crude movements to Japan and Houston are $12.13 and $11.52 per barrel, respectively. The $0.61 per barrel difference essentially represents transportation costs that could be saved from the shorter transportation routes for moving Alaskan oil to Japan and Saudi oil to the U.S. Gulf Coast.

As a final note, because of the leadtimes involved, none of the pipeline projects (except possibly the Four Corners and Trans Mountain lines) or refinery modifications will likely be

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**The OSG analysis places the wastage associated with traversing the Panama Canal at 10%-15%.*

***The MARAD Study states: "In the case of these tankers which receive operating-differential subsidies, eligibility for domestic service could be obtained by foregoing subsidy assistance for the period of domestic employment. This would assure compliance with Section 605(a) of the Merchant Marine Act of 1936. The issue of construction-differential subsidy repayment during periods of domestic employment, while more complex, is possible under Section 506 of the Act."*

available before 1979 at the earliest. A detailed discussion of each of these projects is beyond the scope of this report, but the analysis which follows does consider wellhead profitability on North Slope crude movements to the Gulf Coast and Chicago, respectively, utilizing the LATEX and Trans Mountain pipeline systems as the representative southern and northern routes.

Crude Pricing

The pricing of North Slope oil is another key unknown at this time – a situation partly attributable to key pending Government policy decisions. The following excerpt from the Joint Conference Committee report of the 1975 *Energy Policy and Conservation Act (EPCA)* outlines the basic provisions of the crude pricing legislation applicable to Alaskan North Slope oil production.

> On April 15, 1977, the President is required to submit to the Congress a report on the adequacy of the then current weighted average price to provide positive incentives for the development of Alaska oil production without reducing ceiling prices and production incentives in the lower forty-eight states.
>
> If the President finds that the then current maximum weighted average price is not adequate to provide such positive incentive, he may submit to the Congress a proposal, in the form of an amendment to the pricing regulation, to exclude up to 2 million barrels per day of Alaska production flowing through the Trans-Alaskan pipeline referred to in paragraph 2(a) in subsection (g) from the calculation of the actual weighted average price. Such a proposal must include a proposed ceiling price or prices for such excluded Alaska production, the average of which cannot exceed the highest actual weighted average first sale price permitted under the regulation for significant volumes of any other classification of domestic oil. Such proposal must be supported by findings justifying the level of such ceiling price or prices.* Disapproval of the proposal by either House within 15 days under expedited procedures would prevent such an amendment to the regulations from taking effect.
>
> If such an amendment is disapproved, the President can send an additional proposal for exempting Alaska production within 30 days of the initial disapproval. If either proposal becomes effective, beginning on January 1, 1978, and at no sooner than 90 day intervals thereafter, the President may submit to the Congress, proposals to modify the ceiling price or prices established in his initial Alaska exemption proposal. If either House disapproves the proposal within 15 days, the proposed modification may not become effective.

- While the FEA has been conducting certain preliminary staff analyses and public hearings connected with meeting the above requirements, it currently appears that much additional work remains before the new Administration is prepared to forward its findings and recommendations to Congress regarding the pricing policies for North Slope oil. Given the

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**The conference report further suggests that a detailed examination of the actual costs of Prudhoe Bay production as well as an analysis of the project's expected rate of return would be the required basis for justifying a proposal to exclude Alaskan production from the calculation of the U.S. composite price. This could provide fertile ground for debate as to (1) the proper costs to be included in the analysis, (2) the appropriate methodology of calculating investment returns, and (3) the "fair and equitable" return to be allowed.*

significance of crude prices in an assessment of company earnings prospects, this section identifies and discusses the major factors under consideration in formulating a workable policy and also offers some tentative views concerning possible courses of action to be adopted. While these latter judgments will form the basis for our subsequent profitability analysis, our approach to modeling North Slope economics is flexibly structured so that it facilitates the incorporation of any meaningful change from the anticipated pricing policies that may emerge from the Administration's recommendations to Congress in mid-April.

At the time of the *EPCA's* enactment, we discussed its provisions with a member of the Senate Interior Committee. He indicated that the legislative architects deemed the term "first sale" to refer to the oil's wellhead price. Although this intent is not well-specified in the *EPCA* conference committee report, the *Congressional Record* of December 17, 1975 indicates quite clearly that Congress intended the first sale price for purposes of calculating the U.S. composite price to be "the wellhead price or the nearest equivalent prior to the time the oil has entered the common carrier Alaskan pipeline." Notwithstanding this seemingly well-defined legislative intent, regarding the term "first sale" as it applies to North Slope pricing policy matters, it appears that the FEA is analyzing several different approaches to applying the *EPCA's* provisions to North Slope oil. Essentially, the following alternatives will probably receive the greatest consideration:

(1) Allowing North Slope oil to compete freely with the world price of import alternatives in the markets to which it is shipped. If the wellhead value of North Slope oil exceeds the composite U.S. selling price, it should be excluded from calculation of the composite in order to remove any disincentives to lower-48 production.

(2) Placing North Slope oil in the upper tier category under *EPCA* with the West Coast landed price defined as the point of pricing regulation and include this oil in the calculation of the U.S. composite price.*

(3) Providing a ceiling wellhead price for North Slope crude oil which is equal to the maximum composite price under the current price regulations. In December 1976, the composite ceiling price was $8.24 per barrel. In August 1977, it will be $8.79 per barrel and presumably will continue to escalate thereafter at a 10% annual through May 1979.

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*In its recent Notice of Inquiry on Alaskan North Slope pricing, the FEA has actually suggested using the refiner's average acquisition cost of crude oil ($11.44 in December 1976). Due to the quality difference between North Slope oil and the average crude run in West Coast refineries, we believe a case using the upper tier price for oil comparable to Prudhoe Bay crude more appropriately brackets the range of possibilities.

Alternative 1: The full ramifications of this alternative are potentially complex but they deserve discussion because they provide considerable insight into the potential dynamics of U.S. oil pricing in general, particularly under conditions of high import dependence. In order to understand the issues involved, it is useful to begin with an examination of the laid-in equivalent price of a competing imported oil (i.e., Saudi Arabian Light crude) adjusted for the difference in quality. Table 7 presents the calculation of these various laid-in prices for a variety of end markets and the resulting Valdez netback values associated with each market.

It is evident from Table 7, that if the pricing of Alaskan oil is allowed to be determined solely by the price of imported oil, a variety of imputed Valdez netback values would result due to the differences in transportation costs involved in moving the oil to each market. Accordingly, the question arises whether producers will be allowed, or able, to discriminate in the pricing of Alaskan oil among various end markets. To the extent that pricing is discriminatory, the Valdez netback values calculated in Table 7 would become the appropriate price inputs for any assessment of unit profitability by market of destination. On the other hand, if non-discrimination in pricing at Valdez becomes necessary, either for antitrust or competitive reasons, a considerably more complex, dynamic economic pricing model for North Slope oil would result.

In this connection, it is interesting to note that company respondents to a Senate Interior Committee survey do not fully agree on the question of whether multiple Valdez netbacks are feasible. Sohio's view is that:

> Sales east of the Rockies are expected to be made at or about the same price as on the West Coast (i.e., the landed foreign sour crude price) and the seller will have to absorb the extra transportation costs. . . Thus, for those sales, the wellhead realization will be lower than for sales on the West Coast by the amount of the extra transportation costs involved which can't be recovered in the market.

By contrast, all of the other companies surveyed expect a uniform price at Valdez to prevail.

The implications of a non-discriminatory pricing situation are detailed in our May 1975 *Industry Review – North Slope Oil and Gas* and will not be repeated here. In general, however, our previous discussion indicated that as long as North Slope production is only meeting District V crude deficits, the expected Valdez netback would be that associated with Long Beach, or $12.62 per barrel under the assumptions used in constructing Table 7. However, as shipments to more distant markets commence, and if the pricing of sales at Valdez does not discriminate as to destination, Houston would become the relevant market for pricing and would tend to depress the Valdez price of all Prudhoe oil to (1) $11.52 per barrel by our current calculations (assuming availability of Sohio's LATEX pipeline) or (2) $11.12 per barrel using U.S.-Flag tankers through the Panama Canal. Therefore, under non-discriminatory pricing at Valdez, the producers' selection of more distant markets to move incremental barrels of Alaskan oil will have to take account of the effect of such movements on the overall price of Alaskan oil.

(See Table 7 on following page)

Table 7

Valdez Netbacks by Market of Destination
($ Per barrel)

Market of Destination	Yokohama/Tokyo	Puget Sound	San Francisco	L.A./Long Beach	Houston	N.T./Chicago
34° Arabian Light selling price (FOB Ras Tanura)	$12.09	$12.09	$12.09	$12.09	$12.09	$12.09
Ocean transportation (at current AFRA) (a)	0.62	1.12	1.23	1.17	1.42	1.39
Terminal charge at port of entry	0.10	0.10	0.10	0.10	0.10	0.10
Crude oil import fee	–	0.21	0.21	0.21	0.21	0.21
St. James, La. to Chicago (via Capline)	–	–	–	–	–	0.30
Landed crude oil price	$12.81	$13.52	$13.63	$13.57	$13.82	$14.09
Quality adjustment (b)	(0.25)	(0.25)	(0.25)	(0.25)	(0.25)	(0.25)
Prudhoe Bay equivalent price	$12.56	$13.27	$13.38	$13.32	$13.57	$13.84
Transportation costs to Valdez:						
Pipeline					(1.35)(c)	(1.31)(d)
Tanker	(0.43)	(0.50)	(0.80)	(0.70)	(0.70)	(0.50)
Valdez netback	$12.13	$12.77	$12.58	$12.62	$11.52(f)	$12.03(g)

(a) The movements to the West Coast ports have been computed at Worldscale 56 for LR-2's (80,000-159,999 dwt), except for San Francisco, which because of a size limitation to 50,000 dwt, has been computed at the LR-2 rate of Worldscale 56 to L.A./Long Beach, with an additional five Worldscale points added to reflect a "double-porting" movement to San Francisco with a partial load (i.e., a 100,000 dwt tanker carrying a half load). The cost of ocean transportation to the Gulf Coast ports assumes a movement from Ras Tanura to the Freeport (Bahamas) transshipment terminal in a VLCC at Worldscale 49, and from Freeport to the Gulf Coast in an LR-1 at Worldscale 81. Transshipment costs are estimated at 10¢/bbl. The movement to Yokohama/Tokyo is assumed to be in a VLCC at Worldscale 49.

(b) Reflects net adjustment for higher gravity of Arabian Light and lower sulfur content of Prudhoe Bay crude.

(c) Cost from Long Beach-Houston via Sohio's proposed LATEX pipeline system to Midland and thence via connecting pipeline to Houston.

(d) Cost from Puget Sound-Chicago via proposed yo-yo of the Trans Mountain pipeline system to Edmonton, Alberta and thence via the Interprovincial and Lakehead pipeline systems to Chicago. Under a batch reversal configuration, the total pipeline cost to Chicago would be 98¢/bbl., with a corresponding increase in the Valdez netback to $12.36/bbl.

(f) Assuming a movement by Jones Act tanker between Long Beach and Houston via the Panama Canal, at an incremental cost of $1.75/bbl., the Valdez netback would be reduced to $11.12 per barrel.

(g) For Northern Tier refiners, who will have no other alternative once Canadian exports cease, the cost of crude will be equal to the delivered (controlled) price of Alaskan oil on the West Coast plus the pipeline tariff to move it to the refinery destination.

Under perfectly competitive conditions, there is little doubt that the non-discriminatory pricing situation would prevail. However, not much oil will actually be sold at Valdez to third parties, but will be moved by the producers to appropriate markets where it can compete with similar imported oils. Toward this end, both Sohio and Exxon, who have the bulk of the anticipated West Coast surplus, have entered into transportation arrangements that have relatively high fixed-cost components, and that therefore should tend to discourage aggressive discounting to gain market share in District V.* Accordingly, we do not find the competitive market arguments favoring a fully non-discriminatory pricing mechanism particularly persuasive.

The antitrust implications of such a pricing mechanism are not altogether clear, but available evidence suggests that discriminatory pricing, albeit with the possibility of moderate discounting, is the more likely situation. Sohio believes that as long as its pricing policy does not discriminate between buyers in the *final markets* and it does not conspire with Exxon or others in setting its prices for third-party sales, it will be in compliance with current antitrust laws. While some observers believe that certain provisions of *The Clayton Act* could be interpreted as prohibiting such a pricing approach, there apparently is no case law to support this view. Moreover, further support for Sohio's expectation of multiple Valdez and wellhead netbacks is provided by the fact that a similar situation has existed in the Cook Inlet for a number of years.

The FEA has indicated that it is fully aware of the need to consider the implications of entitlements treatment for the prices that refiners will actually be willing to pay for North Slope. Under the FEA's interpretation of current regulations, it appears that Prudhoe Bay crude would be classified as upper tier for purposes of the entitlements program. Thus, in order to avoid the disincentive of an entitlements purchase obligation for a refiner of North Slope oil, the FEA recognizes that it will be necessary to afford this crude a stripper or imported oil status if it is determined that its pricing at imported oil levels is desired.

Alternative 2: This possibility envisions applying the upper tier ceiling price to the landed price of Alaskan oil at a prescribed West Coast location. This would approximate the upper tier price of Signal Hill 27° gravity crude, which, after the recent 65¢ per barrel of cumulative rollbacks, is currently frozen at $9.91 per barrel. The regulated wellhead price of Alaskan oil could then be calculated by subtracting estimated transportation costs. *In this case, price regulation under EPCA would result in a meaningful revenue reduction for both producers and the State of Alaska.* As a result, there is the question (which the FEA must address in its rulemaking) whether this price level would provide sufficient positive incentive for developing other northern Alaskan reserves.** For example, initially (i.e., mid-1977) a $9.91 per barrel

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It has been estimated that of the $1.75 per barrel of incremental transportation costs to move oil from Long Beach to Houston, perhaps 25¢ per barrel is variable (principally bunkers and crew wages). Thus, discounting would probably approximate this figure.

***As mentioned previously, this approach would appear to contradict the intent of Congress in passing EPCA. Nevertheless, it appears that the currently ongoing FEA analysis is likely exploring such a policy option with the idea of recommending a change if it is shown to be a preferable pricing alternative.*

allowed price at Long Beach less a 70¢ per barrel tanker charge and $4.70 of pipeline tariff results in a wellhead price of $4.51 per barrel versus the $6.42 wellhead value associated with pricing tied to the landed value of Saudi Arabian oil in Houston under the first alternative described.

Actually, however, if this option were adopted and the low wellhead value of North Slope were also included in the U.S. composite calculation, it appears likely that within a fairly short period of time there could be a partial offset in the form of resumed upward revisions in the FEA's upper tier crude oil ceiling prices. In fact, our preliminary analysis would suggest that the FEA price schedule for domestic oil prices published in the spring of 1976 could be resumed by early 1978. On this basis, the appropriate upper tier value would become $11.79 per barrel by January 1, 1978, averaging $10.85 per barrel during the second half of 1977.*

Since Alaskan oil would be sold at a price other than the cost of imports, provisions for partial entitlements treatment would likely be required to equalize the costs for refiners running varying proportions of Alaskan crude. This possibility could further complicate the pricing of Alaskan oil, To understand the situation, it is necessary to consider the value of North Slope oil from the viewpoint of the refiner whose alternative is imported oil for which he receives the right to sell a full entitlement. Thus, if a West Coast refiner is required to purchase a partial entitlement for each barrel of Prudhoe crude used, he would pay a maximum price equal to the refinery gate price of equivalent imported oil *less* the value of the partial entitlement. By one account, the inclusion of North Slope oil in the U.S. composite is likely to reduce the average realized U.S. price sufficiently to increase the value of such a partial entitlement to approximately $3.00 per barrel. Thus, for example, a Long Beach refiner considering North Slope oil might well be only willing to pay $10.32 ($13.32 landed value of equivalent Saudi crude less $3.00) for North Slope oil at the refinery gate.**

**For example, if 1.2 million b/d of North Slope oil is priced at an upper tier level of $11.79 for crude movements as outlined in Table 16, the weighted average wellhead price of North Slope oil would be $6.26 per barrel, well below the then prevailing statutory price ceiling of $9.06 per barrel. These calculations are based on a $4.23 per barrel tariff, the computation of which is discussed in the North Slope Profitability Model section.*

***A graphic illustration of a similar situation in which entitlements treatment has become the determining factor in crude oil pricing is provided by the current West Coast heavy oil situation. Arco testimony submitted last fall shows that because of the entitlements treatment of lower tier heavy oil, the latter is actually more expensive to the refiner than imported Saudi crude as shown below:*

	Wilmington Heavy		*Saudi Light*
Lower tier ceiling price	*$ 4.53*	*Landed price*	*$12.65*
Gravity adjustment	*0.50*		
Reqd. entitlement purch.	*7.85*		
Avg. entitlement credit	*(2.80)*	*Avg. entitlement credit*	*(2.80)*
Refiner's cost	*$10.08*	*Refiner's cost*	*$ 9.85*
Cost disadvantage	*$0.23*		

As will be discussed further in our section on *Alaskan Taxation*, because such a pricing alternative is under consideration (with or without the entitlements twist just outlined), the State of Alaska is considering new tax legislation in an attempt to protect its oil revenues at the wellhead by making certain adjustments to its production tax structure.

Alternative 3: The principal purpose of adopting the option of pricing North Slope oil at the composite price level would be to avoid the future possibility of Alaskan oil prices becoming a disincentive for lower-48 production, should the gap between upper tier and imported oil widen to the point where Prudhoe Bay oil would be priced higher at the wellhead than the composite price. In putting forth this alternative, the FEA indicated that the entitlements treatment of the oil would be either the same as imported crude or as a separate tier if that should become necessary. Under this scheme, Alaskan North Slope oil would escalate in line with the rate allowed by *EPCA* (and modified by *ECPA*) for the composite price through May 1979.

As another part of its preliminary staff analysis in preparing to meet the Administration's April 15, 1977 reporting requirement to Congress, the FEA engaged an outside consultant (Mortada International) to review the economics of the entire North Slope project. The purpose of this contract was *not* to present a set of final recommendations on the pricing of North Slope oil, but to develop an objective analytical framework for drawing some price judgements. Some of the consultant's more important observations are summarized below:

- Equitable prices of Prudhoe Bay crude (in 1976 dollars) at Valdez fall between $11.50 and $12.40 per barrel, to be adjusted quarterly for inflation.
- Pricing at Valdez provides a built-in incentive for developing the more speculative Kuparuk and Lisburne Oil Pools.
- Pricing at Valdez circumvents the uncertainty in tariff rates.
- Equitable prices of Prudhoe Bay crude at the wellhead fall in the range of $7.00-$7.90 per barrel (1976 dollars), to be adjusted quarterly for inflation.
- The study did not address itself to the implications on pricing of any surplus of crude on the West Coast.

While these observations would seem to suggest that an analytical basis is being established for North Slope prices essentially in line with, or only slightly below the world price of equivalent imported oil, it is probably risky to place too much weight on the influence of one outside consultant's findings on the outcome of the FEA's final ruling.* In fact, it is increasingly evident that this study is but one step in the rulemaking process; the others include public hearings by the FEA on the matter as well as possible supplementary hearings by the Senate Energy and Natural Resources Committee to inform its members of the issues. Clearly then, pricing expectations must be formulated with caution.

**As pointed out at the recent FEA hearing by a legal consultant to the State of Alaska, the methodology in the Mortada study for establishing the tariff structure does not consider the implications of the recent Williams Brothers Pipe Line rate case and the related matter of the ICC Ex Parte No. 308 proceeding.*

Furthermore, while the State of Alaska and the North Slope producers as expected have argued at these hearings for a price based on the value of the import alternative, some observers believe that the FEA will be under considerable pressure from other sources to adopt an alternative similar to the second one outlined above and, concomitantly, to structure its entitlements program so as to equalize the costs of North Slope oil delivered to the West Coast and the Gulf Coast/Midwest. To this end, one proposal calls for adopting discriminatory entitlement treatment for North Slope oil. For example, West Coast refiners obtaining Prudhoe crude at an upper tier price might be required to purchase a partial entitlement for each barrel processed, whereas the District I-IV refiners using the same oil (which would have a $1.75 per barrel higher delivered cost via the Panama Canal) could be granted either an exemption from an entitlements purchase obligation or a right to sell a partial entitlement. Theoretically, by adjusting the magnitudes of the entitlement awards and purchase obligations of these parties, the actual costs of North Slope oil in the various markets could be evened out.

The consideration of such an approach is probably partly based on the following section from the *Trans-Alaska Pipeline Authorization Act of 1973:*

> **Equitable Allocation of North Slope Crude Oil**
>
> Sec. 410. The Congress declares that the crude oil on the North Slope of Alaska is an important part of the Nation's oil resources, and that the benefits of such crude oil should be equitably shared, directly or indirectly, by all regions of the country. The President shall use any authority he may have to insure an equitable allocation of available North Slope and other crude oil resources and petroleum products among all regions and all of the several States.

There are now well-established precedents for the use of the FEA's entitlements program to even out the costs of petroleum products between various regions of the country. These involve the complex regulations applicable to domestic refiners and importers of residual fuel oil that have undergone a number of actual and proposed modifications and, most recently, the adoption of a similar program to provide price relief to northeastern consumers of No. 2 heating oil by spreading the cost to consumers in other parts of the U.S. Given these precedents and the legislative provision cited above, the push for a similar treatment of Alaskan oil may politically be very difficult to dismiss.

In making its final decision on Alaskan oil pricing, the FEA will probably be guided by three basic considerations: (1) a need to provide sufficient incentive to maximize Prudhoe Bay production; (2) a desire to provide equitable distribution of the benefits of that oil among various regions; and (3) a desire to create added pricing flexibility for other U.S. production. Considering all the factors discussed above, it will probably be difficult for the FEA to select an alternative that fully accommodates all three objectives. Thus, in view of the uncertainty that will continue to characterize the pricing of North Slope oil until the FEA completes its rulemaking process in April, our economic analysis which follows presents two scenarios. Case I assumes a world price for Alaskan oil netted back to Valdez on a basis that permits discrimination as to final destinations for the crude. Case II calls for an upper tier realization for Prudhoe Bay oil on the West Coast with a return to the FEA's initial pricing schedule for upper tier oil by January 1, 1978, as a result of inclusion of Alaskan oil in the U.S. composite. The range of reasonable possibilities appears to be well bracketed by these two cases without detailed analysis of numerous other possibilities that we consider to be less probable and certainly more speculative.

Alaskan Taxation – "We're Albertans, Too!"

Alaska's Governor Jay Hammond recently introduced his Administration's proposed oil and gas taxation package at a news conference. In doing so, he defined what constitutes Alaska's fair share of the revenues from development of oil and gas resources on state lands, and thus provided yet another perspective on a matter of critical concern to the oil companies operating in Alaska:

> . . . we must keep in mind that these nonrenewable resources will be developed only once and that the revenues produced will have to serve us not only for today but as a savings account for future Alaskans.

Hammond's statement can also be interpreted as a political rationalization of a proposed legislative program designed to add some $200 million a year to the state's coffers by 1985. Be that as it may, the latest state action raises anew the question of whether the oil industry and investors can reasonably expect a fair, workable, and, most importantly, stable tax regime to ultimately emerge in Alaska. In other words, will compromise replace confrontation?

Prior to 1976, Alaska had exhibited a disquieting ability to affect radical changes in oil taxation whenever its prospective oil revenues appeared threatened (the 1972 tax package, since modified), or when an imminent general fund budget crisis so dictated (the 1975 ad valorem tax on in-place oil and gas reserves). Today, largely thanks to its OPEC brethren, the state no longer need worry about generating sufficient tax receipts from Prudhoe Bay to fund its current and envisioned budget outlays; instead, the focus of tax policy has shifted to devising means whereby the state can extract its "fair share" of the economic rents created by OPEC's pricing power in order to provide a continuing legacy for the current, as well as future, generation of Alaskans. The shift had begun in 1976, with the so-called Huber tax proposals.* The proposals called for a steep excess value (windfall) tax on the difference between the West Coast landed value of North Slope oil and a state-determined value ($7.00 per barrel, initially).** If the Huber tax package had been enacted, total Government take from the Prudhoe Bay field would have risen to a level not unlike that in some OPEC countries.

**The Huber tax proposals were named after their principal sponsor, State Senator John Huber, Chairman of the Alaskan Senate's Special Committee on Taxation and Revenue in 1976.*

***Besides the excess value surtax, the tax package submitted by the Special Committee on Taxation and Revenue would have: (1) raised the production tax on North Slope oil from 7.8% to 12.6% (with concomitant modifications to the cents-per-barrel minimum tax); and (2) modified the corporate income tax structure, under the guise of a net properties proceeds tax, to ensure that oil and gas income derived from Alaska would be separately accounted for in the determination of corporate income tax liability. An outline and discussion of these proposals appears in our Special Report – Alaskan Tax Proposals of January 22, 1976.*

The Alaskan legislature finally tabled the Huber proposals on the adjournment of the 1976 session, reflecting its belief that such legislation was ill-timed (partly due to an intensive and effective lobbying campaign waged by a curious amalgam of interests). At that point, with an eye towards formulating a new set of oil taxation initiatives, the Administration initiated a revenue and taxation study by its Department of Revenue in cooperation with the Legislative Council's Interim Committee on Oil and Gas Leasing and Tax Policies.

Early in the 1977 legislative session, the Interim Committee submitted two new tax bills constructed along the lines of the less onerous features of the Huber package (i.e., the production tax and net properties proceeds tax proposals). The Committee did not attempt to resurrect the excess value tax concept of 1976. Then, in early March, Governor Hammond presented his Administration's oil and gas taxation package to the legislature. (The Hammond proposals are based on a massive study released by the Department of Revenue in February 1977 entitled *Alaska's Oil and Gas Tax Structure: A Study with Recommendations for Improvement.* As stated in the foreward, the study's basic objective was to suggest a *stable* tax system sufficient to meet Alaska's revenue *needs* and respond to changes in economic conditions, Federal policies, and industry operations.) Specifically, Hammond's package comprises five essential features:

(1) The corporate income tax would be replaced with a franchise tax based on income which corporations report to shareholders rather than the current system which is tied to taxable Federal income.

(2) The property tax, now assessed on pipelines and exploration and production facilities, would be extended to cover oil tankers, LNG facilities, refineries, and petrochemical plants. The Administration's property tax proposal would also tax pipelines based on their economic value instead of depreciated historical cost.

(3) A simplified oil production tax (with a maximum rate of 10%) would be substituted for the current stair-step mechanism in order to properly reflect the considerable differences in economic factors governing production operations in various parts of the state. In addition, to protect tax revenues from erosion due to unpredictable pricing actions at the Federal level and from possible corporate profit-shifting activities, a "floor" (initially set at 75¢ per barrel) would be established under the oil production tax at a level approximating the "free market" (OPEC) value of the oil. The floor would escalate over time in line with the GNP deflator. Natural gas would be similarly treated. The current percent-of-value tax rate of 4% would be raised to 10% and, for the first time, a cents-per-Mcf minimum tax (initially set at 6.4¢ per Mcf) would be established. The latter figure is not subject to escalation as is the case with oil.

(4) Because of a larger-than-anticipated budget surplus in fiscal 1977, the assessment rate for the oil and gas reserves tax would be reduced from 20 mills to 12 mills. If TAPS is not transporting at least 600,000 b/d on October 1, 1977, however, the full 20 mill rate would become payable on the January 1, 1977 assessment.

(5) The contribution to the permanent fund from royalties and lease bonuses would be raised from the current level of 25% (as provided by a constitutional amendment approved by Alaskan voters in November 1976) to 75% in fiscal 1979 and 100% thereafter.

Compared to the legislature's own proposals to modify the stair-step production tax schedule now in effect and to adopt a direct accounting system for measuring Alaskan oil and gas income, Hammond's objectives in these areas incorporate some novel twists.

First, Hammond has recommended that an Economic Limit Factor (ELF) concept replace the current production tax, which establishes higher tax rates (cents-per-barrel minimums) according to the productivity of individual wells. In essence, ELF is the ratio of the production rate at the true economic limit to the current production rate, and would be used to reduce the severance tax rate as output declines toward the economic limit. This is accomplished by multiplying a basic tax rate (10%) times one minus ELF to produce a smooth continuous series of tax rates which scales the effective tax rate down to zero at the economic limit. Relative to the existing production tax mechanism, ELF's advantage is that it can be tied to the actual economic characteristics of a given property -- without resorting to multiple tax rates tied to averaged well production per producing property. To provide downside protection to production tax revenues, an initial "floor" price of $7.50 per barrel would be established, with escalation in subsequent periods tied to the GNP deflator. Under the ELF method, the cents-per-barrel minimum tax for any given year is calculated by multiplying the product of 10% plus the "floor" price by the ELF.

In sum, ELF would bring about a rather hefty increase in the overall level of the production tax. Despite some positive structural features, it would also inevitably cause a squeeze on company producing margins should the FEA set a ceiling price for North Slope oil below that which equates at the wellhead to the state's "floor" price.* (A high pipeline tariff would generate the same result.) This situation is akin to the position of the oil industry in Canada in 1974-1975, when the provinces and the federal government clashed over shares in revenues to the detriment of producer margins and eventually drilling activity and investment spending. In the U.S., the situation is one more example of the growing assertion of states' rights in the field of energy -- with the oil industry caught seemingly helpless as pawns in the struggle. Moreover, in Alaska's quest to maximize its take from presently proven North Slope reserves, the state appears to be disregarding the disincentive it is creating for the development of more marginal reserves, such as those in the Kuparuk and Lisburne formations. It may be recalled that *EPCA* sanctioned *positive* incentives for the development of Alaskan North Slope oil.

**The Department of Revenue had also considered a "lost value" surtax designed to offset lost royalties resulting from oil prices below the "floor" price. However, the surtax was not included in the final legislative proposal.*

The second novel twist of the Hammond package is its proposal to install a franchise tax in lieu of the corporate income tax in an attempt to alleviate certain alleged deficiencies in the present income tax structure as regards multi-jurisdictional corporations. These deficiencies relate to (1) the definition of the taxable base, and (2) the formula for apportionment of taxable income provided in the *Uniform Division of Income for Tax Purposes Act (UDITPA)*. Alaska, as a member of the Multistate Tax Compact (that currently comprises 21 states), is subject to the UDITPA's three-factor formula for apportioning business income to a state.* However, the Hammond Administration is recommending** that the corporate income tax be separated from the Federal definition of taxable income (with all its exemptions, incentives, and credits). To do so, a tax base measured by book income would be substituted for the Federal taxable income base. Then, a franchise tax (determined at the rate imposed under existing Alaskan statute) would be applied in lieu of the normal corporate income tax on a corporation's pretax income as reported to shareholders.

To overcome the problem of the sales factor in the current apportionment formula (which relates to the fact that the value of petroleum products is assigned to the state where the final destination sale is made, not to the state where the petroleum is produced), an extraction factor would be substituted for the sales factor. The extraction factor would relate a corporation's oil and gas production in Alaska to its worldwide production. If such an origin-oriented factor had been applied in 1975 to the 13 largest oil corporations operating in Alaska, it would have added more than $50 million to the state's apportioned taxable income. Moreover, Zeifman and Ainsworth estimated that their franchise tax proposal would have increased corporate income taxes paid by oil and gas corporations in 1975 more than four-fold – from $3.5 million to $14.4 million. Also, by modifying the apportionment formula, instead of developing a direct accounting method for Alaskan oil and gas income (as contemplated in HB 145), the total taxable income of the unitary business could continue to be combined, thus avoiding the complexities associated with attempting to disentangle intercompany transactions.

From Alaska's standpoint, passage of the franchise tax would undoubtedly resolve some glaring deficiencies in its current income tax treatment. Also, it would ensure that the North Slope producers pay something resembling the 9.4% nominal tax rate imposed on domestic (Alaskan) corporations doing business only in the state – versus the 2%-3% rate that

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**The three factors are property, payroll, and sales. The formula assumes that these factors equally contribute to the generation of income by a corporation and that the total income of a corporate business can be divided among the taxing states in proportion to each state's share of property, payroll, and sales. Under the Uniform Act, Alaska's taxable income is determined by multiplying the taxpayer's entire taxable income by a fraction which comprises the ratios of Alaska-to-total property, payroll, and sales.*

***The Administration's recommendation relied on the findings of two consultants (Zeifman and Ainsworth) contained in a study entitled "The Taxation of the Petroleum Industry Under Alaska's Corporate Income Tax."*

otherwise would apply to a multinational oil company. Unfortunately, in extending the reach of the tax collector to encompass OCS production and oil tankers, the state is probably exceeding the limits of fairness and reasonableness. While the Hammond tax package purports to close a number of existing loopholes in Alaska's current tax system, another key objective apparently is to expand permanent fund revenue. The increase would provide for future generations of Alaskans, and simultaneously allow the general fund budget to keep pace with population growth and inflation. In essence, the oil industry is being "asked" to fund a $200 million per year balancing wheel.

Table 8, from the Department of Revenue study cited previously shows the impressive buildup of general and permanent fund balances that will occur through fiscal 1985 even without the proposed tax changes. Petroleum revenues have been calculated using a world oil price assumption. Costs of moving the state capital from Juneau to Willow (between Fairbanks and Anchorage) and expenditures on the North Slope Haul Road have been excluded on the expenditure side.

Table 8

General and Permanent Fund
Finances with Arctic Gas Pipeline
(In millions)

	General Fund Expend.	Petro. Revenue	Non Petro. Revenue	Interest	Total Revenue	General Fund Balance	Perm. Fund Balance
FY 76	$ 616.4	$ 378.2	$292.6	$ 31.7	$ 702.5	$ 569.3	$ 0.0
FY 77	728.1	489.9	362.8	26.9	879.6	718.3	2.4
FY 78	853.8	646.6	225.8	35.0	907.4	689.7	84.7
FY 79	942.1	895.7	236.3	53.9	1,185.8	803.3	214.7
FY 80	979.5	1,079.2	256.8	68.5	1,404.5	1,063.0	380.0
FY 81	1,042.7	1,318.2	279.0	94.0	1,691.2	1,514.5	577.0
FY 82	1,111.0	1,632.8	294.3	132.8	2,059.9	2,234.4	806.1
FY 83	1,058.0	2,025.4	317.1	189.7	2,532.2	3,415.1	1,099.5
FY 84	1,086.9	2,307.6	343.2	278.0	2,928.8	4,917.3	1,439.2
FY 85	1,159.2	2,519.0	373.3	388.3	3,280.6	6,664.5	1,813.5

Source: State of Alaska, Department of Revenue.

If 100% of oil and gas royalty and bonus income is placed in the permanent fund beginning in 1980, the figure of $1.8 billion shown in Table 8 would, according to Department of Revenue projections, grow to more than $7 billion by 1985. The balance in the general fund would be about $2.5 billion, compared with general fund expenditures estimated at $1.2 billion for fiscal 1985.

At this juncture, with hearings having just taken place, and the possibility of substantial legislative revision to follow, it is somewhat premature to discern the final outcome on the latest set of tax proposals and to gauge their specific impact on North Slope earnings. However – and notwithstanding the Alaskan legislature's more conservative orientation, together with a drastically altered leadership and committee set-up in the Senate – the state will probably be concerned primarily with the timing and mechanics of how best (not whether) to obtain a portion of the economic rents it believes exists at Prudhoe Bay. Because

the legislature shows every intention of sticking with a mid-April adjournment date, and given the importance of North Slope oil pricing on their deliberations, it is conceivable that little could be accomplished this year. Certainly, a delaying action would likely be in the best interest of the oil companies. Whereas the price of Alaskan oil is paramount to the state's future oil revenues, developments affecting the TAPS tariff (examined in the next section) could moderate some of the state's drive for new oil revenues, and, at the extreme, soften the margin impact of a high "floor" price under the production tax if that feature is adopted and the price of North Slope oil is set below the world level landed on the West Coast. Pending further developments, this report's profitability projections are based on three key taxation assumptions: (1) an effective 9.4% corporate income tax rate; (2) the Administration's proposed ELF production tax mechanism; and (3) a TAPS property tax based on historical cost depreciated over a 30-year period.

Appendix B lists the results of some discounted cash flow (DCF) calculations the writers made using the net cash flows derived from TAPS and oil and gas production from the main (Sadlerochit) Prudhoe Bay reservoir. Real DCF rates of return of 10.6%, 19.1%, and 5.7% using constant (1977) dollars were calculated for TAPS, the main Prudhoe Bay field, and the combined operation, respectively. While many of the specific assumptions used are spelled out below, the DCF analysis assumed a world price for North Slope oil at Long Beach, and a TAPS tariff based on pipeline throughputs approaching 2 million b/d (which incorporates Kuparuk and Lisburne reserves as well as those in the main Prudhoe Bay field) and a return on equity approach in determining maximum allowable pipeline earnings. Relative to DCF rate of return objectives of 20%-25% set by many companies for exploration and production ventures, and actual rates of return for some of the larger North Sea fields far in excess of that, a real rate of return of just under 16% for the largest oil field ever found in North America provides an interesting perspective on the question of economic rents. Moreover, the 15.7% return would probably be depressed further by inclusion of the large investment in tankers required to move the oil to West and Gulf Coast markets, plus full consideration of the economics involved in moving surplus Alaskan oil on the West Coast to other markets.

The analysis of DCF economics also permits a revenue breakdown between the oil companies, municipal, state, and Federal governments. Table 9 shows how the pie is shared for the Prudhoe Bay field. Interestingly, the oil companies would receive less than 50% of revenues less operating costs from TAPS and oil and gas production with which to pay principal and interest to bondholders, dividends to shareholders, and for new investments. In sum, it appears that Government is the main beneficiary of Prudhoe Bay development.

In an address to a group of oil analysts on the West Coast in October 1976, U.S. Senator Ted Stevens of Alaska referred to the state's legacy at Prudhoe Bay by stating "We're Albertans, too!" Since Alaska currently has neither a tax climate nor a set of development incentives to spur new E&P outlays that even remotely resembles Alberta's system, it would seem to have a better affinity with the Indonesians. In all seriousness, the State of Alaska is at the crossroads. A willingness by the legislature and Administration to compromise on some particularly contentious features of the current tax proposals could go a long way towards establishing a tax structure conducive to a healthy investment climate for the oil industry in Alaska -- and to the needed development of the state's potentially enormous petroleum and minerals resources for the benefit of the entire U.S.

(See Table 9 on following page)

Table 9

Distribution of Prudhoe Bay Revenue Pie (a)
(In millions)

Year	Total Revenues Less Oper. Costs	Property Taxes State	Property Taxes Municipalities	Royalty State	Royalty Native Fund (b)	Production Taxes	Income Taxes State	Income Taxes Federal
1976	–	$ 220						
1977	$ 1,399	270		$ 103	$ 20	$ 43	$ 33	
1978	5,446	148	$ 59	412	78	165	230	$ 1,029
1979	5,689	156	63	437	83	171	245	1,031
1980	7,085	162	68	589	112	355	340	1,513
1981	8,390	179	76	707	135	561	419	1,909
1982	8,837	187	81	827	66	590	451	2,085
1983	9,243	196	89	942		619	481	2,226
1984	9,673	203	94	994		648	521	2,408
1985	10,120	206	97	1,047		677	570	2,635
1986	10,577	202	95	1,102		707	629	2,911
1987	10,634	198	93	1,106		703	655	3,032
1988	10,384	196	94	1,072		668	658	3,045
1989	10,156	192	91	1,040		636	662	3,066
1990	9,959	186	90	1,012		603	666	3,084
1991	9,746	181	88	981		573	668	3,093
1992	9,012	175	85	885		499	631	2,920
1993	8,397	169	84	803		434	601	2,783
1994	7,849	164	80	729		377	575	2,664
1995	7,381	156	77	666		325	553	2,560
1996	6,930	148	75	604		284	526	2,432
1997	6,594	141	70	557		250	506	2,342
1998	6,206	132	67	503		212	483	2,234
1999	5,763	123	62	431		170	456	2,112
2000	5,364	114	58	388		131	431	1,995
2001	5,127	103	53	353		107	419	1,939
2002	4,856	91	46	314		80	405	1,873
2003	4,598	79	41	286		60	388	1,796
2004	4,342	66	33	253		37	371	1,718
2005	4,184	55	29	233		24	361	1,671
Totals	$213,942	$4,798	$2,038	$19,376	$494	$10,709	$13,934	$64,106

(a) Excludes Prudhoe Bay field natural gas and oil production from the Kuparuk and Lisburne Pools.

(b) Under the terms of the Alaska Native Claims Settlement Act, all lands selected by the state but which had not yet been patented to it were made subject to a two percent oil and gas royalty interest payable out of the state's one-eighth royalty interest. This provision applies until $500 million has been paid into the Fund.

Distribution of Total Revenues Less Operating Costs:

	Amount (In billions)	*% of Total*
State of Alaska	$ 48.8	22.8
Municipalities	2.0	1.0
Alaska Native Fund	0.5	0.2
Federal Government	64.1	30.0
Oil Companies	98.5	46.0
Total	$213.9	100.0%

North Slope Profitability Model

This section integrates the analysis and conclusions of the previous three sections, and precludes the construction of earnings profiles for the major Prudhoe Bay reserve owners. Specifically, it presents the methodology and workings of a computer model the writers have developed for purposes of calculating the integrated profitability of North Slope crude oil movements. In recognition of the complex interplay of factors bearing on the economics of North Slope oil, the emphasis here is not on postulating a single deterministic solution. Since many assumptions and estimates are necessarily entailed in an undertaking of this kind, in our opinion, an appreciation of the sensitivities associated with key parameters and a framework capable of rapidly assimilating any new data that becomes available is equally as important.

Instead of deriving profitability figures for each company based on its particular circumstances, we have worked with a composite case which represents the companies' aggregate position. While such parameters as TAPS tariffs, tanker transportation charges, and markets of final destination for crude oil liftings will vary somewhat by company relative to our composite case assumptions, the resulting differences should not be sufficiently large so as to preclude the usefulness of our analysis in projecting future earnings for the North Slope producers.

Pipeline Issues and Economics

In the integrated economics of North Slope oil, TAPS simultaneously represents a significant cost and profit center. Moreover, because of important differences in the incidence of taxation on pipeline and wellhead earnings, TAPS is also a source of continuing friction between the interests of the State of Alaska (a maximum wellhead price)* and the TAPS owner companies (for a given level of costs, a maximum pipeline tariff and a correspondingly lower wellhead price). As a result, it would not be surprising if the state filed a contested rate application with the Interstate Commerce Commission (ICC), challenging the initial tariff filings of the eight TAPS owners based on their respective undivided interest in the entire

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* *At a throughput rate of 1.2 million b/d, each one cent per barrel change in the pipeline tariff is the equivalent of $4.4 million in annual revenues. Based on Alaska's current approximate 20% interest in the value of the oil at the wellhead, therefore, a one cent increase in the tariff would deprive it of $880,000 in wellhead revenues, exclusive of any effects on state income tax receipts.*

system. Besides the investor attention likely to be focused on this action, the recently concluded Williams Brothers Pipe Line Company (WBPL) rate case* spawned a far-reaching ICC proceeding (Ex Parte No. 308, *Valuation of Common Carrier Pipelines)* now pending. Among other things, the proceeding will address the fundamental question of what constitutes a proper rate base as well as the closely related issue of what rate of return should be allowed on that base. As such, it promises to have broad ramifications for determining TAPS tariffs (and hence wellhead values) and reported pipeline earnings. To fully appreciate the scope of the issues potentially involved here, it is necessary to understand the ICC's established ratemaking procedures.

The precedent for a maximum 8% return on the value of property owned and used for common carrier purposes by crude oil pipelines was set down in *Minnelusa Oil Corp. v. Continental Pipe Line Co.* (258 ICC 41), in 1944, when the ICC held that such a return was reasonable. The Commission concluded "...that just and reasonable rates... are rates based substantially on the cost of service and fair rate of return on value." As noted in the footnote below, a similar view was taken by a majority of the Commission in the recently concluded WBPL rate case. In addition, a 1941 Consent Decree reached with the Department of Justice (to which all TAPS owners are subject, except for BP and Amerada Hess), prohibits an interstate common carrier owned by a defendant shipper-owner from earning and paying to its parent in the form of dividends or other valuable consideration more than 7% of the ICC's latest final valuation in any given year.

Historically, because the ICC's annual valuation reports have encompassed a carrier's entire inventory of property owned and used for common carrier purposes, pipeline companies have not been required to meet rate of return criteria for each pipeline segment in their system on a stand-alone basis. Since four of the TAPS owners – ARCO Pipe Line, Exxon Pipeline, Mobil Pipe Line, and Sohio Pipe Line – have other holdings besides TAPS that are currently subject to ICC regualtion, a higher return could possibly be earned on TAPS to the extent that the companies' other pipeline segments forego some potential return. Looking ahead, the sheer magnitude and visibility of TAPS, together with ongoing Congressional interest in the subject of segmentized rates, suggests that by choice or otherwise the TAPS owners will probably be shooting for a tariff within the 7% guideline on their undivided interests in the system.

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* *The WBPL rate case – the first oil pipeline rate case to come before the full Commission in over 30 years – evolved out of a protest filed by a group of shippers (mainly independent refiner-marketers) against WBPL's filing of a schedule for increased local rates and, in conjunction with Explorer Pipeline, higher joint rates on petroleum products shipments from and to certain points in the Southwest and Midwest. On reconsideration of the matter, the Commission concluded (with one notable exception) that the criteria employed by Division 2 (the Appellate Division) in judging the reasonableness of WBPL's rates were the proper ones to use in the proceeding, and that, tested by these long-standing criteria (see ensuing discussion), the overall rate level of WBPL was neither unjust nor unreasonable. In essence, a majority of the Commission embraced the principle that operating expenses plus cost of capital define a reasonable rate level. The significance of the WBPL rate case transcends this immediate finding, however, since it raised a number of substantive questions concerning the continued appropriateness of some of the ICC's established ratemaking procedures.*

In determining valuations of pipelines and railroads for ratemaking purposes, Section 19a of the *Interstate Commerce Act of 1887* specifically requires that consideration be given to cost of reproduction new,* cost of reproduction new less depreciation, and original cost. Congress did not specify the weight to be assigned each of these elements of value; rather, it left it to the ICC's discretion to determine how the weights were to be applied.

The ICC valuation process also incorporates amounts for going concern value, present value of land, present value of rights-of-way, and working capital. However, in applying its Congressional mandate, the ICC has elected to emphasize only two elements – cost of reproduction new and original cost. Its position has been that the value of property before depreciation should fall between these two elements of cost, and it has elected to weight the two based on each one's percentage relationship to the sum of the two. Hence, in an inflationary period, cost of reproduction new would receive an increasingly heavier weighting. Next, a condition percent factor** is applied to the weighted average sum of cost of reproduction new and original cost to arrive at an estimate of the cost of the property in its present condition. It is important to note that the reference to depreciation in this instance is not to an actually accrued amount; instead, physical wear and tear is estimated mathematically using condition percent factors. Although the precise manner in which final valuations are derived from among the seven components of value is not disclosed, our approach, while necessarily dependent on several assumptions, seeks to simulate the basic decision-making process followed by the ICC (see page 41 for further details).

Having reviewed established ICC valuation procedures and rate of return standards as they would apply to TAPS, and as a prelude to a discussion of some of the yet-to-be resolved issues likely to envelop TAPS in coming months, the methodology and assumptions underlying our tariff model are next presented.

**Cost of reproduction new is the estimated cost of reproducing substantially the identical property constructed in a prior period at a price level as of a subsequent date. To make this computation, the ICC relies on an analysis of construction techniques and annual and period price indices to establish cost differentials between a predetermined base period (1947) and a current period. In developing its cost of reproduction new figure, the ICC applies a prudent man condition (i.e., from hindsight, how would a prudent man have constructed the pipeline?).*

*** The condition percent factor is a function of the remaining probable life of an item of property at any attained age and its total probable life at that age.*

Assumptions for Tariff and Earnings Computation

(1) Capital cost of the 1.2 million b/d design capacity will be $7.7 billion. To expand capacity to 1.6 million b/d (Case I), incremental capital expenditures will total $700 million (vs. Alyeska's last published estimate of $675 million). A final expansion of capacity to 2 million b/d (Case II) is estimated to cost $400 million. Case I corresponds to a field development program limited to the Prudhoe Oil Pool, whereas Case II incorporates development of an additional 2 billion barrels of speculative reserves believed to exist in the Kuparuk and Lisburne Oil Pools.

(2) Capitalized interest during construction totals $1.3 billion. This amount is then amortized over a 25-year period. For any TAPS expansions which occur, capitalized interest is computed, based on an estimated expenditure and borrowing profile, until the assets are placed into service. At that point, amortization of the cumulative balance commences.

(3) Financing of the $9 billion of initial system capital costs plus capitalized interest is accomplished using 90% borrowed funds. The same debt to total capital ratio is maintained for any system expansions. Debt is retired in equal installments over a 25-year period. The maturity date on any borrowings associated with system expansions is shortened so that all borrowings are repaid as of a common date.

(4) Interest is assessed at the rate of 9% on the average outstanding loan balance in a given year.

(5) For rate determination, pipeline depreciation is on a straight-line basis over 35 years. For Federal and state income tax purposes, a 17½-year, sum-of-the-years-digits method is employed. Federal and state income taxes allowed for ratemaking purposes are normalized (i.e., no flow-through of deferred taxes is required). As pipeline capacity is expanded beyond the 1.2 million b/d level, a shorter depreciable life is used for assets associated with the added capacity (mainly pump stations) to conform with the remaining depreciable life of the initial system.

(6) Combined State of Alaska and municipal property taxes of 2% of assessed value are based on the actual costs of TAPS depreciated on a straight-line basis over a 30-year period. As additional pipeline facilities are added in future years, a depreciable life identical to the remaining life of the initial system is used.

(7) To provide for the expense of removing surface facilities at the exhaustion of the pipeline's economic life, as required in the *Stipulations for the Agreement and Grant of Right-of-Way for the Trans-Alaska Pipeline*, a reserve account has been established to meet this future contingency. Accruals into the fund are at the rate of 10.3¢ per barrel ($1 billion of estimated future cost divided by 9.7 billion barrels of crude and condensate).

(8) Operating costs of the line at a 1.2 million b/d capacity level (1978) amount to approximately 40¢ per barrel. This figure is subsequently inflated at 5% per annum until throughput begins to decline, at which point provision is made for a tapering off of variable operating costs. On completion of the expansion of line capacity to 1.6 million b/d (assumed to occur in 1980), $20 million is added to annual operating costs. With capacity of 2 million b/d, a further $15 million increment to annual operating costs occurs in 1982.

(9) State and Federal income tax liability is assessed at rates of 9.4% and 48%, respectively, on taxable earnings. State income taxes are deductible before computing Federal income tax liability.

(10) In computing the ICC valuation base, original cost is $9.0 billion (including capitalized interest) for a design capacity of 1.2 million b/d, and cost of reproduction new is set at 100% of original cost less the value of land and rights-of-way, or $8.99 billion. A 5% annual inflation factor is thereafter applied to the cost of reproduction new. To the resultant weighted average value of cost of reproduction new and original cost, a condition percent factor is applied each year to obtain an estimate of the cost of TAPS in its present condition. A factor of 1.06 is then applied to this figure to reflect going concern value, before adding $60 million (representing the present value of land, present value of rights-of-way, and working capital) to obtain the final valuation rate base. A similar treatment is employed for any TAPS expansions.

(11) In calculating tariff rates, ICC ratemaking earnings may not exceed a maximum of 10% of the above-determined, year-end valuation base. As noted below, the use of a 10% maximum rate of return on the valuation rate base is postulated on the belief that the ICC will, at a minimum, recognize the actual cost of capital of the TAPS owners in determining what is a reasonable rate level.

(12) Investment tax credits associated with qualified TAPS expenditures under the progress payment method accrue to the owners and not to the shippers in the form of a reduced cost of service (i.e., a lower tariff).

(13) Company ownership interests in TAPS are currently as follows:

(See table on following page)

Company	% of TAPS Owned
Sohio Pipe Line Company*	33.34%
ARCO Pipe Line Company	21.00
Exxon Pipeline Company	20.00
BP Pipelines, Inc.*	15.84
Mobil Alaska Pipeline Company	5.00
Union Alaska Pipeline Company	1.66
Phillips Petroleum Company	1.66
Amerada Hess Corporation	1.50
	100.00%

** As a consequence of the substantial escalation in the estimated cost of TAPS since the pipeline was first planned in 1969, BP and Sohio entered into an agreement as of July 1974 providing that BP Pipelines would acquire a 15.84% undivided interest in TAPS from Sohio Pipe Line in order to facilitate the financing of TAPS. The agreement contemplates that BP Pipelines will lease its undivided interest in the pipeline to Sohio for at least 18 years, and that during the term of the lease Sohio will operate its and BP Pipelines' interests in TAPS. The rental payments to be made by Sohio under the lease would be based upon the profits and tax benefits realized by it from the operation of BP Pipelines' TAPS interest. As to tariffs charged by Sohio and BP, they may not be significantly higher than the highest tariff charged by a third party in respect of TAPS (except that neither company shall be obligated to post a tariff that does not reflect compensation for normal debt service and normal operating costs).*

Utilizing the foregoing assumptions, Tables 10 and 11 present TAPS tariffs and earnings for selected years at pipeline capacity levels of 1.6 (Case I) and 2 million b/d (Case II). In constructing the Tables, we have developed a series of annual unsmoothed tariffs corresponding to the postulated composite profile of the TAPS owner companies. Under the undivided interest form of pipeline ownership, however, each of the owner companies will separately post tariffs and receive tenders of crude oil for shipment through its share of overall pipeline capacity which will be operated as a common carrier. Moreover, the tariff figure for each TAPS owner will be different for several reasons: (1) cost of the debt capital; (2) financing strategy -- debt/equity ratio; and (3) for several companies, the ownership in the pipeline is not the same as the ownership in field reserves, thereby potentially spawning a diversity of viewpoints on the best way to maximize integrated earnings.

As Tables 10 and 11 on the following pages show, the economics of North Slope oil vary considerably, given fluctuations in TAPS throughput. For Case I (field development limited to the Prudhoe Oil Pool), annual tariffs in the period 1978-1990 range between $3.54 and $5.14 per barrel, with an average value of $3.99 per barrel. Reflecting the economies of scale associated with higher levels of TAPS capacity utilization, the comparable annual tariffs for Case II (field development encompassing all three state-defined pools – Prudhoe, Kuparuk, and Lisburne – within the Prudhoe Bay field) range from $3.14 to $4.28 per barrel, averaging $3.55 per barrel over the entire period. Briefly explained, the tariff reduction that occurs at progressively higher levels of pipeline throughput above the initial design capacity of 1.2 million b/d is attributable to the relatively low cost at which increments to initial capacity can be obtained. It is also evident from the Tables that the level of GAAP earnings is essentially unchanged as between Cases I and II, meaning that declining unit depreciation charges associated with high levels of pipeline throughput are reflected in a higher wellhead price (and earnings) and not at the pipeline level, where the economies of scale arise. The explanation for this somewhat paradoxical conclusion, of course, rests with the manner in which pipeline earnings are computed (i.e., as a fixed percentage of an ICC-determined valuation base).

Table 10

TAPS Tariff and Earnings Model (a)

Case 1: Pipeline Capacity 1.6 Million B/D

	1978	1979	1980	1985	1990
Operating Revenues (in mils.)	$1854.4	$1873.9	$1855.8	$2184.7	$2383.0
Oil Shipments (mils. of bbls.)	438.0	438.0	518.0	584.0	464.0
TAPS Tariff	$4.23	$4.28	$3.58	$3.74	$5.14

	Amount	Per Bbl.	Amount	Per Bbl.	Amount	Per Bbl.	Amount	Per Bbl.	Amount	Per Bbl.
Operating Revenues	$1854.4	$4.23	$1873.9	$4.28	$1855.8	$3.58	$2184.7	$3.74	$2383.0	$5.14
Interest Expense	700.4	1.60	671.8	1.53	699.9	1.35	549.9	0.94	392.8	0.85
Depreciation	216.9	0.50	216.9	0.50	216.9	0.42	238.8	0.41	238.8	0.51
Property Taxes	146.0	0.33	149.3	0.34	146.5	0.28	120.8	0.21	94.5	0.20
Amort. of Cap. Interest	51.0	0.12	51.0	0.12	51.0	0.10	56.5	0.10	56.5	0.12
Res. for Rem. of Surface Facil.	45.1	0.10	45.1	0.10	53.4	0.10	60.2	0.10	47.8	0.10
Operating Costs	175.0	0.40	184.0	0.42	213.0	0.41	272.0	0.47	323.0	0.70
Total Operating Expenses	1334.4	3.05	1318.1	3.01	1380.7	2.67	1298.1	2.22	1153.4	2.49
Pretax Earnings	520.0	1.19	555.8	1.27	475.1	0.92	886.6	1.52	1229.6	2.65
Income Taxes (b)	275.0	0.63	294.0	0.67	251.2	0.49	468.9	0.80	650.3	1.40
-State	48.9	0.11	52.2	0.12	44.7	0.09	83.3	0.14	115.6	0.25
-Federal	226.1	0.52	241.7	0.55	206.6	0.40	385.5	0.66	534.7	1.15
ICC Earnings (c)	$ 945.4	$2.16	$ 933.7	$2.13	$ 923.7	$1.78	$ 967.6	$1.66	$ 972.1	$2.09
GAAP Earnings (d)	$ 245.0	$0.56	$ 261.9	$0.60	$ 223.8	$0.43	$ 417.7	$0.72	$ 579.3	$1.25

(a) Totals may not add due to rounding.
(b) Operating revenues less operating expenses (incl. interest expense), times combined statutory tax rate.
(c) Operating revenues less operating expenses (excl. interest expense) and less income taxes.
(d) ICC earnings less interest expense. Note that GAAP earnings as shown do not include ITC benefits accruing to the companies.

Table II

TAPS Tariff and Earnings Model (a)

Case II: Pipeline Capacity 2.0 Million B/D

	1978	1979	1980	1985	1990
Operating Revenues (in mils.)	$1854.4	$1873.9	$1855.8	$2272.5	$2498.9
Oil Shipments (mils. of bbls.)	438.0	438.0	518.0	723.0	591.0
TAPS Tariff	$4.23	$4.28	$3.58	$3.14	$4.23

	Amount	Per Bbl.	Amount	Per Bbl.	Amount	Per Bbl.	Amount	Per Bbl.	Amount	Per Bbl.
Operating Revenues	$1854.4	$4.23	$1873.9	$4.28	$1855.8	$3.58	$2272.5	$3.14	$2498.9	$4.23
Interest Expense	700.4	1.60	671.8	1.53	699.9	1.35	579.7	0.80	414.1	0.70
Depreciation	216.9	0.50	216.9	0.50	216.9	0.42	251.7	0.35	251.7	0.43
Property Taxes	146.0	0.33	149.3	0.34	146.5	0.28	127.9	0.18	100.1	0.17
Amort. of Cap. Interest	51.0	0.12	51.0	0.12	51.0	0.10	58.0	0.08	58.0	0.10
Res. for Rem. of Surface Facil.	45.1	0.10	45.1	0.10	53.4	0.10	74.5	0.10	60.9	0.10
Operating Costs	175.0	0.40	184.0	0.42	213.0	0.41	289.0	0.40	347.0	0.59
Total Operating Expenses	1334.4	3.05	1318.1	3.01	1380.7	2.67	1380.8	1.91	1231.8	2.08
Pretax Earnings	520.0	1.19	555.8	1.27	475.1	0.92	891.7	1.23	1267.1	2.14
Income Taxes (b)	275.0	0.63	294.0	0.67	251.2	0.49	471.6	0.65	670.1	1.13
-State	48.9	0.11	52.2	0.12	44.7	0.09	83.8	0.12	119.1	0.20
-Federal	226.1	0.52	241.7	0.55	206.6	0.40	387.8	0.54	551.0	0.93
ICC Earnings (c)	$ 945.4	$2.16	$ 933.7	$2.13	$ 923.7	$1.78	$ 999.8	$1.38	$1011.0	$1.71
GAAP Earnings (d)	$ 245.0	$0.56	$ 261.9	$0.60	$ 223.8	$0.43	$ 420.1	$0.58	$ 596.9	$1.01

(a) Totals may not add due to rounding.
(b) Operating revenues less operating expenses (incl. interest expense), times combined statutory tax rate.
(c) Operating revenues less operating expenses (excl. interest expense) and less income taxes.
(d) ICC earnings less interest expense. Note that GAAP earnings as shown do not include ITC benefits accruing to the companies.

As noted at the outset of this discussion of pipeline issues and economics, the tariff-setting process for TAPS is presently engulfed in considerable uncertainty – the resolution of which must perforce await future developments involving the ICC and the State of Alaska. Given the importance of the level of the TAPS tariff in the overall economics of North Slope oil, some perspective on the nature and likely basis for resolution of the tariff uncertainty is warranted.

Independent of, but inextricably tied to, the outcome of the ICC's upcoming Ex Parte No. 308 review of the continued applicability of its 8% return standard for crude oil pipelines is the little understood (certainly by the investment community) matter of how TAPS tariffs and reported pipeline earnings will be affected by the Commission's current procedure, as outlined in the WBPL rate proceeding, for calculating ratemaking earnings. The fundamental question involved here is whether total pipeline investment or the equity capital portion alone is the appropriate basis for determining maximum allowable earnings for ratemaking purposes.

By relying on the precedent of the *Elkins Act* Consent Decree ruling of 1941, and the findings of a later contest of that ruling (the Arapahoe Pipeline case), the TAPS owners subject to the original Consent Decree have historically proceeded on the assumption that they could earn and pay as dividends to their parents 7% of the ICC's valuation of their common carrier properties, *after* recognizing interest charges on pipeline debt as a separate component in the tariff buildup. Therefore, the companies were somewhat surprised (to be read, shocked) to learn that the ICC was employing a ratemaking methodology other than that of the *Elkins Act* to measure the reasonableness of the rates of the Williams Brothers Pipe Line.* Although WBPL is primarily a petroleum products carrier, when the ICC treated the company's interest expense for ratemaking purposes it appeared to be implicitly saying that a regulated oil pipeline could earn 8% or 10% (if a products carrier) on valuation over and above interest expense on an equity capital basis – an approach not unlike the FPC's for natural gas pipelines. Given that interest expense is initially deducted from operating revenues in computing GAAP, earnings and then added back to the latter amount to arrive at ratemaking earnings (see footnotes to Table 10), *the net effect is a successive lowering of the tariff, which, in turn, forces down GAAP earnings (since interest expense is treated as a constant in the ratemaking earnings figure).* In essence, the highly leveraged nature of TAPS,** together with a debt cost that exceeds the ICC's 8% return ceiling, results in an excessive rate of return (at least by ICC standards) and a consequent necessity to lower the tariff. This pattern can be easily seen in Table 12.

**To the extent a future rate case involving TAPS reaches the ICC, a salient issue is likely to be whether or not the 1941 Elkins Act Consent Decree and the related Arapahoe Pipeline proceeding are binding on the ICC. According to Commission officials contacted by the writers, the Consent Decree arose out of a Justice Department investigation, and as such, was not a pipeline rate case which set a precedent for the ICC to follow. On the other hand, a view likely to be proffered by the companies would go as follows: since the Consent Decree dealt with pipeline earnings, and a pipeline company's earnings are calculated using tariffs, it follows that the Elkins Act Consent Decree should be binding on the ICC.*

***To avoid the impact of the 7% Consent Decree limitation, pipelines have modified their capital structures by reducing the amount of equity and thereby leveraging the 7% figure to a much higher percent of equity investment.*

Table 12

Alternative Tariff and Earnings Computation -- 1978 (a)
(In millions except per barrel)

	Elkins Act Basis (b)	ICC Basis (c)	
	7% Return	8% Return	10% Return
TAPS Tariff	$6.25/bbl.	$3.32/bbl.	$4.23/bbl.
Operating revenues	$2,739.2	$1,453.1	$1,854.4
Interest expense	700.4	700.4	770.4
Depreciation	216.9	216.9	216.9
Property taxes	146.0	146.0	146.0
Amortization of cap. interest	51.0	51.0	51.0
Res. for rem. of surface facil.	45.1	45.1	45.1
Operating costs	175.0	175.0	175.0
Total operating expenses	$1,334.4	$1,334.4	$1,334.4
Pretax earnings	1,404.8	118.7	520.0
Income taxes	743.0	62.8	275.0
– State	132.1	11.2	48.9
– Federal	610.9	51.6	226.1
ICC earnings	$ 661.8	$ 756.3	$ 945.4
GAAP earnings	$ 661.8	$ 55.9	$ 245.0

(a) Totals may not add due to rounding.

(b) Under the Consent Decree, affected shipper-owners are allowed to post tariffs based on a return on their total pipeline investment.

(c) Assumes tariffs reflect a residual return based on the equity component of investment only. A revised calculation using a 10% return ceiling is used to more properly reflect an estimated cost of capital applicable to the TAPS owners in the aggregate.

Strict adherence to an 8% return ceiling using the ICC ratemaking methodology employed in Williams Brothers results in a tariff of $3.32 per barrel and reported (GAAP) earnings of $55.9 million for 1978, far below the situation prevailing under *Elkins Act* treatment. On the assumption that the ICC would, at a minimum, establish a fair rate of return on value reflective of the actual cost of capital associated with TAPS,* the writers also include a revised set of calculations based on a 10% return on valuation. Accordingly, a $245 million net profit in 1978 would translate into a 27% rate of return (versus 74% under the *Elkins Act* Consent Decree) on $900 million of pipeline equity.

**On the assumption that 90% of the cost of TAPS is borrowed at an effective rate of 9% and that the remaining 10% equity contribution has an after-tax cost of 15%-20%, the weighted average cost of capital for TAPS would be as follows:*

90% debt @ 9%	*= 8.1%*
10% equity @ 15%-20%	*= 1.5%- 2.0%*
weighted average	*= 9.6%-10.1%*

If a rate proceeding involving TAPS occurs, the owner companies would undoubtedly argue that a parent company capital structure would be the proper one to impute in measuring cost of capital. Unlike a gas pipeline, where the gas company typically assumes only a portion of the risk, in the case of TAPS, lending institutions are looking past the pipeline subsidiaries to the parent companies for ultimate payment should TAPS, for one reason or another, be economically unviable. Since an oil pipeline involves a set of risks and obligations different from those inherent in the utility concept underlying a gas pipeline, so the argument goes, an oil pipeline should not be viewed on a stand-alone basis.

Because the incidence of taxation by the State of Alaska is lower on the pipeline than at the wellhead, other things being equal, a lower pipeline tariff would be reflected in a modest reduction in integrated profits for the Prudhoe Bay producers. However, under the ICC ratemaking procedure described above, the impact on integrated profits stemming from a shift in the incidence of taxation is greatly exacerbated by the residual manner in which GAAP earnings are calculated (i.e., as the difference between maximum permitted ratemaking earnings and interest expense). To the extent that a fixed valuation return ceiling is indiscriminately applied to all crude oil pipelines, BP and Sohio in particular stand to be adversely affected given their relatively high cost of debt capital. For Sohio (and indirectly BP through its equity ownership in the company), however, its current prospect of being a substantial net purchaser of pipeline transportation services provides a partial offset to the potential profit impact arising from a low pipeline tariff and a concomitant squeeze on GAAP earnings. From the standpoint of the State of Alaska -- whose concern regarding the potential revenue loss associated with a high pipeline tariff has bordered on the extreme -- the implications of the ICC's return on equity approach to ratemaking, if applied to TAPS, could conceivably result in a more stable tax environment for the petroleum industry in Alaska than might otherwise prevail.

As matters now stand, the TAPS owners are apparently moving forward to post initial tariffs on an *Elkins Act* basis, in the belief that past practice affords good justification for continuing to use this tariff-setting approach. That action, in turn, will undoubtedly precipitate the filing of a contested rate application by Alaska in an attempt to protect its revenue interests -- thus joining the battle lines for what is shaping up as the most significant pipeline tariff dispute since the Interstate Commerce Commission gained jurisdiction over the pipeline field.

In past years, one reason why so few oil pipeline rate cases have reached the full Commission is because most areas of potential dispute were resolved in the early stages of a pipeline's life between the line owners and the ICC staff through a process of exceptions and appeals.* Unfortunately, such an outcome does not appear to be in the offing for TAPS. As one example of the complexities militating against a simple resolution of potential areas of dispute, what amount will be includable in the TAPS tariff for "negative salvage value" -- that is, those costs associated with the eventual removal of all above-ground facilities at some undetermined time? Moreover, owing to the sheer size of TAPS (once constructed, it will represent an investment cost exceeding that of the 100 or so other pipelines under ICC jurisdiction) plus the pioneering efforts entailed in constructing the first "hot oil" pipeline ever built in an Arctic environment, not to mention the unprecedented Government involvement in all phases of the project, it becomes a difficult, if not impossible, task to apply the test of 20-20 hindsight, utilizing the prudent man rule, fairly to this project. In this light, the audit section of the ICC's Bureau of Accounts has already begun to investigate Alyeska with the dual objective of validating its actual cost figures and evaluating those management activities and decisions (such as labor usage and pricing and the remedial welding program) that could have contributed to cost overruns on the pipeline.** To the extent

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**The main reason for the limited number of rate cases occurring over the years, of course, is traceable to the fact that pipeline ownership has typically been in the hands of the shippers.*

***Not to be outdone, Senator Jackson has requested the Government Accounting Office (GAO) to conduct an investigation of TAPS along lines similar to that of the ICC. Presumably, the GAO study, which is being undertaken in three separate stages, would be used in any future Congressional hearings on the pipeline question.*

questionable costs are identified and eliminated, the original cost figure inserted into the valuation base computation would be lower than the $8.99 billion incorporated in our tariff model. Referring back to Table 10, if $500 million was slashed from the number for original cost, in 1978, the per-barrel tariff would fall from $4.23 to $3.98 and GAAP earnings would decline from $245 million to $193 million.

The Alaska Pipeline Commission (APC),* acting on behalf of the State of Alaska, has hired a Washington-based consultant to conduct an investigation into the reasons for (and appropriate documentation of) alleged cost overruns in the construction of TAPS. This study could put some political pressure on the parallel ICC investigation, and also aid the APC in setting tariffs for that portion of North Slope oil sold within the state.

Once the question of the pipeline's original cost has been resolved by the audit section through the exceptions and appeals process, the ICC valuation staff will then be given the vexsome task of determining a cost of reproduction new and, more broadly, a final valuation base for TAPS.** Based on the methodology outlined on page 39, an initial valuation as of December 31, 1977 will probably not be forthcoming until the end of 1978, and at that, may encompass only those companies having other common carrier properties (ARCO Pipe Line, Exxon Pipeline, Mobil Pipe Line, and Sohio Pipe Line). Once TAPS is beyond the 1977 startup stage, the valuation staff expects to have a more realistic picture of TAPS' operations on which to base the 1979 valuation report (covering year-end 1978). From our discussions with ICC valuation officials, the 1979 report is likely to serve as the fair value rate base on which a final evaluation of the reasonableness of the TAPS tariffs may ultimately be made.

tariff will be "set" till 1979

The Alaska Pipeline Commission was formed in 1972 as one element of a broad legislative package dealing with the petroleum industry. In addition to being the state regulatory body where intrastate movements of oil and gas are concerned, a current bill in the House (HB 145) would allow the APC to determine pipeline taxable income according to its regulations (now being developed) if no ICC valuation has been made of an interstate oil pipeline facility or if the oil pipeline facility is engaged wholly or partially in intrastate commerce. Needless to say, the TAPS owners are viewing this authority (to the extent it is not pre-empted by the Federal Government) and the development of the APC's pipeline regulatory apparatus with a great deal of concern.

**In the lower-48 states, the cost of reproduction new has typically amounted to 80%-90% of original cost. To further illustrate the one-of-a-kind nature of TAPS, one of the companies indicated to the writers that it is planning on the basis of cost of reproduction new being 110% of original cost, mainly reflecting the long construction leadtime and intervening rates of inflation more than offsetting any downward bias introduced by the application of the prudent man rule to the construction of the line. If cost of reproduction new at 110% of original cost is substituted for the 100% figure used in our 1978 base case, the per-barrel tariff would rise to $4.49 and GAAP earnings would climb to $298 million.*

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

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Even if the State of Alaska is satisfied with the outcome of the ICC investigation of Alyeska (most importantly, the amount of costs included in the rate base), the substantial questions raised by the protestants in the WBPL rate case would appear to justify a rate challenge in any event, especially if the tariffs are based on the *Elkins Act* Consent Decree.* As such, final resolution of the uncertainty surrounding the tariff appears to rest on the convergence of a TAPS rate case and/or the conclusion of the Ex Parte No. 308 proceeding – both of which promise to be drawn-out affairs.

Sometime in the first half of 1977, after interested parties have had an opportunity to make and respond to written submissions, an Administrative Law Judge is expected to commence hearings. Considering the broad scope of this proceeding, and a companion investigation (Ex Parte No. 308 (Sub.-No. 1), *Investigation of Common Carrier Pipelines*), it may be two years or so before the full Commission acts on the matter. While a plethora of revenue and expense items affecting pipeline tariffs and earnings will be addressed in the context of Ex Parte No. 308, such as the treatment of interest expense, depreciation, and capitalized interest for ratemaking purposes, the critical issues will boil down to what is a proper rate base and what is an appropriate return level on that base in view of the risk and economic/financial climate facing the pipeline industry today. Having reviewed the record of the WBPL proceeding in some detail, our best guess as to the final outcome on these key issues is that the ICC will: (1) retain the valuation rate base concept essentially intact; (2) reaffirm the cost-of-service ratemaking treatment outlined in Williams Brothers (particularly to the extent that the ICC becomes more politicized); and, (3) permit a higher return ceiling than the current 8% and 10% levels to properly reflect today's cost of capital.

It should be fairly obvious from the preceding discussion that any attempt to accurately forecast pipeline tariffs and earnings is fraught with major imponderables. While an endless number of permutations and combinations can be constructed as a means of defining sensitivities, in the end, a useful earnings estimate must rest on a limited number of possibilities. Thus, in developing our 1977-1980 North Slope earnings estimates, we used only two alternatives for deriving TAPS tariffs and pipeline earnings: (1) the traditional *Elkins Act* Consent Decree method, the basis on which the companies (with the possible exception of Amerada Hess) apparently intend to file, at least initially; and (2) the return on equity approach outlined by the ICC in the WBPL proceeding. These two cases can also be viewed as bracketing the eventual outcome.

Production Economics

In an attempt to systematically assess North Slope production economics, the authors have developed a generalized computer model that, based on certain data inputs and assumptions, generates a series of integrated unit profitability figures (the pipeline numbers are fed in by a separate computer sub-routine) linked to a number of potential end markets for Alaskan oil. The model provides the necessary profit data to construct earnings profiles for the North Slope producers followed by Wainwright Securities, and also yields other lesser benefits, such as an ability to analyze the discounted cash flow economics and distribution of oil revenues

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**More recently, in the context of a petition filed by the state with the ICC requesting an immediate prehearing conference on the issues of pipeline rates and the notification period required for filing initial tariffs (now 30 days), it became apparent that Alaska has also engaged the counsel who argued the protestants case in the WBPL proceeding.*

for the Prudhoe Bay field. In addition, the model facilitates rapid updating as the inevitable changes occur and/or better data becomes available.

Beyond this general introduction to our methodology for analyzing North Slope production economics, the following points more fully outline the manner in which such economics are determined and also provide a useful guide to the Tables presented in the body of the report and Appendix C for the various markets of destination under review.

Methodology for Derivation of Unit Producing Profits

(1) Markets of Destination. Although a number of other possibilities exist as regards ultimate movements of North Slope crude, our analysis is limited to Puget Sound, San Francisco, Los Angeles/Long Beach, Houston (a representative Gulf Coast port), Chicago (which also encompasses points along the Northern Tier), and Yokohama/Tokyo.

(2) Production. Based on currently proven reserves of 9.7 billion barrels of crude and condensate in the main (Sadlerochit) reservoir, a production profile has been plotted through the year 2005 which reflects guidance furnished by field operators as well as the State of Alaska. At an assumed MER level of 1.6 million b/d for the Prudhoe Bay Unit, output commences at a rate of 300,000 b/d in July 1977, building up to the 1.2 million b/d level towards year-end. Peak production of 1.6 million b/d is attained in the second half of 1980 and holds constant at that rate through 1986, after which a decline curve sets in. A separate analysis provides for development of 2 billion barrels of speculative reserves in the Kuparuk and Lisburne formations. Production from these more marginal reserves begins in 1982, reaching a peak rate of 380,000 b/d in 1985.

(3) Crude Oil Price. As discussed in the pricing section, two different cases are postulated. Case I assumes a world price for Prudhoe Bay crude tied to the landed value of 34° Saudi Arabian Light (less a 25¢/bbl. quality adjustment) in each market of destination (see Table 7 on page 25). Beyond mid-1977, the delivered cost of Saudi Light is escalated at an annual rate of 4.5%. (In light of a developing global shortage of petroleum, this assumption could be conservative, especially after 1985.) Case II assumes the price of Prudhoe Bay crude is set equal to the current upper tier price for a comparable grade of California crude oil (27° Signal Hill). In August 1977, after a lengthy hiatus, the currently frozen upper tier price of $9.91/bbl. for this crude is permitted to rise within the constraints set by the EPCA composite formula through May 1979. Thereafter, the price moves up at a 5% annual rate, essentially in line with that assumed for the delivered cost of Saudi Light.

(4) Marine Transportation. Except for the Houston market where two tanker movements are necessitated, the marine transportation figure reflects the cost of moving the oil from Valdez to one of the principal West Coast ports or Japan. Where an additional movement through the

Panama Canal to Houston occurs, the incremental cost from Long Beach to Houston is added to the Valdez-Long Beach base figure. A 3% annual escalation has been applied to the initial marine transportation values for each route to cover increases in variable costs.

(5) TAPS Liability Fund. To comply with Interior Department oil spill liability requirements, a cost of 5¢/bbl. will be assessed for each barrel of oil loaded onto tankers at Valdez until a $100 million fund has been built up.

(6) Pipeline Transportation. This category corresponds to the cost incurred in moving North Slope oil via lower-48 pipeline systems. For Houston, this entails Sohio's LATEX system from Long Beach-Midland and thence via connecting pipeline to Houston. The Chicago market is assumed to be served by the Trans Mountain pipeline running from the Puget Sound area to Edmonton, Alberta. From Edmonton, the oil is shipped through the Interprovincial and Lakehead systems to Chicago. The base values used for lower-48 pipeline movements escalate at a 1½% annual rate in subsequent years.

(7) Valdez Netback. Landed crude price minus marine transportation, TAPS Liability Fund, and lower-48 pipeline transportation.

(8) Wellhead Price. Valdez netback less TAPS tariff.

(9) Royalty. Royalty is calculated at 12½% of the wellhead value, payable either in cash (our assumption) or in kind. It appears that at least a portion of Alaska's royalty oil entitlement will be taken in kind to supply Energy Company of Alaska's new refinery near Fairbanks.

(10) Production Taxes. As discussed in the *Alaskan Taxation* section, production taxes for the Prudhoe Bay field are based on the Economic Limit Factor (ELF) concept contained in the Hammond Administration's recently submitted oil industry tax proposals. Thus, on the assumption of a base tax rate of 10%, the production taxes actually paid in a given year are determined as the greater of alternative cents-per-barrel and percent-of-value calculations.* The "floor" price for the cents-per-barrel minimum tax starts at $7.50 per barrel in 1977 and is escalated thereafter at an annual rate of 5% to reflect inflation. The product of the "floor" price times the base tax rate of 10% is then multiplied by ELF to arrive at the cents-per-barrel minimum tax. Based on inputs of annual production data and the number of wells estimated to be producing each year, an ELF series is computed over the life of the field which, when multiplied by the base tax rate of 10%, produces an effective percent-of-value tax rate to be applied each year. The percent-of-value tax is based on an economic limit for the field of 400 b/d per producing well.

**Under a system of early development incentive credits (EDIC), companies will receive, beginning in 1978, a credit against production tax liabilities for properties paying the ad valorem tax on reserves. The EDIC applicable against any future production taxes cannot exceed 50% of the severance tax on any one month's production. At a 50% rate, the state estimates that it will take roughly five years for the Prudhoe Bay field owners to recoup their $490 million of 1976-1977 reserves tax payments for the Sadlerochit formation.*

(11) Property Taxes. Unlike TAPS, combined State of Alaska and municipal property taxes of 2% of assessed value are based on the economic value of the field facilities using a 30-year depreciable life.* A 5% per annum inflation rate has been built into the determination of the economic value of the production facilities.

(12) Lifting Costs. Out-of-pocket operating costs for the main Prudhoe Bay field are estimated at $150 million (34¢ per barrel) for 1978. Thereafter, the base figure escalates by 5% per year. In 1981, $25 million is added to annual field operating costs reflecting startup of a field-wide water injection program. Once field output begins to decline, a provision is made for a tapering off of variable operating costs.

(13) Interest Charges. A flexible loan financing routine is incorporated into the computer model for the field, which permits the user to determine the percentage of total investment to be financed by debt as well as a schedule of borrowings and repayments. Interest expense is computed at a specified rate based on the average loan balance outstanding in a given year. Interest incurred prior to the start of production is capitalized with a provision for amortization over a 15-year period once production begins. Financing of capital expenditures (exclusive of Kuparuk and Lisburne development) incurred in the post-1977 period is assumed to be accomplished using cash flow. The following assumptions underlie the loan financing configuration used in this report:

(a) Interest rate -- 9%.

(b) Borrowings -- 40% of capital expenditures, with initial draw-down occurring in 1974.

(c) Repayments -- commence in the first full year of production (1978) and are spread equally over eight years.

(14) Depreciation, Depletion, and Amortization (DD&A). Starting with initial values for reserves and total capital investment in the oil rim area, the program computes a per barrel DD&A charge to be applied to production in the next period. Any reserve additions (depletion), or additional capital investments are added (subtracted) to the balance being carried for those categories and, accordingly, would be factored into the determination of a new per barrel charge in the succeeding period. Annual investment costs for the Prudhoe Bay field were taken

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**To the extent that a number of municipalities in Alaska may also levy and collect property taxes, such taxes may be claimed as a credit by the taxpayer against the 20 mill state tax on the same properties. A new complexity has been added lately by the North Slope Borough's imposition of a 10.3 mill assessment (which exceeds its permitted maximum of 7.38 mills), the net effect of which would be to effectively increase the total levy on North Slope exploration and production facilities to 23 mills. The companies are currently engaged in litigation seeking to determine the Burrough's authority to enact the new levy and the extent to which it may be credited against the state property tax.*

from a report submitted to the FEA by a consultant (Mortada) under a contract to determine an equitable pricing level for North Slope oil. In developing a capital cost figure for the oil rim area, and in the absence of an operating plan for the Unit on which to rely, the writers have arbitrarily allocated 75% of gas injection development costs (mainly the field fuel gas unit and the central gas compression plant) incurred through 1977 to oil production. Provision has also been made for book amortization of North Slope leasehold acquisition costs on the unit-of-production method over the life of the field. The amortization rate amounts to about 4¢/bbl.

(15) Income Taxes. State and Federal income tax liability is assessed at rates of 9.4% and 48%, respectively, on taxable earnings. State income taxes are deductible before computing Federal income tax liability.

(16) Company Interests. In the absence of a final owners' agreement for the Prudhoe Bay Unit, production interests in the oil rim area have been estimated as follows:

Company	% Interest in Oil Rim	Final
Sohio/BP	53.2%	53.155
Arco	20.5	20.213
Exxon	20.5	20.213
Mobil	2.1	6.299
Phillips	2.1	
Socal	0.8	
PLAGM	0.8	
	100.0%	

To illustrate the workings of Wainwright's Prudhoe Bay field profitability model, Tables 13 and 14 breakdown results for the Long Beach market for selected years.

(See Tables 13 and 14 on following pages)

Table 13

Prudhoe Bay Field -- Main (Sadlerochit) Reservoir
Derivation of Unit Producing Profits
Market of Destination -- L.A./Long Beach (a)

Case I: World Price

	1978		1979		1980		1985		1990	
Production Rate (millions of b/d)	1.20		1.20		1.42		1.60		1.27	
Landed Crude Price		$13.93		$14.55		$15.21		$18.95		$23.62
Marine Transportation		0.71		0.73		0.75		0.87		1.01
TAPS Liability Fund		0.05		0.05		0.05		0.00		0.00
Pipeline Transportation		0.00		0.00		0.00		0.00		0.00
Valdez Netback		13.17		13.77		14.40		18.08		22.60
TAPS Tariff		4.23		4.28		3.58		3.74		5.14
Wellhead Price		8.94		9.49		10.82		14.34		17.46
Royalty @ 12.5%	1.12		1.19		1.35		1.79		2.18	
Production Taxes	0.75		0.78		0.90		1.16		1.30	
Property Taxes	0.14		0.16		0.16		0.30		0.38	
Lifting Costs	0.34		0.36		0.32		0.41		0.62	
Interest Charges	0.22		0.20		0.14		0.03		0.03	
Depr., Depl., and Amort.	0.35		0.40		0.46		1.12		1.19	
Total Costs		2.92		3.09		3.34		4.82		5.71
Pretax Profit		6.02		6.40		7.49		9.52		11.76
Income Taxes										
- State @ 9.4%	0.57		0.60		0.70		0.90		1.11	
- Federal @ 48%	2.62		2.78		3.26		4.14		5.11	
Total Income Taxes		3.18		3.39		3.96		5.04		6.22
Net Profit		$ 2.84		$ 3.02		$ 3.53		$ 4.49		$ 5.54
TAPS Profit		0.56		0.60		0.43		0.72		1.25
Integrated Profit		$ 3.40		$ 3.62		$ 3.96		$ 5.21		$ 6.79

(a) Totals may not add due to rounding.

Table 14

Prudhoe Bay Field -- Main (Sadlerochit) Reservoir
Derivation of Unit Producing Profits
Market of Destination -- L.A./Long Beach (a)

Case II: Controlled Price

	1978		1979		1980		1985		1990	
Production Rate (millions of b/d)	1.20		1.20		1.42		1.60		1.27	
Landed Crude Price		$12.19		$13.17		$13.67		$17.45		$22.27
Marine Transportation		0.71		0.73		0.75		0.87		1.01
TAPS Liability Fund		0.05		0.05		0.05		0.00		0.00
Pipeline Transportation		0.00		0.00		0.00		0.00		0.00
Valdez Netback		11.43		12.39		12.87		16.58		21.26
TAPS Tariff		4.23		4.28		3.58		3.74		5.14
Wellhead Price		7.20		8.11		9.29		12.84		16.12
Royalty @ 12.5%	0.90		1.01		1.16		1.60		2.01	
Production Taxes	0.75		0.78		0.82		1.04		1.21	
Property Taxes	0.14		0.16		0.16		0.30		0.38	
Lifting Costs	0.34		0.36		0.32		0.41		0.62	
Interest Charges	0.22		0.20		0.14		0.03		0.03	
Depr., Depl., and Amort.	0.35		0.40		0.46		1.12		1.19	
Total Costs		2.70		2.91		3.07		4.51		5.44
Pretax Profit		4.50		5.20		6.22		8.33		10.68
Income Taxes										
- State @ 9.4%	0.42		0.49		0.58		0.78		1.00	
- Federal @ 48%	1.96		2.26		2.70		3.62		4.64	
Total Income Taxes		2.38		2.75		3.29		4.41		5.65
Net Profit		$ 2.12		$ 2.45		$ 2.93		$ 3.92		$ 5.03
TAPS Profit		0.56		0.60		0.43		0.72		1.25
Integrated Profit		$ 2.68		$ 3.05		$ 3.36		$ 4.64		$ 6.28

(a) Totals may not add due to rounding.

Similar presentations for the other markets of destination dealt with in this report are included as attachments in Appendix C. For ease of comparison, however, Table 15 provides a useful summary of how unit producing profits would compare by end market in 1980 under the different price cases.

Table 15

Unit Producing Profits by Market of Destination – 1980
($ Per barrel)

Market	Crude Oil Price	
	Case I	Case II
Japan	$3.32	–
Puget Sound	3.59	$3.02
San Francisco	3.51	2.88
L.A./Long Beach	3.53	2.93
Houston	3.10	2.35
Chicago	3.45	2.60

Case I: World price.
Case II: Controlled upper tier price.

North Slope Crude Oil Movements

Having developed projections for Prudhoe Bay unit producing profits in each of six principal refinery markets, the analysis next outlines a possible 1977-1980 marketing model for North Slope output. In it, the writers attempt to apportion each of the major companies' crude liftings among the markets. In the concluding section of this *Industry Review*, the marketing scenario we develop is superimposed on unit producing profits by market, thereby yielding a total production earnings figure for each company. Such figures properly reflect the varying per-barrel margins for the oil in the different markets in which it will ultimately be sold.

The starting point in the construction of the model is a definition of available West Coast refining capacity for processing crude oil with Prudhoe Bay-type characteristics. Based on the results of an FEA survey of the capability of West Coast refineries to run North Slope crude (see footnote on page 15) the indicated physical capacity available to process this oil in 1978 ranges from 601,000 b/d to 969,000 b/d. Using the mid-point of the range, or 785,000 b/d, plus an additional 20,000 b/d from debottlenecking of Exxon's Benicia refinery, the aggregate capacity is then broken down between Puget Sound, San Francisco, and L.A./Long Beach.* (To isolate the situation facing the major Prudhoe Bay reserve owners, production of the PLAGM group – which by our estimate will amount to only 0.8% of the total for the Prudhoe Bay Unit – has been proportionately allocated between the San Francisco and L.A./Long Beach markets, but is otherwise excluded from the analysis.) Next, each

Because the leadtime inherent in accomplishing a major refinery conversion project to permit the processing of North Slope crude will make meaningful amounts of new capacity potentially available only after 1980, the 805,000 b/d capacity level is assumed to remain constant during 1978-1980.

company's captive movements to the West Coast, either to its own refineries or to those of a non-affiliated refiner under a known contractual arrangement (i.e., Phillips' deal to move crude to its former Avon refinery, now owned by Toscopetro), are backed out of the total capacity figure for each market (adjusted for PLAGM) to derive the residual third party market.*

At this juncture, the writers assume that those companies still having oil to market will share the third-party market based on each one's percentage share of the remaining oil to be marketed. While this is the general approach followed, two external constraints have been imposed in an effort to make the analysis more realistic. The constraints are as follows: (1) Sohio obtains the entire third-party crude market in Puget Sound; and (2) owing to a limitation on vessel size in the Port of San Francisco, Atlantic Richfield makes no crude sales in that refinery market area. Using this methodology, the North Slope crude running capacity of Puget Sound, L.A./Long Beach, and San Francisco is successively utilized until a total of 805,000 b/d is placed on the West Coast.

Once the available West Coast market for North Slope crude has been fully satisfied, provision must then be made for disposing of the remaining surplus volumes elsewhere. Until 1979, when the first inland pipeline delivery system (Trans Mountain's yo-yo) is assumed to become operational, any crude volumes surplus to the needs of the West Coast are shipped through the Panama Canal via tanker to Houston. In 1978, some 395,000 b/d (split between Arco, Exxon, and Sohio) will be moved in this manner. With the availability of 165,000 b/d of capacity to move oil eastward in the yo-yo system, however, movements to the Northern Tier and on into the Chicago refinery center become a feasible alternative. Since the Valdez netback on pipeline shipments along the northern route exceeds that for Houston using tankers, the principle of profit maximization (which is the general rule we apply except where certain crude oil supply and/or investment commitments dictate otherwise) would presumably lead the Prudhoe Bay producers to opt for the Northern Tier/Chicago movements over those to Houston. Once again, individual company sales are determined according to percentage interests in the remaining surplus, with the one proviso that Exxon moves at least 30,000 b/d to its Billings refinery. The balance of any additional oil to be marketed is then shipped on to Houston by tanker.

In 1980, the assumed startup of Sohio's 500,000 b/d LATEX pipeline, together with Trans Mountain's adoption of a batch reversal configuration – which increases net eastward capacity to 350,000 b/d – results in an elimination of the necessity for tanker movements to Houston. Because of Sohio's substantial investment commitment to the LATEX pipeline system, in working with that company's 1980 marketing strategy for non-P.A.D. District V destinations, movements to Houston utilizing the pipeline are assumed to take precedence over those to the Northern Tier/Chicago area, a lower Valdez netback notwithstanding. The same general line of reasoning would apply to Exxon, which has recently elected to take a

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**The maximum volume and destination of captive movements as used in Table 16 are as follows: Atlantic Richfield-201,000 b/d (P.S.-96,000 b/d; L.A./L.B.-105,000 b/d; Exxon-95,000 b/d (all S.F.); Mobil-29,800 b/d (P.S.-25,200 b/d; L.A./L.B.-4,600 b/d); Phillips-29,800 b/d (all S.F.); Socal-11,300 b/d (all S.F.).*

20% interest in the pre-construction phase of the LATEX system as the first step towards possible full-fledged ownership in the project.

Table 16 presents Wainwright Securities' scenario for how North Slope crude oil movements might appear for 1977-1980 – and recognizes that the marketing model outlined above represents only a rough cut at what will probably become a very dynamic and complex situation. The analysis also shows the strong marketing position of Atlantic Richfield by virtue of its having some 200,000 b/d of captive West Coast movements, and the scope of the marketing challenge facing Sohio, which currently has no West Coast refining capacity. Given the investor concern surrounding the disposition of Sohio's North Slope crude, the conclusion emerging from Table 16 is that the task is manageable, albeit at some relative penalty to the company's production earnings.

(See Table 16 on following page)

Table 16

North Slope Crude Oil Movements (a)
(Barrels per day)

Company	Market	Puget Sound	San Francisco	L.A./Long Beach	Houston		Northern Tier/Chicago	Totals
					Tanker	Pipeline		
1977 (post-Labor Day)								
Arco		96,000	–	75,300	15,900	–	–	187,200
Exxon		–	111,800	38,800	36,700	–	–	187,200
Mobil		19,200	–	–	–	–	–	19,200
Phillips		–	19,200	–	–	–	–	19,200
Socal		–	7,300	–	–	–	–	7,300
Sohio		12,800	69,800	249,800	153,200	–	–	485,700
Totals		128,000	208,100	363,900	205,800	–	–	905,800
1978								
Arco		96,000	–	119,500	30,500	–	–	246,000
Exxon		–	127,000	48,700	70,300	–	–	246,000
Mobil		25,200	–	–	–	–	–	25,200
Phillips		–	25,200	–	–	–	–	25,200
Socal		–	9,600	–	–	–	–	9,600
Sohio		6,800	133,900	203,500	294,200	–	–	638,400
Totals		128,000	295,700	371,700	395,000	–	–	1,190,400
1979								
Arco		96,000	–	119,500	17,800	–	12,700	246,000
Exxon		–	127,000	48,700	40,300	–	30,000	246,000
Mobil		25,200	–	–	–	–	–	25,200
Phillips		–	25,200	–	–	–	–	25,200
Socal		–	9,600	–	–	–	–	9,600
Sohio		6,800	133,900	203,500	171,900	–	122,300	638,400
Totals		128,000	295,700	371,700	230,000	–	165,000	1,190,400
1980								
Arco		96,000	–	127,700	–	–	67,000	290,700
Exxon		–	128,000	49,500	–	67,200	46,000	290,700
Mobil		25,200	–	4,600	–	–	–	29,800
Phillips		–	29,800	–	–	–	–	29,800
Socal		–	11,300	–	–	–	–	11,300
Sohio		6,800	125,900	188,900	–	432,800	–	754,400
Totals		128,000	295,000	370,700	–	500,000	113,000	1,406,800

(a) *Totals may not add due to rounding*

Natural Gas

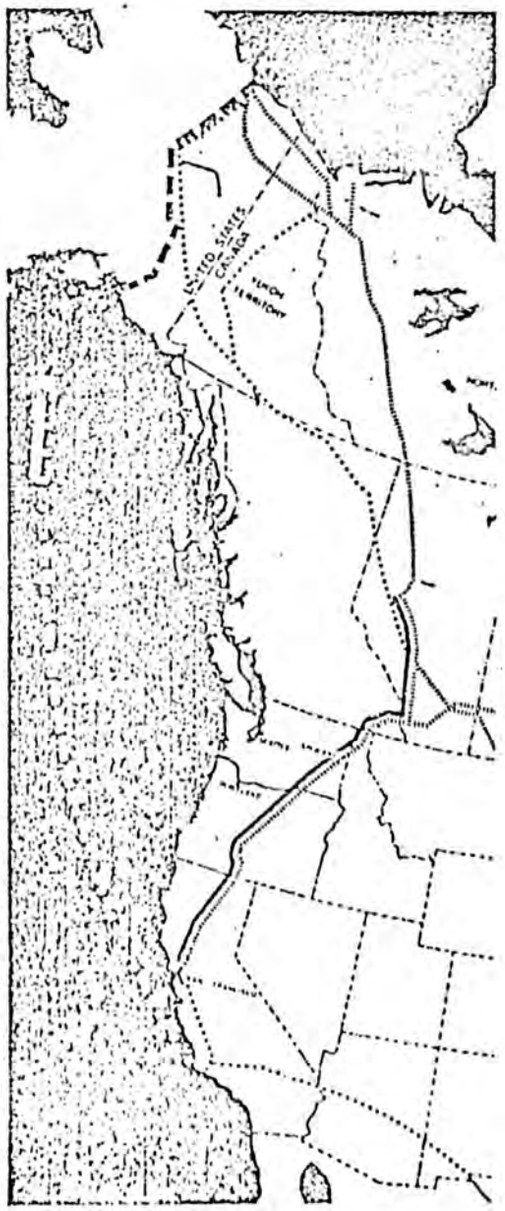
gas liquids?

In addition to the crude oil and condensate which will be flowing from the main Prudhoe Bay field, a significant quantity of natural gas will also be produced during the reservoir's life. In a rare show of unanimity, all parties submitting alternative proposals for transporting Prudhoe Bay gas have agreed that proved saleable gas reserves approximate 23 trillion cubic feet, or 10% of the total proved remaining U.S. reserves of natural gas. In view of the recent shortages of lower-48 gas supplies to meet peak needs, there will probably be ample political incentive to bring these reserves onstream. Nevertheless, there are a number of uncertainties that seriously hamper a comprehensive assessment of the economics of exploiting this resource, including: (1) the time production actually begins; (2) the wellhead price realizable by the producers; and (3) the quantity of gas, net of pressure maintenance requirements, that will be available for sale.

Conservation requirements

Basically, three alternatives have been put forward for transporting North Slope gas to market: (1) the Arctic Gas group's system to bring Prudhoe Bay and Mackenzie Delta gas across Canada and to tie into existing networks for both Midwest and West Coast consumers; (2) the El Paso Alaska Company's proposal to move the gas by a pipeline paralleling TAPS to the vicinity of Valdez and thence by LNG tanker to the West Coast; and (3) Alcan Pipeline Company's express pipeline scheme, which parallels TAPS to Fairbanks and then moves across Canada, tieing into existing capacity below Edmonton. These routes are shown on Map II. A detailed review of the merits of each of the competing proposals is beyond the scope of this analysis. Moreover, from the standpoint of the producing companies, who will be selling the resource at the wellhead, any attempt to predict the chosen mode of transportation is not especially useful at this stage, given the considerable uncertainty surrounding the cost estimates of each system and the realizable value of the resource in the final market in the early-to-mid-1980's when gas sales might begin. Suffice it to say, that the procedure now is in place for the appropriate governmental authorities to review these proposals and select the

MAP II



preferred alternative by late 1977.* On this basis, and allowing for some construction delays, gas sales would probably not begin until 1983 at the earliest.

As to the wellhead price for this gas, the very high transportation costs inherent in all three proposals** should tend to restrain the realizable wellhead value so that the gas can remain competitive with alternative fuels in its final markets. For example, Nahum Litt, the FPC's Administrative Law Judge responsible for reviewing the case for the Commission, recently indicated that if the wellhead price of Prudhoe gas is $1.00 per Mcf and incremental pricing is adopted (i.e., the cost of this gas is borne only by the direct beneficiaries of it), the average city gate price would be $2.41 per Mcf using unescalated cost data. Because such a city gate

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Under the Alaskan Natural Gas Transportation Act signed by former President Ford on October 22, 1976, the FPC is required to forward to the President its recommendation of the preferable route by May 1, 1977. At this point, an Administrative Law Judge has issued a preliminary finding in favor of the Arctic Gas proposal. However, in view of recent modifications in the Alcan proposal and the filing of additional information, the FPC has pledged a complete review of all alternatives prior to making its final recommendation to the President. In turn, upon review of FPC and other input, the President must forward his recommendation to Congress by September 1 (if necessary, this can be delayed to December 1). Congress then will have 60 days to approve or reject the Administration's proposal via a joint House-Senate resolution. If the route selected involves Canada, an expedited approval by this country would be sought under the U.S.-Canadian hydrocarbon pipeline treaty signed in January 1977. In a recent visit to the U.S., Premier Trudeau indicated that a timely decision could be expected.

**Based on unescalated 1975 data, the estimated transportation costs per million Btu's for the Arctic Gas, El Paso, and Alcan proposals will be $1.60, $2.15, and $1.91 per million Btu's, respectively.*

price would be so substantial, Litt recommended the adoption of rolled-in pricing to spread the cost over all customers of the pipelines receiving Arctic gas. On this basis, the average city gate price would be $1.50 per Mcf for a wellhead price of $1.00 per Mcf. Given the current questions concerning the preferred system, its final cost, and the likely regulatory treatment, these and other estimates of the wellhead price of Alaskan gas that could ultimately prevail remain highly uncertain. In any case, however, it seems unlikely that lower-48 wellhead pricing will apply to Prudhoe Bay gas.

As to the quantity of natural gas production which will be available for sale, the effect of such gas withdrawals on oil recovery is probably the most important consideration. Until oil production actually commences and more data becomes available on the performance of the gas cap as well as the aquifer, judgments in this area must remain rather theoretical. Nevertheless, in preparation for conducting its regulatory responsibilities involving Prudhoe Bay production, the State of Alaska, together with the petroleum engineering consulting firm of H. K. van Poollen and Associates, has developed a fairly sophisticated reservoir model. A series of simulations of various combinations of production modes has suggested that the reservoir's oil recovery factor may be sensitive to gas withdrawal rates in excess of 2 billion cubic feet daily.* While future performance could alter such a finding, at this stage, it currently seems to be the best estimate of the upper limit on gas available for sale vis-à-vis the potential impact of higher withdrawals on oil recovery.

**A total of 29 runs were conducted involving various combinations of (1) oil production at rates of 1.2-1.8 million b/d, (2) gas production at rates of 2-4 billion cf/d, and (3) the presence or absence of an aquifer to assist the reservoir drive. As an illustration of the potential sensitivity of oil recovery, these analyses indicated that whereas cumulative oil production might approximate 7.74 billion barrels under a production mode involving a natural aquifer, peak oil production of 1.6 million b/d, water injection of 2.0 million b/d after 4.75 years, and commencement of gas sales at 2 billion cf/d after 6.75 years, oil recovery could be impaired by 680 million barrels if these same conditions are maintained, adjusted for gas sales of 4.0 billion cf/d.*

Given the unresolved issues outlined above, it is not particularly useful to attempt to develop highly definitive earnings projections for natural gas at this time. Nevertheless, Table 17 presents a rough preliminary indication of the unit profitability that might be expected from gas sales in 1983.

Table 17

Potential Natural Gas Profits
(¢ Per Mcf)

Wellhead price		75.00¢		100.00¢
Royalty @ 12½%	9.38		12.50	
Severance tax @ 10%	6.56		8.75	
DD&A and lifting costs	17.57		17.57	
Total costs		33.51		38.82
Pretax income		41.49		61.18
Income taxes @ 52.9%		21.95		32.36
Net income		19.54¢		28.82¢

With gas sales of 2 billion cf/d, these unit margins would suggest total contributions to profits of $143 and $210 million for the respective cases of 75¢ and $1.00 per Mcf at the wellhead. As a final note, Table 18 shows an estimated breakdown of company ownership of the natural gas reserves in the Prudhoe Bay Unit. It should be noted that the various individual company interests differ meaningfully from the distribution of ownership in the oil rim area.

Table 18

Estimated Natural Gas Reserves
Main Prudhoe Bay Field
(Millions of cubic feet)

	Amount	Approximate % of Total
Arco	8,100	33.9% 42.12.4
Exxon	8,100	33.9 42.12.4
Mobil	230	1.0
Phillips	230	1.0
Standard Oil (Ohio)	7,100	29.7 14.818
Other (a)	140	0.5
	23,900	100.0%

(a) Includes Socal and the PLAGM group.

Company Earnings Profiles

Drawing on the analysis and conclusions of the previous sections, Tables 19 and 20 summarize 1977-1980 earnings prospects for the major Prudhoe Bay reserve owners. The projections are segmented by production, TAPS, and investment tax credits (ITC). Because of the unresolved nature of crude oil pricing and the TAPS tariff -- by far the most significant determinants of North Slope earnings -- two different pricing and tariff cases are presented in an attempt to bracket the likely range of possibilities in these key areas.

Table 19

North Slope Earnings
Modified ICC Basis Tariff Treatment -- 10% Return on Valuation
(In millions except per share)

	1977		1978		1979		1980	
	Case I	Case II	Case I	Case II	Case I	Case II	Case I	Case II
Arco								
Production	$ 49.8	$ 26.2	$249.5	$184.9	$267.4	$215.5	$374.7	$305.9
TAPS	--	--	51.5	51.5	55.0	55.0	47.0	47.0
ITC	132.9	132.9	--	--	20.8	20.8	26.1	26.1
Total	$182.7	$159.1	$301.0	$236.4	$343.2	$291.3	$447.8	$379.0
Per share	$1.58	$1.37	$2.60	$2.04	$2.96	$2.52	$3.87	$3.27
BP								
Equity in Sohio	$ 65.9	$ 37.0	$463.9	$387.6	$411.1	$332.1	$511.7	$418.3
Production	--	--	--	--	--	--	59.6	47.1
TAPS	--	--	38.8	38.8	41.5	41.5	35.4	35.4
ITC	--	--	19.8	19.8	21.1	21.1	18.1	18.1
Total	$ 65.9	$ 37.0	$522.5	$446.2	$473.7	$394.7	$624.8	$518.9
Per share	$0.17	$0.10	$1.35	$1.16	$1.23	$1.02	$1.62	$1.34
Exxon								
Production	$ 47.4	$ 22.9	$238.2	$170.0	$258.6	$201.6	$361.7	$288.8
TAPS	--	--	49.0	49.0	52.4	52.4	44.8	44.8
ITC	128.4	128.4	--	--	20.8	20.8	25.5	25.5
Total	$175.8	$151.3	$287.2	$219.0	$331.8	$274.8	$432.0	$359.1
Per share	$0.39	$0.34	$0.64	$0.49	$0.74	$0.61	$0.96	$0.80
Mobil								
Production	$ 5.2	$ 2.9	$ 26.6	$ 20.2	$ 28.2	$ 23.3	$ 39.0	$ 32.8
TAPS	--	--	12.3	12.3	13.1	13.1	11.2	11.2
ITC	26.4	26.4	--	--	2.1	2.1	4.5	4.5
Total	$ 31.6	$ 29.3	$ 38.9	$ 32.5	$ 43.4	$ 38.5	$ 54.7	$ 48.5
Per share	$0.30	$0.28	$0.37	$0.31	$0.41	$0.36	$0.52	$0.46

(Table 19 continued on following page)

Table 19
(Continued)

North Slope Earnings
Modified ICC Basis Tariff Treatment – 10% Return on Valuation
(In millions except per share)

	1977		1978		1979		1980	
	Case I	Case II	Case I	Case II	Case I	Case II	Case I	Case II
Phillips								
Production	$ 5.0	$ 2.6	$ 25.9	$ 19.1	$ 27.6	$ 22.1	$ 38.3	$ 31.4
TAPS	–	–	4.1	4.1	4.3	4.3	3.7	3.7
ITC	11.4	11.4	–	–	2.1	2.1	2.3	2.3
Total	$ 16.4	$ 14.0	$ 30.0	$ 23.2	$ 34.0	$ 28.5	$ 44.3	$ 37.4
Per share	$0.21	$0.18	$0.39	$0.30	$0.44	$0.37	$0.58	$0.49
Socal								
Production	$ 2.1	$ 1.1	$ 9.9	$ 7.3	$ 10.5	$ 8.4	$ 14.4	$ 11.8
TAPS	–	–	–	–	–	–	–	–
ITC	1.5	1.5	–	–	0.8	0.8	0.5	0.5
Total	$ 3.6	$ 2.6	$ 9.9	$ 7.3	$ 11.3	$ 9.2	$ 14.9	$ 12.3
Per share	$0.02	$0.02	$0.06	$0.04	$0.07	$0.05	$0.09	$0.07
Sohio								
Production	$119.2	$ 55.7	$593.5	$414.0	$652.4	$500.0	$843.7	$666.1
TAPS	–	–	81.7	81.7	87.3	87.3	74.6	74.6
ITC	99.1	66.9	220.4	252.6	53.9	53.9	54.6	54.6
Total	$218.3	$122.6	$895.6	$748.3	$793.6	$641.2	$972.9	$795.3
Per share	$5.34	$3.00	$14.88	$12.43	$13.16	$10.63	$15.90	$13.00

Case I: World price.
Case II: Upper tier controlled price.

Table 20

North Slope Earnings
Elkins Act Tariff Treatment – 7% Return on Valuation
(In millions except per share)

	1977		1978		1979		1980	
	Case I	Case II	Case I	Case II	Case I	Case II	Case I	Case II
Arco								
Production	$ 49.8	$ 26.2	$175.0	$109.9	$197.3	$145.1	$302.5	$230.0
TAPS	–	–	139.0	139.0	137.3	137.3	135.8	135.8
ITC	132.9	132.9	–	–	20.8	20.8	26.1	26.1
Total	$182.7	$159.1	$314.0	$248.9	$355.4	$303.2	$464.4	$391.9
Per share	$1.58	$1.37	$2.71	$2.15	$3.07	$2.62	$4.01	$3.38
BP								
Equity in Sohio	$ 65.9	$ 37.0	$435.3	$358.1	$383.7	$305.3	$491.6	$395.4
Production	–	–	–	–	–	–	47.1	34.2
TAPS	–	–	104.8	104.8	103.5	103.5	102.4	102.4
ITC	–	–	53.4	52.8	52.8	52.8	48.5	42.1
Total	$ 65.9	$ 37.0	$593.5	$515.7	$540.0	$461.6	$689.6	$574.1
Per share	$0.17	$0.10	$1.54	$1.34	$1.40	$1.20	$1.79	$1.49

(Table 20 continued on following page)

Table 20
(Continued)

North Slope Earnings
Elkins Act Tariff Treatment – 7% Return on Valuation
(In millions except per share)

	1977		1978		1979		1980	
	Case I	Case II	Case I	Case II	Case I	Case II	Case I	Case II
Exxon								
Production	$ 47.4	$ 22.9	$163.4	$ 94.5	$188.1	$131.3	$288.9	$213.0
TAPS	–	–	132.4	132.4	130.7	130.7	129.3	129.3
ITC	128.4	128.4	–	–	20.8	20.8	25.5	25.5
Total	$175.8	$151.3	$295.8	$226.9	$339.6	$282.8	$443.7	$367.8
Per share	$0.39	$0.34	$0.66	$0.51	$0.76	$0.63	$0.99	$0.82
Mobil								
Production	$ 5.2	$ 2.9	$ 19.0	$ 12.6	$ 21.2	$ 16.1	$ 31.6	$ 24.9
TAPS	–	–	33.1	33.1	32.7	32.7	32.3	32.3
ITC	26.4	26.4	–	–	2.1	2.1	4.5	4.5
Total	$ 31.6	$ 29.3	$ 52.1	$ 45.7	$ 56.0	$ 50.9	$ 68.4	$ 61.7
Per share	$0.30	$0.28	$0.49	$0.43	$0.53	$0.48	$0.65	$0.58
Phillips								
Production	$ 5.0	$ 2.6	$ 18.3	$ 11.4	$ 20.4	$ 14.9	$ 30.9	$ 23.7
TAPS	–	–	11.0	11.0	10.8	10.8	10.7	10.7
ITC	11.4	11.4	–	–	2.1	2.1	2.3	2.3
Total	$ 16.4	$ 14.0	$ 29.3	$ 22.4	$ 33.3	$ 27.8	$ 43.9	$ 36.7
Per share	$0.21	$0.18	$0.38	$0.29	$0.43	$0.36	$0.57	$0.48
Socal								
Production	$ 2.1	$ 1.1	$ 7.0	$ 4.3	$ 7.8	$ 5.7	$ 11.6	$ 8.9
TAPS	–	–	–	–	–	–	–	–
ITC	1.5	1.5	–	–	0.8	0.8	0.5	0.5
Total	$ 3.6	$ 2.6	$ 7.0	$ 4.3	$ 8.6	$ 6.5	$ 12.1	$ 9.4
Per share	$0.02	$0.02	$0.04	$0.03	$0.05	$0.04	$0.07	$0.06
Sohio								
Production	$119.2	$ 55.7	$399.3	$218.2	$468.9	$317.5	$664.4	$481.6
TAPS	–	–	220.6	220.6	217.9	217.9	215.6	215.6
ITC	99.1	66.9	220.4	252.6	53.9	53.9	54.6	54.6
Total	$218.3	$122.6	$840.3	$691.4	$740.7	$589.3	$934.6	$751.8
Per share	$5.34	$3.00	$13.96	$11.49	$12.28	$9.77	$15.27	$12.28

Case I: World price.
Case II: Upper tier controlled price.

While the Tables are fairly self-explanatory, several clarifying comments are in order. In developing our earnings projections for second-half 1977, we have assumed a cost-of-service (breakeven) tariff. Recognizing that the pipeline tariff is inversely correlated with pipeline throughput, shipper-owners of TAPS are likely to adopt a tariff strategy in the initial startup period of line operation partly designed to assuage (but certainly not eliminate) the State of Alaska's concern regarding the effect of an inordinately high initial tariff posting on its take at the wellhead. Passage of either of the two competing oil production tax proposals now

before the Alaskan legislature would further reinforce the desirability of preserving a "reasonable" wellhead value. Since production earnings will probably not be booked by the parent companies until the oil actually arrives on the West Coast, 1977 volumes must therefore be segregated between the amounts going into inventory and final sales. Allowing for inventory buildup and the voyage time required between Valdez and the West Coast, the writers assume that production earnings would not be reflected on a book basis until after Labor Day.

Appendix D shows the derivation of ITC benefits related to the Prudhoe Bay development project. Book ITC is taken into earnings the year it becomes available. However, for BP and Sohio, which are constrained during 1977 and 1978 by the statutory limit on ITC ($25,000 plus 50% of taxes payable), the accrued benefits are taken down as permitted by earnings. As the figures in Appendix D indicate, the absolute size and significant year-to-year fluctuations in ITC cannot be ignored in formulating overall earnings expectations for the big North Slope interest holders.

Besides production and TAPS, marine transportation is a third profit center in the integrated movement of North Slope oil to markets of destination. Lack of available information on tanker requirements, and the age, cost, and ownership characteristics of each company's vessels destined for the Alaskan trade precludes reliable forecasts of tanker profits by company. Nevertheless, based on our conversations with the companies, a 10¢-15¢ per barrel profit component probably will be included within the 70¢ per barrel tanker charge from Valdez-Long Beach on owned and long-term-chartered vessels. As a general observation, Atlantic Richfield seems to enjoy a superior marine transportation position relative to Exxon and Sohio, given its 100% coverage of requirements by owned and long-term-chartered vessels, together with the average size and construction cost of its fleet.

As alluded to earlier in the discussion of pipeline issues and economics, Sohio's current interest in TAPS will make the company a substantial net purchaser of pipeline transportation services once Prudhoe Bay output commences. As such, Sohio, unlike Arco and Exxon, would be relatively immune to an adverse earnings impact if a return on equity approach to ratemaking is ultimately applied to TAPS. As Tables 19 and 20 show, Sohio's total North Slope earnings are actually *higher* under the return on equity tariff treatment vis-á-vis the *Elkins Act*. However, two factors could tend to lessen any absolute advantage to be enjoyed by Sohio: (1) a possible increase in its interest in TAPS in any future realignment of company equities; and (2) compared to our composite case interest rate assumption of 9%, Sohio's somewhat higher cost of debt would tend to result in a higher pipeline tariff (and a lower wellhead price) and lower GAAP pipeline earnings than our analysis would indicate. On the other hand, because of a lower-than-average cost of debt, the earnings penalty ascribable to Arco and Exxon under the modified ICC basis tariff treatment may be slightly overstated.

Beyond 1980, North Slope earnings should continue to expand, reflecting full-year attainment of peak production of 1.6 million b/d from the main (Sadlerochit) reservoir in 1981, the likelihood of further price increases, development of Kuparuk and Lisburne reserves, and 1983 startup of natural gas production. Arco and Exxon will be the main beneficiaries of natural gas production, whereas Arco and BP, based on their sizable acreage holdings (particularly in the Kuparuk trend west of Prudhoe Bay), should garner the bulk of any eventual Kuparuk and Lisburne production. Appendix F provides some preliminary profit projections for the Kuparuk and Lisburne formations. Although the unit profitability

numbers are far lower than those for the main Prudhoe Bay field, development of these currently marginal reserves, by increasing pipeline throughput, will enhance the economics of other North Slope production.

Granted, this *Industry Review* has detailed many of the uncertainties affecting the realization of North Slope earnings. On the positive side, the uniqueness of long-lived Prudhoe Bay reserves cannot be emphasized enough in today's industry environment. With most companies facing the difficult task of replacing depleted low-cost reserves, access to substantial North Slope reserves affords the luxury of a stable underlying basic cash flow on which to launch *new* corporate investments for future growth.

WAINWRIGHT SECURITIES INC.
Paul R. Leibman
Thomas A. Petrie

Computer Applications
Richard C. Marks

(See Appendices on following pages)

APPENDIX A

WEST COAST SUPPLY/DEMAND -- BACKGROUND DATA

Projected P.A.D. District V Product Demand
(In millions of b/d)

	1977	1978	1979	1980	1981	1982	1983	1984	1985
FEA				2.4		2.6			3.0
Arco		2.7				3.1			
Exxon	2.4	2.6	2.8	2.9	3.0	3.0	3.1	3.2	3.3
Kitimat (Ashland)	–	–	–	–	–	–	–	–	–
Sohio (Pace)	2.8			3.2	2.9	2.9			3.2
Socal	2.5	2.6	2.7	2.7	2.8				3.2

Projected Refining Throughput P.A.D. District V
(In millions of b/d)

	1977	1978	1979	1980	1981	1982	1983	1984	1985
FEA	2.1			2.3					
Arco									
Exxon	2.5	2.6	2.6	2.6	2.6	2.7	2.9	3.1	3.2
Kitimat (Ashland)	2.5	2.6	2.6	2.6	2.7	2.8	2.8	2.9	2.9
Sohio (Pace)		2.4		2.5					
Socal		2.6		2.6					

Projected West Coast (P.A.D. District V) Production Other than North Slope
(In millions of b/d)

	1977	1978	1979	1980	1981	1982	1983	1984	1985
FEA		1.2		1.3					1.7
Arco	1.0	1.0	1.0	0.9	1.0	1.0	1.1	1.4	1.6
Exxon	1.1	1.1	1.2	1.2	1.2	1.3			
Kitimat (Ashland)	1.1	1.2	1.2	1.3	1.3	1.4	1.4	1.4	1.4
Sohio (Pace)		1.2-1.4		1.4		1.3			
Socal		1.0		1.1					

Projected Imports of Crude Oil Into P.A.D. District V
(In millions of b/d)

	1977	1978	1979	1980	1981	1982	1983	1984	1985
FEA									
High case	0.6	0.5		0.5		0.5			
Low case	0.6	0.5		0.3		0.3			
FPC		0.6				0.5			
Exxon	0.8	0.6	0.5	0.6	0.5	0.5	0.4	0.3	0

(See Appendix B on following pages)

APPENDIX B

DCF Economics – TAPS (a)
(In millions)

	Operating Revenues	Operating Costs	Property Taxes	Income Taxes		Capital Expenditures	Borrowings	Repayments	Net Cash Flow (c)
				State	Federal (b)				
1969						$ 35			($ 35)
1970						180			(180)
1971						109			(109)
1972						49			(49)
1973						47			(47)
1974					($ 46)	857	$1,247		(811)
1975					(200)	2,772	2,813		(2,572)
1976					(406)	2,698	2,958		(2,292)
1977	$ 583	$ 75			(620)	953	1,082	$ 159	175
1978	1,854	175	$ 146		(16)	200	180	318	1,349
1979	1,874	184	149		(49)	400	360	318	1,190
1980	1,856	213	147		(120)	100	90	318	1,516
1981	2,076	224	150	$ 16	42	400	360	318	1,244
1982	2,155	250	145	30	138			318	1,592
1983	2,188	262	139	41	188			350	1,558
1984	2,228	275	133	53	243			368	1,524
1985	2,273	289	128	65	299			369	1,492
1986	2,319	304	122	77	356			368	1,460
1987	2,362	316	117	89	413			369	1,427
1988	2,405	326	111	102	470			368	1,396
1989	2,450	336	106	114	528			369	1,366
1990	2,499	347	100	127	588			368	1,337
1991	2,550	358	95	140	648			369	1,309
1992	2,613	376	89	154	711			368	1,283
1993	2,678	394	83	167	774			369	1,260
1994	2,748	414	78	181	839			368	1,236
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]	[illegible]
1996	2,894	457	67	205	927			368	1,230
1997	2,970	479	61	211	977			369	1,242
1998	3,049	503	56	220	1,018			368	1,252
1999	3,131	528	50	229	1,060			369	1,264
2000	3,214	554	45	238	1,102			368	1,275
2001	3,301	582	39	247	1,144			369	1,289
2002	3,390	611	33	257	1,187			358	1,302
2003	3,405	642	28	257	1,190				1,288
2004	3,462	674	22	260	1,203				1,303
2005	3,521	708	17	263	1,216				1,317
Totals	$74,868	$11,291	$2,528	$3,935	$16,712	$8,800	$9,090	$9,090	$31,602

(a) 1977=100.

(b) Tax benefits accruing to the TAPS owners from investment tax credits and expensing of interest incurred during construction are reflected as a reduction in Federal income tax liability in the appropriate year.

(c) Excludes borrowings and repayments.

(Appendix B continued on following page)

APPENDIX B
(Continued)

DCF Economics – Prudhoe Bay Field (a)
(In millions)

	Oil Revenues	Lifting Costs	Royalty	Production Taxes	Property Taxes	Income Taxes		Capital and Exploratory Expenditures	Borrowings	Repayments	Net Cash Flow (c)		
						State	Federal (b)				Oil	Natural Gas (d)	Combined
1959								$ 2			($ 2)		($ 2)
1960								1			(1)		(1)
1961								1			(1)		(1)
1962							($ 1)	8			(7)		(7)
1963							(4)	18			(14)		(14)
1964							(12)	31			(19)		(19)
1965							(7)	26			(19)		(19)
1966							(3)	7			(4)		(4)
1967							(4)	12			(8)		(8)
1968							(5)	14			(9)		(9)
1969							(23)	418			(395)		(395)
1970							(21)	90			(69)		(69)
1971							(11)	51			(40)		(40)
1972							(4)	23			(19)		(19)
1973							(3)	27			(24)		(24)
1974							(12)	157	$139		(145)		(145)
1975							(58)	781	292		(723)		(723)
1976					$220		(261)	1,215	462		(1,174)		(1,174)
1977	$ 982	$ 91	$ 123	$ 43	270	$ 33	(130)	799	108		(247)		(247)
1978	3,916	149	490	165	61	230	1,029	545		$125	1,247		1,247
1979	4,157	158	520	171	70	245	1,031	549		125	1,413		1,413
1980	5,608	166	701	355	83	340	1,513	748		125	1,702		1,702
1981	6,734	196	842	561	105	403	1,867	1,087		125	1,673		1,673
1982	7,142	210	893	590	123	421	1,947	1,074		125	1,884		1,884
1983	7,539	222	942	619	146	440	2,038	1,131		125	2,001	$268	2,269
1984	7,948	228	994	648	164	468	2,165	1,075		125	2,206	294	2,500
1975	8,375	239	1,047	677	175	505	2,336	587		126	2,809	336	3,145
1986	8,813	251	1,102	707	175	552	2,555				3,471	362	3,833
1987	8,847	259	1,106	703	174	566	2,619				3,420	369	3,789
1988	8,573	268	1,072	668	179	556	2,575				3,255	376	3,631
1989	8,318	276	1,040	636	177	548	2,538				3,103	417	3,520
1990	8,094	287	1,012	603	176	539	2,496				2,981	392	3,373

(Appendix B continued on following page)

APPENDIX B
(Continued)

DCF Economics – Prudhoe Bay Field (a)
(In millions)

	Oil Revenues	Lifting Costs	Royalty	Production Taxes	Property Taxes	Income Taxes State	Income Taxes Federal (b)	Capital and Exploratory Expenditures	Borrowings	Repayments	Net Cash Flow (c) Oil	Net Cash Flow (c) Natural Gas (d)	Net Cash Flow (c) Combined
1991	$ 7,849	$ 295	$ 981	$ 573	$ 174	$ 528	$ 2,445				$ 2,853	$ 401	$ 3,244
1992	7,077	302	885	499	171	477	2,209				2,534	411	2,945
1993	6,421	308	803	434	170	434	2,009				2,263	392	2,655
1994	5,834	319	729	377	166	394	1,825				2,024	373	2,397
1995	5,326	330	666	325	161	359	1,662				1,823	356	2,179
1996	4,835	342	604	284	156	323	1,495				1,631	308	1,939
1997	4,457	354	557	250	150	295	1,365				1,486	331	1,817
1998	4,027	367	503	212	143	263	1,216				1,323	321	1,644
1999	3,541	381	431	170	135	227	1,052				1,145	272	1,417
2000	3,100	396	388	131	127	193	893				972	260	1,232
2001	2,821	413	353	107	117	172	795				864	249	1,113
2002	2,508	431	314	80	104	148	686				745	237	982
2003	2,286	451	286	60	92	131	606				660	224	884
2004	2,024	470	253	31	77	111	515				561	212	773
2005	1,864	492	233	14	67	98	455				495	201	696
Totals	$159,016	$8,651	$19,870	$10,739	$4,308	$9,999	$45,378	$10,477	$1,001	$1,001	$49,624	$7,362	$56,986

(a) 1977=100.

(b) In addition to investment tax credits, tax benefits accruing to the North Slope producers from expensing of intangibles, interest incurred during construction, and the ad valorem tax on in-place oil and gas reserves are reflected as a reduction in Federal income tax liability in the eppropriate year.

(c) Excludes borrowings and repayments.

(d) Whereas a separate cash flow analysis was performed for natural gas, for ease of presentation, natural gas is shown each year as a net cash flow amount.

DCF Rates of Return:

TAPS	10.6%
Prudhoe Bay	19.1
Combined	15.7

(See Appendix C on following pages)

Appendix C

Prudhoe Bay Field -- Main (Sadlerochit) Reservoir
Derivation of Unit Producing Profits
Market of Destination -- Japan (a)

Case 1: World Price

	1978		1979		1980		1985		1990	
Production Rate (millions of b/d)	1.20		1.20		1.42		1.60		1.27	
Landed Crude Price		$13.13		$13.72		$14.34		$17.87		$22.27
Marine Transportation		0.41		0.42		0.43		0.50		0.58
TAPS Liability Fund		0.05		0.05		0.05		0.00		0.00
Pipeline Transportation		0.00		0.00		0.00		0.00		0.00
Valdez Netback		12.68		13.25		13.86		17.37		21.69
TAPS Tariff		4.23		4.28		3.58		3.74		5.14
Wellhead Price		8.45		8.97		10.28		13.63		16.55
Royalty @ 12.5%	1.06		1.12		1.28		1.70		2.07	
Production Taxes	0.75		0.78		0.85		1.10		1.24	
Property Taxes	0.14		0.16		0.16		0.30		0.38	
Lifting Costs	0.34		0.36		0.32		0.41		0.62	
Interest Charges	0.22		0.20		0.14		0.03		0.03	
Depr., Depl., and Amort.	0.35		0.40		0.46		1.12		1.19	
Total Costs		2.86		3.02		3.22		4.67		5.52
Pretax Profit		5.59		5.95		7.05		8.96		11.03
Income Taxes										
- State @ 9.4%	0.53		0.56		0.66		0.84		1.04	
- Federal @ 48%	2.43		2.59		3.07		3.90		4.80	
Total Income Taxes		2.96		3.15		3.73		4.74		5.83
Net Profit		$ 2.63		$ 2.80		$ 3.32		$ 4.22		$ 5.20
TAPS Profit		0.56		0.60		0.43		0.72		1.25
Integrated Profit		$ 3.19		$ 3.40		$ 3.75		$ 4.94		$ 6.45

(a) Totals may not add due to rounding.

(Appendix C continued on following pages)

Appendix C (con't)

Prudhoe Bay Field -- Main (Sadlerochit) Reservoir
Derivation of Unit Producing Profits
Market of Destination -- Puget Sound (a)

Case I: World Price

	1978		1979		1980		1985		1990	
Production Rate (millions of b/d)	1.20		1.20		1.42		1.60		1.27	
Landed Crude Price		$13.87		$14.50		$15.15		$18.88		$23.53
Marine Transportation		0.51		0.52		0.54		0.62		0.72
TAPS Liability Fund		0.05		0.05		0.05		0.00		0.00
Pipeline Transportation		0.00		0.00		0.00		0.00		0.00
Valdez Netback		13.32		13.93		14.56		18.26		22.80
TAPS Tariff		4.23		4.28		3.58		3.74		5.14
Wellhead Price		9.09		9.65		10.98		14.52		17.66
Royalty @ 12.5%	1.14		1.21		1.37		1.81		2.21	
Production Taxes	0.76		0.80		0.91		1.18		1.32	
Property Taxes	0.14		0.16		0.16		0.30		0.38	
Lifting Costs	0.34		0.36		0.32		0.41		0.62	
Interest Charges	0.22		0.20		0.14		0.03		0.03	
Depr., Depl., and Amort.	0.35		0.40		0.46		1.12		1.19	
Total Costs		2.94		3.12		3.17		4.85		5.75
Pretax Profit		6.14		6.52		7.81		9.66		11.92
Income Taxes										
- State @ 9.4%	0.58		0.61		0.72		0.91		1.12	
- Federal @ 48%	2.67		2.84		3.31		4.20		5.18	
Total Income Taxes		3.25		3.45		4.03		5.11		6.30
Net Profit		$ 2.89		$ 3.07		$ 3.59		$ 4.55		$ 5.62
TAPS Profit		0.56		0.60		0.43		0.72		1.25
Integrated Profit		$ 3.45		$ 3.67		$ 4.02		$ 5.27		$ 6.87

(a) Totals may not add due to rounding.

Appendix C (con't)

Prudhoe Bay Field -- Main (Sadlerochit) Reservoir
Derivation of Unit Producing Profits
Market of Destination -- Puget Sound (a)

Case II: Controlled Price

	1978	1979	1980	1985	1990
Production Rate (millions of b/d)	1.20	1.20	1.42	1.60	1.27
Landed Crude Price	$12.19	$13.17	$13.67	$17.45	$22.27
Marine Transportation	0.51	0.52	0.54	0.62	0.72
TAPS Liability Fund	0.05	0.05	0.05	0.00	0.00
Pipeline Transportation	0.00	0.00	0.00	0.00	0.00
Valdez Netback	11.63	12.60	13.08	16.83	21.55
TAPS Tariff	4.23	4.28	3.58	3.74	5.14
Wellhead Price	7.40	8.32	9.50	13.09	16.41
Royalty @ 12.5%	0.93	1.04	1.19	1.64	2.05
Production Taxes	0.75	0.78	0.82	1.06	1.22
Property Taxes	0.14	0.16	0.16	0.30	0.38
Lifting Costs	0.34	0.36	0.32	0.41	0.62
Interest Charges	0.22	0.20	0.14	0.03	0.03
Depr., Depl., and Amort.	0.35	0.40	0.46	1.12	1.19
Total Costs	2.72	2.94	3.10	4.56	5.49
Pretax Profit	4.68	5.38	6.40	8.53	10.91
Income Taxes					
- State @ 9.4%	0.44	0.51	0.60	0.80	1.01
- Federal @ 48%	2.03	2.34	2.79	3.71	4.75
Total Income Taxes	2.47	2.84	3.39	4.51	5.77
Net Profit	$ 2.20	$ 2.53	$ 3.02	$ 4.02	$ 5.14
TAPS Profit	0.56	0.60	0.43	0.72	1.25
Integrated Profit	$ 2.76	$ 3.13	$ 3.45	$ 4.74	$ 6.39

(a) Totals may not add due to rounding.

Appendix C (con't)

Prudhoe Bay Field -- Main (Sadlerochit) Reservoir
Derivation of Unit Producing Profits
Market of Destination -- San Francisco (a)

Case 1: World Price

	1978		1979		1980		1985		1990	
Production Rate (millions of b/d)	1.20		1.20		1.42		1.60		1.27	
Landed Crude Price		$13.99		$14.62		$15.28		$19.04		$23.72
Marine Transportation		0.81		0.84		0.86		1.00		1.16
TAPS Liability Fund		0.05		0.05		0.09		0.00		0.00
Pipeline Transportation		0.00		0.00		0.00		0.00		0.00
Valdez Netback		13.13		13.73		14.36		18.04		22.57
TAPS Tariff		4.23		4.28		3.58		3.74		5.14
Wellhead Price		8.90		9.45		10.78		14.30		17.43
Royalty @ 12.5%	1.11		1.18		1.35		1.79		2.18	
Production Taxes	0.75		0.78		0.89		1.16		1.10	
Property Taxes	0.14		0.16		0.16		0.30		0.38	
Lifting Costs	0.34		0.36		0.32		0.41		0.62	
Interest Charges	0.22		0.20		0.14		0.03		0.03	
Depr., Depl., and Amort.	0.35		0.40		0.46		1.12		1.19	
Total Costs		2.91		3.08		3.33		4.81		5.70
Pretax Profit		5.99		6.37		7.46		9.49		11.73
Income Taxes										
- State @ 9.4%	0.56		0.60		0.70		0.89		1.10	
- Federal @ 48%	2.60		2.77		3.24		4.13		5.10	
Total Income Taxes		3.17		3.37		3.94		5.02		6.20
Net Profit		$ 2.82		$ 3.00		$ 3.51		$ 4.47		$ 5.53
TAPS Profit		0.56		0.60		0.43		0.72		1.25
Integrated Profit		$ 3.38		$ 3.60		$ 3.94		$ 5.19		$ 6.78

(a) Totals may not add due to rounding.

Appendix C (con't)

Prudhoe Bay Field -- Main (Sadlerochit) Reservoir
Derivation of Unit Producing Profits
Market of Destination -- San Francisco (a)
Case II: Controlled Price

	1978	1979	1980	1985	1990
Production Rate (millions of b/d)	1.20	1.20	1.42	1.60	1.27
Landed Crude Price	$12.19	$13.17	$13.67	$17.45	$22.27
Marine Transportation	0.81	0.84	0.86	1.00	1.16
TAPS Liability Fund	0.05	0.05	0.05	0.00	0.00
Pipeline Transportation	0.00	0.00	0.00	0.00	0.00
Valdez Netback	11.33	12.28	12.76	16.45	21.11
TAPS Tariff	4.23	4.28	3.58	3.74	5.14
Wellhead Price	7.10	8.00	9.18	12.71	15.97
Royalty @ 12.5%	0.89	1.00	1.15	1.59	2.00
Production Taxes	0.75	0.78	0.82	1.03	1.21
Property Taxes	0.14	0.16	0.16	0.30	0.38
Lifting Costs	0.34	0.36	0.32	0.41	0.62
Interest Charges	0.22	0.20	0.14	0.03	0.03
Depr., Depl., and Amort.	0.35	0.40	0.46	1.12	1.19
Total Costs	2.69	2.90	3.06	4.48	5.42
Pretax Profit	4.41	5.10	6.12	8.23	10.55
Income Taxes					
- State @ 9.4%	0.41	0.48	0.58	0.77	0.99
- Federal @ 48%	1.92	2.22	2.66	3.58	4.59
Total Income Taxes	2.33	2.70	3.24	4.35	5.58
Net Profit	$ 2.08	$ 2.40	$ 2.88	$ 3.88	$ 4.97
TAPS Profit	0.56	0.60	0.43	0.72	1.25
Integrated Profit	$ 2.64	$ 3.00	$ 3.31	$ 4.60	$ 6.22

(a) Totals may not add due to rounding.

Appendix C (con't)

Prudhoe Bay Field -- Main (Sadlerochit) Reservoir
Derivation of Unit Producing Profits
Market of Destination -- Houston (a)

Case I: World Price

	1978	1979	1980	1985	1990
Production Rate (millions of b/d)	1.20	1.20	1.42	1.60	1.27
Landed Crude Price	$14.19	$14.83	$15.49	$19.31	$24.06
Marine Transportation	2.49	2.56	0.75	0.87	1.01
TAPS Liability Fund	0.05	0.05	0.05	0.00	0.00
Pipeline Transportation	0.00	0.00	1.40	1.51	1.63
Valdez Netback	11.65	12.21	13.29	16.92	21.42
TAPS Tariff	4.23	4.28	3.58	3.74	5.14
Wellhead Price	7.42	7.93	9.71	13.18	16.28
Royalty @ 12.5%	0.93	0.99	1.21	1.65	2.04
Production Taxes	0.75	0.78	0.82	1.07	1.22
Property Taxes	0.14	0.16	0.16	0.30	0.38
Lifting Costs	0.34	0.36	0.32	0.41	0.62
Interest Charges	0.22	0.20	0.14	0.07	0.03
Depr., Depl., and Amort.	0.35	0.40	0.46	1.14	1.19
Total Costs	2.73	2.89	3.12	4.58	5.47
Pretax Profit	4.69	5.04	6.58	8.61	10.81
Income Taxes					
- State @ 9.4%	0.44	0.47	0.62	0.81	1.02
- Federal @ 48%	2.04	2.19	2.86	3.74	4.70
Total Income Taxes	2.48	2.67	3.48	4.55	5.72
Net Profit	$ 2.21	$ 2.38	$ 3.10	$ 4.05	$ 5.09
TAPS Profit	0.56	0.60	0.43	0.72	1.25
Integrated Profit	$ 2.77	$ 2.98	$ 3.53	$ 4.77	$ 6.34

(a) Totals may not add due to rounding.

Prudhoe Bay Field -- Main (Sadlerochit) Reservoir
Derivation of Unit Producing Profits
Market of Destination -- Houston (a)

Case II: Controlled Price

	1978		1979		1980		1985		1990	
Production Rate (millions of b/d)	1.20		1.20		1.42		1.60		1.27	
Landed Crude Price		$12.19		$13.17		$13.67		$17.45		$22.27
Marine Transportation		2.49		2.56		0.75		0.87		1.01
TAPS Liability Fund		0.05		0.05		0.05		0.00		0.00
Pipeline Transportation		0.00		0.00		1.40		1.51		1.63
Valdez Netback		9.65		10.56		11.46		15.07		19.63
TAPS Tariff		4.23		4.28		3.58		3.74		5.14
Wellhead Price		5.42		6.28		7.88		11.33		14.49
Royalty @ 12.5%	0.68		0.78		0.99		1.42		1.81	
Production Taxes	0.75		0.78		0.82		1.03		1.21	
Property Taxes	0.14		0.16		0.16		0.30		0.38	
Lifting Costs	0.34		0.36		0.32		0.41		0.62	
Interest Charges	0.22		0.20		0.14		0.03		0.03	
Depr., Depl., and Amort.	0.35		0.40		0.46		1.12		1.19	
Total Costs		2.48		2.68		2.90		4.30		5.24
Pretax Profit		2.95		3.59		4.99		7.02		9.25
Income Taxes										
- State @ 9.4%	0.28		0.34		0.47		0.66		0.87	
- Federal @ 48%	1.28		1.56		2.17		3.05		4.02	
Total Income Taxes		1.56		1.90		2.64		3.71		4.89
Net Profit		$ 1.39		$ 1.69		$ 2.35		$ 3.31		$ 4.36
TAPS Profit		0.56		0.60		0.43		0.72		1.25
Integrated Profit		$ 1.95		$ 2.29		$ 2.78		$ 4.03		$ 5.61

(a) Totals may not add due to rounding.

Appendix C (con't)

Prudhoe Bay Field -- Main (Sadlerochit) Reservoir
Derivation of Unit Producing Profits
Market of Destination -- Chicago (a)

Case I: World Price

	1978		1979		1980		1985		1990	
Production Rate (millions of b/d)	1.20		1.20		1.42		1.60		1.27	
Landed Crude Price		$14.47		$15.12		$15.80		$19.69		$24.54
Marine Transportation		0.51		0.52		0.54		0.62		0.72
TAPS Liability Fund		0.05		0.05		0.05		0.00		0.00
Pipeline Transportation		1.32		1.34		1.02		1.10		1.18
Valdez Netback		12.59		13.21		14.20		17.97		22.63
TAPS Tariff		4.23		4.28		3.58		3.74		5.14
Wellhead Price		8.36		8.93		10.62		14.23		17.49
Royalty @ 12.5%	1.05		1.12		1.33		1.78		2.19	
Production Taxes	0.75		0.78		0.88		1.15		1.31	
Property Taxes	0.14		0.16		0.16		0.30		0.38	
Lifting Costs	0.34		0.36		0.32		0.41		0.62	
Interest Charges	0.22		0.20		0.14		0.03		0.03	
Depr., Depl., and Amort.	0.35		0.40		0.46		1.12		1.19	
Total Costs		2.84		3.01		3.29		4.29		5.71
Pretax Profit		5.52		5.91		7.32		9.44		11.78
Income Taxes										
- State @ 9.4%	0.52		0.56		0.69		0.89		1.11	
- Federal @ 48%	2.40		2.57		3.18		4.10		5.12	
Total Income Taxes		2.92		3.13		3.87		4.99		6.23
Net Profit		$ 2.60		$ 2.79		$ 3.45		$ 4.45		$ 5.55
TAPS Profit		0.56		0.60		0.43		0.72		1.25
Integrated Profit		$ 3.16		$ 3.39		$ 3.88		$ 5.17		$ 6.80

(a) Totals may not add due to rounding.

Appendix C (con't)

Prudhoe Bay Field -- Main (Sadlerochit) Reservoir
Derivation of Unit Producing Profits
Market of Destination -- Chicago (a)

Case II: Controlled Price

	1978	1979	1980	1985	1990
Production Rate (millions of b/d)	1.20	1.20	1.42	1.60	1.27
Landed Crude Price	$12.19	$13.17	$13.67	$17.45	$22.27
Marine Transportation	0.51	0.52	0.54	0.62	0.72
TAPS Liability Fund	0.05	0.05	0.05	0.00	0.00
Pipeline Transportation	1.32	1.34	1.02	1.10	1.18
Valdez Netback	10.31	11.26	12.06	15.73	20.37
TAPS Tariff	4.23	4.28	3.58	3.74	5.14
Wellhead Price	6.08	6.98	8.48	11.99	15.23
Royalty @ 12.5%	0.76	0.87	1.06	1.50	1.90
Production Taxes	0.75	0.78	0.82	1.03	1.21
Property Taxes	0.14	0.16	0.16	0.30	0.38
Lifting Costs	0.34	0.36	0.32	0.41	0.82
Interest Charges	0.22	0.20	0.14	0.03	0.03
Depr., Depl., and Amort.	0.35	0.40	0.46	1.12	1.19
Total Costs	2.56	2.77	2.97	4.39	5.33
Pretax Profit	3.52	4.21	5.51	7.60	9.90
Income Taxes					
- State @ 9.4%	0.33	0.40	0.52	0.71	0.93
- Federal @ 48%	1.53	1.83	2.40	3.31	4.30
Total Income Taxes	1.86	2.22	2.92	4.02	5.23
Net Profit	$ 1.66	$ 1.98	$ 2.60	$ 3.58	$ 4.66
TAPS Profit	0.56	0.60	0.43	0.72	1.25
Integrated Profit	$ 2.22	$ 2.58	$ 3.03	$ 4.30	$ 5.91

(a) Totals may not add due to rounding.

(See Appendix D on following page)

APPENDIX D

Derivation of North Slope Investment Tax Credits
(In millions)

Year	1969	1970	1971	1972	1973	1974	1975	1976	1977(c)	1978(c)	1979(c)	1980(c)
Capital expenditures:												
TAPS	$35.0	$180.0	$109.0	$49.0	$47.0	$ 857.0	$2,772.0	$2,698.0	$ 953.0	$200.0	$400.0	$100.0
Field development	20.0	82.0	51.0	23.0	27.0	157.0	781.0	1,215.0	799.2	544.5	549.4	748.0
Total	$55.0	$262.0	$160.0	$72.0	$74.0	$1,014.0	$3,553.0	$3,913.0	$1,752.2	$744.5	$949.4	$848.0
Expenditures qualifying for ITC (a):												
TAPS	$31.5	$162.0	$ 98.1	$44.1	$42.3	$ 771.3	$2,494.8	$2,428.2	$ 857.7	$180.0	$360.0	$ 90.0
Field development	10.0	46.0	28.0	15.0	21.0	145.0	732.0	1,097.0	613.9	559.4	454.9	631.0
Total	$41.5	$208.0	$126.1	$59.1	$63.3	$ 916.3	$3,226.8	$3,525.2	$1,471.6	$739.4	$814.9	$721.0
ITC rate	7%	7%	7%	7%	7%	7%	10%	10%	10%	10%	10%	10%
Accumulated ITC (b):												
TAPS	$ 2.2	$ 11.3	$ 6.9	$ 3.1	$ 3.0	$ 54.0	$ 249.5	$ 242.8	$ 85.8	$ 18.0	$ 36.0	$ 9.0
Field development	0.7	3.2	2.0	1.1	1.5	10.2	73.2	109.7	61.4	55.9	45.5	63.1
Total	$ 2.9	$ 14.5	$ 8.9	$ 4.2	$ 4.5	$ 64.2	$ 322.7	$ 352.5	$ 147.2	$ 73.9	$ 81.5	$ 72.1
Book ITC (c):												
TAPS	–	–	–	–	–	–	$ 49.9	$ 147.0	$ 450.4	–	–	$ 63.0
Field development	–	–	–	–	–	–	14.6	58.5	186.6	–	$101.4	63.1
Total	–	–	–	–	–	–	$ 64.5	$ 205.5	$ 637.0	–	$101.4	$126.1

(a) This calculation assumes that 90% of TAPS expenditures and 100% of tangible outlays for field development qualify for ITC on an annual basis.

(b) Computed as the product of expenditures qualifying for ITC and the applicable ITC rate in a given year.

(c) For pre-1975 expenditures, the accumulated 1969-1974 ITC is booked in 1977 as the qualifying assets are placed into service. Beginning in 1975, the Tax Reduction Act of 1975 offered the taxpayer a choice between two methods for recognizing ITC on long-leadtime (three or more years) construction projects: (1) a progress payment treatment whereby ITC can be taken in as expenditures are made during the construction stage of a project; or (2) the historical treatment – that is, the full amount of ITC is reflected in the year the qualifying assets are taken into service. Given these alternatives, the TAPS owners have opted for the progress payment method. Under a five-year phase-in rule, book ITC in 1975 is equal to 20% of accumulated ITC for that year; for 1976, it is equal to 40% of that year's accumulated ITC plus another 20% of the previous year's amount; finally, in 1977, the remaining 60% for 1975 and 1976 is taken, as well as 100% of the 1977 amount.

(See Appendix E on following page)

APPENDIX E

Computation of Shares Outstanding – Standard Oil Company (Ohio)

Date	Gross Production	Net Sohio Production	Shares Outstanding – Common and Common Equivalent				BP's Equity Ownership in Sohio
			Special Stock	Common Stock	Total	Weighted Annual Average	
	(In thousands of b/d)		(In millions)				(Percent)
July 15, 1977	300	140	8.9	29.6	38.5	–	–
September 1, 1977	600	279	8.9	29.6	38.5	–	–
October 15, 1977	600	279	13.8	29.6	43.4	–	–
November 1, 1977	1,200	559	13.8	29.6	43.4	–	–
December 1, 1977	1,200	559	15.7	29.6	45.3	–	–
December 31, 1977	1,200	559	27.9	29.6	57.5	40.9	30.2%
December 31, 1978	1,200	559	30.2	30.1(a)	60.3	60.2	51.8
December 31, 1979	1,200	559	30.2	30.1	60.3	60.3	51.8
March 1, 1980	1,400	613	30.2	30.1	60.3	–	–
April 15, 1980	1,400	613	31.5	30.1	61.6	–	–
October 1, 1980	1,600	636	31.5	30.1	61.6	–	–
December 31, 1980	1,600	636	31.5	30.1	61.6	61.2	52.6

(a) Assumes exercise of options covering 476,000 shares at prices ranging from $12.15 to $53.13 per share.

(See Appendix F on following page)

Appendix F

Prudhoe Bay Field -- Kuparuk and Lisburne Formations
Derivation of Unit Producing Profits
Market of Destination -- Houston (a)

Case I: World Price

	1982		1983		1984		1985		1990	
Production Rate (millions of b/d)	0.19		0.26		0.32		0.38		0.35	
Landed Crude Price		$16.80		$17.56		$18.36		$19.19		$23.94
Marine Transportation		0.80		0.82		0.85		0.87		1.01
TAPS Liability Fund		0.00		0.00		0.00		0.00		0.00
Pipeline Transportation		1.44		1.47		1.49		1.51		1.63
Valdez Netback		14.56		15.27		16.02		16.80		21.30
TAPS Tariff		3.29		3.22		3.17		3.14		4.23
Wellhead Price		11.27		12.05		12.85		13.66		17.07
Royalty @ 12.5%	1.41		1.51		1.61		1.71		2.13	
Production Taxes	0.60		0.68		0.74		0.82		0.98	
Property Taxes	1.01		1.04		1.07		1.07		1.05	
Lifting Costs	1.80		1.58		1.45		1.51		2.00	
Interest Charges	2.31		1.62		1.19		0.87		0.23	
Depr., Depl., and Amort.	2.20		3.08		3.97		4.85		4.97	
Total Costs		9.33		9.51		10.02		10.83		11.37
Pretax Profit		1.93		2.54		2.83		2.84		5.70
Income Taxes										
- State @ 9.4%	0.18		0.24		0.27		0.27		0.54	
- Federal @ 48%	0.84		1.10		1.23		1.23		2.48	
Total Income Taxes		1.02		1.34		1.50		1.50		3.02
Net Profit		$ 0.91		$ 1.20		$ 1.33		$ 1.34		$ 2.69
TAPS Profit		0.51		0.53		0.55		0.58		1.01
Integrated Profit		$ 1.42		$ 1.73		$ 1.88		$ 1.92		$ 3.70

(a) Totals may not add due to rounding.

(Appendix F continued on following page)

Appendix F (con't)

Prudhoe Bay Field -- Kuparuk and Lisburne Formations
Derivation of Unit Producing Profits
Market of Destination -- Houston (a)

Case II: Controlled Price

	1982		1983		1984		1985		1990	
Production Rate (millions of b/d)	0.19		0.26		0.32		0.38		0.35	
Landed Crude Price		$14.95		$15.70		$16.50		$17.33		$22.15
Marine Transportation		0.80		0.82		0.85		0.87		1.01
TAPS Liability Fund		0.00		0.00		0.00		0.00		0.00
Pipeline Transportation		1.44		1.47		1.49		1.51		1.63
Valdez Netback		12.71		13.41		14.16		14.95		19.51
TAPS Tariff		3.29		3.22		3.17		3.14		4.23
Wellhead Price		9.42		10.19		10.99		11.81		15.28
Royalty @ 12.5%	1.18		1.27		1.37		1.48		1.91	
Production Taxes	0.57		0.63		0.68		0.74		0.90	
Property Taxes	1.01		1.04		1.07		1.07		1.05	
Lifting Costs	1.80		1.58		1.45		1.51		2.00	
Interest Charges	2.31		1.62		1.19		0.87		0.23	
Depr., Depl., and Amort.	2.20		3.08		3.97		4.85		4.97	
Total Costs		9.07		9.23		9.72		10.52		11.07
Pretax Profit		0.35		0.96		1.27		1.29		4.21
Income Taxes										
- State @ 9.4%	0.03		0.09		0.12		0.12		0.40	
- Federal @ 48%	0.15		0.42		0.55		0.56		1.83	
Total Income Taxes		0.18		0.51		0.67		0.68		2.23
Net Profit		$ 0.16		$ 0.45		$ 0.60		$ 0.61		$ 1.99
TAPS Profit		0.51		0.53		0.55		0.58		1.01
Integrated Profit		$ 0.67		$ 0.98		$ 1.15		$ 1.19		$ 3.00

(a) Totals may not add due to rounding.

WAINWRIGHT SECURITIES INC.
Paul R. Leibman
Thomas A. Petrie

Computer Applications
Richard C. Marks

Prov

p. 29 cites precedent for FEA to do discrim entitlements.

FEA will do 3 objectives:
① reconcile Prudhoe wax
② regional equalizn
③ flex for other U.S. prod.

No approach does all 3.

So WW does 2 cases:
① exempt, no entitle, discrim pricing at Valdez
② up. tier on W. coast/andy. at W. coast
in composite.

p. 29.

So neither real tariff.

bracket range of possibilities. 2 extremes.

Major uncertainties in figuring rate of return: p1

① pricing & mktg of US oil
② setting of tariffs
③ State taxation

TAPS tariff delay in setting.
p3 "In all likelihood resolution of ....

TAPS total cost. p.9 – Alyeska little credibility
Sale of surplus equip not incl. p.9.

R or R

p3 – tariff will be lower than expected.

p22 – Bolton - Corp report – "approp method for calculating" prudent investment supposed to be based on ror

p35 – DCF ror = 10.6 for pipe 19.1 on field 15.7 combined
assume - expense of 2 mb/d, ror on equity on pipe

p36 good quote – ror

p35 "yield main be refining"

p35 Indonesia quote

p37 – do oil co aggregate

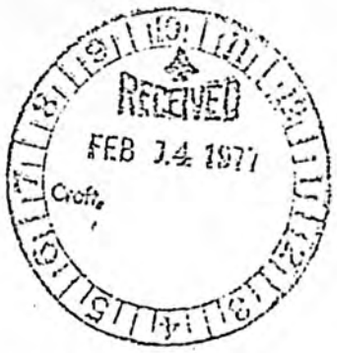
STATE OF ALASKA

JAY S. HAMMOND, GOVERNOR

DEPARTMENT OF NATURAL RESOURCES

OFFICE OF THE COMMISSIONER / POUCH M — JUNEAU 99811

February 10, 1977



The Honorable Chancy Croft
Alaska State Legislature
Pouch V
Juneau, Alaska 99811

Dear Senator Croft:

In addition to Dr. Mason Gaffney, the following persons who prepared parts of the Oil and Gas Leasing Study are expected to be in Juneau for presentation of the study to your committee on February 17, 1977:

Professor Richard Norgaard, U. of California, Berkeley

Professor Robert Rooney, California State, Long Beach

Professor Michael Cromlin, U. of Melbourne, Australia

Will get more details for you as I know them.

Sincerely,

Jack Roderick /ms

Jack Roderick
Deputy Commissioner

cc: Commissioner Guy Martin
Greg Erickson

AGO 531371

? for Sohio —

plan to squeeze us by low equity to field?

p. 42 - pay BP standard low profits so want low tariff

53.155 — field
33.347o — pipe
BP
} Sohio

Wainwright —
prop tax pipe valuation. 110% - ICC, state.

prob with WW — 48% fed tax
Effective!!

How SOHIO diff from other industries:
① pipe ownership
② mktg opportunities.

Wkon FERC pricing tariff

AGO 531372

Probs with WW

1. Assumes effective 48% fed.

2. Equity or yield slightly off.

3. p 42 shows unamortized tariffs.
DB products will smooth

?

Use ICC valuation of pipe for state prop.
p. 48 - Co. high.

7. p. 49 all except Amerada Hess intrastate tariff.

TARIFF

47 Alyeska audits by
① ICC
② GAO for Jackson
③ State

(48) products initial valuation on pipe, could come out till end of 78
early 1979 will issue report "on whether final level of reasonableness of TAPS tariffs may ultimately be made."

49 "may be 2 years or so before final Commerce."

49 Main question:
① "what is a proper rate base
② what is an appro return level . . . ."

projects ① rate base valuation same
② reappr cost of Glenn treatment
③ permit hearing return.

USL 2 Cases
① treatment investment total.
② return on equity
③ get Wm Brothers & Ex Parte 308

TAPS / TARIFF

37 State Int = max WH
Compint = max tax, low WH
} due to diff in tax.

37 appeals state to file case against initial tariff filings of Co.

38 Wm Bros Pipeline Case – ~~equity~~ on total invest. 45

38 predicts owners will go for 7% tariff

39. assumes ICC will use current valuation procedures.
assumes tariff based on ① 2 mb/d/day (KEL)
② 1.6 mb/day (no KEL)

assumes ICC will use 10% or equity.

42. " diff in ownership spawns diversity of viewpoints in best way to max Revenues."
p. 42 SOHIO – BP agreement – net profits

42. Case I (1.6) = av 3.99 / bbl Tariff 1978-1990 1978= 4.23
Unsmooth Case II (2.0) = av 3.55 ↗ 1978= 4.23

45 – tariff setting uncertainty
49 – final after rate case & exhausts 308 proceeding. "Inv of ConCarr Pipe"
46 – industry argument of incl pipe plus field together. "good grade."

47 – SOHIO wants hi tariff cuz hi debt, but doesn't cuz not purchaser.
AK "Concern focused on the return."

47 – predicts State will contest rate "most significant dispute."

Surplus & Mktg

(p 13) ant of surplus estimates range widely. Can't know.

(p 13) Socal currently expects refinery utilization will be largest W coast processing N. Slope.

(p 14) barrel surplus even worse use of low quality crude.

(p. 16) need de-sulph products due to air poll. regs.
Prudhoe makes it tougher on already hi-sulphur crudes.
adverse effect

p 18 !! " : it is clear that

? cites Socal & Union as being credible sources. 14, 16

19: surplus = 300,000 b/d 78
350,000 b/d 79

Socal projects 1978-1980 imports of 400,000-600 b/d of exports mostly Indonesian.

p. 18 "practicality & politics = consideration of measures" ← start of 12 solutions p 19.

projects: ① start - unsub Jones Act US Flag vessels Trans Pan. p. 18
+ small Trans 4 corners pipe & rail.
② Henry Subsid vessels + Jones Act waivers of privilege of Ns or Calif saves costs with Japan Can. p. 21

Canal limitation (19) = 60,000 dwt., tho some 90,000 dwt can traverse partly loaded.

p 15 show shutting option as "Not Applicable."

21 only small pipeline capacity available Trans 4 corners or Trans-Mt Yoyo till 79.

NATURAL GAS FACT SHEET

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Estimated reserves= 26 to 32 Trillion Cubic Feet (TCF)
Estimated daily flow from pipeline= 2.5 Billion Cubic Feet* (BCF)
Estimated yearly flow = .9 Trillion Cubic Feet

Alaska's royalty share= 3.25--4 TCF
Daily royalty share = 312 Million Cubic Feet (MMCF)
Yearly royalty share = 114 BCF

*Department of Interior study.
More proven reserves are expected to be proven in the North Slope area.

ALASKAN USE

Almost all the natural gas used in Alaska is in the Cook Inlet area.

Anchorage Natural Gas uses about 30 BCF per year.
That is equal to 12 days production from Prudhoe Bay.
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Consumers are willing to pay a premium for gas. It is a clean energy source.
On strictly energy equivalent, $2.00 per MCF gas = $12 barrel oil.
Considering the advantages of using gas, $2.00 gas = $9 barrel oil.

United States gas production has declined from a peak of about 62 BCF per day in 1973 to 55 BCF/day in 1975.

Raising prod.

Overall discussion (p 8) ① W. coast supplies in 78-79
② U.S. pricing uncertainty

WW estimates new capacity to 1.6 not till late 1980 — (p.8)

(p.8) SOHIO doesn't want more oil would raise ownership & have need to take on larger TAPS so more financing + mktg problems

(p 9) will cost 700 mill (Ahpo estimates 675 m) to bring up to capacity.

(p 9) by Nov 1977 will have enuf wells drilled to yield 1.2

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Compromise tax –

p 2 "While little support appears to exist for the radical excess value (windfall) tax of a few yrs ago, a consensus has apparently formed on the necessity for a major overhaul of the state's prod. tax & Corp. income tax."

p. 30 "fair, workable & most imp. stable tax regime"
focus tax policy on collecting "Fair share"

p 31 good quote "As stated . . . stable."

p 32 "Hammonds' objectives incorporate some good tweaks"

p 32 * good quote supports ELF

bad p 32 prob with $ / barrel – Con. ELF } Sev.

bad p. 32 "disincentive..." ELF

bad p 33 "alleged differences" inc.

good p. 33 "From AK standpt" in } inc

bad p. 34 OCS quote Inc

p 35 if things go well w TAPS state may not seek more taxes & ELF/Flow would hurt. p. 47 good quote on same T

Logistics:

p 3 "Moreover ..... rest."

p. 34/35 "Timing & mechanics" long quote

35 – properties assess
① effective 9.4 %
② ELF
③ TAPS historical – not Cov. p.39 – TCC uses historic replacement cost.

35 Crossroads – compromise is current !!

Alaska State Legislature

JUNEAU ALASKA

SENATE RESOURCES COMMITTEE - KAY POLAND, CHAIRMAN

HOUSE RESOURCES COMMITTEE - ALVIN OSTERBACK, CHAIRMAN

JOINT HEARINGS - OIL & GAS TAXATION

A G E N D A

TUESDAY, MARCH 22

BRIEFING BY RICHARD KILGORE — 9:00 A.M.
* ROOM 126, CAPITOL

BRITISH PETROLEUM — 1:30 P.M.
* COURTROOM A

WEDNESDAY, MARCH 23

F.E.A. HEARING - ANCHORAGE
FEDERAL COURTHOUSE, CONF. ROOM 284 — 9:30 A.M.

THURSDAY, MARCH 24 — GOLD ROOM - BARANOF HOTEL

COMMISSIONER GALLAGHER — 1:30 P.M.
DICK DONALDSON - SOHIO
MONTE TAYLOR - EXXON
ROGER BONEY - EXXON

FRIDAY, MARCH 25 — GOLD ROOM - BARANOF HOTEL

LARRY WILSON - UNION OIL — 9:00 A.M.

BRISTOL BAY NATIVE CORPORATION — 1:30 P.M.
OLIVER LEAVITT - ARCTIC SLOPE
MARC SINGLETARY - ATLANTIC RICHFIELD

AGO 531381

Privacy

26, p. 27.

(2) Set upper tier at W coast. — would this have any drawbacks. if choose this, WH will be low so will help composite & allows upper tier price to rise.

if set at upper tier must do entitlements & way downgrade currently costs upper more than unpt for Calif (reason why Calif having probs).

(3) WH = composite rate

would ensure AK Calif doesn't use to become diseir to lower pr.

entitlements = none a raw tier (so can purchase entitlements to raise low to composite level).

p. 29. believe FEA may opt for #2 & set entitlements to equalize E & W. Dislikes entitlements W purchases a portion E exempts sells.

quotes TAPS act "benefits of such crude oil should be equally shared, ... by all regions of the country".

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Pricing

p. 22 cites conf rept saying decon to be based on effected rate of return.

p 22 — "much additional work remains before new Admin guidelines & rules"
delay p. 28 quote on can't know outcome yet.

Question - at WH or at Valdez? (p. 23)
Mortada suggests Valdez — provides ① incentive to devel Lisb & Kapuni p. 28
② gets around tariff considerations p. 28
p. 23 committee rept & C.R. clearly state first-sale at WH.

Interpolate 3 options for FEA:

① exempt ~~crude~~ (state position) hi for short & long.

② set upper price at W. coast port low

③ set ~~wh~~ price at WH & make it = to max composite price. (hi) for now

internally - like Tosco only excludes if gasoline than composite!!!

① exempt (p. 24)

a. discriminatory price based on destination (may violate anti trust) so same WH for all
all other comparable prices. LA = mkt

b. non SOHIO prefers (Houston becomes mkt so depresses all). ~~so diff WH~~ so WH = lowest value = Houston. or multiple.

In competitive mkt - non would prevail & prod. would try to sell at W. coast. But SOHIO, EXXON integrated & have arranged for transpt — so would go into price war on W. coast.

(24)

26 WW-predicts — discrim (even tho will be moderate price war "discounts")

multiple WH has existed in Cook Inlet

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

Alaska State Legislature

SPECIAL COMMITTEE ON
THE SALE OF
ROYALTY GAS

(907) 465-3873
POUCH V
JUNEAU, ALASKA 99811

April 11, 1977

House of Representatives

TO: Representative Clark Gruening
FROM: Brian Rogers
RE: Wainwright Securities, Inc. Review of the Petroleum Industry: North Slope Oil and Gas

Wainwright Securities, Inc. recently compiled a comprehensive investment analysis of North Slope Oil and Gas. Their Industry Review, dated April 1, 1977, analyzes the current situation, from the investor standpoint.
Bearing in mind that the basic outlook of an investment house is different from that of the State of Alaska, opinions expressed on such matters as oil taxation by the State of Alaska may not reflect factors which should be taken into account by the State. However, the review concludes that even with the many uncertainties existing on North Slope Oil and Gas economics,

> "the uniqueness of long-lived Prudhoe Bay reserves cannot be emphasized enough in today's industry environment. With most companies facing the difficult task of replacing depleted low-cost reserves, access to substantial North Slope reserves affords the luxury of a stable underlying basic cash flow on which to launch <u>new</u> corporate investments for future growth." (emphasis by Wainwright).

Wainwright finds seven major observations about North Slope Oil and Gas as follows:

1. Construction Status (of TAPS): essentially on-time; 600,000 b/d starting in August, 1.2 million b/d by year-end.
2. West Coast Supply/Demand: At 1.2 million b/d, excess supply will range from 300 to 600,000 b/d. Excess will probably be shipped via Panama Canal to Houston. "The alternative of exchanging North Slope oil with Japan ... will become an option only if the surplus becomes so large that it forces a shutting in of Prudhoe Bay production."
3. Crude Oil Pricing Policy: Price will probably range from upper tier landed West Coast price to price competitive with imported oil. Wainwright analysis suggests possible range in Long Beach in early 1978 of 11.79 to 13.90 per barrel.

4. Alaskan Taxation:"A consensus has apparently formed on the necessity for a major overhaul of the state's production tax and corporate income tax." ..."It is somewhat premature to guage their impact on North Slope earnings." suggests perhaps the State will wait until next year because of early adjournment.
5. Pipeline Tariff Determination: Wainwright believes that there are major questions about ICC ratemaking procedures. They project a tariff in the vicinity of $4.25 per barrel in 1978 at 1.2 million b/d.
6. Production Economics: $/barrel profits to the companies range from 3.10 (Houston Delivery) to $3.59 (Puget Sound) at world price; 2.88 Houston to 3.02 Puget Sound for controlled upper tier price.
7. Company Earnings: Wainwright presents earnings expectations for each of the major reserve owners in the Prudhoe Bay field under specified price and pipeline tariff assumptions.

In their detailed analysis, they present the following statistics and arguments which are (1) new to us or (2) important data for our consideration:

1. Crude surplus on West Coast is a disincentive for expansion of pipeline capacity from 1.2 to 1.6 million b/d. (note: not Alaska tax plans). Wainwrights "best estimate" for the onstream date for the 1.6 millon b/d capacity is late 1980.
2. Wainwright believes the cost of additional capacity to be:
   to 1.6 million b/d: $700 million
   to 2.0 million b/d: $855 million estimate for expansion from 1.2 to 2.0 is "probably too low".
3. Wainwright examined a number of West Coast supply/demand analyses which show more optimistic assesments of West Coast production from (1) production from Elk Hills (2) improved economics for enhanced recovery projects and (3) renewed offshore development activities. The nature of the problem is "anything but deterministic." Socal will have the ability to be the largest West Coast processor. Wainwright examined various possibilities for treatment of the surplus problem (see pp. 18 - 20).
4. Wainwright explored the alternatives available on FEA pricing of North Slope oil. They suggest that discriminatory pricing, with the possibility of moderate discounting, is a likely situation, as has existed at Cook Inlet for a number of years.
5. On the matter of Alaskan taxation, Wainwright asks if compromise will replace the confrontation which existed last year. A full reading of pp 30 - 36 would be advisable. Wainwright

notes two "novel twists" in the Alaskan taxation picture: the E.L.F. concept and the franchise tax. They suggest that ELF has some positive structural features, but creates a disincentive for development of Kuparuk and Lisburne. "From Alaska's standpoint, passage of the franchise tax would undoubtedly resolve some glaring deficiencies in its current income tax treatment. Also, it would ensure that the North Slope producers pay something resembling the 9.4% nominal tax rate imposed on domestic (Alaskan) corporations doing business only in the state - versus the 2%-3% rate that otherwise would apply to a multinational oil company." Wainwright asserts that encompassing OCS production and oil tankers exceeds the limits of fairness and reasonableness. They see a key objective for Alaska as being the expansion of permanent fund revenue as well as closing of existing loopholes.

Wainwright says that legislative consideration is unsure, "with a drastically altered leadership and committee set-up in the Senate", and that the state "will probably be concerned primarily with the timing and mechanics of how best (not whether) to obtain a portion of the economic rents it believes exists at Prudhoe Bay." Wainwright believes the uncertainties of pricing may delay consideration, adding "Certainly, a delaying action would likely be in the best interest of the oil companies."

6. Wainwright asserts Real DCF rates of return on Prudhoe Bay production of 19.1 %, on the pipeline of 10.6%, and a 15.7 % composite rate. They make predictable noise about theneed for the state to compromise on taxation "to go a long way towards establishing a tax structure conducive to a healthy investment climate for the oil industry in Alaska."
7. Wainwright discusses tariff possibilities in light of the Williams Brothers Pipe Line Company (WBPL) rate case
   a and how it pertains to the proper rate of return on the rate base. (meaning possible 7 % rate of return on equity, instead of 7 % on total investment). They predict that Prudhoe Oil Pool field development will result in a tariff ranging between $3.54 and $5.14 per barrel. With the inclusion of Kuparuk and Lisburne, the tariff ranges from $3.14 to $4.28 per barrel.
8. Wainwright says the tariff uncertainties are the largest currently in the picture, due to the inportance of the level of TAPS tariff in the overall economics of North Slope oil.
9. Wainwright make s a number of estimates of profitability of the Prudhoe Bay field, depending on a number of factors: market destination, production level, crude oil price, marien transporation, 12½ % royalty, PRODUCTION TAXES BASED ON E.L.F., property taxes, STATE INCOME TAX AT 9.4%, and federal income tax at 48%.

10. Wainwright briefly examines North Slope natural gas issues, noting the "number of uncertainties tat seriously hamper a comprehensive assessment of the economics of exploiting this resource."
11. Detailed forecasts of company earnings are made on pp. 64 - 66.
12. Wainwright notes that unit profitability for Kuparuk and lisburne will be far lower than for the main field, but "development of these currently marginal reserves, by increasing pipeline throughput, will enhance the economics of other North Slope production."

K. E. SHOWALTER: The following is a phone conversation between K. E. Showalter of Sohio, and Mr. Paul Leibman, Wainwright Securities, Inc. in New York. The call was made on April 14, 1977 to clarify the rate of return numbers as contained in the report versus those arrived at by the Alaska State Department of Revenue. Other points of contention in the report were also explored.

SHOWALTER: Mr. Leibman, the Alaska Department of Revenue offered testimony this morning to the House Finance Committee that characterized your reported 19.1% rate of return on Prudhoe Bay as incorrect, and stated that the real rate of return is 25.4%, and they used your cash flow numbers. Can you tell me how such a difference could occur?

LEIBMAN: Well, in the first instance, they have taken a cash flow series that reflects escalation from both Prudhoe price and operating costs over the life of the field. And looking at a real rate of return on a project, you then have to perform one additional calculation which involves going through and deflating the entire series back to a current year. In this case, 1977. So for expenditures that occurred prior to 1977, the cash flow numbers that we show would be increased, and for those that occur after 1977, both inflows and outflows, they would be deflated or reduced. So in the end you come up with an adjusted cash flow series which is then put into a computer program, which is how we derived the 19.1%. The difference can be characterized as a real return versus a nominal return. In one case inflation is included in the calculation, in the other it is excluded.

SHOWALTER: A further question on that same point, Mr. Leibman, how would an investor look at this? By which method would an investor typically calculate the rate of return?

LEIBMAN: Because so many assumptions are necessitated, as far as looking at inflation in future years, it is our impression that most companies approaching a major new project would tend to base their calculated threshold return on a real rate of return, excluding any influence of inflation.

SHOWALTER: In other words, they would do it by the method that you used in your study?

LEIBMAN: Yes.

SHOWALTER: A further question -- In your report you show calculated returns using a 9.4% direct accounting income tax and the new economic limit factor severance tax. Why did you do this since these are not current law?

LEIBMAN: There are really two reasons why I think we adopted that approach. On the one hand are analyses already included: two cases for crude oil prices, two cases for the final determination of pipeline tariffs. To go one step further and to have two additional cases for taxes, both the current situation and the proposals as outlined by the Hammond Administration, would result in so many different earning cases for the companies, that would not really be relevant in terms of presenting something to investors they could really understand. Given that we feel the crude oil pricing question and the pipeline tariffs issue are probably more important in an absolute sense, we have decided to use only one guess as far as how we think the legislation might come out.

The second point is, to the extent that we are dealing here with equities or common stock, most investors, I think, are more sensitive to determining what could be called a "worse case" possibility. They want to see what the fundamental position of the companies would be to the extent that the worse possible solution occurs. That is probably the most conservative way of approaching investment. From that standpoint we, once again, try to make our best guess as to how the current proposals would finally emerge from the legislature. We've tried to be conservative in developing our earnings estimates, feeling that if some change occurred in the future we would not have to go back and recalculate our numbers, which can cause much disharmony in the stock market.

SHOWALTER: Are you, then, endorsing increased taxes in Alaska?

LEIBMAN: It is fair to say that while there are probably some legitimate problems with the current tax structure of the State of Alaska, as affects the petroleum industry, we feel that, on balance, that their current arrangement appears more than adequate, given the State's fiscal outlook, and what appears to us to be an absence of what many people are considering to be economic rents of the Prudhoe Bay field. The companies at Prudhoe Bay are earning what by most measures would be a below average rate of return -- when you consider that this is the largest oil field ever found in North America. And that the cash flow from Prudhoe Bay has to cover the dry holes that are being drilled in many other parts of the United States and abroad. We have a hard time reconciling the desire for increased taxation with what appears to already be a return on investment situation which is, in many respects, marginal.

SHOWALTER: In one section of your report you mentioned some particularly contentious provisions in the tax proposals now before the legislature. Could you tell us what those are?

LEIBMAN: I think the points that bother us the most break down in three ways. First of all, the concept of a floor price underneath the production tax proposal. This in effect would allow the State to determine its severance tax on the basis of a deemed market price for the oil landed on the West Coast. The problem here is, to the extent the

federal government requires a price for Alaskan oil that is below the market price for foreign oil landed on the West Coast, this would tend to squeeze the companies margins fairly severely. In effect, they would be caught between the State of Alaska's desire to maintain their revenue flow and the federal government's desire to set a price for political and other factors. We think the State is, in effect, weakening their case for a well price by, in effect, trying to protect itself in any event.

A second point would be extending the concept of the franchise tax to include such facilities as LNG, plants, refineries, petrochemical plants.

We think, thirdly, offshore oil and gas. That trying to derive taxes from OCS production appears to be far beyond what the State feels is their need to redress and legitimate questions in their current tax structure.

And finally, the concept of an economic value for the pipeline, in terms of property tax determination, appears to us to be motivated more by desire to increase revenue than to look at the historical situation of pipelines, in terms of their economic situation and how taxation should be applied to them. The basic rationale here is that historic cost has been the traditional way that pipelines have been valued, and the State is now talking of a replacement cost-type concept which we find hard to accept.

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Finance Committee Chairman's Report
on HCS CS SB 238,
the Oil and Gas Properties Production Tax

PART I. SUMMARY OF TESTIMONY

Hearings were held from April 12 to April 14 by the House Finance Committee to take testimony on bills dealing with state taxation of the oil industry. Testimony was presented by consultants for the committee, representatives of the state Department of Revenue, the oil industry and by other individuals.

The first witness, Mr. Niall Trimble, Principal Economist for the Alaska Department of Community and Regional Affairs, testified that Alaska continues to be a most attractive prospect for oil development. Alaska still offers the oil industry high profits, low taxation relative to other areas of the world, outstanding geological prospects, and security of supply.

Mr. Trimble concluded that the oil industry will remain and continue to expand its activities in Alaska whether or not the modest tax increase proposed by the administration is adopted.

Professor Jerome Zeifman, Professor of Law at the University of Santa Clara and formerly Senior Counsel to the United States House Judiciary Committee, specializing in state-federal tax relations, testified that current state tax policy (i.e. the multi-state tax compact), with its use of federal taxable income, substantially erodes the State's tax base. He observed that changes in state and local taxation have never caused companies to change the location of their exploration and development efforts. In response to industry arguments that no tax increases ought to be considered when state budget surpluses are anticipated, Mr. Zeifman reminded the committee of the Biblical injunction to store grain in the seven fat years to avoid famine in the seven lean years.

Professor Edward Shaffer of the Department of Economics at the University of Alberta pointed out that oil will provide Alaska's major source of capital for the next several decades. This capital can be turned into human capital by way of education and health, or into direct business capital, which provides a stream of employment and income for a rising standard of living for Alaska's residents.

Adequate transformation of capital can only take place, Dr. Shaffer noted, by effective state government tax policy and, in part, by the use of the Alaska Permanent Fund. An increase in state tax revenues from the oil industry was necessary, in his view, to sufficiently finance the diversification of the Alaska economy, since the oil industry would otherwise use a substantial part of

its profits for investment in other parts of the world. Diversification of Alaska's economy could take place through long-term loans from the Alaska Permanent Fund, or through capital budgets for transportation, communication, and the like.

Professor Schaffer pointed to the experience of oil production in Alberta and Nigeria and copper mining in Zambia and Chile, where these industries have not, in-and-of themselves, fostered economic diversification. Dr. Shaffer believes that local processing, business expansion or new businesses spurred by the oil industry in Alaska would likewise not be large-scale, and will decline as oil production declines.

Mr. Joseph Kemp, a noted specialist in the field of oil taxation, and Senior Lecturer in Economics at the University of Aberdeen, Scotland, commented on the many parallels between oil development in Scotland and in Alaska. He noted that the discoveries near Scotland came in the late 1960's, after payment of relatively modest lease fees for exploration rights. Following the fourfold rise in oil prices in 1973, North Sea oil fields were, like the Prudhoe field, suddenly capable of large returns (up to 50% on a discounted cash flow basis.)

Mr. Kemp explained that much of these windfall profits were surplus to amounts needed by the companies to develop the North Sea fields and to search for additional fields. Despite tax raises in 1975 of 60 to 70 percent of total profits, there was no slowing of oil industry activity in the North Sea.

Mr. Kemp described the unusual action taken by the people of the Shetland Islands, who secured compensation from the oil industry to provide for the social and economic disruption caused by oil development activities. This compensation, he said, is being used to rebuild and diversify local industries and to pay the costs of providing additional public facilities, a function possibly similar to that of the Alaska Permanent Fund.

The Department of Revenue offered data gathered from the tax commissioners of eight states which show that Alaska ranks fourth among the states in total oil and gas taxation.

Alaska would rank second, following Louisiana, if the tax measures proposed by the Administration are passed.

Moreover, the proposed tax increases will not, according to the administration, have a major impact upon the rate of profitability. Using the assumptions and data of the report by Wainwright Securities, the changes reduced discounted cash flow returns on the field by less than 1% (in nominal terms).

The Administration strongly urged raising the wellhead value at which the cents-per-barrel severance tax goes into effect (from the present $6.33 to $7.50). In addition, the Administration recommended that the wellhead value floor (at which the cents-per-barrel tax would go into effect) should rise with inflation relative to the Gross National Product deflator (instead of the Wholesale Price Index, which for some years has been going up more rapidly than the cost of living). These provisions would

give the State an "insurance policy" against Federal or corporate manipulations of wellhead values and would help protect the State's revenues.

Numerous witnesses from the oil companies appeared before the committee and there was a certain amount of repetition in this testimony. The following is a summary of each of the arguments directed against the bills:

Several of the companies pointed out that the State of Alaska had signed contracts with them in 1964, 1966 and 1969 to lease the land at Prudhoe Bay. They felt that the state was trying to "change the rules of the game" by the unfair use of the state's taxing power.

Even though taxation increases will probably not affect industry willingness to remain at Prudhoe Bay, it could reduce the incentives for further oil exploration and development, the witness said.

Oil company witnesses stressed the need for tax rates in Alaska to stay in line with other states, and since they alleged that tax rates on oil in Alaska were already the highest in America no further increases should be allowed.

Oil company witnesses, while avowing the readiness of the industry to pay its share of taxation actually required by the state, expressed reluctance to pay higher taxes when the Department of Revenue was predicting budgetory surpluses.

Producers in the Kenai-Cook Inlet area warned that higher taxes would compound the problems they face as a result of Federal price controls and the greater costs in the later stages of field recovery.

Most of the testimony from oil company witnesses was largely philosophical in nature, without specific attacks on the provisions of the bills before the committee or the research reports that lay behind them. However, the testimony from one company-Exxon-differed sharply from the others. Exxon submitted to the committee its own economic analysis of the profitability of the Prudhoe Bay field. This study was the first detailed industry comment on the profitability report prepared for the Legislature by consultant Dr. Michael Tanzer over 15 months ago.

A number of errors of fact in the Exxon testimony are already apparent:

1. In questioning the accuracy of the probable rate of profitability of the Prudhoe Bay Field established by the Tanzer reports, Exxon witness Monte Taylor stated that no allowance was made for payment of reserves tax by the companies. Payment of reserves tax was in fact included in the calculations presented on pages 42-43, 49 and 94 of Tanzer's first report to the Legislature.

2. Mr. Taylor also stated that Tanzer did not deal with payments in respect to property tax. In fact, Tanzer covered this on pages 44, 47 and 49 of the first report.

3. Mr. Taylor also criticized the Tanzer report for not including $900 million in bonus bids paid in the 1969 lease sale. He neglected to mention that 90% of these payments were for areas outside the boundaries of the oilfield under consideration. These payments were not made by the principal leaseholders in Prudhoe Bay.

4. The Exxon study asserted that the return on the field and the pipeline should be considered together. However, since pipeline tariffs have first claim on any return from Prudhoe Bay, it is clear that the risks involved on the two investments are of different orders of magnitude. These differences are reflected in the willingness of banks to finance 85-90% of the pipeline costs, compared with only 45-55% of field development costs. Dr. Milton Lipton of Walter Levy & Associates and Dr. Walter Mead of the University of California both concur in the validity of treating the pipeline as a separate profit center.

Likewise, Messrs. Lipton and Mead agreed that Exxon's inclusion of $1.8 billion for construction of new tankers in the capital cost of field development is improper.

Mr. Taylor contrasted the DCF rate of return produced by Exxon (18%) with that contained in the latest report from Tanzer (29%). He did not inform the committee that Exxon's figure was a constant dollar rate of return, which took out the effects of inflation. If it were done on the same basis as Tanzer's, the Exxon rate would be around 25%.

The Exxon representative attacked Dr. Tanzer's approach in excluding the cost of the pipeline from field investment, describing it as "faulty economic analysis,... naive and illogical" and "completely unrealistic". Mr. Taylor admitted that he did not know of any independent, published economist who agreed with his views, and "had not tried to find one."

One individual witness, Mr. Eben Hobson, Mayor of the North Slope Borough, focused on the need for the industry to become "good corporate citizens" and to pay the taxes they can well afford to bear. Mr. Roger Lang, appearing for the Bristol Bay Native Corporation, expressed fears that some Native regional corporations might be adversely impacted in their search for, and development of, medium and marginal prospects under their lands.

Mr. Duane Carlson testifying for the AFL-CIO, Alaska, advanced the view that oil taxes in other states were "their own business" and that Alaska's goal must be a consensus on the "price we want for our resources". Until that occurs, he said, the industry had a legitimate complaint about unstable tax policy in Alaska. However, he said the price Alaska chooses to set should not depend on whether or not Alaska has predicted budgetory surpluses.

Mr. Vic Fisher, a senior member of the Institute of Social and Economic Research, University of Alaska, set out a "one-time" theory of taxation, arguing that oil, primarily Prudhoe Bay, is the only known source of large revenues for Alaska for decades to come. He challenged industry claims that such revenues are "surplus" to Alaska's real needs, noting the great cost of needed capital improvements in most of rural Alaska, using the North Slope Borough's plans as an example.

PART II. NEW INFORMATION

The new facts that emerged from the House Finance hearings include:

a) Industry acknowledgement that Alaska's taxation on oil is much lower than that found in the vast majority of oil producing areas in the world.

b) According to the administration's calculations, based on information from tax commissioners of eight oil producing states, Alaska does not have the highest oil taxes in the U.S. Alaska now ranks fourth and will, after the passage of these bills, rank second.

c) The discounted cash flow (DCF) analysis of returns appears to be the main technique used by the oil companies in estimating the profitability of an oil field.

d) The risks for the pipeline are in a lower category than for the field itself and that returns on the pipeline investment are limited by U.S. law to 7%.

e) The Administration and Drexel-Burnham studies of DCF returns on Prudhoe Bay were 26% and 27% (at today's dollars and setting aside pipeline and tanker investment). Both studies used medium estimates for oil production and both made the conservative assumption that the companies will pay an effective 48% Federal income tax rate. Several companies admitted, however, that they paid far less than the full Federal rate.

f) The Administration offered data showing that the proposed taxes would lower DCF returns on Prudhoe Bay by less than 1%. Witnesses appearing in behalf of the oil companies conceded this point.

g) BP and SOHIO stated that passage of the tax bills would make no difference to their future operations. They will continue their investment in Prudhoe Bay and will continue their exploration program in Alaska.

PART III. CONCLUSIONS

The industry spoke of the "unfairness" of changing the tax rules after thay had made substantial investments in Prudhoe Bay. Since 1973, though, the price of oil has more than quadrupled, dramatically increasing the value of this field without any effort on the part of the companies. While inflation and environmental constraints have pushed up total costs, total profits have risen even further. There must be a balance of the "loss" of profits which the companies could not, and did not, expect against the responsibility to protect the long-run interests of Alaskans.

Certainly the oil companies would have been expected to come to the state if the costs of the pipeline or mistaken estimates of recoverable reserves had trapped them under the previous, depressed prices. No contract prevents the industry from asking for, and receiving, lower

severance and other taxes. Dr. Shaffer reported that companies in Alberta broke a joint venture agreement with the province for extracting oil from tar sands (the Syncrude project) until new terms were obtained, including higher government aid.

No oil company has ever had an agreement with the state of Alaska that taxes would not be raised in the future. To the contrary, the oil companies holding the major leases on the North Slope fully expected that taxes would in fact be raised even before the oil flowed.

The industry emphasized that higher taxation could discourage further oil activity in the state. They did not, however, explain why this might occur when Alaska does offer exceptional discovery prospects, higher profits and lower taxes as compared to many parts of the world, and security of supply, (i.e. no risks of revolution, war, expropriation and, in Prudhoe Bay, the absence of the disruptions associated with off-shore operations.)

It appears on the hearing record that oil prices, the size of reserves and the costs of extraction will be far more critical in determining the magnitude of future oil exploration and development than the modest tax proposals before this committee.

In particular, weight should be given to the Administration's study (which used industry-based data), which shows that the severance tax proposal reduces DCF profits by less than 1%, a reduction which BP and SOHIO witnesses frankly stated would not cause them to halt investment in Prudhoe Bay or reduce present plans for exploration.

The claim by the industry that Alaska's oil and gas taxes are the highest in the nation, thereby lessening Alaska's competitive position, is contradicted by the Administration's claim that Alaska now ranks fourth among the states and would move to second with the passage of their bills.

In making its comparison, the Department of Revenue superimposed tax structures of other states on the production, income and property in Alaska. To be conservative, the Department excluded sales and use taxes, special pipeline taxes, and other taxes unique to other jurisdictions. The analysis of eight state tax commissioners appears to be more credible, but regardless of the past decisions of other states, Alaska is not and should not be bound by those past decisions alone.

First, the oil fields found in other states are now in large part in the later years of their life--smaller, and less profitable (often only stripper wells are involved).

Secondly, virtually all leases in the lower 48 states are on private rather than public lands and therefore do not involve the extraction of non-renewable resources belonging to all the people. The primary concern here is that the people of Alaska receive a satisfactory return for the extraction of non-renewable resources.

The industry contended that Alaska has all the revenues it needs, as proven by the prediction that a major "surplus" will accumulate in the Alaska Permanent Fund and the general fund.

Moreover, in recent statewide media presentations, the oil industry praises the Permanent Fund but makes much of the assertion that no legitimate purpose is given for the predicted surpluses.

Nevertheless, one of the major objectives of the Permanent Fund is to develop an economic base for Alaska beyond the monolithic oil industry. Viewed in this light, the use of oil revenues to diversify the Alaska economy is certainly as worthy a purpose as is, for example, Mobile Oil's recent takeover of Montgomery Wards.

The final shape of the Alaska Permanent Fund is open, but there is wide consensus that it can be used both to provide savings and income for the years after oil declines and to build a diversified, private economy and a new tax base. The capital projects from the general fund or bonding will hopefully compliment those broad goals. No one knows whether Alaska will, in fact, have a surplus; since no one knows, today, what will be the needs as oil production inevitably declines.

As for the problems of the Kenai-Cook Inlet operators, the Administration has pointed out that Federal price relief is available and that Federal controls may go on a stand-by basis in 1979 under the Energy Act. Yet there are delays in obtaining price relief, and the future of controls is uncertain. Moreover, as most of these fields are declining, it is sound policy to provide, in advance, that oil recovery and revenues be stretched out as long as possible.

Accordingly, a formula has been adopted that will immediately reduce severance taxes in the Kenai-Cook Inlet area and will, in future years, reduce the rates there more sharply than in other, more profitable areas.

It was argued by the industry that they were suffering an undue burden from taxation at existing rates. Specifically, the data in SOHIO Submission One reveals, according to Walter Levy & Associates, that the effective income tax on the oil industry under the current law will not exceed about 2.5%, as opposed to the 9.4% in the statute. The oil industry never denied that most Alaskan businesses pay a higher effective rate. This arises from the large subsidies in the Federal taxable income figure on which our tax is based today* and because the actual value of North Slope production is not reflected in oil property, sales, and payrolls in the state (the factors now used to divide income).

In the course of the hearings, one major conflict kept emerging - the state's need for incentives versus the desires of Alaskans to turn oil capital, which can never be replaced, into uses that will provide benefits for the present and future generations.

It is the task of the Legislature to balance these desires, and the uncertainties that go with each of them.

Given the tax relief that the administration's severance tax proposal will afford the economically marginal oil and gas fields and the relatively modest increase in taxation the proposal places on the highly productive and profitable oil and gas fields, House Finance Committee Substitute for CS for SB 238* represents a balanced and reasonable adjustment to the present tax law.

HB 322, the corporate franchise tax, as well as HB 145, the direct accounting approach recommended by the Subcommittee on Oil and Gas Taxing and Leasing Policy, merely represent a mechanism to produce an effective rate equal to that which the present income tax law is supposed to recover for Alaska.

In light of the testimony and a thorough review of the analysis and study of tax proposals over the past three years, a majority of the members of the House Finance Committee recommends passage of HCS for CS for SB 238.

Rep. Steve Cowper, Chairman
House Finance Committee

Footnotes

* No such agreement could exist, since Article IX, Section 1, of the Constitution of the State of Alaska prohibits the surrendering of the power of taxation.

* Last year, the largest oil companies in Alaska reported $3 billion more income to stockholders than they were required to report to the I.R.S.

* House Finance Committee Substitute for CS for SB 238 is essentially the Governor's bill.

MAJOR PROVISIONS OF THE OIL AND GAS PROPERTIES PRODUCTION TAX

The severance tax for oil is set at 12.5 percent of the wellhead value, or $.9375 per barrel, whichever is higher. The cents-per-barrel "trigger" is set at a wellhead value floor of $7.50, a floor which escalates at the rate of the GNP deflator. The floor, combined with the escalator, gives the state "downside protection" from the risks of changes in Federal pricing policy or attempts by the oil companies to shift costs from the fields to the pipeline and tankers (thus lowering wellhead values) or to move profits to the refinery, marketing, and distribution phases of their operations (thus lowering the profits exposed to taxes in Alaska). The $7.50 floor was not criticized by the industry as unreasonable, and the escalator is seen as being essential to insure that Alaska's revenues keep pace with the rising value of Alaska's oil and to protect the purchasing power of the state's dollars.

By raising the minimum economic limit factor (ELF) from 100 to 300 barrels, the special problems of marginal producers, such as those on the Kenai-Cook Inlet fields, are recognized. The ELF formula has been altered with an exponent that speeds the fall in severance tax for marginal fields.

The definitions of "gross value at the point of production" in Section 7 avoid the instability that came from the six years of litigation over the pricing of Cook Inlet oil.

The severance tax rate for gas is set at 10 percent of value, or $.064 per thousand cubic feet, whichever is greater. Again, there is a floor under revenues, guarded by the GNP deflator. Again, because of the ELF formula, the less profitable a field, the more rapidly the severance tax ends. The former tax on all flared gas (a drafting error in the original bill) has been replaced by a penalty on gas use exceeding that allowed by the State Conservation Committee for safety flaring and for operating purposes on a lease.

OUTLINE OF HCS CSSB 238

The House Finance Committee Substitute for Committee Substitute for Senate Bill No. 238 provides for a production tax on oil and gas which has the following characteristics:

FOR OIL,

1. A 12.5% of value tax; or,

2. A $.9375 per barrel tax ($7.50 floor price), whichever is higher;

3. An escalator for the cents per barrel tax based on the GNP deflator;

4. An economic limit factor (ELF) which reduces the effective tax rate as production approaches the economic limit; and

   (a) which presumes 300 barrels per day as the economic limit subject to the taxpayer demonstrating otherwise; and

   (b) which contains an exponent that further reduces the effective rate for leases with an economic limit of less than 300 BPD; and

   (c) which relies on the free market price of imported oil for determining the economic limit;

5. A definition of the point of production.

FOR GAS,

1. A 10% of value tax; or

2. A $.064 per thousand cubic feet tax, whichever is higher;

3. An escalator for the cents per MCF tax based on the GNP deflator;

4. An economic limit factor which reduces the effective tax rate as production approaches the economic limit; and

   (a) which requires a hearing to determine the economic limit; and

   (b) which relies on the highest field price within 100 miles for such determination;

5. A penalty on gas flared in excess of that authorized for safety equal to the production tax on gas;

6. A definition of the point of production.

Prepared by:

Legislative Affairs Agency
Research Division 6 May 77

OUTLINE OF CSSB 238 am

The Senate Resources Committee Substitute for Senate Bill No. 238 as amended in the Senate provides for a production tax on oil and gas which has the following characteristics:

FOR OIL,

1. A 11.5% of value tax; or
2. A $.75 per barrel tax ($6.52 floor price), whichever is higher;
3. No escalator for the cents per barrel tax;
4. An economic limit factor (ELF) which reduces the effective tax rate as production approaches the economic limit; and
   (a) which presumes 100 barrels per day as the economic limit subject to the taxpayer demonstrating otherwise; and
   (b) which contains an exponent that further reduces the effective tax rate for leases with an economic limit of less than 750 BPD; and
   (c) which relies on the free market price of imported oil for determining the economic limit;
5. No definition of the point of production.

FOR GAS,

1. A 10% of value tax; or
2. A $.064 per thousand cubic feet tax, whichever is higher;
3. No escalator for the cents per MCF tax;
4. An economic limit factor which reduces the effective tax rate as production approaches the economic limit; and
   (a) which requires a hearing to determine the economic limit; and
   (b) ~~which relies on the highest field price within 100 miles for such determination;~~ no
5. No penalty on gas flared in excess of that authorized for safety.
6. No definition of the point of production.

Prepared by:

Legislative Affairs Agency
Research Division
6 May 1977

EFFECTIVE SEVERANCE TAX RATES IN PERCENT FOR PRESENT LAW,
HOUSE FINANCE COMMITTEE SUBSTITUTE FOR
COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 238,
AND
SENATE RESOURCES COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 238 am

Field Units	Present Law	House Finance CS CSSB 238	Senate Resources CSSB 238am
Beaver Creek	8.3	0	1.1
Granite Point			
280001	7.7	5.5	2.3
280002	7.5	1.0	0.8
280012	7.0	0	0
280022	8.0	4.2	1.5
McArthur River			
520001	10.5	14.7	8.6
520002	9.0	5.6	2.3
520003	8.8	7.7	3.7
Middle Ground Shoal			
524001	5.6	1.8	1.0
524002	6.0	4.4	1.9
524003	5.8	5.0	2.5
524013	5.6	3.8	1.7
Swanson River			
772001	10.4	1.0	0.6
772002	0	0	0
Trading Bay			
800001	7.6	0	0.6
800002	7.2	0	0
800003	0	0	0
800004	8.5	0	0.1
800005	7.1	0	0
Production Weighted Kenai-Cook Inlet Composite	8.9	8.4	4.9
Prudhoe Bay	7.7	12.2*	10.4*

*Assuming an economic limit of 750 bbl/day.

Prepared by:

Legislative Affairs Agency
Research Division
6 May 1977

COMPARISON OF TOTAL* SEVERANCE TAX REVENUES GENERATED BY PRESENT LAW,

HOUSE COMMITTEE SUBSTITUTE FOR
COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 238
AND
COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 238 AMENDED

	Millions of Dollars*		
Field	Present Law	House Finance CS CSSB 238	Senate Resources CSSB 238am
FY 1978:			
Kenai-Cook Inlet	23.5	22.3	13.1
Prudhoe Bay**	171.4	270.8	227.8
TOTAL	192.7	293.1	242.9
FY 1979:			
Kenai-Cook Inlet	19.6	19.0	11.1
Prudhoe Bay**	255.8	397.6	349.4
TOTAL	275.4	416.6	360.5
FY 1980:			
Kenai-Cook Inlet	18.2	16.3	9.3
Prudhoe Bay**	303.7	471.9	413.6
TOTAL	321.9	488.2	422.9
	790.0	1197.9	

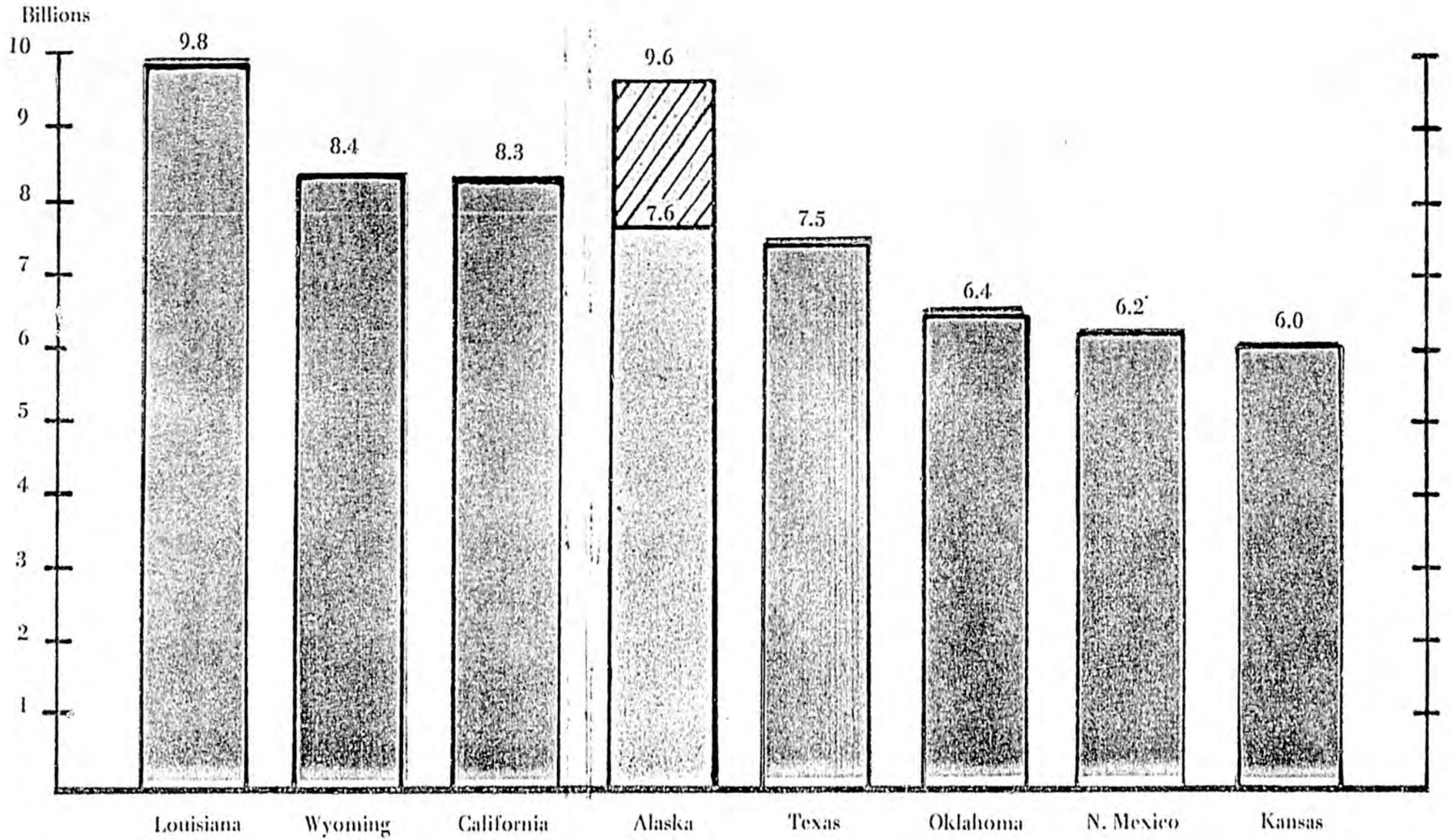
* All figures are gross, EDIC has NOT been credited.

** Assume wellhead value at Prudhoe Bay Oil is $7.38/bbl in FY78 with 5% inflation thereafter.
Assume economic limit at Prudhoe Bay is 750 bbl/day.

Prepared by:

Legislative Affairs Agency
Research Division
6 May 1977

Tax Comparison



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1977
House Resources
Taxation Report
(subcommittee chaired
by Snider)

TO: CHAIRMAN, HOUSE RESOURCES COMMITTEE
AND ALL COMMITTEE MEMBERS

FROM: SUB-COMMITTEE ON OIL & GAS

During the week of march 21 - 26 the Joint Senate and House Resources Committees met to hear testimony relating to the various oil and gas taxation bills currently before us. Some of the bills under discussion, have not been refered to this committee.

Of the ones that have been, the Sub-committee on Oil and Gas recommends that H.B. 321, H.B. 322, C.S.H.B. 323, H.B. 328, and S.B. 274 be brought to the full committee's attention for consideration and that they be acted upon and passed out of committee no later than April 7.

Each of these bills have a further referal to House Finance and the Finance Committee has scheduled hearings and work sessions on these bills beginning early next week. Representatives from the oil companies and several nationally recognized economists will be present. We urge all members, who are able, to attend.

RECOMMENDED BILLS

H.B. 321 - SEVERENCE TAX

This tax, in our opinion, rates highest in priorities. It's timeliness is dependant upon the actions undertaken by the Federal Energy Administration in setting a recommended "well head" price by April 15, 1977, and further by actions later taken by the I.C.C. in recommending the transportation cost of North Slope crude. For other features of the bill, we refer the committee's attention to the Governor's transmittal letter for H.B. 321, included with this report.

H.B. 322 - ALASKA NET INCOME TAX OR FRANCHISE TAX

This tax bill, in our opinion, has several advantages over our present income tax collection system. It is easy to administer, is based upon the amount earned within the state, including OCS development, and would provide the State and the industry with a stable taxation policy for years to come. For other features, we refer you to the Governor's transmittal letter for H.B. 322, included in this report.

H.B. 323 - PROPERTIES AD VALOREM TAX

This tax bill, in our opinion, is premature. It would increase the scope of taxable property to include refining, liquefaction, and marine transportation. We believe that it would act as a "disincentive", at this time, for future development within our state, and of all the tax bills before us, meet with the most resistence. Accordingly, we have asked the Department of Revenue to place before this committee, a committee substitute for H.B. 323 which would reduce the bill to a "house-keeping" measure. This has been done and is before the committee for consideration.

H.B. 328 - RESERVE TAX

This tax bill amends the reserves tax bill to allow a credit reduction of tax levied 12 [20] if the oil flow through the Trans-Alaska Pipeline by October 1, 1977 has reached at least 600,000 barrels of oil on a daily average. Otherwise, the bill extends the reserve tax beyond the December 31, 1977 effective date of the original act. We urge its passage.

S.B. 274 - THE TAKING OF OIL AND GAS ROYALITY IN KIND

This bill requires that royality oil and gas be taken "in kind" rather than in money unless deemed otherwise by the commissioner, the Alaska Royality Oil and Gas Development Advisory Board, and the the Legislature. As an encouragement for future development within our state, we urge the passage of this bill.

RCD ?
Are you taking up that last Amendment that's supposedly Stuart's part of?

CONCLUSION:

The Sub-committee bleieves that the passage of these tax proposals, taken in conjunction with the desire to have the Alaskan Permanent Fund replace the eventual and inevitable passage of our nonrenewable resources, will produce a desired benefit for the State of Alaska. We further believe that they will not act as a disincentive for the oil industry and that their passage will ensure Alaska's "fair share" in the wealth of our state. Regarding this aspect, we urge committee members to read the Tanzer Report, "IMPACT OF INCREASED TAXATION ON OIL EXPLORATION AND DEVELOPMENT IN ALASKA", submitted to all members of the Alaskan State Legislature on March 25, 1977.

We have asked that Mr. John Messenger from the Department of Revenue be present to assist committee members in answering their questions and would, as this time, like to highly commend the staff of Senate and House Resources for providing the back-up material needed for the committee's deliberations.

Rep. Merle G. Snider
Rep. Hugh Malone
Rep. William Akers.

HOUSE BILL NO. 321 by the Rules Committee by request of the Governor, entitled: HB 321

"An Act relating to the oil and gas properties production tax; and providing for an effective date."

was introduced, read the first time and referred to the Committees on Resources and Finance.

The Governor's transmittal letters appear following the bill to which it pertains: fiscal notes appear in House Supplemant No. 31 to today's journal.

"March 8, 1977

HB 321

The Honorable Hugh Malone
Speaker of the House
Alaska State Legislature
Juneau, Alaska 99811

Dear Mr. Speaker:

Under the authority of art. III, sec. 18 of the Alaska Constitution, and in accordance with AS 24.30.060(b) and the Uniform Rules of the Alaska State Legislature, I am transmitting a bill relating to the oil and gas properties production tax.

As a result of a recent study of Alaska's oil and gas tax structure, the Department of Revenue has recommended several changes in the state's production or "severance" tax. This bill incorporates those specific recommendations.

Currently the state's oil production tax is calculated according to "stair stepped" rates depending upon the level of production for the lease or property. As currently structured the tax may have an adverse impact upon a particular property as it reaches its economic limit. The "stair step" approach may not alleviate this adverse effect since the economic limit may vary substantially from one part of the state to another. This is because it may be more costly to produce and transport the oil in the more remote areas of the state. Accordingly, the bill contains an economic limit mechanism which automatically scales the tax rate down as the production nears its economic limit. This will insure that the tax will not unduly inhibit oil production as it reaches its economic limit.

One of the immediate dangers which face the state's revenue picture is the potential for artificially depressed pricing of the state's North Slope oil. This could result from federal pricing decisions or excessive tariff costs from the wellhead to the refinery. To insulate the state's petroleum revenues from these forces, the bill provides for a mechanism which would raise the cents-per-barrel floor to correspond to a mid-range market value for North Slope oil and tie that floor to an index which will let the floor keep pace with inflation.

One of the Department of Revenue's recommendations -- the oil and gas surtax -- which was designed to offset revenue losses due to depressed pricing of North Slope oil and which was to be imposed only on holders of state-owned leaseholds was deleted on the advice of this department because of the substantial legal problems involved.

The bill places the tax on gas at a parity with the tax on oil. Currently gas is taxed at only 4 percent while oil is taxed from 5 to 8 percent. The bill would tax both oil and gas at 10 percent. In addition, the bill sets a cents-per-Mcf floor for the gas tax similar to the cents-per-barrel floor for oil. This new floor for gas corresponds to the highest market price in the state, and it too is tied to an index to keep pace with inflation.

Sincerely,

Jay S. Hammond
Governor "

AGO 531501

HOUSE BILL NO. 322 by the Rules Committee by request of the Governor, entitled: HB 322

"An Act establishing an oil and gas corporate franchise tax; and providing for an effective date."

was introduced, read the first time and referred to the Committees on Resources and Finance.

"March 8, 1977

The Honorable Hugh Malone
Speaker of the House
Alaska State Legislature
Juneau, Alaska 99811

Dear Mr. Speaker:

Under the authority of art. III, sec. 19 of the Alaska Constitution, and in accordance with AS 24.50.060(b) and the Uniform Rules of the Alaska State Legislature, I am transmitting a bill establishing an oil and gas corporate franchise tax.

The Department of Revenue, in its oil and gas tax study, found two basic deficiencies with the corporate income tax as it relates to oil and gas corporations. This bill would correct those deficiencies.

HB 322

The first problem is the eroded federal tax base. The department found that the federal corporate tax base which Alaska has adopted has been substantially eroded by special exemptions, deductions, credits and other accounting devices. The result has been that oil and gas corporations pay an effective tax rate much smaller than the statutory 48 percent. Accordingly, the bill would enact a separate franchise tax on a corporation's "book income." "Book income" is the net income which the corporation reports to its stockholders. This would eliminate all the special Congressional tax provisions.

In addition, the department found that the present apportionment formula does not fully represent the oil and gas corporate activity in the state. The present formula of property, payroll, and sales generally measures corporate business activity in the state. For natural resource companies, however, it does not. No reflection in the present formula is made for the scarcity value of the oil and gas produced. Accordingly, the bill will substitute for the present sales factor an extraction factor which will give weight specifically to oil and gas production activity.

One of the advantages of this franchise tax is that it will take into account elements of property, payroll, and extraction located on the Outer Continental Shelf which causes a resulting impact on the adjoining state. Thus property, payroll, and extraction not located in any state but which are located off the shores of an adjoining state which is impacted by the oil and gas production activity will be allocated to that state suffering the impact. Although this latter provision may raise some constitutional law questions, we believe that the proposal comes within the limits of the state's taxing powers given the impact on the coastal communities of our state of these OCS activities.

Sincerely,

Jay S. Hammond
Governor"

AGO 531502

HOUSE BILL NO. 328 by the Rules Committee by request of the Governor, entitled: HB 328

"An Act amending the oil and gas reserves ad valorem tax; and providing for an effective date."

was introduced, read the first time and referred to the Committees on Resources and Finance.

" March 9, 1977

The Honorable Hugh Malone
Speaker of the House
Alaska State Legislature
Juneau, Alaska 99811

Dear Mr. Speaker:

Under the authority of art. III, sec. 18 of the Alaska Constitution, and in accordance with AS 24.50.060(b) and the Uniform Rules of the Alaska State Legislature, I am transmitting a bill amending the oil and gas reserves ad valorem tax.

Section 1 of this bill proposes that the reserve tax levy be reduced from 20 mills to 12 mills this year with the condition that an additional levy will be made if there is a delay in the start-up of the Trans-Alaska Pipeline.

This amendment is proposed because the state has a budget surplus for FY 1977. This surplus is somewhat illusory, however, since the reserve tax payments may be recouped by oil and gas producers by credits against future severance tax. Accordingly, the adoption of this measure would reduce the surplus for 1977 and also reduce the amount "borrowed" from future revenues.

Section 2 provides for a contingent 1978 assessment at a rate to be determined by that year's legislature.

Sincerely,

Jay S. Hammond
Governor"

HOUSE BILL NO. 323 by the Alaska Committee by request of the Governor, entitled:

"An Act relating to the oil and gas exploration, production, and pipeline and marine transportation property tax; and providing for an effective date."

introduced, read the first time and referred to the Committees on Resources and Finance.

"March 8, 1977

The Honorable Hugh Malone
Speaker of the House
Alaska State Legislature
Juneau, Alaska 99811

Dear Mr. Speaker:

Under the authority of art. III, sec. 18 of the Alaska Constitution, and in accordance with AS 24.30.050(b) and the Uniform Rules of the Alaska State Legislature, I am transmitting a bill relating to the oil and gas exploration, production, and pipeline and marine transportation property tax.

The Department of Revenue has recently completed its study of Alaska's oil and gas tax structure and has made several recommendations. One set of recommendations dealt with the state's 20-mill property tax imposed by AS 43.56. This bill would implement that set of recommendations.

The bill corrects four problem areas in the current property tax: the omission of certain important kinds of oil-and-gas-related properties from the definition of taxable property; present uncertainty about how pipelines should be valued; the static nature of the $1500 per-capita limitation on municipal taxation, and the extent to which municipal property tax payments should be allowed as credits against the state tax. The bill's features are described below:

Section 1 of the bill makes clear that taxes paid to municipalities which exceed the statutory limitations in AS 29.53.045 and 29.53.050 are not creditable against the state tax.

Section 3 of the bill removes the current uncertainty on pipeline valuation by ensuring that pipelines will be valued on the basis of their full and true value with due regard to their economic value. This will eliminate the possibility of pipelines being valued under the depressed valuation method of actual cost depreciated.

Section 4 of the bill defines full and true value of property used in refining or liquefying of gas or oil as replacement cost less depreciation. It also defines the value of taxable marine transportation property.

Section 7 adds new categories of taxable property including oil refineries, gas processing plants and liquefied natural gas facilities. This will mean greater revenues to the state from these important oil and gas properties.

Section 8 and 9 of the bill tie the $1500 per capita municipal limitation to the Anchorage cost-of-living index in order that the limitation would increase over time as inflation raises the cost to municipalities of providing services to its residents.

HB 323 In addition, Sections 2, 4, 5, 6, and 7 are aimed at amending the relevant provisions of AS 43.56 to provide for the taxation of marine transportation property (i.e. tankers) on an apportioned basis determined by the number of days spent on ports loading and unloading gas and unrefined oil divided by the total number of days-spent-in-ports everywhere. Although these provisions raise close and difficult questions of constitutional law regarding the ability of the state and municipalities to impose an ad valorem property tax on such vessels in light of the traditional application of the "home port" doctrine, it is the view of the Department of Law that these vessels have sufficient nexus with the state to bring them within the constitutional parameters of the state's taxing power.

Sincerely,

Jay S. Hammond
Governor"

AGO 531504

SCOMM

#12:12

FRANCHISE – Governor's transmittal letter

HB 322
SB 234

HOUSE BILL NO. 322 by the Rules Committee by request of the Governor, entitled: HB 322

"An Act establishing an oil and gas corporate franchise tax; and providing for an effective date."

was introduced, read the first time and referred to the Committees on Resources and Finance.

"March 8, 1977

The Honorable Hugh Malone
Speaker of the House
Alaska State Legislature
Juneau, Alaska 99811

Dear Mr. Speaker:

Under the authority of art. III, sec. 18 of the Alaska Constitution, and in accordance with AS 24.50.060(b) and the Uniform Rules of the Alaska State Legislature, I am transmitting a bill establishing an oil and gas corporate franchise tax.

The Department of Revenue, in its oil and gas tax study, found two basic deficiencies with the corporate income tax as it relates to oil and gas corporations. This bill would correct those deficiencies.

HB 322

The first problem is the eroded federal tax base. The department found that the federal corporate tax base which Alaska has adopted has been substantially eroded by special exemptions, deductions, credits and other accounting devices. The result has been that oil and gas corporations pay an effective tax rate much smaller than the statutory 48 percent. Accordingly, the bill would enact a separate franchise tax on a corporation's "book income." "Book income" is the net income which the corporation reports to its stockholders. This would eliminate all the special Congressional tax provisions.

In addition, the department found that the present apportionment formula does not fully represent the oil and gas corporate activity in the state. The present formula of property, payroll, and sales generally measures corporate business activity in the state. For natural resource companies, however, it does not. No reflection in the present formula is made for the scarcity value of the oil and gas produced. Accordingly, the bill will substitute for the present sales factor an extraction factor which will give weight specifically to oil and gas production activity.

One of the advantages of this franchise tax is that it will take into account elements of property, payroll, and extraction located on the Outer Continental Shelf which causes a resulting impact on the adjoining state. Thus property, payroll, and extraction not located in any state but which are located off the shores of an adjoining state which is impacted by the oil and gas production activity will be allocated to that state suffering the impact. Although this latter provision may raise some constitutional law questions, we believe that the proposal comes within the limits of the state's taxing powers given the impact on the coastal communities of our state of these OCS activities.

Sincerely,

Jay S. Hammond
Governor"

AGO 531393

04-D3LH

STATE OF ALASKA

JAY S. HAMMOND, GOVERNOR

DEPARTMENT OF REVENUE

OFFICE OF THE COMMISSIONER / POUCH S – JUNEAU 99811

April 25, 1977

circled suggestions were adopted by Sen. Resources

The Honorable Kay Poland
Chairman
Senate Resources Committee
Alaska State Legislature
Juneau, AK 99801

Dear Senator Poland:

You have asked the Department of Revenue to testify on the proposed CS for SB 105 relating to the Alaska net income tax act. Specifically you have asked the department to respond to ways in which the bill may be changed to improve the administration of the tax. Accordingly I have included the technical changes and administrative changes which we would recommend.

1. page 1, line 25
delete the reference "AS 43.20.066" and insert the following in its place "AS 43.20.011"

2. page 2, line 2
after the word "accordance" delete the following phrase "with section 18 of article IV of the Multi-State Compact (AS 43.19.010) and"

3. page 2, line 3
after the word "secs." delete the phrase "12-14" and insert the following in its place "67-69"

4. page 2, line 8
after the word "under" delete the phrase "secs. 11(e) and (f) of this chapter" and insert the following in its place "sec. 11(f) of this chapter."

5. page 2, lines 9 and 10
after the word "chapter" delete the rest of the sentence and insert the following in its place "shall be calculated using gross income and deductions from gross income as defined in this section."

6. page 2, line 11
delete the word "revenue" and insert "income" in its place.

important change →

7. page 2, line 12
delete the words "wellhead value" and insert the phrase "value of oil and gas produced" in its place.

AGO 531394

8. page 2, line 15
delete the word "revenue" and insert the word "income" in its place.

9. page 2, line 25
after the word "the" insert the word "direct" (exclude indirect & overhead)

10. page 2, line 28
after the word "services" insert the phrase "and not including indirect costs or overhead"

11. page 3, line 5
after the word "capitalized" insert the phrase "and also including the amortization of"

12. page 3, line 20 NOT ADOPTED
after the word "properties" insert the phrase "after a well has been plugged and abandoned."

13. page 3, between lines 25 and 26
insert the following:
(e) deductions from gross income under this section shall not include expenses previously deducted on a return filed under this chapter. (Same as used for severance).

14. page 6, line 21
delete the word "consolidated" and insert the word "combined" in its place.

15. page 6, line 21
delete the word "allocation" and insert the word "apportionment" in its place.

16. page 7, line 15
delete the reference "As 43.20.330" and insert "AS 43.20.335" in its place.

17. page 8, between lines 3 and 4
insert the following:
Sec. 43.20.075 BOOKS AND RECORDS. The department may provide by regulation the manner in which books and records must be kept and maintained for purposes of determining gross income and deductions from gross income under secs. 67-69 of this chapter.

Sincerely,

John R. Messenger
Deputy Commissioner

QUESTIONS AND ANSWERS IN TESTIMONY OF TOM WILLIAMS DIRECTOR OF PETROLEUM AND REVENUE FOR THE JOINT SENATE-HOUSE RESOURCES COMMITTEE MEETING ON OIL AND GAS TAXATION (24 MARCH 1977)

WILLIAMS TESTIMONY

(Answer to question asked by George Silides in Commissioner Gallagher's testimony)

Tom Williams Madame Chairman with your permission I would like to try to address that question and also try to speak a little bit to what Senator Radar was talking about earlier. For the record my name is Tom Williams I'm the Director of Petroleum and Revenue. We have two changes in the severence tax that we are suggesting. One is the economic limit factor and the other is the increase in cents per barrel floor. Right now we have a federal pricing decision to give oil , to Prudhoe Bay oil new oil treatment for both pricing purposes and for entitlements purposes. Entitlement is a transfer of money back and forth among the refiners to equalize their apposition costs to the national average, that is the objective of the entitlement, and new oil in the lower forty eight comes in the refinery less than imported oil consequently there is a fraction of an entitlement that didn't flaw, for the right to run as new oil. Our oil when it gets there, will not be below the cost for import oil it will be right at the cost for import oil. In fact the national policy has been for new oil like high risk North Slope production we got right from our Prudhoe Bay field. National policy is to give that, right now a $10.95 average price, cause of the realities of market, we tried, if we insisted

or if the producers who own that insisted on getting a market price at the refinery that corresponded to a $10.95 well-head price, someone is going to have to pay the transportation cost, and if you have say a total $5.00 transportation cost you would be getting into the market place at $15.95 the Saudi oil which is competitive with ours is selling for $13.50 to $13.75 so somebody would have to, I mean where's the incentive to buy, you'd have to compell people to buy our oil to get $10.95 price or there would have to be a subsidy. This has not been a thing that we have been requesting the federal government to do. We recognize the fact that this is how the market is, we are far away from it in terms of cost. Consequently the well-head value is not that it's realized by a refinery price that's competitive with the Saudi Arabian oil. Our well-head value is going to be lower than the ceiling. The problem is that they are going to, if they treated this new oil, they are going to try to equalize something that is already equalized and it is going to result in a penalty over $3.00 a barrel, this equalization. They will equalize all the rest of new oil for the lower forty eight, it won't hurt them too much, it will cause some problems though, because it will over equalize new oil producers in the lower forty eight. But for us it doesn't, it's completely inappropriate because our oil is already coming in at the level corresponding to imports. There is no need to equalize. Consequently if you make them buy at a fractional entitlement at a cost of $3.00 or $3.35 that means the refiner is going to pay that much less instead of paying $13.50 he will pay $10.50, and that means a Prudhoe Bay producer or the State of Alaska if it takes its royalty in kind and goes out and tries to sell it, when he gets it to the west coast is gonna see only $10.50 coming to him. $3.00 goes into the entitlement,

we never see that. So you start from $10.50 down there in California and then you have that when you get to a $4.00 welling price. Our contention is that if that happens the game is over. There will be no more exploration. There are no more Prudhoe Bays. It is highly unlikely, there is only one Prudhoe Bay in the United States and there may be a second one down in Mexico, in the Tabascoarea in the farmers fields, but a, there pretty darn few and far between to find a field that large and at $4.00 well-head value. If that's the prospect, four dollar well-head with

today's cost, even if you found it out of Prudhoe Bay the chances are nill that it would be developed. And so the game is over because we are not likely to find fields twice and three times the size of Prudhoe Bay. So given that the game would be over, we are not doing any more damage by saying that well, instead of $6.00, $7.10 is the floor and the post which is our present floor with the cents per barrel, we are simply saying, Why should the people of Alaska follow the resource? At the game, it then becomes a question of priorities and where our allegiance lies, with the people of Alaska or the share holders in the larger corporations? Now there is a balance, but given that &7.50 is not a reasonable well head price for North Slope oil in the beginning of a cut, and as production continues and through what builds up, if it, the federal began, assuming the federal government doesn't screw things up and destroy the insantitudes, the increase thuroughfare will lower the pipeline tariff. This will allow the well head value to rise. OPEC countries can be expected to raise their price, that includes Arabia. So if the refinery price for our oil, our refineries will raise the charge for getting our oil from Prudhoe Bay to the refineries will be less. These two things will conbine to raise our well head value and by the early 1980's we won't get by talking about the well head value of $7.50, we will be taldingabout well head values greater than $10.00. In fact extrapulating out by the end of this century, we will be seeing well head values of well, your world market values it sounds obsurd today, but $20.00 well values are certainly not inconceivable at that time, and thats $20.00 in terms of today's dolars, you know, not inflation dolars of the year 2000, that twenty of today's dolars,

thats simply because we have increasing demand, our Latin American neighbors for instance, their energy consumption is growing at a rate ten times ours, their population keeps growing, and world energy demands are far outstripping our own nation's demand and as vast as the OPEC resources are, this is a world wide shortage developing in the next 10-15 years. This shortage is going to cause, ask developers, its going to cause the price to rise in real terms that is to say in addition to the effects of inflation, we will have an additional increase in the real rather than the illusion. Consequently when we turn back, to the point, if the federal government gives us new oil in Tilener's treatment, the question then becomes whether we are willing to sit by and say OK we will take 8% or 10% off for dolars and there it is, its not good, but thats all there is to it. Even though we are paying right now, importing almost 10 mission barrels a day to each, though I don't know what the latest figures are and we are paying our good, loyal allies, Arabs, Iranians, Abu Dhabians, and all those nice people and Indonesians, Nigerians and Algerians, 14-15 somewhere in that range, 14-15 dolars is the average per import acquisition cost.

QUESTION- Tom, I understand what you are saying, I really do, but how, I must have missed somthing, how does that help Cook Inlet today?

- OK, with Cook Inlet, we, Sterling and I have gone to the Federal Energy Administration last summer and in fact, the hearings that they had earlier, in April or May, it was in Anchorage regarding the price of new oil and how to compound the upper and lower tears should move through time, and also about this problem

of oil production that reaches its break-even point with the control oil price. Right now, I mean the federal government is not reluctant to price our oil severly below what its actually worth, in the inlet that oil is beginning from $5.00 to $5.15, and for oil of similar quality we are paying, almost, we are probably paying over $15.00 a barrel to get it from Indonesia to the west coast or Pudget Sound. So we don't see a very friendly attitude on the behalf of the federal government toward Alaska production to begin with. We went there and pointed out that there are some properties in the oil that were at that time dangerously close to reaching this break-even point at $5.00 a barrel, we said we know you have shis procedure to allow pricing on this basis, to allow the price to go up, so that they continue to have more revenue than expenditures. Then they, thats indeed true, then they said that of course we are not going to give it to the State of Alaska because thats fixed cost, you are going to be stuck there at $5.00. Well that presents an interesting question about how they rewrite our lease, but they said that they would allow that much pressing relief and return the property to the level of profitability enjoyed in May of 1973 when price controls, that's the reference period they all relate back to, May of '73. But he said, we'll allow to have that same measure of profitability, which to my thinking would include among an profit, you have what's over for tax. So if you raised the severence tax, that's an increase cost, but an oil company can go into the FEA and present the case saying, here are my thoughts, now give me my May 1973 rate of return,

and in fact that should accelerate the movement to a more realistic price to the upper tear which is not still the market price, but at least its, $10.95 is a good site better than $5.00. And consequently, if the Federal Energy Administration is doing what they say they are going to do and if they can do it in a timely fashion, there should be no problem for the oil companies because this is simply an expence, severence taxes are recognised as such.

- that had not been explained before. thank you.

GALLAGHER TESTIMONY

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

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

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

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

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

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

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

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

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

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

numbers is using current dollar basis.

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

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

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

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

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

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

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

Commissioner Gallagher - You mean the reserves tax?

Senator Radar - Reserves tax yes.

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

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

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

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

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

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

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

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

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

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

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

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

above that.

Senator Radar - No.

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

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

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

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

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

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

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

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

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

Commissioner Gallagher - Yes, I do.

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

and 16% worth of return on this project.

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

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

Commissioner Gallagher - About 18% over all five bills.

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

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

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

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

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

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

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

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

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

(GAP)

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

which is the price for Swede a 34° gravity on the west coast, we are only going to 7 1/2 because of Prudhoe Bay, so we are not being inconsistent, we are giving them a break.

Senator Colletta - Thank you Madame Chairman.

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

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

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

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

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

Commissioner Gallagher - Absolutely.

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

Commissioner Gallagher - Of course they are hired by me.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

George Silides - The North Pole an export refinery?

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

George Silides - But the SOCAL one?

Commissioner Gallagher - I know some piloteers for it.

George Silides - The SOCAL one?

Commissioner Gallagher - Yea.

George Silides - Are they export?

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

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

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

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

George Silides - I see.

Commissioner Gallagher - We already think we have it.

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

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

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

ZEIFMAN TESTIMONY

QUESTIONS AND ANSWERS
PROFESSORS ZEIFMAN AND AINSWORTH
March 21, 1977

SENATOR HUBER - I'd like to get into that change in apportionment formula. I believe you said substituting a production factor for sales.

PROFESSOR ZEIFMAN - We called it an extraction factor.

SENATOR HUBER - Alright an extraction factor. Was that in addition to sales or was that separate from sales?

PROFESSOR ZEIFMAN - In our proposal, we recommended the use of an extraction factor instead of the sales factor. So that there would only be property, payroll, and extraction.

SENATOR HUBER - Okay, now you can by defending yourself, why instead of an extraction factor, in answering this question, you'll get what I want, instead of an extraction factor why didn't you, so that Alaska would get the best possible deal, why didn't you put in a factor that said the average number of degree days below zero degrees celceus? Now, I'm serious about that. If you can answer why you did something like that instead of that....

PROFESSOR ZEIFMAN - If I were a resident of Alaska, I think I'd prefer rainy days in Juneau.

SENATOR HUBER - _____ but why is it we can't use something like that instead of adding an extraction factor. What stops us?

PROFESSOR ZEIFMAN - Well, I think the nature of the Supreme Court decisions in this area if you'll look at the Northwestern Portland Cement Company case, is that an apportionment factor has to or should in some ways reflect the business activities of the company in the State and be reasonably related to the economic impact that those activities have on the State. If we were using rainy days in Juneau to total rainy days, that would make no sense unless the companies themselves were producing the rain.

SENATOR HUBER - Excuse me Madam Chairman. Do we have to have the concurrence of any of the other members of the multi-state compact in order for the change in factor or can we change it unilaterally for Alaska?

PROFESSOR ZEIFMAN - I think that you can change it unilaterally for Alaska both persuent to Section 18 of the compact, but also this is a soverign state and you can enact this whatever laws you wish. There is no penalty provided for in the compact for states that depart in this line. I think that you can change it unilaterally.

SENATOR HUBER - If we went ahead with the extraction factor which would take care of things in oil, wouldn't we then have lost the sales factor that takes care of such things as us getting a fair return from the J. C. Penny Company, and from other outfits that sell in Alaska? In other words, you've got enough of it, I think.

PROFESSOR ZEIFMAN - Yeah. Well, I don't think in fact that that follows. I think you could continue to use the sales factor for other types of industries. As a matter of fact I would draw a distinction between the petroleum industry and other types of industry because of the fact that the petroleum industry is removing from the State a non-renewable resource, and I think that's a perfectly legitimate basis for drawing distinction between the use of an extraction factor and sales factor. I think that the sales factor is far more appropriate to a merchantile type of operation that is not engaged in production and certainly not engaged in the removel or the extraction of non-renewable resources.

SENATOR HUBER - Well, I can see Professor, and I won't pursue this much longer, Madam Chairman. I can see that our extraction factor could very well be New Jersey's sales factor, and they could for instance have an extraction factor maybe on wood products or something else. That would then become a sales

factor here. It's like a doubled ended thing, it could work from both ends.

PROFESSOR ZEIFMAN - Well, My immediate reaction is that I don't think you have to worry about that too much. West Virginia for example has a two factor formula based only on property and payroll, and Florida has a different type of a sales tax there than Alaska does. The fact that other states have departed from the Uniform Act in one form or another or had not adopted the Uniform Act, I don't think is a matter that ought to pursuade you one way or another.

SENATOR HUBER - It is obvious, Madam Chairman, that some of us don't understand about the multi-state compact and how some of the factors are brought into it. They might appreciate an answer of just if you wanted to change to the two factor system or substitute extraction factors for sales on petroleum, or sales on other things, who in this State has to act in what manner. What has to be done to bring this about?

PROFESSOR ZEIFMAN - I think it simply requires an act of the State Legislature.

SENATOR HUBER - I can't find any multi-state compact act in our books now. It looks like the thing is done somewhere else, except we're members is all I know. I can't find it in the statutes.

PROFESSOR ZEIFMAN - There is a statute, I don't have the statutes in front of me, but the citation is referred to.

SENATOR HUBER - It makes us a member of the multi-state compact but it doesn't spell these out.

PROFESSOR ZEIFMAN - You have also adopted the formula and also the formula has a provision in it that the Uniform Division of Income for Tax Purposes Act has a section 18 which permits modification.

SENATOR CROFT - I had two particular sets of questions. One, in the Bill itself on the bottom of Page 3, the definition of net income, Section 41.1030 defines net income as the net income determined and certified by an independent certified public accountant for the purpose of a report to shareholders covering its earnings, and the like, and I noticed in today's Wall Street Journal on Page 6 there's a summary of a considerable amount of recent activities with regard to the drawing suspicion that independent auditor's opinions are simply unreliable. In the first place, the commission on auditor's responsibilities of the American Institute of Certified Public Accountants as long as two and one half years ago put out a report critical of auditors opinions, and now there's a Senate subcommittee headed by Lee Metcalf of Montana holding hearings on the role of auditors and financial reporting,

and this article says a highly critical report by the subcommittee staff accused auditors of being too close to their corporate clients and recommended a major expansion of the government's role in setting accounting and auditors standards, and I'm curious why with the increasing suspicions that corporate management can manipulate the auditors reports. You're suggesting that the study should base its tax on something of that nature.

PROFESSOR ZEIFMAN - Well, Senator, I think that any changes in the procedure in this area as our society becomes more and more consumer oriented, if that's the right way to describe it, any changes will reflect a tightening up of the procedures rather than a liberalization of them in terms of tax avoidance, so that the concern of Senator Metcalf, which I would agree is a legitimate one, about the use of the independent _____ I think is relevant, but I think that the significant thing is that given all of the flexability that does exist in the law, the company has an incentive under the present system to face it fully and realistically, to put it in a colloquial way, I think our proposal catches the company between the bark and the tree, or the auditor between the bark and the tree. The accountants have an interest in maximizing earnings and profits in terms of the report to the share holders, and they have an interest in minimizing taxable income for tax accounting purposes. So we're suggesting that the State would do better by adopting a tax base which is measured by an amount where the

company itself has an incentive to maximize the amount rather than minimize it. I cannot see company accountants for purposes of reporting earnings and profits collectively, espousing as your suggesting, espousing an accounting method that's going to decrease their earnings and profits. So, to whatever extent there is flexability, by and large, the companies own accountants will want to maximize the book income, now if we were talking about this as a 60% tax, we might have a different kind of a situation, but in view of the fact, once again, that the accountants have a desire to maximize earnings and profits, I would think that it would be a desirable thing for the state to simply say, listen what you report to your shareholders, we regard as more a reflection of your real profitability, and then as a way of protection, I don't think this is needed, but as the Administration bill does, if you simply say look, we'll take federal taxable income or book income whichever is the higher, you have plugged the loopholes if that's what you want to call them more effectively than has the federal government, and I would suggest you have plugged the loopholes more effectively than has any other state in the United States.

SENATOR CROFT - Madam Chairman, I don't care to belabor the point, I do understand what you're saying if you're basic assumption is correct that the companies for reporting purposes will maximize their income in terms of book value which may or may not be correct, then what you say may be appropriate,

but the notion that the independent autitor is not subject to manipulation by the corporation, it seems to me that all of the information the past couple years indicates they are, but if you are correct about book value, it seems to me that what you're saying is that our Department of Revenue, if you're correct with regard to your figures about oil corporations in Alaska today, our Department of Revenue has simply not been doing an adequate job of enforcing the existing law, be it you're saying that they can take book value now and have increased the income taxes to be paid to the State of Alaska because they have the authority to do that even under the multi-state compact do they not?

PROFESSOR ZEIFMAN - No. Respectfully, I think you misunderstand the law. The law talks about giving the administrator the power to modify the apportionment formula, but not the unapportioned tax base.

SENATOR CROFT - Let me ask you then, what is the interpretation of 43.19.010, Section 18, which says that the allocation and apportionment provisions of this article do not fairly represent the extent of the taxpayers business activity in this state. The taxpayer may petition for or the tax administrator may require in respect to any or all of the taxpayers business activity if reasonable A. separate accounting. And then they go ahead and list three other factors.

PROFESSOR ZEIFMAN - Senator, I believe that's not relavent to this discussion. That is the means of dividing a pie. The pie is the tax base prior to apportionment. The size of the allocation and apportionment method is a method of determining what percentage of the pie is going to be taxed by Alaska, but the subject of how large is the pie which is going to be subject to the apportionment and allocation is the subject of the undivided tax base. For defining the undivided tax base prior to apportionment, the State has adopted the federal definition of taxable income so that our findings in no way indicate any remission on the part of the Department of Revenue, though the Department of Revenue does not have the power to eliminate the deductions for intangible drilling expenses in defining the tax base, so I think that the talk about the tax base prior to apportionment is a separate subject than the subject of modifying the apportionment formula. I hope that's clear.

SENATOR CROFT - Then I'm curious why you propose, Madam Chairman, that we change the formula if the present formula adequately addresses Alaska's interests. Why is one of your major provisions a change in the formula as well as increasing the size of the pie?

PROFESSOR ZEIFMAN - Well, if I were hungry so to speak, and I was concerned about getting more to eat, I would try to

persuade my mother to both make larger pies and to give me a larger percentage.

SENATOR CROFT - And would you argue the percentage of the existing pie if you had the authority to do it?

PROFESSOR ZEIFMAN - Yes.

SENATOR CROFT - And we have that authority?

PROFESSOR ZEIFMAN - No. Only under extraordinary circumstances is the case I would argue that in terms of both the case law and the statutes that only under those circumstances in which the company is involved in something called a nonunitary type of business and that would not be relevant with respect to the vertically integrated petroleum companies.

SENATOR CROFT - I thought you had said a minute ago that the section of the statute that I read gave the State only the authority to change the allocation as it related to other states and not to increase the size of the pie itself.

PROFESSOR ZEIFMAN - Right.

SENATOR CROFT - Then my question is, how has the State attempted to increase the amount of the multi-state income that's allocated

to the State under its existing statute? You said that that was one of the two things that you would do.

PROFESSOR ZEIFMAN - Well, when you say the State do you mean the Department of Revenue or the legislature?

SENATOR CROFT - No. the Department of Revenue.

PROFESSOR ZEIFMAN - Well, the Department of Revenue, as I understand it, has been trying to administer the present formula in its present statutory form. The legislature in its wisdom has enacted a statutory method including the use of a sales factor and said, so to speak, to the Department of Revenue, this is the general method of doing it, and this is the method that you should use. In very extraordinary cases, we are giving you authority to exercise some discretion. Generally, that kind of administrative discretion that is provided for in the statute has not been construed as far as I understand it by the tax administrator of this State or by the tax administrators of other states as a kind of license to exercise an _____ discretion and say look, we don't like the size of the pie that the statutory formula gives us, so therefore I'm going to come up with my own method of doing this. I would be opposed frankly as an interested citizen if you will, to that type of approach to the whole text deals anyway with where the Administrator would take the position of "We didn't get enough money from

your company this year, therefore, we're going to change the rules some. I think that's the worst kind of tax administration.

SENATOR CROFT - One final question. Doesn't your bill allow that though? Doesn't it say that in the event the Commissioner of Revenue decides that the method of reporting that the company uses on book value isn't adequate, that the Commissioner can change the rules of the game and require a different reporting method?

PROFESSOR ZEIFMAN - Now, that's a different kind of a situation, Senator Croft, that's prescribing a normal amount of administrative discretion with respect to prescribing rules which most tax administrators have that would be consistent with the statutory scheme. I would not construe every grant of discretion to be a total departure, I think as you are suggesting, from the prescribed statutory methods.

SENATOR RADER - Is there an easier way or a more clearer way to get the tax that the State should have from the petroleum activities and what we _____do you have any other suggestions? Are there any other avenues that would be easier or more fair?

PROFESSOR ZEIFMAN - Well, easier, yes. I think that, first of all my philosophical point of view, if you wish, the nature of a corporate income tax, a tax measured by profitability

is such that it invariably runs into the kinds of problems we're discussing, allocation and apportionment. I personally feel that the most effective and the easiest way to tax petroleum production is at the wellhead in terms of the severance tax. I think that an effective severance tax is perhaps the most, certainly the easiest if it's valued properly. I want to add, however, though there's a subject that I'm particularly interested in. The income tax does offer you the advantage perhaps, and I don't hold out any guarantee of this, but at least it gives you a crack at outer-continental shelf development through the apportionment device. Under the present law, you are just not going to get, I would say you have no chance of winning a supreme litigation, trying to impose a severance tax with respect to outer-continental shelf activity, so in that regard, that would be the exception. I think an apportioned income tax has a better chance of withstanding constitutional attack with respect to the outer-continental shelf production, but generally in the arsonal of state tax weapons, if that's an appropriate way to put it, I would regard the severance tax as the main battery, and income tax as kind of a secondary battery.

SENATOR RADER - Are there other states using the method that you are suggesting here that we adopt.

PROFESSOR ZEIFMAN - There are no other states as far as I know that have adopted the method of using book income. It's rather interesting. Some years ago, the State of Tennessee had that kind of a provision that taxable income is the income determined by a normal _____two standard accounting procedures. When we were investigating the tax structures of all the states, I was particularly fascinated by that and talked to the tax administrator, and to my surprise, he said "oh well, we don't bother with that, we'll accept whatever income they report for federal tax purposes. That part of it is novel of our proposal in that respect. The idea of an apportionment formula based on production as one of the factors is not novel, it's used in one form or another by different types of states. A few states, I don't have our report with me, but some states have used apportionment factors, special apportionment factors based on cost of production. As I mentioned West Virginia eliminates the sales factor entirely, so that the use of a specially fashioned apportionment factor designed to reflect the peculiar economic situation of the State I think is very conventional.

PROFESSOR AINSWORTH - Senator, if I might add just a comment to Professor Zeifman here that the book value is not used as such by any state that we know of. On the other hand, a number of states do start with taxable income and then tend to restore

toward book value to some degree. I think with the Supreme Court case in mind that Professor Zeifman just mentioned in his earlier testimony and with the general desirability as many states see it of restoring taxable to a degree that this would be a forward looking step and you might find yourself cut off from the restoration thing and you would have to go all the way to its value if you wished to use it.

SENATOR RADER - Of course you have a great volume of law and experience and regulation as to what is _____ taxable income. Do we have any such law, body and experience as to what should be book value income, so that when you have this acute, I know that you mentioned that the bad apple is the bad apple, the bad apple accessor or the bad apple tax payer in this direct accounting approach left too much to discretion. Do we have a body of law that can resolve disputes? Part of our problem with our corporate citizens or other citizens is to resolve as easy as possible, put grease on those places where we have pressure and have a difference of interests so that it will work without too much scraping and burning and chewing. What kind of discription do we have of book income that when we get into a dispute with someone as to.....

PROFESSOR ZEIFMAN - Well, I think that we have the experience of the Securities Exchange Commission and the experience of

stockholders in general. I appreciate the observation, and I think Senator, that it's a very profound one. I think that the great body of law however, is a two edge sword. The great body of law has also created an army of lawyers, accountants and tax planners that have given an enormous incentive to diminish the taxable base through various types of devices. I think that the beauty of the book income proposal is that the company as I mentioned to Senator Croft, if the company wants to diminish its income for Alaska tax purposes, it's got to persuade its shareholders that it is not being operated very profitably.

SENATOR RADER - Well, let me ask you this. Let's take EXXON because they're so large and let's assume that only 5% of their operation is in this state. From their point of view to their stockholders, they're going to be interested in a consolidated sheet that shows their whole operations. Do you say it's their incentive to keep them honest and to sell their stock and to keep the FCC, and if they meet all of the FCC requirements, but still won't they have the same incentive and the same opportunity to shift the responsibility of their costs in the book method as they would have in any other method? And if we are only 5%, let the Alaska portion show as being unprofitable and pick it up someplace where they don't go on book method.

PROFESSOR ZEIFMAN - Again, Senator, I think that your observation gets right to the heart of the question, and I agree with your

observation, however, that would occur only if you have a separate accounting system. I think your question illustrates the disadvantages and the dangers of separate accounting.

SENATOR RADER - Can you create a system to do that? I mean you've only had one system and the federal government doesn't care, they're not going to care as to how we do it at least between the states, excuse me, go ahead.

PROFESSOR ZEIFMAN - You see the advantages, rather than talk about individual companies like EXXON, we have not identified the individual companies. In no case, let's assume that the book income, I think you can reasonably assume that the book income is going to be at least twice, at least double the amount of federal taxable income.

SENATOR RADER - This is as defined by them.

PROFESSOR ZEIFMAN - Yes, worldwide.

SENATOR RADER - Without any body of law to define how they define that.

PROFESSOR ZEIFMAN - Other than the regulatory procedures of the FCC.

SENATOR RADER - Which are only calculated to prevent them from overstating their _____, not understating them, I assume.

PROFESSOR ZEIFMAN - Well, it cuts both ways, and although we are talking about book income as though it were different from federal taxable income. Let me also point out this, Senator, I think this is a key feature that frankly I think that Mr. Kilgore glossed over. Many of the basic book accounting mechanisms are in fact policed by the Internal Revenue Service. For example, Mr. Kilgore mentioned inventory accounting and talked about the fluctuation of inventory. Well, the Internal Revenue code requires that the company use the same tax accounting technique in terms of evaluation of its inventory, the exact same for federal tax purposes as it does for reporting its book income, and so in a sense the advantages of book income as I see it is you have the feds. in a sense policing a big hunk of the accounting aspects of the company. The company cannot play hanky panky with its inventory accounting, with its gross receipts, with the major blocks of its item. The IRS is policing that, and the internal revenue code requires that it police that, so that in using book income, you're not departing from.....(end of tape) ..... provision that would go like this would say no depreciation deductions would be allowed in excess of the depreciation actually taken of the companies books. In that way small companies would

continue to have the advantages of excellerated depreciation here and there, but the large companies would not be able to use quick write-offs to a very large extent to substantially reduce their taxable income. So, I think that although we have been talking about the difference between book income and federal taxable income as though they were two different things, the major sediments that comprise blocks of income and expenses that comprise book income are in fact audited by the Federal government.

SENATOR RADER - Well, then you're saying we're not making a significant change. It is a significant change, but you're saying that the major portions are already audited so _____ right now.

PROFESSOR ZEIFMAN - Right.

SENATOR RADER - And so we're talking about this insignificant change which is going to be tempered by their own statement to their own stockholders in which they have a goal of maximizing profits instead of minimizing, but then I get down to this, and we don't have a body of law. That's really largely management discretion, I assume. The security exchange regulation which I don't know now, that's what I'm asking you, isn't it largely a management discretion then to, you're not breaking the federal tax laws when you report your income differently to your stockholders on different accounting

basis, and as Senator Croft observed independent auditors will I think, generally submit to management discretion if there is no breech to the law, and the most that they would do would be to footnote it with an asterik and say this is within management discretion, and can be done three different ways, This is an acceptable way. How do we eliminate without a body of knowledge and law, and with the same opportunity to shift income for book purposes between one state and another or between one opportunity and another, so long as the bottom line is the same.

PROFESSOR ZEIFMAN - Well, the last part of your sentence, Senator, is the part that I have the most trouble with, and somehow Senator Croft's question indicated for example a misunderstanding. We are combining the notion of use of book income with the idea of the combined report. We are saying to EXXON if you will, look, we don't care. If you want to play games for any purposes. If you want to keep your Alaska subsidiary at a low level of profitability for your books, you go ahead and do it. We are aware of that fact that you might want to do that. The advantages of the apportionment formula and the combination approach, and as a result the _____disadvantages of separate accounting is we are saying look, we are going to look at the whole pie, and we want the book income of the whole pie, and so long as we're dealing with the book income of the whole pie, it makes no difference whether the company in its internal bookkeeping among its affiliates divides it up.

SENATOR RADER - I see what you're saying. I understand that, but now let me ask you one other thing. You say no other states have adopted this. Now, to be the devil's advocate, why not? Is this something of your own creation that hasn't been tried yet?

PROFESSOR ZEIFMAN - Let me make this observation of why not, and I say this I hope that based on 20 years of experience working for the United States Congress, I would say lack of political muscle, in the sense especially with respect to the petroleum industry and because of the United States Congress. The Congress does not have political muscle in part to remove the tax subsidies from the internal revenue code, on the one hand that are related to the petroleum industry. Another part of it is perhaps a question of policy. When Congress decided that it was going to, if ever there was a radical departure from the use of normal accounting procedures, it was percentage deflation. Congress decided it was going to subsidize the petroleum industry, and so it provided for a percentage depletion. In a sense, the use of book income as we conceive it, and in terms of a general policy, we are saying look what we are interested in the earnings and profits with no subsidies. If we are going to subsidize the petroleum industry, we might do it in other ways, but we're talking about a tax base that is based on purely accounting procedures, as distinct from a tax base that's eroded through policies that reflect a desire to reduce the tax.

SENATOR RADER - Let me ask you again, and I think you've answered it, and it's only my own inability to receive your intelligence as fast as you can state it. I'm unaccustomed and haven't got quite the receiver you have transmitter either, but when you get back to it, is there a body of law through the FCC or otherwise to which we could go to if we were in a dispute with any one of our corporate citizens, and say, we think that when we say book value that the questions have been answered to the extent that there's a reasonable body of law that people with the opposite interests of the taxpayer and the tax collector can look at that and their attornies can look at that and handle that problem without rubbing each other wrong and fighting their way through courts interminably.

PROFESSOR ZEIFMAN - I think Senator, that there's probably as much of a body of law on that subject as there is..... I think it's a less complicated body of law in terms of the federal taxable income, and its lack of complexity, I think, is an advantage. As a lawyer, let me make this observation. This is an everyday kind of dispute. If I'm a minority stockholder for a closely held corporation, and we get involved in litigation as to its profitability, or if there's going to be a dispute among partners for the evaluation of the states. The extent to which the accountants have overstated or understated various items I think is a subject that the courts and most lawyers have had a great deal of experience with. I suppose I'm doing my own profession a disservice, but I'm suggesting that the use of book

income takes the body of law, the normal body of law, and applies that as distinct from the highly specialized priesthood of the internal revenue code.

SENATOR RADER - One more question, if I might. Now, Mr. Kilgore, I think, suggested this morning that he made some actual projections using this extraction factor and it did not appear to him to protect the State as well as he had thought it might. I might have misunderstood him in that, but have you done any such estimates as to how it will actually work.

PROFESSOR ZEIFMAN - Yes, we have on the basis, and I'm glad you mentioned that Senator, because I had a meeting with Mr. Kilgore and Mr. Lipton in New York, and at the outset before I agreed to accept the contract as a consultant to Alaska, I made it clear that I did not want to be a consultant or make any recommendations unless I was able to make the recommendations as I put it on the basis of actual data and not addressing myself to paper solutions to paper problems. I think that the data that Mr. Kilgore has relied on has been data which has been admittedly been fictitious, a sample that was provided to a large extent by Standard Oil of Ohio. Our predictions and our data are based on a study of the actual tax returns.

SENATOR RADER - If my previous question about is there an easier or better way, and you said well, the easiest and the simplist way is at the wellhead. Count the barrels and put a tax on it, and a gross income tax instead of a net income tax so you don't have to worry about all the rest or the other half of that problem. What is the customary way of doing that? Do I understand you to say that the main reason that you're proposing the book income tax is the ability or the possibility to capture the outer-continental shelf production which can not be done with a severance tax.

PROFESSOR ZEIFMAN - No. The use of the book income, you could adopt our proposal in part using the extraction factor and the outer-continental shelf feature without adopting the book income part. Do you follow? That's an apportionment part. The book income is the means of defining the pie.

SENATOR RADER - Now wait a minute, say that to me again, I don't understand it.

PROFESSOR ZEIFMAN - You could continue to use federal taxable income and still have a formula that has an extraction factor in it, and also include in the numerator of the extraction factor as is done in the administration's bill, the amounts related to the outer-continental shelf production. It's not the book income feature of our proposal which relates to the

outer-continental shelf, it's the extraction factor.

SENATOR RADER - I see. Thank you, Madam Chairman.

SENATOR HUBER - I wonder if I could get just a line, a short quicky on the bottom of Senator Rader's before the thought is lost? I was following along very well when you answered Senator Rader about going it alone. This is the reason for going with the compact instead of going it alone. If a corporation or any corporation taking in a profit, is doing so from a state such as Delaware or Washington, that does not have an income tax, and then they have an Alaska subsidiary here, and they don't give a darn about the Alaska subsidiary taking a blood bath every year in the annual report book because their stockholders are in the main corporation and they think the more Alaska takes a blood bath in the Alaska corporations the higher the value of the coupons that I clip. Now, aren't we still leaving that loophole? I think it's a yes or a no.

PROFESSOR ZEIFMAN - Under our proposal, No.

SENATOR HUBER - That loophole is plugged?

PROFESSOR ZEIFMAN - Yes, because of the fact that we're saying to the company, that's the advantage, and you see this is the disadvantage to saparate accounting. We're saying to the

company, look, we're saying to the whole group, the whole multi-corporate enterprise. We're saying look, we want to see the whole pie, and then we will apportion a piece of the whole pie to us, and so if the company, for example, and I appreciate your question, Senator because it really illustrates what we're getting at. Suppose you had under the present system to make it simple. Lets say New Hampshire does not have a corporate income tax, and I were going to drill in Alaska, here's what I would do. I would create a New Hampshire parent. I'd get a Delaware corporation, has its principal place of business, its so called domicil with Deleware, have its office in New Hampshire, and have it own an Alaska subsidiary. I would operate the Alaska subsidiary at a low level of profitability and the New Hampshire parent at a high level of profitability. Since New Hampshire has no corporate income tax, I'd be off the hook entirely, and if Alaska insists on separate accounting, Alaska has no remedy. Under our proposal, we're saying look, we are going to take the Deleware corporation. We don't care about all these arrangements, we want to know the size of the pie, the total income, the total profitability of the whole family, then we will make an apportion to Alaska. That is the modern progressive method of corporate income taxation that has been adopted by those other states that have progressive modern forms of taxing corporate income including California, Minnesota, and many other states.

SENATOR HUBER - They can't get out of that by only operating in the states that isn't a member of the inter-state compact?

PROFESSOR ZEIFMAN - That's right. They cannot get out of it. That's the advantage of the combined report approach, and you see, this is exactly what has been going on in Alaska for years. Alaska affiliates of large petroleum companies have been reporting to Alaska that they have a low level of profitability. They have said separate accounting. The tax administrator recently, consistent with the practices of a multi-state tax compact have been saying in so many words, listen, we are not going to buy that. We want to know whether or not, we want to know about the relationship between you and the parent. In a sense this is what I'm getting at with the treaty. The treaty which Great Britian has persuaded the Treasury Department to adopt, and which the Senators from Alaska were opposed as well as I understand the Governor and the tax administrator would say to Alaska, you must only look at the Alaska subsidiary, and if the Alaska subsidiary is operated a low level of profitability, there is no way, according to this treaty, that you can look at the parent if the parent is located in Great Britain, and that's exactly the disadvantage of separate accounting. It's been _____, I suppose I'm making a speech, but it's been _____by the proponents of separate accounting some wierd notion, they say we ought to draw a ring around Alaska as though it's kind of a bath tub, and only look at the local subsidiary. Well, I am suggesting to

you that if you really want to know about the profitability of the petroleum companies operations in Alaska, that I would urge you not to simply look at the books of Alaska's subsidiary, but to go for the whole pie.

SENATOR HUBER - Thank you Madam Chairman. It did straighten me out, but I'm going to have to do some more background yet on why, I guess that's the word. There's a piece missing there.

REPRESENTATIVE GRUENING - Professor Zeifman, you mentioned the treaty. Does that treaty in any way prevent us from getting the advantage of the franchise tax?

PROFESSOR ZEIFMAN - It sure would. Of course, the treaty has not yet been approved. Fortunately, it has to be ratified by the United States Senate, and due to the opposition of some Senators it came close to being ratified by the way. I would like to urge this body to adopt a resolution urging the President to withdraw the treaty, and the present Secretary of the Treasury to get the United States out of that treaty. But at any rate the treaty would, as I indicated, prevent you from looking at the whole pie. It also would prevent you from. I'm sorry, the treaty would. The separate accounting proposal would accomplish the same thing as the treaty, and that's what I find is rather extraordinary, the proposal that Alaska would inflict upon itself. The same limitations on its

own taxing power by compelling its own tax administrator to look only at the Alaska subsidiary in its books, destroy the most powerful weapon that it's had, when the petroleum industry is urging especially those parts of it that are related to the United Kingdom is urging the Congress to impress this limitation on Alaska as well.

REPRESENTATIVE GRUENING - Aren't we doing about the same thing though on the franchise tax in terms of apportionment in theory as done under the multi-state compact by saying, okay, we're going to take a different look at what the basis is, but we're still going to use an apportionment theory to attribute the sum of that income back to Alaska.

PROFESSOR ZEIFMAN - Right, exactly.

REPRESENTATIVE GRUENING - But is there a constitutional problem then with through treaty with the federal government telling us that we can't use this as a describing basis. I mean isn't this an interference under the constitution with State rights?

PROFESSOR ZEIFMAN - One of the unfortunate conditions under which you labor is the supremecy clause of the constitution which makes the federal statutes and treaties and treaties are given equal status under the supreme law of the land, so that if for example the United States were to enter into a treaty with France protecting french citizens against

inheritance taxes in Alaska, I think you would be stuck.

REPRESENTATIVE GRUENING - I have one other question. Mr. Kilgore, this morning outlined some disadvantages of the franchise tax, and I think maybe Senator Rader's questions about the body of law might have answered them, but as I recall, you were here this morning listening to his presentation. Three things allows a different treatment on accounting methods, greater write-off flexability and companies can revise their accounting procedures. Now, maybe Mr. Kilgore ought to elaborate on that, but as I understand the criticism there, it's not so definite, you're relying on the incentive factor to keep them from changing, as I understand his criticism, I may be unfairly stating it.

PROFESSOR ZEIFMAN - I very much appreciate the fact that Senator Rader brought this up in questioning because it frankly compelled me to address myself to it. That is, you know, I want to make it clear that the use of book income is not an either, or, we're not saying we're not going to use the federal tax system because anyone who has filed a corporate income tax report can tell you. You just don't go changing your inventory method in terms of the book income and your accounting method for the purposes of the companies books without the IRS policing them, and so any system, for example, and I was rather amazed by Mr. Kilgore's observation about inventory. There is a very strict requirement, and as a matter

of fact there is probably no subject which is more carefully audited by the Internal Revenue Service. You just can't go playing around for federal tax purposes by using a different inventory method of accounting on your books that you are using for federal tax purposes. The inventory accounting that you use for federal tax purposes is required by law to be the same as you are using for your book income. So that fluctuation, I think, is very unrealistic.

REPRESENTATIVE GRUENING - What is meant by greater write-off flexability under the franchise. Maybe I should ask _____ I mean that was listed as a disadvantage, greater write-off flexability.

PROFESSOR ZEIFMAN - I would agree that there would be greater write-off flexability with the use of book income, and some write-offs would be permisable.

REPRESENTATIVE GRUENING - That are not permisable under .....

PROFESSOR ZEIFMAN - Yes, but again the observation is the company, if it does that, it's going to diminish its earnings and profits for shareowners. I'll give you the example, I think, the most dramatic example of that. The petroleum industry as you know, is able right now to expense intangible drilling costs. Take a current deduction, and use intangible drilling costs to minimize their federal taxable income as a result. Well, many

of the large petroleum companies do not expense their intangible drilling costs because if they did they would diminish their earnings and profits for purpose of distribution to the shareholders, so they capitalize their earnings and profits, in a sense it is true, I would agree with Mr. Kilgore's observation that there may be some ways in which the companies could have a lower book income this year, that they would have some flexability, but at the same time that flexability as I put it sort of gets them between the bark and the tree because in order to reduce the Alaska tax base, they would have to tell their stockholders they were earning less money, and that's a different kind of position than they are now in.

REPRESENTATIVE MEEKINS - Is there a provision in the bill that, I think I heard you say, that you take the federal taxable income or the book value, whichever is greater, so in relation to what Senator Rader was asking, you're saying that there's a motivation that's strong enough to keep them from playing around with these possibilities, flexabilities they have, with the motivation being that they have to report to their stockholders the profitabilities because that's what we're looking at. They can't erode our Alaska tax base without going against that other need that they have.

PROFESSOR ZEIFMAN - Yes, they could not go below which is the advantage of the alternative base here. No matter how much flexability there is.....

REPRESENTATIVE MEEKINS - They'll never go below the taxes, so in that respect we're not any worse off even if they did.

PROFESSOR ZEIFMAN - It is inconceivable to me that the use of book income will cause, the way it's written in this bill, it's inconceivable to me that the use of book income would result in a lower tax base for Alaska with the alternative written into it.

REPRESENTATIVE MEEKINS - You see, that brings up the question, I mean the point of going to book income is that there's not really that much faith in the federal taxable income because of the subsidy as you call it written into it. So I'm wondering wouldn't it also make sense to, couldn't we have the alternative be federal taxable income plus putting back into that some of these allowances that are taken out? Couldn't we do that also and then.....

PROFESSOR ZEIFMAN - Yes, we mentioned that in our report as an alternative. You could take federal taxable income _____ add back all capital losses. California has done that. Federal taxable income plus, we will prohibit carryovers. Federal taxable except that intangible drilling expenses are to be deducted.

REPRESENTATIVE MEEKINS - Well the, what I'm getting at is then you would really have them because you could also then say that either, or whichever is higher, book value or that value, but that valu

is even higher, so the difference, if there was any possibility of arranging that as some people are fearing, you'd have even still a higher base for the federal taxable income in which to make or take your percentage.

PROFESSOR ZEIFMAN - I agree that that's an alternative. The advantage of book income is that you're doing it all in one fell swoop and the easiest way that we know how. The item by item thing, frankly again if I can be political, would compel you to have to fight it out on each front. You're going to add back, you're going to have a vote and add back, disallow the carryover, the capital gains item by item. The book income does have the advantage of simplicity, I think.

REPRESENTATIVE MEEKINS - I have one more question on separate accounting. I'm not quite sure. When you do separate accounting, does that mean you just look at the Alaska subsidiaries, the numbers that they have on their books, but you don't consider anything else at all. There's no apportionment whatsoever, there's just totally separate accounting?

PROFESSOR ZEIFMAN - Essentially, yes.

REPRESENTATIVE MEEKINS - Essentially you are using the numbers that the companies give you, in that case, wouldn't that be correct?

PROFESSOR ZEIFMAN - Essentially, yes.

REPRESENTATIVE MEEKINS - Can you put back into that your own extraction factors and things like that?

PROFESSOR ZEIFMAN - No, the extraction only works when you are talking about a pie to a portion.

REPRESENTATIVE MEEKINS - Yes, so if you put in an extraction factor, you're not.....

PROFESSOR ZEIFMAN - Let me give you a simple example of separate accounting that the Supreme Court reputiated. There is a case, Wallgreen Drugs. Now you know everybody's got a drug store, that ought to be simple, it's just like a candy store. Wallgreen Drugs tried to argue that it ought to be able to use separate accounting because it could show through separate accounting that its Minnesota drug stores were being operated at a lower level of profitability than its non-Minnesota drug stores. The Minnesota tax administrator said, "hey listen, we can't unscramble that egg. All we know is that Wallgreen is in the drug retailing business. In effect it's a kind of a view that goes like this, it doesn't have any geographic source. It has an economic source. They said in effect, "look the ice cream manufacturing plant that you've got outside of Minnesota, that contributes to the profitability of the Minnesota store, so we're going to require you now to make an apportionment, add the

whole thing together. How much income did all of your drug stores earn all over the United States, and then we will make an apportionment based on the ratio of Minnesota to total property payroll and sales. The taxpayer argued separate accounting. We ought to be able to use separate accounting, I can keep my own books, I can show you the Minnesota sales of the Minnesota drug store", but the court reputiated that, so on its surface separate accounting is deceptively simple, but with any degree of sophistication at all, especially when you're dealing with multi-national companies, it is no difficult problem at all for a non-United States company for example, or a New York based company to operate its Alaska subsidiary at a low level of profitability, and especially in getting it back, Senator, to your observations about the federal government, here's the rock now. The federal government doesn't care. In other words if you have a New Hampshire company operating at a high level of profitability, and the Alaska subsidiary at a loss, the federal government doesn't care because it's getting the tax from the New Hampshire company, and it's not concerned about the policing of it. The federal audit in the apportionment area is not really going to be helpful. So, I hope that my observations are, I hope that I have been helpful to you, and again, I want to reiterate that no state of the United States, currently and as far as I know in the last 30 or 40 years has adopted separate accounting method of taxation under these

kinds of circumstances as a general method of imposing a tax. The controversy has always been as to whether or not any form of separate accounting was going to be permitted, even in extraordinary circumstances, and generally the court has been said to look with disfavor on the separate accounting notion. I might add, for example, in California, you don't have much Alaska case law. I mean, you have no Alaska case law on this subject, but in California, let me give you an example. This perhaps will confuse you because it goes the other way. The Wildcat Oil Company, drilling a dry hole in one state and operating, if you want, not striking oil. It then goes to drill another hole in another state and still doesn't strike oil, and it goes on through six or seven states that way, and still doesn't strike oil, but most of California, and in California it strikes oil, and all of the oil is sold at the wellhead, right then and there. This is an unusual type of operation. The California tax administrator said in so many words, "this is one of those extraordinary cases in which we might try separate accounting, because after all if we only talk about the California operation, it's a desirable state of affairs. The taxpayers said, "listen I'm a unitary business, I've been operating all around, you've got to treat me as a single entity. The California courts invalidated the use of separate accounting under those circumstances. So, again, I would urge you to examine the notion of separate accounting very carefully because, not because of the disadvantages that Mr. Kilgore points out, about the hypothetical pricing and

the administrative overhead. That's not the disadvantage of separate accounting, the disadvantage of separate accounting is that you don't get to look at the whole pie, and he didn't mention that.

SENATOR RADER - Then, it's like you say, if the piece of the pie was very porfitable and the rest of their operation non-profitable, we might want to separate out and have accounting only as California attempted to do. You're saying that our court, if they followed the California court would not permit separate accounting if the Alaska operation was a bonanza and the Texas operation was no longer profitable.

PROFESSOR ZEIFMAN - That's right if they followed the California Supreme Court. And perhaps Professor Ainsworth ought to address himself to this because in the longrun the advantages of the combination approach, as I see it, is in the longrun you're dependent upon the fact that on the overall profitability of the whole multi-corporate family, and I would argue that that provides you with a much more stable type of a tax base. It's almost like a diversified investment. We could, for example, in the Wallgreen Drug case, you could have this kind of a situation which would make good business sense. Wallgreen goes into Minnesota, intentionally operates its drug stores at a low level of profitability, sells its products low and at a cheap price in order to compete in the local market, but it really is as a result the profitability of the whole. The whole company is

enhanced because of the additional sales and the large quantity, so for the State to deny itself, and to take away from the tax administrator, if I could leave you with this thought, whether you buy that proposal or adopt a proposal of that book income, or the extraction factor, perhaps there's a separate question, and maybe these are not alternatives. Whether you adopt the proposal of book income or the extraction factor is perhaps a separate question, but I would urge you to not voluntarily, by your own act, deprive your Department of Revenue and your State of the most effective tax weapon that you have in the corporate income tax area, and that's the ability to look at the whole picture and the whole pie.

SENATOR RADER - Well, I have a little different line of inquiry, if I could? We're in Juneau with the Prudhoe Bay situation where we're in pricing hearings right now, or we start Wednesday. Are you at all familiar with what our problem is there? They have not set a price for Prudhoe Bay as one tier or another tier, new oil or old oil. They haven't said, they might leave it uncontrolled like they suggested for Pet 4, which is not producing doesn't make any difference then. There's some suggestion that's come to our attention that the Federal government in their Prudhoe Bay pricing will take into consideration the tax structure that the corporations operating there and elsewhere in Alaska are facing in so far as it affects their incentive to explore and develop further. It seems to me

like sort of a delima problem. If we were going to increase the tax burden on a petroleum industry, our state administration is going in and asking for the highest possible price, I believe that's there position, the highest possible allowable federal price, it would be new oil or uncontrolled oil, and so it would be with the foreign oil, and their argument is that we need this as an incentive because of the extraordinary cost in Alaska. True we've had a bonanza in Prudhoe Bay, but then that's statistically and otherwise not expected to be counted upon and that we really need a very, very high price here to insure that lesser sands, sands that we know to be less profitable in existance, that you will preclude us from pumping or developing those, or even exploring further unless you give us a high price, and the State if urging the same thing because we are a royalty owner on one side. We've got one hat as an _____ and on the other side, we have the hat of the tax collector, and on the side of the _____, we want the highest price we can get, and we also want it for our oil company citizens. We're all citizens and we are all _____ 7/8 and 1/8 all have the same interests, but when you get to the point of doing the taxes, should the State if we're going to pull taxes, impose it now before they set a price on that oil, or should we wait until after they set a price on that oil. The argument being that if we try to set it before we set a price on the oil, that it destroys our credability that we need a high price for purposes of encouraging development, and the other argument being that if

we don't assess it now, that it will not be taken in as a cost, and therefore that if we try to assess it later on, we would genuinely create a disincentive that would be so severe to the companies that they couldn't produce under the pricing, and I'm not sure I understand the problem, so I'm certainly sure I can't explain it. Does any of this ring a bell to you?

PROFESSOR AINSWORTH - I think that in a situation like that, I don't know how the State tax or the enactment of a state tax right now would effect the price that the federal authorities might permit you or might not permit you. I would suggest, of course, that any business entity including oil companies would welcome a higher price, and part of the justification in that in the case of oil is always the exploration and coming up with new and better resources, and I think so far as the oil supply situation in general was concerned, that I would leave that pretty much to national policy. Now, as to your own tax, I would say yes, a state tax will indeed reduce in some measure, if you look narrowly at it, the profitability of the oil company. I don't think there's any question about that. On the other hand, what I think taxpayers as well as tax collectors and the State generally would also see is that this tax comes at a time and in a situation where you have no history of taxing oil companies really. I think that this is a whole new thing as far as the State of Alaska goes with substantial oil being produced and generating income and therefore being subject to tax. So that you're coming in more or less at ground zero

as far as major production is concerned and what you ought to be concerned about is not whether you go from say the experiences of '73, '74 where so many separately accounted zero income to your state and so on and so forth, but you ought to look at that and say well now, how will our tax compare with other taxes around about in other states because ultimately it's the differential between your state's tax and other oil producing states tax. If that differential is not substantial after you take account of the very high quality deposit you have here, why then I'd see no great disadvantage to the State going with a 9.4% tax that was effectively applied to oil profit. Every State taxes it in some measure.

SENATOR RADER - Now let's follow that up a little bit. I saw an analysis put together by one of our operators here which had indicated that our total combined tax load if you consider our Ad Valorum taxes, the taxes on the pipeline, the taxes on the whole works, of their properties and their operation that we were 114% above California, or Texas, or something like that. We were 99% of Louisiana. In other words there might be one state in the Union that has imposed a heavier tax load on its petroleum extraction industry than Alaska. Is that, how do you respond to that kind of a statement? And if that is the case should we be talking about imposing any more tax?

PROFESSOR AINSWORTH - Well, I'm not familiar with that particular oil company's own report on its tax problems, but I would suggest

that this is one company, and it apparently comes up after it analyzes its own tax situation for its own information presumably. With this finding, that difference might possibly apply to one company, but not apply to all companies. Certainly a differential of tax as between and among states would however, have to look at what I understand to be the relatively good deposit that you have here, differentially good deposits relative to some other area, and if I were looking at this, I think, strictly from a state point of view, I would certainly take account of that quality differential before I assessed any ninety nine hundred and fourteen study that a particular oil company made.

SENATOR RADER - Let's assume that we determined that our present tax level was all taxes combined, was at the very top, very close to the top in the nation. Do you think as a policy matter, can we go much beyond that or not? What kind of constraints do we have there?

PROFESSOR AINSWORTH - All taxes combined, I think I've seen some of these general statements also, and yet I don't have a detailed picture of them before me, but frequently the general statements I've seen, when they say all taxes combined, the oil companies had sometimes included what they paid the farmer for the oil in North Dakota as a part of the payment to the State.

SENATOR RADER - They broke out the royalty payments as being different than the tax payments.

PROFESSOR AINSWORTH - So you certainly ought to wipe that out first.

SENATOR RADER - I think that's broken out clearly. What they did was they took the operation, they took the wells in operation, and they took the pipeline, the gathering lines of the rest of it and they applied it, and said you can pick this whole thing up and move it to Louisiana and use Louisiana's rates, in some places they're higher than ours, in some places they're lower than ours, and in some places there's no Ad Valorum taxes, _____ that we were at 99% Louisiana, and Louisiana was the highest in the nation, and we were 114 - 125% of other states to which they made the comparison. Now let's assume, I don't know if it's right or not either, but let's assume for purposes of discussion that that presentation was fairly made.

PROFESSOR AINSWORTH - If that were fairly made, then I would only caution that the only thing that they can't pick up from the State of Alaska and put it in Louisiana, even hypothetically, is the oil itself in the ground, and that's differentially good in Alaska, so you may have a margin there to work on.

SENATOR RADER - And how would you determine that the historical experience of the petroleum industry in all fields of Alaska as compared with historical experience of the industry in all fields in Texas, or something? How would you determine that?

PROFESSOR AINSWORTH - Well, I think I would make a current comparison of productivity, potential productivities as we look from here ahead.

SENATOR RADER - Well, if you do that, because of our extraordinary Prudhoe Bay situation, then I would assume that you might say we could afford a tax at a much higher rate than 125% of the next highest state in the nation, and still not provide disincentive to the petroleum industry. If you look at only where we are so far rather than statistically trying to estimate the liklihood of a repeat. I don't know how to judge it, I'm completely at sea on it myself, so I'm not asking you a question on which I have any opinion. I just know that the oil companies make the argument that I'm making to you, and that is "look, we're at the very highest right now, we admit that Prudhoe Bay is a heck of a find, but can we afford to continue hoping to hit that one long shot if your taxes are out of line with what is customary in other producing states". How do we analyze that?

PROFESSOR AINSWORTH - I would say the first thing to analyze would be to do your own study of differential taxation. Included in that study, I would certainly look at all of the work that

the companies have done and take full account of what they've done, say for their Texas, their Louisiana, whatever other place, how they came out of it there as getting all the information you can about statements regards taxability, levels of taxation in various states, and come to your own conclusions, then as to how far you could go on a differentially high side would depend largely, I think, on the relative of quality which is perhaps not quite the right word here of your own deposits visa vis others, actual and potential, and I would be concerned that the State of Alaska should, especially with this a non-renewable type resource, take its own long distance welfare into account in deciding whether or not the tax differentially high, and how far you might reasonably go in that direction.

SENATOR RADER - Well, I think in taking a look at our own welfare, we'd like to say that, we certainly would not want this to be the last exploration done by the petroleum industry in this state because of the fact that we have established an unreasonable taxing method based upon a bonanza, instead of based upon what could be expected to be an average productivity profitability for an industry, and I have no idea how to judge that, nor do I think again, I think you're right, you have to look at and compare our own state with other states, and I don't say you rely on any one elses analysis for that, but I'm just saying let's assume that we've made that analysis, and we've found that our taxes were among the highest and we have transportation

costs. If you did get too high, how would you know it?

PROFESSOR AINSWORTH - You would know it by whether or not the companies continued to operate at profitable levels and whether they continue to explore, how far they went. I would think you could consider that as kind of a current evaluation of what they do in the circumstances that they present.

SENATOR RADER - If we were to take something that's current here on how to explore, what would we have to do, ask them ask EXXON, I keep picking on EXXON just because we started in. It's nothing personal or impersonal about it, but they are a corporate citizen. Would we ask them how much of their exploration budget is coming to us as against other states and other areas of the United States to determine whether or not we think that we have already based a tax level which has created disincentive considering the costs of production and the transportation problems when we get through with the rest of it. How would we go about putting our finger on what is a reasonable level? Everybody talks about fair share. You want to tax your fair share? Sure. I want to pay my fair share. Sure. They're miles apart. Nobody knows what that is.

PROFESSOR AINSWORTH - I think you have very little problem there because as is so vividly reported at the federal level and regards the shortages of fuel just this past winter.

Nobody seems to have data that they agree about regards reserves and what was and what wasn't done with that. We seem to get different stories on that. I would think that the best thing and it probably doesn't apply explicitly or exclusively to Alaska, but would be that if one could come up with your own independent testiments of what your resources are, and the potential yields and profitabilities of them.

SENATOR RADER - Well, we could do that to some extent, but finally the proof is what is their ability to spend the money to poke the hole, and there's been some suggestion that the state should start going out and wildcatting. That way they would know alright, but I imagine they would blow a lot of money too.

PROFESSOR AINSWORTH - That might be a kind of a check that the State would want to make.

SENATOR RADER - Can you think of any way we could get a handle on that problem as to whether or not we've become unreasonable in our tax policy, and in effect driving our petroleum industry out of the state, or diminishing to an unreasonable point their incentive to explore further for new finds and new development.

PROFESSOR AINSWORTH - I think the only way to work at that is to do what seems to be a reasonable job of getting your tax in order for the first time on this kind of industry and activity

really. By that I mean bringing it up surely to the level of other states which with the sales destination and so on, I would judge under the separate accounting would not be the case. Get it up to that level then assess the differential quality as best you can. The information is imperfect. The companies and the energy people in the federal government seem to agree on that at least, and you just have to continue to evaluate.

SENATOR RADER - Well is there any argument in anybody's mind that we are taxing among the highest rate on our severance taxes and on our other taxes than any other states? You see that I thought we were nudging the very top for a long, long time and exceeded almost everybody.

PROFESSOR AINSWORTH - Of course, we're buying an awful lot of oil just now from foreign sources which I think would have a total tax and price situation that would make Alaska's quite minutive perhaps.

SENATOR HUBER - In the studies that you've been doing, do you have any doubt but what singling out Prudhoe Bay. It seems to be what we're basically talking about there anyway. Is there any doubt but what it could stand exceptionally high taxation rates in comparison with other places in the country? Have you discovered that it couldn't, that it would have to be held down to an average of what other states are, or could Prudhoe Bay as being a bonanza, something that you don't find

everyday, could it bear a high rate of taxation in relation to other places?

PROFESSOR AINSWORTH - Of course we're out of the area of the income tax.

SENATOR HUBER - No, we're really not out of the area of the income tax. We're talking about a total rate. Madam Chairman, if you'll give me a little latitude here, Senator Rader was tying us down to the approximate maximum of what other states were doing, and we've had other studies and testimonies since the Tanzer report indicating that Prudhoe Bay is capable of supporting from 50-85% total taxation rate, and many other studies that show maybe as much as 50%. We know that countries in the middle east, some of them with about the same production that we have here are sustaining from 10-11 dollars a barrel tax out of a total price of $14, so that's what I want to get some comments about. I thought it was all going on one side that maybe the oil companies were going to leave before we left this room.

PROFESSOR AINSWORTH - I would not expect that, but more specifically to that point, I think first of all, your suggestion, Senator, that one looks to the other states, but also of course to other places in the world, the petroleum market and its exploration and so on is indeed a worldwide kind of thing, so before concluding as to what could be done by way of taxation

of petroleum companies in Alaska, I would certainly take a very broad look at it. Secondly, it seems to me that we're really not quite at the point of being differentially high in Alaska. We're really sort of starting from the beginning as far as oil operations are concerned, and the ineffectiveness historically, ineffectiveness of the sales destination package historically has set a low base here as a starting point and unless something is done, I think that it would continue perhaps unfortunately low to the disadvantage of the State. Then a final observation I would make is this that in terms of the kind of taxes that are most inconveniently kind, as it were, for all taxpayers, but certainly including corporate taxpayers, it seems to me the net income tax applies only when there is in fact net income, and what we're proposing primarily is a system for determining what that net income is and assigning its fair share to Alaska, and then taxing it. If it comes out zero as it conceivable could, though I think unlikely in the forseeable future, why then it would go away, unlike a tax, say well the tax that Professor Zeifman mentions as the first string on the bow, if you wish, the severance tax, that does not vary with the profitability of the oil companies, so in a sense an income tax is a more conveniently kind tax which gets less if profitability diminishes. So its differential effect between and among the states would be somewhat moderated as compared with say the severance tax and those other taxes which are not geared to net profitability, so I think you have a way

to go before you come up to for all practical purposes this line if you look nationwide and indeed OPECwide, and also the income tax would be of less concern, I should think, than almost any other tax because it is a net thing. It's only after their profitable that in fact taxes are applied.

SENATOR HUBER - Madam Chairman, would you care to comment upon the different make up of the type of oil companies that we have on the slope in Alaska, mainly comment maybe on there being more of the vertically integrated multi-national in regards to the small independents there in many states like Texas and other places. I know it's an entirely different problem of handling them and dealing with the two different kinds of companies. In fact it's entirely different to be fair with them even. Would you care to comment on that?

PROFESSOR AINSWORTH - I would comment to this extent on that, and then perhaps Professor Zeifman can add something. It seems to me that if you look at the House proposal before you 322, the destination versus the Senate proposal 105, the separate accounting one, that for the company which is entirely and exclusively in Alaska, any one of these three is likely to come to about the same end result, because you are indeed all there. Now, if you look at it however, from the other perspective. If you keep the destination factor or if you use the separate accounting device as a way to determine Alaska taxable income, then you will be providing an opportunity

for the large integrated company to reduce its tax liability differentially low, relative to the small highly local company because the effective rate of 9.4% will indeed be applied to that local company which is 100% Alaska no matter how you look at it. The whole pie is here obviously and simply. The destination factor and the separate accounting factor provides an opportunity for some shipping of income out of Alaska which might buy the House 322 be apportioned to Alaska, and in that sense, the small local company will be treated equally. They will pay their 9.4% on income just as the large company will pay 9.4% on its income more reasonably now apportioned to Alaska, so the small company gains not in the sense that its taxes go down all that much, but in the sense the other competitors, larger competitors will be paying at the same effective rate or more nearly so, now there is also a size provision that applies in some measure here and perhaps Professor Zeifman.....

PROFESSOR ZEIFMAN - Our proposal of course applies really for all practical purposes only to multi-national corporations, and I think we've already discussed the tax avoidance possibilities of them with respect to the use of separate accounting. I would sort of like to address myself to both of your observations, and that is that I wouldn't necessarily be persuaded by one way or the other by the fact that whether Alaska has the highest effective rate of taxation of the petroleum industry of any state in the United States of course has some relevance, but

I don't think that that ought to be necessarily the measure. At the same time, you could say that one of the chief industries of Alaska, perhaps more than other states, that the heaviest industry in Alaska is the petroleum industry, and therefore it follows that it would come out that way. I interestingly enough, and this is purely coincidental, most of my experience or ten years of my experience with the Congress, especially with the subcommittee on the outer-continental shelf was working with a chairman from Louisiana who used to be in his earlier days, was the majority leader of the Louisiana assembly, and he used to talk to me in great lengths about the problem of taxation in Louisiana where the State had a similar kind of situation before the oil companies came, and that was the timber industry. It came into Louisiana, stripped the timber bare, and left, and left the state with practically no tax base, and then when the petroleum industry came, I suppose Huey Long who often became criticized for other things began a program to try to develop an effective tax program with respect to the petroleum industry, but as the petroleum industry becomes more and more multi-national, again I want to reiterate that for the State to look at a multi-national petroleum company, only in terms of the profitability as determined by the company, in terms of its own books, in terms of the Alaska subsidiary, I think prevents you from getting the kind of data and the kind of perspective that you would need in order to make this kind of a decision. As I mentioned to you before, if I were working for a multi-national petroleum

company, what I would do would be to try to demonstrate again, and again, and again the low level of profitability of Alaska petroleum developemnt, and the way I would do it would be to establish affiliates, have them operate in Alaska, and control them from parent corporations that exist elsewhere and argue that their profitability was low. So again, I think in order to get the kind of perspective that you're talking about, that both of you are talking about, you have to look at the whole picture of the petroleum companies operations. Also, again I think that we run into this problem all over, in the sense that the New York stock exchange threatened to move out of New York. There are some industries that can't move. The California wine industry is not going to move from California. I don't think the citrus industry is going to move from California, and the petroleum industry is not going to move from Alaska, but you have, I think, an especially important problem here, and that is the non-renewable nature of the resource, and so I think that in addition to asking yourself the question about what happens if, are we going to discourage the petroleum companies to move out. You ought to also ask the question of the extent to which you are extracting revenues from them that are commensurate with the burden and with the long-range economic environmental burden that they are imposing on the State. The more the petroleum industry comes into Alaska, the more it imposes burdens, so I would suggest to you that an important measure of the tax begins where I first started, the preficatory

language of the bill that the measure of the tax to a large extent ought to be related to the economic burden and demand for services that the petroleum industry creates for the State. Admittedly, to translate that into a tax rate is I guess fortunately for us lawyers, that's the kind of thing that economists are dealing with.

SENATOR HUBER - Madam Chairman, it's interesting to note about this language at the beginning of the bill. I think maybe Professor Zeifman mentions that it seems to be important. If I remember right, I don't have to remember back very far. Four years ago our drafting attornies used to tell me that we couldn't put it in. Three years ago they started putting it in if I jumped up and down hard enough, and now every bill I get has it drafted in, and they all tell me it don't mean anything, it has nothing to do with the legality, so I'm not sure that it does, but there's one observation that you made about the 9.4% tax that Alaska corporation would have to pay doing the same thing, and where the malti-national or vertically individual company gets away from it, and this is where we got started, where we are now is trying to plug up that loophole, that Alaska corporation would have to pay, and the other ones wouldn't have to pay. We look back at history like you mentioned in Louisiana, and we found that our fur traders were here and all they did was left us with a bunch of mad indians, and then they came along and dug the gold up and left us with tailing piles, then the salmon were gone and

all we're left is fighting with the Japanese over whats left of the little piddlin bit of salmon that's left, so now it's oil. It seems like Alaska has had one after another.

PROFESSOR ZEIFMAN - It sort of ends the history of successful people in mankind doesn't it?

SENATOR HUBER - Something on that order, but we end up with in each case Alaska's ending up with the impact, but look at salmon, and those pilings that we pick up all over aren't worth a damned, as Senator Poland will tell you. It's another thing that makes it a paying thing, and somehow or another I suppose we're trying to do the same thing with the petroleum industry which we know is depletable.

CHAIRMAN Poland - Senator Huber, did you have another question? I think that our consultant for the Committee, Mr. Silides might have some.

GEORGE SILIDES - Madam Chairman, both Mr. Erickson and I have several, but I think we'll have to defer, except for one which I think is going to need answering on Rader's plan of _____ If we might be able to mail them or telephone them in.

PROFESSOR AINSWORTH - Or if you wish we could remain with you, whichever.

GEORGE SILIDES - I'm concerned about how effectively your approach would be in apportioning income to Alaska from Prudhoe Bay and the Alyeska operations. You know, Alyeska in particularly is wholly an inter-state corporation. That was the question. How effective are you or would your scheme be in apportioning income to Alaska from the Prudhoe Bay and the Alyeska operation?

PROFESSOR AINSWORTH - Well, I would argue that it is the more effective way by far in the sense that first of all, I think there's a little bit of a mystery as to how the pipeline company is going to operate totally, but I would argue that, let me put it this way in order to be very specific. Again, I'm not talking about the book income part of it, and I'm talking in part about the extraction factor, but the part again that I want to emphasize, because frankly, respectfully, I feel that Mr. Erickson has totally misunderstood the nature of this problem, but anyway I want to make that clear that the idea of looking at the whole picture of the out of state owners and their profitability of the whole picture of their profitability is important, extremely important because the truth of the matter is that in a true economic sense, the pipeline companies are not operating solely in Alaska. They are part of a worldwide conglomerate type of operation, and although they have set up subsidiaries that operate in Alaska, in a true economic sense, those pipeline companies are truly and part of a unitary kind of business, and it has been suggested

to me for example by Mr. Erickson, that the state ought to draw a ring around Alaska, and therefore make sure that it is effectively taxing all those companies. That ring that Mr. Erickson would draw around Alaska is a ring that would prevent the State from having any effective remedy if the control of the pipeline companies, let's face it, the pipeline companies are not controlled by Alaska. They are not controlled by the legislature. They are controlled by corporations who have their corporate headquarters, and the major portion of their resources outside of Alaska. If they operate those in a manner to minimize their profitability which they easily can do, and the Department of Revenue is stradled with what I call this bow and arrow, obsolete, outmoded, mioptic form of taxation based on separate accounting. I think you are opening the flood base for widespread tax avoidance on the part of pipeline operators.

GEORGE SILIDES - Madam Chairman, Professor, that was not Mr. Erickson's question, but at any rate, one last thing. What is to prevent, now let me ask you this, you have said that no other state has adopted this particular procedure.

PROFESSOR AINSWORTH - Now, let me be very specific about this, and I'm very appreciative to Senator Rader for having brought this up. When I said that no other state has adopted this procedure, I am talking about the use of book income as a taxpayer, not the subject of the so called worldwide combination

or combined report which most of the progressive states have adopted.

GEORGE SILIDES - I understand all that, but now supposing that all the other 49 states have adopted this book income, wouldn't Alaska or Prudhoe Bay with it's high profitability, wouldn't Alaska income be voted by other states as jumping on to a possible venture?

PROFESSOR AINSWORTH - If all of the states adopted the book income approach, all the states would agree on the total size of the worldwide pie that's all. That is not related. If I could rephrase your question, I think what you're getting at is if all states are adopting the kind of apportionment formula that we are talking about.

GEORGE SILIDES - No.

PROFESSOR AINSWORTH - Well, I understand it to be addressed to book income, and I would say that the effect of all states adopting book income as the state taxable income would be to enlarge the corporate tax revenue for every state, a little bit as we suggested it be enlarged in Alaska. It would not shift income from one state to another, but every state would be more effective in raising revenue by that device.

GEORGE SILIDES - From the company?

PROFESSOR AINSWORTH - Yes, but not at the expense of Alaska.

GEORGE SILIDES - That answers my question.

PROFESSOR AINSWORTH - If I may Madam Chairman, in further comment so far as the pipeline property is concerned, in making my estimates of revenue, I have assumed that property would indeed be incorporated into the numerator and the denominators of the appropriate oil company, so in that sense it would also be incorporated into this proposal that we have. We did not exclude that as part of the property factor.

GEORGE SILIDES - Professor we understand that we have a unique situation here, the pipeline companies are actually small.

PROFESSOR AINSWORTH - Also, let me make an additional observation about the pipeline company which is a form of justification for departing from the uniform act. The uniform act itself and the draftsman of the uniform act expressly, intentionally they were cognizant of the fact that transportation companies present special problems, and so they did not include, they excluded transportation companies from the coverage of the uniform act, which is a further justification for the use of an extraction factor with respect to the apportionment of income in Alaska.

CHAIRMAN POLAND - Are there no further questions? Thank you very much Professor Ainsworth and Professor Zeifman, and ladies and gentlemen for your patience. We will resume our joint resources meeting here tomorrow at 1:30 in the afternoon.

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THE NORTH SLOPE: PARADISE LOST?

SUMMARY AND CONCLUSIONS

Perspective

Despite the frustrations and delay in moving North Slope crude to market, and escalating costs, North Slope earnings prospects--while still under attack--have never looked better, thanks to the surge in crude prices worldwide and in the United States. Since mid 1972, the surge in exempt crude prices has importantly overshadowed hefty escalations in the estimated cost of TAPS and field development, resulting in a handsome widening of prospective profit margins. Per barrel profits, calculated on recent parameters (crude price, cost estimates, tax policies, production prospects, and market outlook) could approximate $3.18 a barrel, divided $1.03 a barrel on TAPS and $2.15 at the wellhead, at a 1980 crude production rate from the main Prudhoe Bay reservoir of 1,500 thousand barrels daily. This $3.18 barrel compares with only $0.95 a barrel estimated two years ago.

Investors had been deeply disturbed by the unrelenting increases in TAPS cost estimates prior to the OPEC-induced explosion in global crude prices at the turn of 1973/1974. In December 1972, Standard of Ohio had reported an estimate of TAPS cost, <u>including construction interest</u>, of $2.9 billion for capacity of 1.2 million B/D (over $3.1 billion for capacity of 2 million B/D). By late January 1976, Alyeska had raised its official estimate of TAPS capital requirements to $7 billion. Construction interest will raise initial costs to $8.3 billion (a staggering sum for an outsized gathering line). Expansion of TAPS to 2 million B/D, to cost an additional $855 million, will bring ultimate cost of the pipeline to $9.16 billion. As a result, the prospective TAPS tariff has risen to $4.60 a barrel compared with $1.50 (calculated on an I.C.C. basis) two years ago. Moreover, marine costs between Valdez in southern Alaska and Los Angeles have increased from $0.35 to $0.50 a barrel, reflecting inflation in tanker construction costs, higher bunker costs, and soaring hull insurance premiums.

Investors have also begun to witness enormous upward revisions in development costs. We surmise that the capital cost of developing the 9.5 billion barrels of proved reserves in the main Prudhoe Bay field could cumulate to $7 billion, or 75¢ per barrel. The conventional wisdom had long placed such expenditures at $2 billion, or 21¢ per barrel.

Fortunately for North Slope prospects, crude prices began to rise in 1973, and then surged, thanks to OPEC. The posting of Signal Hill (27° API gravity)

NORTH SLOPE OF ALASKA
CALCULATION OF PER BARREL EARNINGS IN 1980:
CURRENT PARAMETERS VERSUS 1972 PARAMETERS

(Dollars Per Barrel)

		Spring 1976		
		Proposed Tax Laws	Current Tax Laws	Summer 1972
(1)	California Price	$11.00[a]	$11.00[a]	$3.19[b]
(2)	Tanker Cost (Valdez-L.A.)	0.50	0.50	0.35
(3)	(1-2) Price at Valdez	10.50	10.50	2.84
(4)	TAPS Tariff	$ 4.60	$ 4.60	$0.88[c]
(5)	Costs (incl. Taxes)	3.57	3.57	0.80
(6)	Pipeline Earnings	1.03	1.03	0.08
(7)	(3-4) Wellhead Price	$ 5.90	$ 5.90	$1.96
(8)	Costs (incl. Taxes)	4.40	3.75	1.09
(9)	Production Earnings	1.50	2.15	0.87
(10)	(6+9) Integrated Earnings	$ 2.53	$ 3.18	$0.95

a. Possible "upper-tier" price for Signal Hill (27° API) crude at year-end 1976.
b. Posted price for Signal Hill (27° API) crude.
c. Compared with I.C.C. tariff of $1.54; we then assumed the companies would elect to live with a 2% return on TAPS to minimize Alaskan taxation on integrated operations (discussed later).

crude in California, $3.19 a barrel in the spring of 1973, had climbed to $4.79 a barrel by year-end 1973. The two-tier system for pricing domestic crude, introduced in August 1974, then permitted "new" (uncontrolled) crude prices to depart from "old" (controlled) crude prices. Exempt Signal Hill crude was subsequently drawn up by OPEC's cartel-imposed prices for imports to more than $11 a barrel. This price was recently rolled back to $10.27 a barrel by the Energy Act of 1975. Under that same act, the "upper-tier" (new) price with move back toward $11.00 a barrel by the close of 1976.

Accordingly, the debt owed to OPEC for the still favorable outlook for North Slope crude may be illustrated: as noted, "yesterday's" posting for Signal Hill (27° API gravity) crude was $3.19 a barrel; today's integrated cost (i.e., average total cost) of the project, assuming a profitless TAPS, is almost $3.60 a barrel. Integrated "cost" of moving a barrel of North Slope crude to the West Coast, assuming a profitable TAPS but no profit at the wellhead, would

approach $6.50. Domestic crude prices were already beginning to move higher in 1973, absent OPEC's cartel pricing--how much higher is now moot, but certainly not to $11.00 a barrel.

Outlook

Concern over escalation in costs and the risk of protracted delay is completing either TAPS or field development is fading fast. The costs of bringing North Slope crude on stream by mid-1977--to exceed $12 billion--are now essentially in place. Further increases in project costs, while quite likely, will probably be of tolerable proportions. Major increases in costs are most likely to relate to significant increases in proven reserves. Longer term, development of the Kuparuk and Lisburne reservoirs, possible investment in tertiary recovery in the main (Sadlerochit) reservoir, and development of gas production could add billions more to capital outlays over the life of the project. The economics of investing in all of these areas would be impaired, perhaps irreparably, if Alaska adopts the stiff increases in taxation recently proposed for oil and gas production. The risk of protracted delay in completing TAPS is minor. In fact, the project will probably be completed on, or even ahead, of schedule.

Major areas of investor concern regarding the North Slope oils include (1) a precipitous drop in OPEC prices, (2) the future of controls on U.S. crude prices, (3) untoward trends in Alaskan tax laws, and (4) possible delay in constructing a transportation system to move Prudhoe Bay crude to the Midwest.

The paramount issues of North Slope economics are, in our view, the two interdependent issues of crude prices and U.S. and Alaskan taxation. OPEC has decisively withstood the test of adversity and, in our judgment, will remain essentially intact at least well into the 1980's. We therefore expect prices for OPEC crude to rise steadily, although perhaps moderately, over the medium term. While we expect domestic crude prices to remain on relatively high ground, we also expect Congress to permit scheduled expiration of price controls only if the OPEC ceiling moves up very gradually indeed (or, better yet, declines). Alaska appears to be ensuring that in the United States, as abroad, "progressive" tax policies can threaten to severely constrain the upside earnings potential implicit in high, or rising, crude prices. We, nonetheless, profess to optimism about the ultimate outcome of the Alaskan tax debate. The tax changes proposed so far in Alaska would still leave the companies with "acceptable" unit margins, in an environment of slowly rising crude prices. The issue of increased taxation on Alaskan oil and gas will not be settled once and for all time, whatever the fate of the initially proposed tax package.

This report is primarily an appraisal of the economics of North Slope oil and gas. We examine a variety of plausible models of volumetric prospects and a range of pricing possibilities from major setback to moderate appreciation. We work towards a matrix of earnings possibilities for North Slope oil and gas. We examine separately the admittedly interrelated variables of crude price and taxation on production earnings. As noted, our own conclusions are biased in favor

of crude prices, at least in money terms, remaining on high ground, but with governments assessing the "adequacy" of profit margins. In so doing, Alaska would continue to emphasize the indicated discounted rate of return on production only (now around 23% based on near-term prices and taxes), while the companies will point to an approximate 14% return on the integrated project. Those who disagree with our conclusions, nevertheless, can find the report useful to test the earnings possibilities on the North Slope under less attractive assumptions. A constructive posture on Atlantic Richfield ($90 1/4) and Standard of Ohio ($69 1/4)--overwhelmingly so in the case of Sohio--must rest upon a leaning towards an optimistic scenario being the most probable one. Our own BUY recommendations for ARCO and Sohio rest upon such assumptions.

Chapter I of the report reviews the cost components of the project and assesses the risk of delay in completing the project. We then examine the economics and political parameters that will govern the companies' profit margins on crude. Clearly, the major factors are crude prices (analyzed in Chapter II) and taxation (examined in Chapter III). Chapter IV presents the analytical models that bound the earnings possibilities in the transportation and production functions. Our earnings models are differentiated as to pipeline throughput and production volumes, and crude price and tax assumptions. Chapter V translates the models into matrices of earnings possibilities for Atlantic Richfield and Standard Oil of Ohio. Chapter VI examines the regulatory, political and economic factors that will govern the start-up date for production, the destination, and prospective earning power for North Slope gas. Our final chapter translates the industry cost analysis into the specific capital requirements (past, present, and future) of ARCO and Sohio. It also examines patterns of financing to date, shortfalls, and the forms that future financing might take. Obviously, the way the companies finance will affect their future earnings per share.

Our formal projections of pipeline tariffs and earnings are based on capital costs which are a shade lower than the latest estimate. We have not changed our earnings models on this account. The gain in analytic purity from reworking the entire exercise is minor. Ceteris paribus, the higher the pipeline cost, the higher the TAPS tariff would tend to be pressed. It does not follow that the tariff would necessarily be raised, nor, if it were, that integrated profitability would be much affected. However, we do take into account the full January 1976 increase in TAPS estimated cost in our discussion of financing.

The appendix tables present detailed exercises for all our earnings models.

THE TRANS ALASKAN PIPELINE SYSTEM AT A GLANCE

TAPS AGREEMENT

Duration: initial term, 30 years

Form of Ownership:
undivided joint interest

Transfer of Ownership:
- permissible, for cash
- partners have first purchase rights

Expansion from 1,200 TB/D to 2,000 TB/D:
- any participant may propose
- other partners may acquire proportionate shares or decline
- each partner has option to acquire share for 2 years after expansion

TAPS OWNERSHIP

	Revised as of July 1974[a]	Original[b]
Std. of Ohio	33.34%	27.50%
BP	15.84	0.58
Atlantic Richfield	21.00	28.08
Exxon	20.00	25.52
Mobil	5.00	8.68
Union	1.66	3.32
Phillips	1.66	3.32
Amerada Hess	1.50	3.00
	100.00%	100.00%

a. Capacity of 1,200 TB/D
b. Capacity of 600 TB/D

PIPELINE DATA

Completion: mid-1977
Diameter: 48 inches
Length: 798 miles
Initial design capacity: 1,200 TB/D
Ultimate design capacity: 2,000 TB/D

Pump stations:
5 for startup at 600 TB/D by July 1977
3 additional to raise capacity to 1,200 TB/D by November 1977
4 additional to raise capacity to 2,000 TB/D

Environment:
Temperature range - −80°F to 90°F
Continuous permafrost - 250 miles
Terrain - 3 mountain ranges, 70 rivers and streams
Major earthquake fault in Alaska Range

MODES OF PIPELINE CONSTRUCTION

Conventional burial (insulated pipe resting on bedding), 380 miles

Elevated (insulated in fiberglass jacket on cross beams between flexible vertical supports), 410 miles

Special burial (double insulation; circulating brine in pipe running along bedding), 8 miles

VALDEZ TERMINAL

Port: deep-water, ice-free fjord
12 miles long, 2½ miles wide

Tank farm:
initial storage, 9 million barrels, (18 tanks)

Marine terminal:
5 berths
4 handling 150,000 DWT tankers
1 handling 120,000 DWT tankers

TAPS COST ESTIMATES

At initial design capacity of 1,200 TB/D:

Capital	$7.0 billion
Construction interest	1.3
	$8.3
Expansion to 2,000 TB/D	0.9
Total	$9.2

Company costs:

	at Capacity of 1,200 TB/D	at Capacity of 2,000 TB/D
Std. of Ohio	$2.8 bill.	$3.1 bill.
BP	1.3	1.4
Atlantic Richfield	1.7	1.9
Exxon	1.7	1.9
Other	0.8	[illegible]

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THE PRUDHOE BAY FIELD AT A GLANCE

GENERAL DESCRIPTION

Location: North Slope of Alaska

Area: 45 miles, east-west
20 miles, north-south

Reservoirs: Sadlerochit -- main Jurassic - Triassic

Lisburne -- deeper reservoir extending east of main reservoir

Kuparuk -- shallower Cretacious, extending over broad area to west of main reservoir.

MAIN RESERVOIR DATA

Proved reserves:
oil, 9.5 billion barrels
gas, 24 trillion cubic feet

Pay thickness:
630 feet (porous, permeable sandstone)

Depth:
up to 9,000 feet

Large gap cap; enormous water face

Crude:
27° API Gravity, 0.82% sulphur

Gas/oil ratio:
tested at 740 cu. ft. per barrel

COMPANY NET PROVED RESERVES

Main Reservoir:

Crude and Condensate (billion barrels):		
Std. of Ohio	3.9E	47%
BP	0.5E	6
Atlantic Richfield	1.7	21
Exxon	1.7	21
Other Companies	0.5	5

Natural Gas (trillion cubic feet):		
Std. of Ohio	6.2	30%
Atlantic Richfield	7.0	33
Exxon	7.0	33
Other Companies	0.8	4

Reserves shown exclude Alaskan royalty crude.

PRODUCTION

Main reservoir capacity:
approximately 1,500 TB/D based on currently proved reserves

Kuparuk/Lisburne reservoir capacity:
400 TB/D + (speculative)

Water injection in main reservoir likely - to sustain production

Miscible drive a good possibility - to increase recoverable reserves in main reservoir

Alaska must approve MER
Natural gas initially reinjected

PRODUCTION FACILITIES

Producing wells:
initially 130
drilled from 22 pads

Flow Stations:
4 in 1977
2 in mid-1978
total capacity-1,800 TB/D +

Gas Compression plant:
8 low-pressure trains
4 high-pressure units
capacity-1.66 bill. cfd

Power Plant
Handling capacity of combined facilities: 1,600 TB/D

DEVELOPMENT COSTS (MILLION $)

Development of Proved Reserves (9.5 bil. bbls.)

1969-1978:	Field Capacity 1,200 TB/D	$3.3 bil
	Increment to 1,500 TB/D	0.6
	Subtotal	$3.9 bil
	ARCO Share	1.1
	Exxon Share	1.1
	Sohio Share	1.6
Post 1978 Field Maintenance		$3.0 bil
Kuparuk/Lisburne Oil Development		3.0

while others are required by the terrain.

Geotechnical (geologic-soil) conditions have been quite problematic. One type of geotechnical problem--but not the worst--has found drilling equipment often mismatched to soil conditions (for example, encountering rock where gravel is expected), causing expensive delays. Another more serious type of geological surprise has been the encountering of massive ice and permafrost where ice-free gravel or rock had been expected, requiring elevation of an additional 50 miles of pipeline. The longest stretch affected is a 25-mile stretch in Section 2 (south of Fairbanks) between the Salcha River and Sourdough. The redesign and construction will be expensive and will require an additional 300-man construction camp and expansion of an existing camp. As noted previously, the number of VSM's will approach 78,000, up from the 72,000 estimated six months ago. The cost of drilling and inserting each pile averages $5,000. Alyeska has VSM's on open order, so no shortage of piles is expected.

Several potentially serious, and certainly costly, problems were also encountered at the Valdez terminal site because of unexpected soil and rock conditions. In one case, more overburden than anticipated was encountered because of misleading test borings at the tank farm site. Also, foundation rock was found to be not as competent as earlier borings had indicated. This necessitated the removal of huge amounts of overburden (14 million cubic years versus the 9 expected), the quarrying of rock, and construction of adequate tank foundations requiring enormous quantities of concrete fill and steel piles driven as deep as 50 feet. In the second half of 1975, a large rock slide behind the vapor recovery unit at the terminal slowed work there and made it necessary to cut away large quantities of potentially unstable rock or bolt it into place. This process involved drilling holes horizontally into the rock, inserting bolts about 30 feet in length, and grouting them into place. The degree of effort reflects the realization that Valdez is a prime earthquake zone. Remarkably, construction of the tank farm and other terminal facilities remains on (or ahead of) schedule.

Outlook for TAPS Costs and Completion

The cost of threatened, but averted, delay takes the form of greater commitments of manpower and other resources--in short, higher capital costs. The cost of actual delay takes the form of delayed revenue (heavier discounting of future revenues) and aggravation of financing problems. As noted, Alyeska has managed to avert actual delay, even if sparing no cost in doing so.

Repeated or prolonged labor stoppages are more than possibilities. Alyeska has encountered considerable disruptions of work dispite the absence of the usual gripes over wages or living conditions. Renegotiation of the wage contract in June 1976 could involve work stoppages. The settlement will probably be exorbitant. Low productivity of labor may continue to pose obstacles to timely completion of the project, or else to necessitate higher-than-expected employment.

Adverse weather conditions are fully as likely to threaten or cause construction delay. Heavy rains and severe winter weather have already occurred and been overcome--at a price--and barring truly extraordinary adversity, Alyeska will probably cope again. The containment of a recent North Slope oil spill--caused by a sudden temperature change--points up the protective measures anticipated by Alyeska and supervisory government watchdogs. One should not be too surprised if the weather causes occasional bugs in the smooth functioning of TAPS in its early winters of operation.

The prospect of major new geologic surprises is unlikely now that recoring has been done and all major foundation sites throughly explored, if not constructed, both at the Valdez terminal and on the North Slope.

TAPS represents the first above-ground placement of large diameter pipe in the United States; the effort has proved highly successful so far. The VSM's have held up well. Adaptation of familiar equipment has been achieved in numerous instances; new technology has been tested and either accepted or rejected. In contrast, design changes will continue, but will be handled expeditiously as at present. As noted, continuing smooth operation of the strategic Yukon bridge will facilitate movement of men, materials, and equipment.

The one major risk not yet encountered is an earthquake. Alyeska has invested heavily in specially-designed materials, engineering, line blocks, and detecting equipment to deal with the threats of earthquake-related pipeline breaks and oil spillage. Storage tanks, the power plant, and ballast water treatment and vapor recovery facilities at the Valdez terminal are all located on high elevations to escape possible tidal waves unleased by earthquakes.

Continued.....

NORTH SLOPE PROJECT: EVOLUTION OF COSTS AND STATUS OF CONSTRUCTION

Introduction and Summary

This chapter examines the evolution of investment costs for the principal components of transportation and production of the North Slope project as required for startup of production by mid-1977 and for maintenance and possible expansion of production over the longer term. It also reviews the status of various phases of construction and the factors that have to date temporarily caused setbacks in scheduling and that conceivably could result in future delay.

The costs of bringing North Slope crude on stream by mid-1977 are now essentially in place. In late January 1976, Alyeska raised its official estimate of TAPS capital costs for capacity of 1.2 million barrels daily to $7 billion. Interest during construction will raise that figure to about $8.3 billion. The estimated cost of developing the main field to an initial capacity of 1.2 MM B/D will approximate $3.3 billion; expansion of capacity to 1.5 million B/D would raise the total to $3.9 billion. The total cost (including tankers) of bringing Prudhoe Bay crude production on stream will exceed $12 billion.

Although the companies are approaching the final phase of construction preceding startup, further escalation in project costs cannot be ruled out. However, such increases are likely to be of tolerable dimension.

While the past focus of investor concern has been the quantum jumps in estimated pipeline costs, investors have begun to witness enormous upward revisions in development costs. Fortunately, a large portion of these increases in development costs will occur only after the North Slope project has begun to yield large cash flows. Meanwhile, considerable disagreement exists over the eventual total cost of developing <u>proved</u> reserves in the Prudhoe Bay field. We surmise that the total investment cost over the life of the main field could amount to $7 billion, or 75¢ per barrel. The conventional wisdom had long placed expenditures for developing proved reserves at $2 billion or 21¢ per barrel. Clearly, the costs of North Slope oil are not nearly so attractive as once anticipated. Owing to the enormity of North Slope reserves, however, sizeable inflation in development (as also pipeline) costs will still average out to relatively low levels per barrel (or per MCF) when compared to unit costs for new discoveries in the lower 48 states and, more importantly, in relation to projected quantum jumps in realizations for "new" crude.

Longer term, development of the Kuparuk and Lisburne reservoirs, possible investment in tertiary recovery in the main (Sadlerochit) reservoir, and development of gas production could add billions more to capital outlays over the life of the project. The economics of investing in <u>all</u> of these areas would be impaired, perhaps irreparably, if Alaska adopts the stiff increases in taxation recently proposed for oil and gas production.

We note the growing divergence among various unit costs for individual

companies although these differences, so far, tend to cancel one another out on aggregation. Models of project earnings thus retain their utility for analytical purposes.

We also note the persisting, but rapidly shrinking, uncertainty regarding dates of completion for critical components of the project. At year-end 1975, construction on the overall project was slightly ahead of schedule. The most probable threat to timely completion of the initial phase of construction is the risk of prolonged work stoppages on TAPS--a danger averted so far. Other impediments to completion by mid-1977 can be overcome through the application of ever more men and equipment to the job. The weather, no matter how capricious, is not likely to retard progress on the pump stations and on the terminal at Valdez, since most of the work remaining for next winter will be carried out indoors. The last phase of pipelaying will be conducted during the summer and fall of 1976. The prospect of major new geological surprises is unlikely now that recoring has been completed and all major foundation sites thoroughly explored. In addition, required new technology has now been tested. Another major threat to the construction schedule, one not yet encountered, would be an earthquake. Barring this eventuality, the project will probably be completed on, or even ahead, of schedule--at cumulative costs not outrageously different from current estimates.

Trans Alaskan Pipeline
Costs

In late January 1976, Alyeska raised its official estimate of TAPS capital cost (excluding capitalized interest during construction) for 1.2 million B/D capacity to $7 billion, up $625 million or 9.8% from the August 1975 estimate of $6.38 billion.* The latest hike in capital cost automatically raises interest during construction on the 85% debt portion of capital, by our reckoning, from $1.17 billion to perhaps $1.3 billion, bringing total startup cost to $8.3 billion. Subsequent expansion of capacity from 1.2 to 2.0 million B/D, to cost at least $855 million, will raise the ultimate cost to almost $9.16 billion.

Construction interest on the TAPS debt constitutes a major component of TAPS' eventual cost, growing inexorably with each escalation in TAPS capital cost. Our own $1.3 billion plus estimate of interest during construction assumes an average interest cost for the group of 9.3% on the 85% debt portion of TAPS capital. To date, ARCO's interest cost on its TAPS debt averages roughly 9%. Sohio's average interest cost slightly exceeds 10% per annum. As noted in the preface to this report, the TAPS tariffs employed in our models of prospective North Slope earnings reflect an initial capital cost of $6.8 billion ($8.0 billion, including construction interest) for capacity of 1.2 million barrels daily. This estimate

*In August 1975, Alyeska had raised its TAPS estimate to $6,375 million excluding provision for contingencies, up $395 million from 1974's $5,980 million (including $460 million for contingencies).

EVOLUTION OF TAPS COST ESTIMATES
FOR INITIAL PIPELINE CAPACITY*

(Billions of Dollars)

	TAPS Capital Cost plus Interest on Debt during Construction
December 1972	$2.9
December 1973	4.0
July 1974	7.0[a]
August 1975	7.5[b]
January 1976	$8.3
Capital	7.0
Interest	1.3

* 1.2 MM B/D
a. Included $460 million for contingencies.
b. Excluded provision for contingencies.

is based on data contained in company prospectuses issued after the August 1975 date of Alyeska's official estimate but prior to its recent revision to $7 billion.

The latest increase in TAPS capital and construction interest costs reduces integrated profits per barrel slightly below our estimate. Interest costs that prove higher than our assumed 9.3% per annum would have a similar impact (work in the same direction). Ceteris paribus (including the tariff on TAPS), Sohio's unit profit on TAPS will tend to be somewhat lower than ARCO's--on our earnings models--owing to its higher interest rate. On the other hand, Sohio will enjoy lower unit capital costs in the Prudhoe Bay field (more later).

We repeat the comment made in the preface to this report, that while our earnings models are based on below-actual costs of TAPS, we take the latest cost increase into account in our discussion of company financing of North Slope expenditures.

The increase in TAPS' estimated cost from $6.38 billion to $7 billion largely reflects lower-than-anticipated labor productivity. It is also worth noting that the preceding large increase in TAPS cost in August 1975 mainly represented the cost of catching up for pipeline delay in order to complete construction of the pipeline per se by October 1976, as originally scheduled. (Project completion for 1.2 million barrels daily, including pump stations and the Valdez terminal, is scheduled for July 1977.) The cost of catch-up on pipeline construction involved a greater application of resources--additional rigs to drill holes for the vertical support members for the above-ground half of the

pipeline and additional pipeline spreads--rather than major revisions for inflation or wages.* Site preparation at the Valdez terminal has also proved much more costly than originally expected.

Unfortunately, Alyeska's latest cost estimate for TAPS cannot be regarded as definitive. Costs may well go still higher (see below). Possible utilization of much of Alyeska's 8,209 pieces of equipment, once TAPS is complete, to build a natural gas pipeline across Alaska would recoup several hundred million dollars, a welcome offset to potential escalation in TAPS cost.

Pipeline Construction Progress

Construction of the pipeline slipped behind schedule in the winter of 1974/75. A late 1974 start in work-camp construction, caused by delay in receiving environmental clearances, limited movement of men into the field to clear right-of-way, to build work pads (the 50-foot wide gravel strips along the 798-mile pipeline route), and to lay pipe. In addition, delayed delivery of specially-designed rigs to drill the holes required for the vertical support members (VSM's) for the above-ground half of the line pushed construction of the line behind schedule. The permit problem was resolved in the spring of 1975, and the number and rate of delivery of VSM drilling rigs was stepped up to target levels in the late summer of 1975.

By year-end 1975, the overall TAPS project was 41% completed but still short of the 45% goal set a year earlier. Construction of the pipeline itself (including clearing right-of-way, work pad construction, installation of above-ground pipeline supports, and pipeline installation) was 56% completed. Approximately 25% of construction on the pump stations and 28% on the Valdez marine terminal was completed.

On the pipeline portion of TAPS, work on some 700 miles of 50-foot wide gravel work pads--required to support heavy pipeline construction equipment and to protect the fragile permafrost from damage--was originally scheduled to begin in the fall of 1974 and to end in the spring of 1976. The mainline work pad was essentially completed by year-end 1975.

At the height of the summer-1975 construction season, 44 rigs were in operation for drilling holes for vertical support members. By year-end 1975,

*Virtually all materials for the pipeline have been ordered. Most contracts for materials provide for inflation between order and delivery dates "based on appropriate indices!" The current TAPS estimate still allows for 12%-15% inflation on materials. Most construction contracts provide for reimbursement of costs plus fixed fees. Wages are agreed upon through June 1976; they are estimated to increase 12% more in the third (presumably final) year of construction.

47,000 supports were set, and slurried in place, of the 78,000 required for the above-ground segments of the pipeline.

Full-scale pipelaying got underway only in late summer 1975. Nevertheless, by December, 370 miles of mainline pipe of the 798 miles required had been installed: 224 miles were laid underground, 145 miles on VSM's aboveground. Approximately 420 miles of mainline pipe will be elevated, and 380 miles will be installed underground. Each pipeline section will be tested with water upon its completion. By mid-November, when record cold and winds effectively shut down pipe installation and almost all welding, overall project construction was nearly a month ahead of schedule. Pipelaying per se was a bit behind schedule as winter closed in.

The Yukon River bridge--the one-half mile, $31.5-million connecting link between the northern and southern halves of the pipeline--was opened to 24-hour traffic in the first week of November 1975, two months ahead of schedule, despite an earlier delay due to inadequate piling for one of the four support piers. The timely completion of this permanent bridge assures all-season transport across the Yukon. Installation of the pipeline across the bridge is scheduled for the summer of 1976. Meanwhile, concrete footings have been poured for two other major suspension bridges, across the Tanana and Tazlina Rivers on the southern half of the pipeline.

Pump Stations Construction

Pump station and Valdez terminal construction schedules are programmed up to the second quarter of 1977, leaving no leeway for any major delay if the overall project is to be completed by mid-1977. However, to date pump station construction is on schedule. During the summer months of 1975, the main thrust of construction at the pump stations needed for the line's first operational months (Stations 1, 3, 4, 8 and 10) involved the pouring of foundations and erection of structural steel for permanent buildings, completion of crude and fuel tankage, and the beginning of main pump installation. All necessary pumps, turbines and generators are now in place, and the six main buildings required for operation at each station are essentially closed in. In addition to living quarters for the crew of technicians, a shop and warehouse building and structures were constructed for housing station controls, main pumps, booster pumps, turbines and manifolds. Station tankage, necessary for initial operation of the line, was also completed, with hydro-testing of the tanks scheduled to begin in the spring. Similar progress was made in building tanks and other facilities at Pump Station 5, which will be used initially only as a pressure relief station on the south side of the Brooks Range. Work on pump stations has continued at a high level despite the severity of the weather; the emphasis, however, has shifted to interior work--the installation of electrical and lighting systems, paneling for permanent buildings, of heating systems, and of ventilating systems for main turbines. Since installation of equipment will be carried out in winterized structures, any delay in pump station construction later on is not likely to be protracted.

Temporary construction work has been completed on the three stations (6, 9 and 12) which will raise line flow from 600 TB/D to 1,200 TB/D in late 1977. Work on permanent facilities at these sites is also underway, and will continue

through the current winter.

Demobilization for winter has taken place at future stations (2, 7 and 11) which will eventually raise line capacity to 2,000 TB/D. During the early stages of operations, these will be operated as pass-through stations; no major equipment will be installed until the decision is made to increase pumping to the maximum level.

Another major undertaking has been construction of a natural gas line from Prudhoe Bay to Pump Station 4. Gas from the line will power turbine pumps at Stations 1, 2, 3 and 4. Approximately 6 miles of that 150-mile line have been completed after the start of construction on November 1.

Valdez Terminal Construction

The terminal site covers about 1,000 acres and includes crude storage tanks, docks, tanker loading and ballast water-treatment facilities, power plant and vapor control facilities, and other infrastructure.

As noted, the Valdez terminal project is also on a tight construction schedule; here again, "critical paths" in the sequential requirements of terminal construction have not been violated, although delays in delivery of materials to the site, limited road access, and an initial shortage of quarters slowed construction until well into 1975. Specifically, concrete tank rings for four 510,000-barrel storage tanks were completed on schedule, April 15, 1975. The first tank erection began at the Valdez terminal's east tank farm in May. Ten of the 14 tanks in the east tank farm were essentially completed by the close of 1975. Eventually 18 tanks will be built, but not all will be required for startup at 600 TB/D. Work is proceeding at various stages on the other tanks and on the oil containment walls that will surround the east tank farm. The initial 18 tanks will provide 8 days' supply of oil at a delivery rate of 1,200 TB/D. By the time the line reaches its 2 million barrel daily capacity, there could be up to 32 tanks. Site preparation at the west tank farm is also proceeding.

Three 432,000-barrel ballast water treatment tanks are basically completed. These facilities will be able to accommodate and treat, within 48 hours, the anticipated ballast from arriving tankers. Construction of two associated skimming tanks is essentially finished.

The foundation has been set and structural erection finished on the vapor recovery unit to which vented gas (released when crude storage tanks are being filled) will be withdrawn for reprocessing. The first inert-gas compressor has been set. The main steel structure of the power plant is largely completed and the large condensers for the three stream turbines and boilers have been erected. Additionally, significant progress has been made in trestle construction for tanker berth number four. In 1976, while berth four is being completed, work will begin on berth five. Berths one and three, completing the first phase of terminal construction, will be built in 1977. The berths are designed to accommodate tankers of over 150,000 tons. Turn-around time for the ships averages one to two days.

Labor Force on TAPS

At the height of the summer 1975 construction season the total work force on TAPS was 21,600. The 1975/76 winter work force was down by half. Winter weather virtually shut down pipelaying until spring. Emplacement of VSM's has continued but at a sharply curtailed rate. Preparations for construction of a natural gas line from the Prudhoe Bay field to the first four pump stations are accelerating. There has been no reduction in pump station manpower, and only a moderate cutback at the Valdez terminal. Remobilization of labor is now underway.

Tankers

The costs of large crude carriers built in American shipyards have risen from around $150-$200 per deadweight ton in 1970 to almost $500 a ton on current orders. Atlantic Richfield's tanker fleet for North Slope oil includes two 70,000 dwt tankers, three 120,000 tonners--all five delivered--and three 150,000 tonners (two firm orders, one option), for delivery in 1979-1980. The total tonnage comes to 950,000 dwt and our estimate of cost (including interest during construction), $393 million. Sohio's North Slope fleet, to transport its share of 1.2 million B/D+ of production includes two 80,000 tonners on long-term charter, two 120,000 tonners on firm orders, and six 165,000 dwt tankers ordered with various degrees of firmness for delivery in 1977-79. The fleet under construction aggregates some 1,230,000 deadweight tons; its total estimated cost will approximate $720 million including escalation provisions and interest during construction.*

Sources of Delay and Higher Costs on TAPS

Almost everything that could have gone wrong since commencement of construction of TAPS in the spring of 1974 has gone wrong--the exception being a major earthquake along the pipeline route or at Valdez. Each problem, however, has been manageable. The price of threatened delay is reflected in the recent major increases in the estimated cost of TAPS.

The factors mitigating against definitive estimates of cost and related completion dates, even at this late date, include: (1) the question as to the availability of skilled labor; (2) more worrisome, the uncertain productivity of labor and equipment under arctic conditions; (3) abnormal weather patterns; (4) the application of untried technology; (5) the possibility of mandated changes in design or construction for protection of the environment; (6) the associated possiblity of delays in obtaining construction approvals from regulatory authorities; and (7) unforeseen geologic or other conditions.

* The North Slope companies will lease, rather than own, their tankers for vessel life. The financing of tankers--involving complex and variable relationships among shipbuilding firm, chartering company, oil company and investment banker--is discussed in Chapter VII, NORTH SLOPE FINANCING.

Construction of TAPS has been plagued by labor unrest despite record wages and a no-strike agreement between Alyeska and the unions. The welders, in particular, have staged two major walkouts and their performance is reported to be spotty at best. Welding is probably the most basic yet vital aspect of building TAPS and is turning out also to be the most troublesome. The majority of pipe connections have used conventional stick-welding techniques except for several semi-automatic prototypes in limited use on the project. The welders union reportedly has vigorously opposed improved equipment and techniques. In August 1975, Alyeska authorized increased welding speeds for certain pipe welding operations after detailed testing. An average of 25% of manual welds have been rejected immediately (at times, 40%). In contrast, the reject rate for automatic shop welds is 5%.*

Despite all prescribed safeguards, quality control has been a source of embarrassment for Alyeska. In pipeline section three (a 150-mile stretch from the Yukon to 50 miles south of Fairbanks), an audit found that 247 welds of 3,748 completed required additional radiography and possible repair work either because of misinterpretation of X-ray results or procedural errors in radiographic examination.

As noted earlier, severe winter weather delayed construction of work camps and other progress in the winter of 1974/75 and record cold and snows brought pipeline activity to a near-standstill this past mid-November. In the fall of 1975, an unusual 4-inch rain in 2 days' time washed out two sections of the access road to the marine terminal site at Valdez. It also washed out part of the work pad in the southernmost pipeline section, causing rock and mud slides and temporarily closing a section of the Richardson Highway. Damage in both cases was quickly repaired and the tempo of construction accelerated to make up for lost time. The most outstanding examples of special weather-related construction modifications are the elevation of more than half the pipeline in areas of massive ice-permafrost soil conditions and heavy fiberglass insulation of the pipe in its elevated portions.

Construction of TAPS has also involved the application of significant new technology. Procedures for aboveground construction of a large-diameter pipeline (let alone one in arctic regions) have met with success. Prototype equipment has generally worked well but with some notable failures. Still, the most significant success is associated with adaptations to standard, simple equipment. Alyeska is employing some 8,200 pieces of equipment worth $300 million on construction of the pipeline.

Mandated changes in the pipeline route for environmental reasons have become routine. The pipeline will contain 800 animal crossings--about one per mile on average--some of which are designed to accommodate caribou migrations,

*According to Alyeska's quality control, every internal and external girth weld is X-rayed to detect hidden flaws and tested to assure hardness and impact resistance to 20 foot-lb. at -50° Fahrenheit. The pipeline is designed to withstand an earthquake registering up to 8.5 on the Richter scale. It can withstand an axial force of 2.5 million lb. and lateral deflection force of 450,000 lb. before wrinkling.

ESTIMATED CAPITAL EXPENDITURES ON PRUDHOE BAY FIELD

(Billions of Dollars)

Development of Proved Reserves (9.5 bil. bbls.)	
1969-1978: Oil Productive Capacity, 1,200 TB/D	$3.3
Increment to 1,500 TB/D	0.6
Subtotal	$3.9
Post 1978 Field Maintenance	3.0
Tertiary Recovery in Main Field[a]	3.0
Kuparuk/Lisburne Oil Development[a]	3.0
Gas Development[a]	2.0
Grand Total	$14.9

a. Speculative

Prudhoe Bay Costs and Facilities

Estimates of the capital cost of developing and producing the 9.5 billion barrels of proved crude reserves from the main (Sadlerochit) reservoir have ballooned in recent months. In fact, we are now witnessing something akin to the earlier horrendous escalation in pipeline costs. The estimated cost of developing the main field to an initial capacity of 1.2 million barrels daily will approximate $3.3 billion; expansion of capacity to 1.5 million B/D would raise the total to $3.9 billion. Even more astounding, post-1978 expenditures could exceed $3 billion, bringing the total capital cost of developing proved crude reserves to $7 billion (the same as the initial capital cost of TAPS), or almost 75¢ a barrel. The conventional wisdom had long placed expenditures for developing proved oil reserves in the main field at $2 billion, or 21¢ a barrel. These projected expenditures are apart from possible outlays on tertiary recovery, for development of Kuparuk/Lisburne reservoirs, or on expenditures for natural gas production (discussed later).

Initial development of the eastern half of the field where Atlantic Richfield is the operator (mainly for itself and Exxon) will greatly exceed expenditures on developing the western portion of the field, where BP is operator (for Standard Oil of Ohio). Sohio's expenditures associated with field capacity of 1.2 million B/D will approximate $1,260 million ($1,435 million in connection with capacity of 1.5-1.6 million B/D). In contrast, the capital costs of developing the eastern half of the field will approximate $2,040 million and $2,465 million,

respectively. The disparity represents the encroachments of inflation upon the much slower rate of development adapted by ARCO during the long delay in obtaining approval for TAPS.* BP/Sohio proceeded more boldly.

Production of 1.2 million B/D from the main reservoir will eventually require completion of 130 development wells from 22 sites, with 6 to 8 directionally-drilled wells per site. Each pad will tap a subsurface area of 3,800 acres. At year-end 1975, 88 production wells had been drilled. Ten wells for gas re-injection are also being drilled. Production of 1.5 million B/D will require about 170 producing wells. Aside from development wells, the infrastructure for field capacity of 1,500 TB/D includes field pipeline systems, gathering centers, field fuel unit, gas compression plant, gas reinjection wells and power plant.

By early 1976, ARCO had completed 33 of 60 wells initially planned for pipeline startup in mid-1977; the company is operating 6 rigs to complete the initial development of the eastern portion of the Prudhoe Bay Field. ARCO shipped enough modules in the 1975 sealift to complete one of two initial flow stations in the eastern half of the field. In contrast to ARCO, Sohio's development program is further advanced; at year-end 1975, the company had drilled over 50 of 70 initial wells planned--all should be completed by early 1977. Sohio has also drilled 11 service wells which are presently suspended and reserved for future use. Sohio has shipped all components for two gathering centers to the Slope.

ARCO and Sohio are both constructing two gathering centers (flow stations), which together will handle 1.2 million B/D+ of crude. Two additional centers are scheduled for completion in mid-1978, raising gathering capacity to at least 1.8 million B/D. The latter facilities will be available for field expansion and standby use.

The approximate priorities for completing major components of Prudhoe development, beyond well completions and field gathering-pipeline systems, are: (1) the field fuel gas unit which will supply fuel to the power plant and first four pump stations on TAPS; (2) flow station module assembly; and (3) gas plant assembly.

Post-1978 Expenditures at Prudhoe Bay

Considerable confusion has arisen over the eventual total cost of developing the main reservoir's proved reserves of oil and also gas. Part of

*Capital expenditure estimates for ARCO and Sohio are presented and discussed in more detail in the section on financing. Costs of the power plant (Sohio's area of development) and of the gas compression plant (on ARCO's area of development) are being shared according to the tentative equities in the oil.

the confusion is due to widely varying company estimates of post-1978 capital expenditures. The variability is understandable: (1) even approximate cost estimates must await operational experience, particularly reservoir behavior; (2) estimating the rate of inflation over a prolonged period is an exercise in speculation.* Additional confusion arises over the prospective allocation of costs between oil and gas. Clearly, a hefty portion (perhaps 40%) of capital expenditures incurred to bring field capacity to 1.5 million B/D, and which are necessarily assessed against oil at least until gas production begins, represents joint costs. These facilities include flow stations, gas compression plant, gas reinjection wells, and power plant. Another aggregation of costs, more directly attributable to gas, will arise once plans to produce the gas are developed. The latter include additional gas wells, possibly additional gas-plant capacity to compress the gas to pipeline standards, extraction of additional liquids from the gas, and intensification of waterflooding to replace the reservoir pressure lost through gas production.

Atlantic Richfield has estimated the cost of developing its share of the proved oil and gas reserves in the main Prudhoe Bay field through 1990 at approximately $2.5 billion. We tentatively assume that over 70%, or $1.8 billion of this total, may be allocated to oil (leaving $700 million attributable to facilities to be constructed once gas production is scheduled). ARCO estimates it will have spent $1,136 million on field development through 1978, leaving $664 million to be spent on oil development in the 1979-1990 period. On grossing up ARCO's share of oil-development expenditures after 1978, we find that total oil field expenditures would approximate $3,160 million. Total expenditures for 9.5 billion barrels over the life of the field sum to $7,192 million.**

In contrast, Sohio has ventured a guess that post-1978 spending of all companies on the main Prudhoe Bay oil field beyond the initial aggregate investment to reach 1,500 TB/D capacity could average $50-$100 million annually or $600 million-$1,200 million cumulatively through 1990. On Sohio's rough reckoning, the cost of developing 9.5 billion barrels of Prudhoe oil reserves will approximate $4,500-$5,100 million, a level of expenditures far below that extracted from ARCO's estimate.

A study published by the Department of the Interior in December 1975 cited the additional capital cost of developing and producing main reservoir oil at $8.2 billion (not counting $1.2 billion previously spent on field facilities) and $3.8 billion for additional facilities to develop and produce the gas. These estimates appear high even in comparison with ARCO's, owing to

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* Post-1978 field facilities associated directly with oil include a waterflood and a gradual increase in the number of wells from 130 initially to 500-600 over the life of the field.

** Prospective expenditures directly attributable to gas gross up to $2.1 billion (ARCO's share $700 ÷ 33 1/3%).

the inclusion of estimated operating as well as capital costs in the totals. We surmise that ARCO's estimate of its share of oil and gas expenditures on the main reservoir allows generously for inflation and contingencies. Interior's estimates offer some clue as to the rough apportionment of expenditures between oil and gas.

Capital allowances in our models of Prudhoe Bay oil earnings (see Chapter V, EARNINGS MODELS OF NORTH SLOPE OIL) are based on company projections of cumulative spending through 1978 coupled with ARCO's projections for post-1978 outlays.

Tertiary Recovery

Prospects for tertiary recovery from the Prudhoe Bay field remain uncertain. We gather that injection of a miscible drive based on CO_2 extracted from the field's gas is technically feasible. Significant projects, employing miscible flood based on CO_2, are proving successful in the mid-continent area of the lower 48. There appears to be a difference of opinion among producers as to the adequacy of the CO_2 (16% of gas cap gas by volume) contained in the Prudhoe gas. The economics remain unproved; the total costs of such a project, the results measured in incremental reserves, and, of course, the market price of the added supply all remain elusive. Adoption by Alaska of the package of proposed tax changes would probably jeopardize such an undertaking. Previously, prospects for application of tertiary recovery at Prudhoe Bay appeared more promising. One of our earnings modles (designated the "production potential" case*) incorporates a tertiary recovery project; it allows for $3.0 billion for a miscible flood, employing CO_2 derived from natural gas, and for an increase in the main reservoir's recovery factor from roughly 40% or 9.5 billion barrels to an estimated 46% or 11.5 billion barrels. The incremental capital cost is assumed to be $1.50 per barrel. The latter numbers represent plausible guesses (we hope), rather than precise projections.

Kuparuk/Lisburne Reservoirs

Our estimate of the capital cost of developing the Kuparuk/Lisburne formations is also very tentative at best. We have assumed that capital cost averages $1.50 per barrel, owing to much lower well productivity than in the Sadlerochit (main) reservoir. ARCO expects that production of Kuparuk reserves would require water injection. Based on a production curve reflecting recent company speculation on peak production of 400 TB/D, we have derived a gross working estimate of $3 billion for the total capital cost of developing an assumed 2 billion barrels of oil from the Lisburne/Kuparuk formations.

Neither area has yet been declared commercial. Apparently 6 to 12 more exploratory wells will be necessary for a reliable initial definition of deposits in the scattered, shallow Kuparuk sands. However, the Kuparuk looks promising. Well productivity may approximate 2 TB/D. ARCO has completed

*See Chapter V, EARNINGS MODELS OF NORTH SLOPE OIL.

West Sak wells numbers 3, 5, and 6; numbers 1 and 2 will be completed soon. ARCO has suspended drilling in the Kuparuk area until the winter of 1976/77. Even less activity has taken place to date in the Lisburne formation; results, moreover, have been kept confidential owing to expected state leasing in the adjacent Beaufort Sea.

Outlook for Prudhoe Bay Costs and Completion

While the companies now have a good fix on development costs through 1978, some further moderate escalation would not be surprising. In fact, no escalation would be most surprising. Investors will have to live for years with great uncertainty over the eventual total cost of development--including maintenance of the main field, tertiary recovery, and commercialization of the Kuparuk/Lisburne reservoirs.

The 1975 barge shipment of production-facility modules critical to the initial development of the Prudhoe Bay field arrived at Prudhoe Bay in early autumn. Delivery of these most essential, large production-facility modules obviates reliance on the 1976 sea lift to have producing capacity of 600 TB/D ready by mid-1977. Accordingly, initial development of the Prudhoe Bay field at a production rate of 600,000 barrels of oil daily remains on schedule for mid-1977. Thirteen oceangoing tugs returned from Prudhoe Bay in October 1975 and will be available for the somewhat smaller sea lift planned for next summer. Nine lightering tugs remained. The prospective supply of barges is expected to be adequate although 25 remained at Prudhoe Bay. The planned increase of field capacity to 1.2 million barrels per day by late 1977 may be contingent upon a successful barge shipment during the summer of 1976. However, shipment of field equipment could be made by existing land and air routes if a major electrical unit were disassembled and transported in components. The odds, at least, favor clear sailing in the summer of 1976.

On a different note, another--but not major--risk has arisen in the form of trespass claims against non-Native land users on the North Slope. In April 1973, Federal District Court Judge Oliver Gasch ruled in the Edwardsen vs Morton suit that trespass actions could be initiated against non-Native users of Alaskan land before the Native Claims Settlement Act became law on December 18, 1971. Thus, any company or individual who occupied or used land claimed by the Natives is, according to Judge Gasch's opinion, subject to a potential lawsuit for trespass. And this is possible even if the company or individual held a valid federal permit to use the land. The judge held that the Native Claims Settlement Act of 1971 resolved who owned Alaska's aboriginal lands now, but it did not clear up settlement questions regarding prior damage; the court ordered the Justice and Interior Departments to draw up suits for trespass on 57 million acres on the North Slope.

In October 1975, Interior filed suit against 126 companies, including Alyeska, ARCO, BP and Exxon. The suit, filed on behalf of the Arctic Eskimos, asked that they be compensated for damage done to their aboriginal lands before

the 1971 Act. The following (among others) are included as trespassory acts--utilization of the surface for airfields, buildings, roads and other structures; removal of sand or gravel; the taking of water; acquisition of valuable information regarding surface or subsurface resources; and extractions of oil or gas. Senator Ted Stevens of Alaska has proposed an amendment to the Alaska Native Claims Settlement Act of 1971 that would reaffirm the intent of Congress that the Act compensated for loss of Native-claimed land and that it extinguished all Native land claims. If he fails, the lawyers may do as well as the welders.

Scientists affiliated with the U.S. Geological Survey have warned that the massive, 425-square-mile Columbia Glacier jutting into Prince William Sound, just west of Valdez, may be on the verge of a drastic retreat that could discharge numerous icebergs into the shipping lanes of Prince William Sound--creating a hazard for oil tankers. Recent ice discharges reportedly suggest that the retreat may have started. If the glacier retreats from the shoals into the deeper water of the fjord, the rate of breakup and ice discharge could increase sharply just when crude shipments begin, and the problem could endure over an extended period. At present, this risk is nebulous. The companies could probably deal with the problem if it reached moderate proportions.

The most significant oil spill during construction occurred recently at Prudhoe Bay. Around 70,000 gallons of diesel spilled from a TAPS-owned storage tank when a sudden 50° F change in temperature caused an "overfull" tank to blow its lid. All but 2,000 gallons was contained by a dike; the bulk of the oil was pumped back into a storage tank. The remaining cleanup will follow in the spring.

CRUDE PRICE OUTLOOK

Introduction and Summary

This section is concerned with the institutional arrangements that will play decisive roles in governing the future level of crude oil prices in the United States. Clearly, the rational economics of petroleum as an internationally traded commodity is now dominated by these arrangements. We are, of course, concerned here with OPEC's pricing policies, and the constraints upon these policies, and with evolving national energy policy in the United States.

Prices on international oil flows are now established by the OPEC cartel; its ongoing commitment to continued escalation of crude prices is well known. Although the recently-enacted Energy Policy and Conservation Act now breaks the direct link with OPEC prices, OPEC pricing will clearly continue to set the ceiling on U.S. crude prices. OPEC has decisively withstood the test of adversity and, in our judgment, will remain essentially intact at least well into the 1980's. We therefore expect prices of OPEC crude to rise steadily, although perhaps moderately, over the medium term.

The new U.S. Energy Act extends price controls over a protracted period, rolls back "new" crude prices temporarily, provides for virtual recovery in the average price of the rollback in 1976, but does little else to clarify prospective price levels over the medium term. Projection of domestic crude prices will therefore entail supplemental judgments about political attitudes, election results, etc. We were relieved, however, to see that the final bill softened a provision in a working draft that would have required cost-related pricing for North Slope crude. Nonetheless, the bill, with its provision for inflation-based indexing and the special incentive increase in price, still smacks of cost-related pricing.

Unless the Congress proves unexpectedly generous in authorizing higher crude prices at home--and abandons its manifold objections to development of domestic energy supplies--dependence on imports will surely accelerate, giving renewed credence to the invincibility of the cartel and increasing economic pressure for higher domestic crude prices. If past is prologue, the cynic might then expect Congress to maintain a tight lid on domestic prices, the FEA Administrator's long-term pricing schedule (looking toward eventual decontrol) notwithstanding.

In sum, our conclusion remains that domestic crude prices will continue on relatively high ground, as compared with historical relationships to prices for other essential goods and services. We expect Congress will permit scheduled expiration of price controls only if the OPEC ceiling actually rises at a slower pace than we anticipate or, better yet, declines. For North Slope investors, of course, these favorable crude prices are clearly crucial to attractive earnings prospects. However, as we do not pretend to assess future levels of crude prices with perfect foresight, our models examine earnings possibilities for a range of crude prices, both above and below the recent level. Furthermore, recent tax developments in Alaska have reinforced)

our earlier conviction that the significance of crude prices per se for unit margins has become blurred by governmental proclivity to assess the "adequacy" of profit margins (translated: how little is enough?) and adjust taxes accordingly. In addition, the recent allusion at the federal level to cost-related pricing (shades of natural gas regulation) also reinforces our belief in the relevance of political "reasonableness" to earnings in each of our models.

The Critical Role of Government

The paramount issues of North Slope economics are, in our view, the two interdependent issues of crude prices and U.S. and Alaskan taxation. As we are now observing, rising prices do not necessarily imply commensurate increases in earnings. A safe, if unhappy, premise is that benefits from higher prices would accrue disproportionately to Alaska, and possibly the federal government, and that the penalty of sharply sinking prices would be borne disproportionately by the North Slope companies. Political entities, whether OPEC or Alaska, share similar biases; they will be assessing the "adequacy" of profit margins in relation to their own unquenchable thirst for oil revenues. Clearly, we do not mean to denigrate the importance of crude prices per se; obviously, higher prices are still preferable even under progressive tax regimes. Moreover, state tax collectors could confront contraints on their revenue-raising ambitions (more in the section on taxes).

A Glimpse Backward

In looking back only two years, we observe that domestic crude prices were benignly sheltered from the competitive pressures of the then lower-cost foreign crude by comprehensive import controls. Prices were then gravitating toward replacement cost as the drag on prices from surplus domestic producing capacity eased. On the West Coast, the "natural" market for North Slope crude, the widening imbalance between oil demand and local crude supply (the gap controlling permissible import volumes) portended ample accommodation of prospective North Slope production through displacement of imports. In that environment--where potential competition from foreign crude was constrained--were North Slope crude to move in limited quantity to the West Coast, its landed value would be established by the price of comparable domestic crude (taken as Signal Hill, 27° API gravity) on the West Coast. Once the market value of North Slope crude was thus established, the wellhead price would also be established, by the West Coast price less marine and pipeline transportation costs between the North Slope and the West Coast.*

*As a result, the wellhead price would vary with changes in market price or in the TAPS tariff (consisting of operating costs, interest charges, depreciation, state and federal taxes, and profits)--the lower the tariff, the higher the wellhead, and vice-versa.

Clearly, oil pricing, worldwide, has since become increasingly dominated by governments, with prices on international flows now established by the OPEC cartel. The United States has become a sub-sector of that international oil market. Once OPEC pricing no longer threatened to depress domestic prices, volumetric controls on imports were dismantled and reliance on imports accelerated. Accordingly, consuming nations have become relegated to the role of reluctant price takers, their control over the oil price mechanism limited to keeping prices of internal energy below OPEC-mandated levels (e.g., on controlled domestic crude), or to raising oil costs further (e.g., through import fees or tariffs). The response of the U.S. government has been to become ever more deeply involved in the price of energy fuels. For most of 1975, the United States simultaneously featured the lowest (for controlled crude) and highest (for exempt crude) prices among major Free World producers. Against this background, we examine trends in institutional arrangements governing the outlook for OPEC and domestic oil prices.

OPEC Pricing

The Current Environment

OPEC's overall steadfastness over the last eighteen months or so has been impressive, considering the sharp contraction in crude requirements over an unexpectedly long period--particularly for the heavy crudes--and Iraq's potentially disruptive drive for greatly increased market share. OPEC not only maintained a basically intact pricing structure, but even raised the general price level by approximately $1.00 per barrel in October 1975. It is true that erosion of prices from these higher levels has since occurred, but--with the apparent exception of Iraq--the reductions have been orderly and modest. In short, OPEC has encountered considerable downward pressure on market prices, disappointment in the slow pace of economic recovery in major markets, and a "spoiler" in its midst, but has withstood the test of adversity.

Owing to the sharp contraction in export demand--reflecting deep, worldwide recession, inventory depletion by importers, price elasticity, mild weather, and conservation measures--OPEC's crude production declined to 27.1 million barrels daily (MM B/D) in 1975, down 11.4% from the 30.6 MM B/D in 1974 and 17.6% below the pre-embargo level of 32.9 MM B/D in September 1973. At year-end 1975, OPEC's producing capacity amounted to 37 MM B/D. Of total surplus capacity of 10 MM B/D, some 7.3 MM B/D was located in the Middle East, with Saudi Arabia accounting for 3.3 MM B/D. In January 1976, OPEC production averaged 26.7 MM B/D, off 2.2% from the like 1975 period (and 1.8% below December 1975), offering no perceptible evidence of the expected cyclical recovery in aggregate demand in OECD markets. Demand for the heavier crudes (feedstocks for boiler fuels)--closely correlated to the pace of industrial production--has been particularly depressed. It is interesting to note that, while Iraq raised its 1975 production on average by 20%, its production dropped 13% in January 1976 (from 2,076 TB/D in December 1975 to 1,809 TB/D), due in part to competitive price cutting by other Gulf producers of heavy crudes. OPEC production was up smartley (+7.3%) in February 1976 to 28.1 MM B/D, the long-awaited beginning of recovery perhaps. Saudi Arabia's production rose strongly (+17.5%) to 7,940 TB/D. Iraq's production gained by a modest 3.1% over February 1975.

"Statesmanship" was the expected, almost inevitable, outcome of OPEC's conviction that volumetric setbacks would prove to be temporary and its awareness that the cost of competition would be incalculable, but enormous. OPEC is fully aware of the huge gap yawning between its own price level and the very low cost of producing still-abundant supplies of Middle East crude. At the same time, OPEC has been fortified by its perceptions of economic justice--including optimal pricing of its crude on a replacement-cost basis and maintenance of the purchasing power of its oil revenues.

The general increase in OPEC prices of last October was adopted when expectations of rapid recovery in the OECD economics ran high. The setting of price differentials to reflect relative crude values was to be taken up at a later date. The recession subsequently proved to be more enduring than earlier anticipated, exacerbating the problem of price differentials. In particular, asking prices for heavy crudes looked to be increasingly out of line, prompting companies to shift their liftings toward more attractive sources of supply. Squabbling among OPEC members over relative crude values intensified, leading to repeated postponements of a conference to settle the issue. Nevertheless, progress in reducing prices of overvalued crudes has been achieved through actions of individual nations--however reluctantly--in response to the offtake decisions of the major oil companies. Saudi Arabia, Kuwait, and, most recently, Iran have shaved prices of the heavier crudes from their October 1975 levels. On February 14, 1976, Iran reduced the price of its heavy crude by a token 9.5¢ per barrel to $11.40, although trade sources indicated that a greater reduction was warranted. Of course, strong recovery of production of heavy crudes ultimately must await parallel recovery in the OECD economies.

In sum, most of the major OPEC producers have accepted sharp reductions in production, tolerated Iraq's ambitions, maintained orderly markets, and minimized reductions in prices. Most importantly, Saudi Arabia has played the key role of "swing" producer (with the Aramco partners acting as informal surrogates), sopping up the largest part in market-dictated cuts in oil production among OPEC members. The impressive outcome of these developments is that, on average, the sales price of the principal OPEC crudes has moved higher, rather than lower, despite the most severe recession in major markets since the "Great Depression."

The Outlook for OPEC Pricing

The issue of OPEC pricing is most relevant for the potential market value of North Slope crude over the medium term--and, perhaps, through 1985. Investors are probably far less concerned over much longer-term trends in OPEC pricing. For one thing, progressive depletion of the low-cost reserves of the Middle East eventually and inevitably points to secular inflation in real energy costs worldwide--even when measured against the current price level imposed by OPEC. For another, investors will discount deeply the speculative character of truly long-term projections as also the distant realization of revenue and earnings. (Nevertheless, we would be hard put to pinpoint the year when Middle East supplies would no longer play the decisive role in worldwide pricing of crude.)

The complex issue of prospective pricing through 1985 hinges critically on the supply/demand balance for OPEC crude and the durability of the cartel. The issue could become increasingly intricate if political rather than purely economic forces more importantly dominate that balance. For example, present policies in major consuming nations regarding enlargement of indigenous supplies of energy--now generally half-hearted--could be modified. Further, OPEC itself, at least theoretically, could program the prospective supply/demand balance in international oil by fine-tuning its pricing and production policies. Specifically, OPEC could conceivably undermine new energy investments in consuming nations, aimed at heightened self-sufficiency, by manipulative pricing.* The test of a cartel is its degree of success in responding to market pressures or in manipulating those pressures by discrete, controlled alteration in the cartel's prices and volumes. Setting aside the issue of manipulative pricing for a moment, the key questions relating to OPEC's future reduce to (1) how burdensome might surplus capacity become over the medium term, and (2) if surplus capacity remains large and even grows, how might key members of OPEC respond to the pressures on volumes and revenues? To wit, would members submit to formal prorationing and severe constraints on prices if market pressures so dictate?

The Near-Term Outlook

For the immediate future, current pressures on OPEC are bound to ease as economic recovery in OECD nations progresses, however gradually. An improving economic environment facilitates agreement on price differentials and could even lead to another round of moderate price increases later in 1976. Although Saudi Arabia earlier stated its opposition to a 1976 increase in prices, experience suggests that it would once more go along with the majority. Saudi Arabia clearly prefers long-term accommodation on energy supply and prices to ongoing confrontation with oil-importing nations, in return for stable market arrangements, continuity in foreign investment and associated technological/managerial assistance. On the other hand, that nation has proven far less resistant to pressures for large price increases than its dominance in production and reserves, its strong financial position, and its professed foreign policy inclinations might suggest. Saudi Arabia has apparently chosen to navigate a cautious course through the tempestuous politics of the Middle East. Its indisputable,

*The U.S. proposal for a floor under international crude prices, adopted by the International Energy Agency at $7.00 a barrel, is intended to cushion the possible undermining of high-cost, internal energy investment whether triggered by accidental collapse or programmed reduction in the cartel's prices.

potential power as the balance wheel of OPEC production is thus notably offset by manifest political, demographic and military weaknesses. Saudi Arabia's delicate balance, nonetheless, will continue to have implications for market-sharing among OPEC members as well as for its posture on pricing (more below).

The Medium-Term Outlook

For perspective beyond 1976-77, it may prove useful to construct a hypothetical model of the supply/demand balance for OPEC crude, selecting an assessment which may be considered fairly pessimistic for OPEC. If we assume 4% per annum growth in free world crude demand, measured from 1975's depressed level to 1982 (only 2.5% a year measured from 1974's higher level), demand would rise from 42 million B/D in 1975 to 55 million B/D by 1982*.

This rate of growth is considered quite conservative, incorporating both a significant slowing in energy demand and accelerated development of non-oil energy sources (principally coal and nuclear). On the supply side, we postulate a generous flow of new oil production outside OPEC areas; we assume a potential recovery for declining North American crude production beginning in 1978 (including 2 million B/D from the North Slope, improved recovery of known reserves, and moderate exploration successes) plus a whopping 5 million B/D from the North Sea, and another 7 million B/D--much of this speculative--from non-OPEC sources outside North America. The foregoing demand/supply profile would have the effect of limiting OPEC production requirements in 1982 to approximately 32 million B/D, only modestly higher than 1974's 30.6 million B/D, and still below pre-embargo production levels. Obviously, OPEC's surplus producing capacity would remain large. Precisely how large it is impossible to project, since plans for developing productive capacity are currently being tailored somewhat to the realities of the marketplace. In this scenario, surplus productive capacity could conceivably remain close to today's 10 MM B/D, but this type of speculation can be overdone. The surplus in the ground is most important for the medium-term outlook; the pace of development by OPEC members will provide the clue for future production targets (after allowing for forecasting error) and prospective pressures on markets.

This "pessimistic" model points to no more than simple recovery in aggregate production to the pre-embargo level. Pressures on Saudi Arabia from hungrier nations (notably Iraq and Iran) to curtail drastically its growth in production would probably be intense. Brinkmanship could become the order of the day--Saudi Arabia could break the cartel, although in so doing invites retaliation. Open conflict, however, could potentially involve the superpowers and thus entail unpredictable results for all parties. Reason therefore suggests that security concerns and the "economic glue" that binds OPEC together will be sufficient to result in compromise rather than in confrontation. Yet miscalculation cannot be ruled out.

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*Free world oil consumption expanded at 7.5% a year in the 1968-1973 period (+7.7% a year in the 1963-1973 period).

We have selected 1982 for our exercise because by then the bulk of production from known, large reserves found in recent years, which will preempt markets otherwise supplied by OPEC crude, will be on stream.

In our judgment, OPEC will most likely not confront an extreme test of its durability. It appears to us more probable that demand for OPEC crude will outstrip the "pessimistic" model, in view of the desultory commitment to conservation in many importing nations--especially our own--and the numerous obstacles to development of alternate energy supplies (and the long lead times involved), again most notably in the United States. The major oil-importing nations remain more committed to economic growth than to energy conservation.* Moreover, room for conservation within targets for economic growth is probably somewhat limited. Cumulative policies in the United States, regarding price controls taxes, possible divestiture, governmental power to act as sole buyer of oil imports, etc., all serve to foster growing dependence on imports and to buttress OPEC. If OPEC can moderate its price increases, it will reinforce complacency in importing nations. The case for moderation, as perceived by thoughtful analysts in OPEC, devolves on the importance of keeping one's major clients in a state of relatively good (financial) health.

It is also important to note that such important non-OPEC newcomers to production as Norway and Britain will have a self-serving bias towards high and rising prices. China, Mexico and the Soviet Union will also be content to sell crude at high prices.

On balance, then, we expect the cartel to endure. Prices of OPEC crude are therefore likely to rise at least through the early 1980's and probably well beyond. This thesis certainly holds for prices measured in current dollars; it may be less true for "real" prices. However, the current-dollar price of OPEC supply is the relevant price entering into the U.S. price matrix.

U.S. Oil Pricing Policy

Congress is today found more deeply involved than ever in the pricing of domestic crude and, beginning in 1977, in the pricing of North Slope as well (more below). The loose macroeconomic guidelines for pricing laid down by the Congress will find the FEA entrusted with extraordinary discretion over classifications of crude that can importantly affect the earning power of various categories and vintages of capital committed to petroleum resources.

While prescribing criteria for allowing higher prices for old oil, Congress has clearly suggested that the FEA retain the distinction between old and new crude in establishing pricing tiers. We can now only await, and speculate about, the FEA's coming judgements about incentives for different categories of production. Specific regulations governing pricing of Prudhoe Bay crude will not be formulated for many months and may first require supplemental legislation by Congress.

*We acknowledge that West Germany, much more effectively than the United States, has been most vigorous in moving to diversify its energy sources.

The recently-enacted Energy Policy and Conservation Act severs prices for "new" crude in the United States from OPEC levels at least for a time. The mandated rollback in the composite price of domestic crude to $7.66 a barrel finds new (upper-tier) crude prices rolled back to an average of $11.28 a barrel (with old or lower-tier crude prices remaining at an official $5.25 a barrel). The approximate rolled-back prices of a Prudhoe-type crude on the West Coast is $10.25 a barrel. In contrast, the current delivered cost of Saudi Arabian light, 34° API on the West Coast, is $12.70 a barrel ($11.80 per barrel for Arabian Heavy, 27° API). Of course, OPEC crude, so long as it is freely available, will continue to set the ceiling on the delivered price of North Slope crude on the West Coast. Below this ceiling, however, the Energy Act of 1975 provides the framework for assessing the outlook for prices on Prudhoe Bay crude at least over the next forty months (in effect from mid-1977 when North Slope production is scheduled to begin until mid-1979, two years later), and possibly over the next five years (through 1980).

Ironically, the very act of severing the link between new crude prices and OPEC levels will tend to reinforce the economic relevance of OPEC prices for U.S. pricing. The initial rollback in product prices, even if modest, will lead to increased demand. This, in turn, will lead to increased imports. U.S. pricing policy therefore will tend to (a) strengthen the position of OPEC and (b) undercut the efforts of the other industrial nations to curtail current oil demand, through a regime of high energy prices, and to reduce their dependence on OPEC imports in particular. The reluctance of Congress to sanction appreciably higher prices for natural gas will also translate into increased oil imports over time. Clearly, if any serious sentiment for raising U.S. self-sufficiency in energy fuels survives in the nation and in Congress, this Congress and its successors have a long road to travel.

Rollback in U.S. Crude Prices

It is worth briefly reviewing the pricing section of the Energy Act to gain perspective on Prudhoe Bay pricing prospects. As noted, the act mandates a roll-back in the composite "first sale" price to $7.66 a barrel. (The $7.66 a barrel target arises from the macroeconomic assumptions of 60% controlled crude, at $5.25 a barrel, and 40% "exempt" crude, revalued at the Senate's earlier target rollback to $11.28 (0.6× $5.25 +0.4× $11.28 = $7.66.) Under the rules which took effect February 1, 1976, the FEA will maintain a two-tier system for domestic crude oil production.* The new rules provide a formal definition of "old crude oil" as that volume produced and sold from a property in any month which is equal to the average monthly level of production during the calendar year 1975. (The previous measurement of old crude was production from a given property during the like month of 1972.) The altered FEA definition of old crude presumably

* While prescribing criteria for allowing higher prices for old oil following the initial rollback in the composite prices (more below), Congress clearly suggested that the FEA retain the distinction between old and new crude in establishing pricing tiers. Otherwise, a single pricing system would have required rollbacks in new crude prices of 40% or so; a single price system would also violate congressional intent to prevent the conferral of economic rents (called windfall profits by industry opponents) on older resources.

will require amendment to the Energy Act which established the average monthly production during September, October and November 1975 as the Base Production Level.

"First sale" price refers to "first transfer for value by the producer or royalty owner"--apparently, at or close to the wellhead. In inter-affiliate transfers, the first sale occurs at the same point as in arms-length sales. The "old"/"new" crude designations become lower and upper tier ceilings. Old crude prices remain unchanged, at least initially. Prices of existing new crude production are rolled back by $1.18 a barrel from the September 1975 level.* For prospective new crude production, the new (upper tier) crude ceiling is $11.28 a barrel for 1.7% sulphur, 34° API gravity, with upward and downward adjustments for differing gravity and sulphur contents. (To maintain proper historical perspective, it is worth emphasizing that the rollback in new crude prices is to the level of January 1975--and only temporary; the industry had come a long way by then.)

The $1.18 a barrel rollback to an $11.28-a-barrel new crude price follows from the FEA's estimate of exempt crude prices in September 1975 of $12.46 a barrel. The assumed implicit composite price before rollback (given macroeconomic assumptions of 60% controlled crude at $5.25 a barrel, and 40% "exempt" crude at $12.46 a barrel) was then estimated at $8.13 a barrel. The reduction in the industry's assumed composite price thus works out to $0.47 a barrel. For major integrated companies featuring, more typically, 70% old crude, 30% new, the rollback approximates $0.36 a barrel, or $7.42 (0.7 x $5.25 + 0.3 x $12.46) versus $7.06 (0.7 x $5.25 + 0.3 x $11.28).

In connection with the FEA's new rules on pricing, that agency has reopened for comment the issue of adjustments on gravity differentials for the heavy crudes of California and Alaska. A Prudhoe Bay type crude sold East of the Rockies would be priced approximately 15¢/barrel higher than on the West Coast, as a consequence of larger differentials per degree of API gravity structured into West Coast prices. The regional disparity in pricing of comparable crudes represents an historical penalty assessed against heavy crudes on the West Coast. Prior to full-scale development of sophisticated refinery processes for economically upgrading heavy fractions into lighter products in greater demand in West Coast markets, utilization of predominantly heavy crudes resulted in surplus refining of residual fuel oil which then had to be tankered into low-value export markets.

*For existing new crude production (under the new rules), the ceiling is the highest price realized on at least 25% of sales for each grade from that property in September 1975 minus $1.18 a barrel.

Provisions for Future Increases

in U.S. Crude Prices

Although the pricing section of the new Energy Act clarifies the outlook for domestic pricing and company realizations to some extent (for example, short-term expectations no longer include decontrol and a large jump in weighed-average crude price, nor an accompanying windfall profits tax with plowback credit for investments), the provisions for price escalation are so ambiguous and the FEA's discretion in structuring crude prices is sufficiently broad that one can project prospective crude prices only within a broad range.

The oil-price control authority in the Energy Bill ostensibly reverts to standby status at the end of 40 months and terminates after five years.*

Pricing provisions in the act differ considerably for the first year--the twelve months ending February 1977--than in the succeeding 28 months (before control authority reverts to standby status).

Escalation of the rolled-back composite price, for inflation and production incentive, may begin March 1, 1976. Starting March 1976 upward adjustments--not to exceed 10% in the first 12 months of coverage--are permitted for inflation (measured by the GNP deflator, adjusted to exclude OPEC effects) and to provide adequate incentive for development of high-cost and high-risk properties and for the application of enhanced recovery techniques to existing properties. The 10% "ceiling" includes a specified 3% production incentive, suggesting that the remaining 7% represents the increase for inflation (roughly based on recent experience). The President may propose adjustment in the incentive increase of 3% beginning three months after enactment of the bill, and every three months thereafter until early 1977. Either house may reject such proposal by a simple majority. Thus, the initial year's 10% increase in the composite crude price appears assured. A greater increase--based on an enlarged production incentive--may be proposed by the Administration but in our judgment is likely to be rejected by Congress.

Beyond the first year (i.e. after February 1977), the Energy Act makes possible wide departures from the implied 10% "ceiling" on annual increases in the composite crude price (see table on top of page II - 11). The FEA is expected shortly to issue a 39-month program for increases in crude prices which will incorporate increases in the composite crude price of 10% per annum. The price increases after February 1977 must be regarded as speculative. They are not mandated by legislature. It is even conceivable that the composite price may remain frozen after the initial year (1976). Even the inflation factor requires the President's sanction for its continuance. (Apparently Presidential approval of continuance of the inflation adjustment would not be subject to Congressional veto however.) The President must also approve the continuance of the 3% production incentive, but such approval is subject to veto by simple majority in either house. As noted, only an increase in the 3% production incentive is subject to Congressional veto in the first

*On signing the Energy Bill on December 22, 1975, President Ford simultaneously removed the $2-a-barrel import fee on crude.

ALTERNATIVE DOMESTIC CRUDE PRICE COMPOSITE:
YEAR-END 1975 - APRIL 1979

(Dollars Per Barrel)

	Worst Case	Favorable Case (+10% per year) Alaska Included	Alaska Excluded
Year-end 1975	$7.66	$7.66	$7.66
1976	8.43	8.43	8.43
1977	8.43	9.25	9.27
1978	8.43	10.12	10.20
April 1979	8.43	10.41	10.52

year of the Act. At the other extreme lies the possibility of greater than 10% annual price increases. Beginning in February 1977, and in succeeding Februaries, the President can propose an increase in the annual inflation allowance; this request must be justified to the Congress by an analysis of economic impacts and supply. This adjustment, too, may be blocked by either house. In the event of such disapproval, the President may submit one additional proposal, which could also be disapproved by either house.

It is not clear whether the composite price may be adjusted to reflect an annual inflation rate in excess of 7% (the implicit provision in the adjustment allowed in 1976), or in excess of 10% (the overall cap on the 1976 adjustment for inflation and production incentive that does not require Congressional approval). For example, if the President sanctioned continuance of both the inflation and incentive adjustments (and Congress did not veto the latter), would an adjusted deflator, of say 8%, result in an increase in the ceiling to 11%? Or would the 3% production incentive be effectively pared? If the deflator were 11%, would the current production incentive disappear, and a portion of the promised price adjustment related to inflation not be recouped in the composite crude price?

Clearly, the course of U.S. crude prices over the next 40 months will depend on the composition of the Congress, after the 1976 election, and on who will then be occupying the White House. One can hypothesize a variety of plausible political scenarios. Under a hostile Democratic President and Congress the average price of crude could remain at the February 1977 level--10% above the rollback price ($7.66 x 1.1 = $8.43/barrel), which would be close to the composite domestic crude price prior to the rollback. (Over time, of course, the composite price could still gradually increase, reflecting the growing contribution of new crude to total production.) In that unhappy event, the prior system of price controls, with the exempt categories responding to rising OPEC prices, would have been more rewarding to the companies (so much for the "compromise" characterization of the new Energy Act).

We would also speculate that a less unfriendly Democratic President could more readily obtain consent of a Democratic Congress to more generous increases (say, above 10%) than would a Republican President. (Prospects for election of a Republican Congress appear remote.) The table on page II - 12 sets out a plausible range of a composite domestic crude price.

HYPOTHETICAL STRUCTURES OF DOMESTIC CRUDE PRICES*

FEBRUARY 1976 - MAY 1979

(Dollars per Barrel)

	Unfavorable Composite Price [a]		
	Composite	Lower-Tier[b]	Upper-Tier
Feb. 1976	$7.66	$5.25	$11.28
Feb. 1977	8.43	5.51	12.38
Feb. 1978	8.85	5.65	12.25
Feb. 1979	9.29	5.79	12.28
May 1979	9.43	5.84	12.25
	Favorable Composite Price[c]		
	Composite	Lower-Tier[b]	Upper-Tier
Feb. 1976	7.66	5.25	11.28
Feb. 1977	8.43	5.51	12.38
Feb. 1978	9.27	5.79	12.97
Feb. 1979	10.20	6.08	13.70
May 1979	10.52	6.38	13.77

* North Slope crude excluded from the mix of old (lower-tier) and new (upper-tier) crudes.

a. Composite price rises 10% by Feb. 1977, and 5% per annum thereafter.

b. Lower-tier price permitted to rise at half the rate of increase reflected in composite prices.

c. Composite price rises 10% per annum over the 39-month period.

Even this limited range for average crude prices would lead to notably disparate earnings results. When we superimpose the extraordinary range possible between upper-tier (new) and lower-tier (old) prices within the composite, the potential spread in domestic crude prices becomes enormous. Beginning with an initial upper-tier price average of $11.28 a barrel and a lower-tier average of $5.25 a barrel, one can postulate numerous combinations within the constrained average in each year. (See the table above for two scenarios.) One can probably discard a scenario which merges the two-tier pricing structure into a single price over the next several years, unless permissible increases in the composite price were so large as to permit a large increase in the old-crude price average without squeezing new-crude prices. As noted, the Congress appears to favor continuance of the two-tier pricing system; while it is prepared to allow for incentive pricing on incremental supply, it strongly opposes "windfalls" on old reserves. The projected increase in the proportion of new crude to total

domestic supply will also tend to constrain increases in old-crude prices if new-crude prices are to be maintained or to rise; again, the degree of constraint would depend on the flexibility of the composite ceiling. On the other hand, the FEA apparently wants to eliminate this market-distorting pricing system as soon as practicable, so one can anticipate some, if modest, provision for increases in old crude prices.

North Slope Crude Pricing

The President may propose a separate price ceiling for Alaskan oil in April 1977. Such ceiling may not exceed the highest average sale price permitted for significant volumes of any other category of domestic oil. (The original draft specified $11.28 per barrel, as adjusted by the GNP deflator.) The President must submit findings and the rationale which he believes to justify the separate ceiling price on Alaskan crude. The draft legislation required that this separate ceiling be based on findings concerning the cost of production--a disturbing step in the direction of cost-justified pricing. Equally disturbing, either house can still disapprove this separate ceiling.

It is not clear from the law whether the regulated "first sale" for Prudhoe Bay crude will be taken at the wellhead, at Valdez (the southern terminus of TAPS), or on the West Coast. Ostensibly, regulation of all domestic crude will be at (or very close to) the wellhead. If control is at the wellhead, then the law's constraint on Prudhoe pricing is meaningless even if we were to assume the unfavorable case in the preceding table (upper-tier price approximate to $12.25 per barrel by May 1979). The associated West Coast price for Prudhoe Bay crude works out to almost $17.35 a barrel (wellhead plus TAPS tariff plus tanker transportation: $12.25 + $4.60 + $0.50 = $17.35.) That price would be realizable only if the landed cost of imported supply, which sets the ceiling on Prudhoe crude in its major markets, were at least that high. (As noted earlier, Saudi Arabia light, 34° API gravity now costs $12.70 a barrel delivered to the West Coast.) The import ceiling permitting, the approximate difference in delivered price of Prudhoe Bay versus upper-tier California crude would be $5.10 a barrel, in favor of Alaska.

This dilemma suggests to us that Congress may well legislate again on North Slope crude pricing before mid-1977. We speculate that the value of North Slope crude will then be set <u>at least as high as other upper-tier domestic supply on the West Coast, but no higher</u>.

In any event, it would seem sensible to assume that the higher the realization on North Slope crude the more likely is Alaska to pursue a steep excess profits tax.

Addendum: The FEA Acts on Crude Prices

After wrestling with competing arguments in the realms of equity and efficiency, the FEA has just issued regulations that establish guideline prices for domestic lower tier (old) and upper tier (new) crude for a 39-month period. The regulations are retroactive to March 1. The FEA has chosen to apply the immediately available increases--6.8% for the annual rate of inflation and 3% for the annual production incentive--on an equal percentage basis to lower and upper tier prices through September, 1977. Thereafter, lower tier prices will rise at a decreasing rate to permit upper tier prices to continue to escalate at a pace equal to or greater than the rate of inflation (in order to maintain incentives for exploration and development). In the final month of the present program (May of 1979), the rise in the upper tier price may have to fall below the inflation rate to avoid a reduction in the lower tier price.

The 6.8% rate of inflation utilized by the FEA was the implicit price deflator for the GNP in the fourth quarter of 1975. This rate is revised quarterly. The FEA will employ the first-quarter-1976 rate in its first revision of the crude price schedule. The schedule will be revised at least once every six months and will also take into account improved data on actual prices for crude in 1975 and early 1976, changes in the volume of old oil, and increases in new crude supply. Apart from the future rate of inflation, the upward slope of the price curves will also depend critically on whether Congress chooses to renew the production incentive in 1977, let alone to authorize a factor larger than 3%. In designing the schedule, the FEA has been concerned that the price of upper tier crude should never decline in real terms, while the price of lower tier crude should never decline in nominal terms.

Under the initial schedule, the price of lower tier crude will advance from its February 1 level of $5.25 a barrel to $6.16 by the end of the program; the price of upper tier crude will advance from $11.28 to $13.95. The composite price of crude, now $7.66 a barrel, will reach $10.38 a barrel by May 1979. This calculation allows for the contribution of upper tier crude to increase from its present 40% of total to 54%.

The FEA will issue special rules governing incentive pricing for production arising from enhanced recovery techniques by July 1.

The "base production level," required to establish the volume of new crude production from old fields, will be total 1975 output divided by 365. An adjustment to the base level for natural decline is now available, property by property. The recognized decline rate is 1972 output per day less 1975 output per day, divided by three. The basis for comparison will not roll forward each year, as earlier proposed by the FEA. On July 1, the FEA will permit the first adjustment for natural decline; it will be three-fourths of the actual average annual decline rate between 1972 and 1975. On January 1, 1977, and every six months thereafter, the base level will be reduced again for ongoing decline. This adjustment should reward past and present efforts to retard natural decline.

THE FEA'S PROJECTED PRICE SCHEDULE

(Dollars per Barrel)

	Lower Tier		Upper Tier	
	5/15/73 Posting Plus:	Estimated Price	9/30/75 Posting Less:	Estimated Price
Feb. 1976	$1.35	$5.25	$1.32	$11.28
Feb. 1977	1.74	5.64	0.47	12.13
			9/30/75 Posting Plus:	
Feb. 1978	2.12	6.02	0.23	12.83
Feb. 1979	2.23	6.13	1.14	13.74
May 1979	2.26	6.16	1.35	13.95

The increase in the composite price during the first year of the schedule will be 75 cents per barrel. This works out to approximately 1.8 cents per gallon; such change will be neither onerous, from the standpoint of inflationary pressures, nor much of a force for conservation. The more important force for rising product prices will be the growing volume of imports.

We recognize that the first revision of the schedule will probably feature an inflation rate below 6.8%, reflecting early 1976 experience. This would appear to dictate a downward shift of the schedule. Working in the other direction, however, will be belated recognition that the average price for lower tier crude is below $5.25 a barrel. We also deem it improbable that the FEA will be prepared to project the recently subdued rate of inflation into late 1976, let alone into 1979.

The design of the FEA's price schedule strongly indicates that the price of North Slope crude will be established outside the national composite. This may also be true for approaching production from the Naval Reserves.

We caution that the FEA's schedule will not be binding on whoever may occupy the White House in 1977. Hopefully, however, it would be difficult to gut a rational program in being.

The wide gap between the lower tier and upper tier price in May 1979--even with some escalation permitted for lower tier oil--drives home the improbability that Congress would then permit the decontrol of U.S. crude prices. The upper tier price in May 1979 is likely to be significantly below the laid-down cost of imported OPEC crude.

TAX ISSUES

Introduction and Summary

In this chapter we examine the critical tax issues that are relevant for North Slope prospects. In the United States, as abroad, "government take" has emerged as the largest component among the costs of integrated operations. With the proposed changes in Alaskan oil taxation, the government/company "profit" split approaches some foreign patterns. The windfall profits tax, long threatened but not enacted at the federal level, appears to be emerging forcefully in Alaska --and presumably without provision for plowback. Now that stringent price controls have been adopted at the federal level, a national windfall profits tax no longer warrants serious consideration.

As noted, the issues of crude prices and taxes have become virtually inseparable. We would feel hard put to translate crude prices, even if highly predictable, into after-tax earnings; proposed tax changes in Alaska suggest that ordinary assumptions about proportional changes in taxes and net income have become obsolete. Tax rates are becoming functions of price, worldwide, as taxing authorities (governments) reach into economic rents. Alaska appears to be ensuring that in the United States, as abroad, "progressive" tax policies can severely constrain the upside earnings potential implicit in high, or rising, crude prices. Future tax policies could exacerbate downside risk to earnings if governments also prescribe floors beneath anticipated oil tax revenues and disregard the downside implications of progressive schedules.

Alaska is surpassing even very pessimistic expectations of its probable long-term tax policies. The radical departure from state norm, implicit in the proposed excess-profits tax, could inaugurate an era of instability in federal-state tax sharing beyond Alaska's borders--with the companies squeezed uncomfortably in-between.

We, nonetheless, profess to optimism about the ultimate outcome of the emerging Alaskan tax debate--perhaps naively. The Alaskan tax changes outlined so far--though unwelcome and very poorly timed--would still leave the companies with "acceptable" unit margins. However, the issue of increased taxation on Alaskan oil and gas will not be settled once and for all time, whatever the fate of the initially proposed tax package.

FEDERAL TAXES

At the national level, OPEC's cartel pricing has proved a mixed blessing for oil companies: on the one hand, it has greatly enhanced the value of their domestic inventories in the ground; on the other hand, it has triggered stubborn Congressional resistance to decontrol of domestic crude prices, encouraged efforts to siphon off producers' "windfall gains," and has precipitated complex regulations hindering supply arrangements (allocations) and redistributing competitive advantage (entitlements). New tax legislation has eliminated the percentage depletion allowance for the majors, imposed potentially onerous taxation on foreign-source income, and may presage new regulations before long eliminating the expensing of

intangible development costs for tax accounting.

So long as the Emergency Petroleum Allocation Act was due to expire as scheduled on August 31, 1975, Congress had little choice but to prepare to enact a windfall profits tax. Now that Congress has passed legislation limiting escalation of crude prices at least until the spring of 1979 (when controls revert to standby six months before expiring), the issue of a federal windfall profits tax has abated.

ALASKAN TAXES

Background

Alaska has been disturbingly quick to adopt radical changes in oil taxation when its prospective oil revenues appeared threatened (the 1972 tax legislation, since revised) or when budget deficits so required (the 1975 pre-production tax on Prudhoe oil reserves). We note that the issue of "Alaskan participation" arose once before, in 1972, when Alaska was concerned that the pipeline would emerge as the principal profit center. Alaska then sought complete control over the pipeline right-of-way (including the corridor on federal lands) and an undivided 20% interest in the pipeline, while proposing a steeply progressive tax on pipeline earnings and a minimum take at the wellhead from royalty and severance tax payments. It is now clear that, unless OPEC prices should crack (which we deem improbable) the wellhead will prove to be the principal profit center. (The increase in the West Coast price of "new crude," even as modified by the new energy legislation, will have more than compensated for the escalation of pipeline construction costs, as reflected in the TAPS tariff.) As its first option, Alaska has invariably chosen confrontation and the risk of litigation with the companies --who have not been unsympathetic to Alaska's financial concerns--rather than compromise.

To date, Alaska has had a vested interest in the highest feasible wellhead price for North Slope crude--the basis for calculating royalty and severance taxes which are the major sources of the State's projected oil revenues. It may be useful to review the 1972 confrontation in some detail. In 1972, the prospective wellhead price appeared to be under growing pressure, as the cost of TAPS spiralled upward. Given the (then) stable market price for North Slope crude on the West Coast, an increase in any cost component--marine and pipeline transportation, or in the field--inevitably portended reduced profits and reduced taxes. The locus of the cost increase--in TAPS--promised to be particularly damaging to wellhead price, hence to Alaska's prospective oil revenues, since the wellhead value is established by the market price for crude less marine costs and the TAPS tariff. Moreover, any increase in TAPS cost also increases pipeline profits under I.C.C. tariff construction. Thus, the wellhead price would be reduced by both the amount of cost and the allowable profit increase on TAPS. In short, Alaska became concerned that the pipeline would emerge as the principal North Slope profit center.

Thus, the Alaskan legislature, with the Governor's endorsement, enacted two laws in 1972 to avert such an eventuality. The thrust of the legislation was to persuade the companies to forgo the bulk of their profits on the pipeline (e.g., to post a low tariff) and thereby to raise the notional wellhead price. One law

required Alyeska to negotiate the sale to the state of an undivided 20% interest in the pipeline; it also provided for the taxation of pipeline earnings at a steeply progressive rate (the weighted-average tax worked out to 31.5% of the 8% I.C.C. profits allowance). The second law arbitrarily established the state's minimum take from royalties and severance tax at the wellhead, based upon a wellhead price of $2.65 a barrel--a price then well above the indicated value of North Slope crude (after deduction of an artificially low TAPS tariff or even the deduction of the bare costs of a profitless pipeline).

Throughout the controversy, Alaska viewed the size of permissible TAPS profit as largely a "windfall profit," producing an unjustifiably high return on the equity capital committed to the pipeline. In our earnings models, clearly, a 7% return on the I.C.C. investment base (total invested capital, partially adjusted for inflation) translates into average annual returns of 113%-136% on the 15% equity portion of capital actually employed.* However, the permissible I.C.C. returns on average total capital employed average 15%-20%. Whatever the merits of Alaska's case versus I.C.C. regulation, it was clear that increased taxation on TAPS at the sole expense of TAPS owners would directly controvert regulatory practice on tariff construction for interstate pipelines.

Accordingly, the tax legislation enacted in mid-1972 raised a number of contentious issues which, if unresolved, would have lead to litigation and further delay in constructing TAPS. Since delay would have adversely affected the interests of all parties, and rising U.S. crude prices in 1973 mitigated concern over a cost-squeeze on state oil revenues, the companies and the state resolved their differences through a major revamping of oil tax legislation which became effective in January 1974.

Current Alaskan Taxation

Under the revised tax legislation of 1974, the direct attack on tariff construction through punitive taxation was abandoned. Instead, new property taxes were enacted at a rate of 2% per annum on net investment in TAPS (excluding capitalized construction interest) and a like 2% on exploration and producing properties. Annual property taxes were made payable prior to production startup, based on cumulative investment at the start of each construction year. The levy on TAPS property is recognized as a cost of service in the tariff. (We present in detail the growing pre-production payments on the North Slope project--including property taxes, the tax on reserves, as well as interest during construction--in the section on capital expenditures and company financing.)

Alaskan taxation at the wellhead currently combines features of the rescinded legislation of 1972 with more conventional previous levies. The present legislation has abandoned the concept of notional wellhead value and minimum royalty/severance tax. Once again, royalty is calculated separately from severance tax, whatever the wellhead crude price, and is maintained at 12½% of production, or the equivalent gross value. Prior to the 1972 legislation, severance tax--a levy on

*See Chapter IV, EARNINGS MODELS OF NORTH SLOPE OIL, page IV - 9 for table presenting earnings and rates of return on TAPS under alternative earnings models.

the gross value at wellhead (less royalty) of oil removed or sold--was a simple percentage of value, escalating with well productivity (see table below). As noted, the 1972 legislation fixed a minimum combined royalty/severance tax (50¢ a barrel) based upon an arbitrary wellhead of $2.65 a barrel. Were the indicated value at the wellhead to rise above $2.65 a barrel, then the previous schedule of severance tax would apply. Current legislation provides for alternate methods of calculating severance tax, with the higher of the two becoming the payable levy. The previous method--as a percentage of wellhead value, escalating with well productivity--is retained. However, the applicable tax schedule has been made more progressive. The alternative method establishes a cents per barrel levy (also escalating with well productivity), which varies in proportion to the BLS price index for crude petroleum.

When the current severance tax was framed in late 1973, the cents-per-barrel alternative promised to moderate the downside penalty to Alaskan oil revenue in the event of a precipitous decline in wellhead value that would attend a collapse of market price on the West Coast and/or--more likely--the TAPS tariff increased. At the lower wellhead value then indicated, the percentage and per-barrel severance taxes were about the same (24¢ a barrel). Subsequently, market price for crude soared, even compared to hefty increases in the estimated TAPS tariff, and the margin of percentage severance over per-barrel severance widened dramatically. In our earnings model designated the "reserves constraint" case, percentage severance in 1978 at a market crude price of $11.00 a barrel--wellhead of $5.90 a barrel--amounts to 46¢ a barrel. Per-barrel severance has increased to around 31¢ a barrel.

ALASKAN OIL SEVERANCE TAX*

CURRENT VERSUS PREVIOUS SCHEDULE

	Percent of Gross Value (less Royalty) at the Wellhead		
	Prior to mid-1972[a]		Effective 1974
Average Daily Production per Well		Average Daily Production per Well	
first 300 B/D	3%	first 300 B/D	5%
next 700 B/D	5	next 700 B/D	6
next 1500 B/D	6	over 1,000 B/D	8
in excess of 2500 B/D	8		
Weighted Average[b]	7.34%		7.77%

* Gross Production Tax.

a. Operative also under short-lived 1972 tax legislation when wellhead price exceeded $2.65 a barrel; for lower wellhead prices, the 1972 tax legislation set a minimum royalty/severance tax of 50¢ a barrel.

b. Assuming well productivity of 10,000 B/D.

Additional legislation, recently enacted to close anticipated state budget deficits, introduced a two-year (1976 and 1977) tax on Prudhoe Bay oil reserves. Since this tax was designed to yield pre-determined revenues, the tax formula itself is of secondary importance. For 1976 and 1977, a 2% tax is imposed on the "value" of Prudhoe reserves. The reserves tax will presumably be credited against company severance tax payments in 1978-79. (The hefty increase being proposed for the severance tax--discussed below--represents a back-door reneging on Alaska's earlier promise to repay the reserves tax.) For the two-year period 1976-77, the temporary tax on Prudhoe Bay oil reserves will add approximately $120 million to ARCO's capital expenditures on the North Slope project, and $260 million to Sohio's.

Under current tax legislation, Alaska retains a vested interest in attaining the lowest feasible tariff on TAPS and the highest possible wellhead price. The state is likely to exert every possible pressure on TAPS owners to post tariffs somewhat below the I.C.C.'s permissible maximum. (As discussed in a later section, our earnings models allow for below-maximum profits on TAPS.) However, possible changes in the principles governing I.C.C. tariff construction are not so remote as it previously appeared. Basic issues in pipeline ownership and regulation are even now being scrutinized in Congress.

Proposed Tax Changes in Alaska

The Alaskan legislature has begun deliberating a package of tax proposals designed to sharply (300%) increase the state's anticipated tax revenues from the Prudhoe Bay field, from an estimated $5 billion to $20 billion*. (Competing proposals would raise the state's take even more.) These revenues will be apart from the state's royalty interest (12½%) in oil and gas production. The proposals encompass a major increase in the severance tax, a modification of the corporate income tax structure, and the introduction of a steep excess-profits tax.

The severance tax would rise from an average 7.8% of wellhead value to 12.6%, by the addition of two more steps in the schedule, which escalates with well productivity. Two steps would also be added to the minimum cents-per-barrel severance tax: $0.77 on 1,000-2,000 B/D and $1.015 a barrel on well production over 3,000 B/D. (See table on next page.)

*The oil and gas tax proposals emerged from the deliberation of the Alaskan Senate's Special Interim Committee on Taxation and Revenue, chaired by Senator John Huber. The Alaskan legislature, which reconvened January 19, 1976, limits its sessions to a few months; appointment of a special committee to investigate and propose legislation on particular issues is a frequent practice.

ALASKAN OIL SEVERANCE TAX*

PROPOSED VERSUS CURRENT SCHEDULE

(Percent of Gross Value, less Royalty, at the Wellhead)

Current Average Daily Production Per Well		Proposed January 1976 Average Daily Production Per Well	
first 300 B/D	5%	first 300 B/D	5%
next 700 B/D	6	next 700 B/D	6
over 1,000 B/D	8	next 1,000 B/D	8
		next 1,000 B/D	11
		over 3,000 B/D	14.5
Weighted Average	7.77%	Weighted Average	12.62%

*Gross Production Tax.

Alaska's 9.36% corporate tax rate will be transformed into a "net proceeds" tax when applied to oil and gas income. The state is concerned that a portion of income on Alaskan oil and gas, which actually will arise upon their sale beyond Alaska's borders, should be imputed to Alaska--in short, that Alaska be recognized as a profit center as well as a cost center. At this juncture, we can only speculate that the computation of "net proceeds" for corporate tax purposes will involve levels of transfer prices at Valdez (and at the wellhead); it will certainly limit allowable cost deductions (e.g., allocation of a portion of corporate overhead to Alaska).

The third, and most radical, element in the tax package is an excess value (windfall) tax. The excess value tax, apparently to be a flat 41%, would apply to the difference between the market value of North Slope oil f.o.b. the West Coast and a variable deemed value. (References to a 50% take, which we have seen in the literature, include the state income tax of 9.36%.) The Senate bill specifies a deemed value of $7.00 per barrel as of the date of passage of the bill, but allows for subsequent escalation with the wholesale price index. The bill does not provide for tax credits for investment in Alaskan oil and gas exploration/development (i.e., for plowback).

The Special Committee's tax proposals are too hazy and so obviously subject to substantial revision to allow for definitive estimation of their impact on the companies' earnings prospects. The essential point is that the Alaskan legislature will be concerning itself principally with the timing and mechanics of how best (not whether) to extract a healthy share of prospective economic rents on North Slope oil and gas. The incidence of an excess-profits tax cannot be shifted, because the matrix of crude values in the lower 48 states will be a datum to North Slope operators. Alaska would be taxing an economic rent, and taxing it severely.

The thrust of the excess-profits tax mechanism appears to be to permit the North Slope companies to recover their capital and operating costs (including

severance tax) and to make at least $1.00 a barrel, pre-tax, before the bite of state income, state excess value, and federal income taxes. It is important to note that the "assured" $1 margin would be on the deemed value--to be read, just price--for Prudhoe Bay crude.

In subsequent sections concerned with industry and company earnings possibilities in Alaska, we examine the impact of a flat excess-profits tax (at the suggested rate of 41%) in detail.* We note, in advance, that Alaska's share of production income would be appreciably larger than that accruing either to the Federal Treasury or to the North Slope operators.

At least two critical, nagging questions are at once relevant for the dynamics of the earnings models: (1) Will the escalation of the deemed value proceed pari passu with the sanctioned (or market-determined) value of comparable crude on the West Coast (or in the Midwest)? (2) Will the initial flat rate remain unchanged over time, shift upward periodically in quantum jumps, or evolve into a progressive tax on windfall realizations (as now applies for Dutch gas and for large operators--to be read, Caltex--in Indonesia)?** The answers are interdependent in their investment implications. For example, reasonably parallel escalation and a flat tax rate would permit investors' (i.e., operators' and shareholders') expectations about unit profits to be restored, after a lag, courtesy of the FEA, the market, and/or OPEC. Alas, these assumptions may be overly optimistic.

Comments on Proposed Taxes in Alaska

We are not shocked that Alaska wants and intends to get more of the widening profit margins on North Slope oil. However, we are disturbed that "responsible" Alaskan legislators are seeking so much more of the economic rents, and by the radical route chosen to acquire that incremental revenue.*** In effect, Alaska may be prepared to prescribe a "just price" for North Slope crude on the West Coast. We presume that the tax committees of the legislature would eventually prescribe a just price for natural gas as well. Unfortunately, the notion of a just price is really not far removed from an a priori assessment of what constitutes an "adequate" (ceiling) per-barrel profit margin (in dollars and cents). In short, investors will and should worry that a excess-profits tax can be easily transformed into a steeply progressive one.

Owing to the indicated appreciable increase in tax-paid costs for Prudhoe Bay crude, the viability of North Slope production becomes even more sensitive to any significant reduction in OPEC prices. Ironically, the thrust of both U.S. and Alaskan oil policies will tend to bolster OPEC,**** thus lessening the risk of a

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* See Chapter IV, EARNINGS MODELS OF NORTH SLOPE OIL, and Chapter V, COMPANY EARNINGS ON NORTH SLOPE OIL.

** The Huber Committee explored the possibility of introducing a progressive tax, but opted for a flat tax in the proposed legislation.

*** Preoccupation with the excess value tax can lead one easily to overlook just how substantial is the proposed increase in the "conventional" severance tax as well.

**** By raising demand (U.S.) and dampening incentive (Alaska).

major decline in international oil prices.

It is disturbing that Alaska appears to believe that, like Norway and the United Kingdom, it is entitled to tax away for its own needs a substantial portion of a windfall gain that has resulted from OPEC's pricing power. On the other hand, the analogy cannot be pushed too far. Britain and Norway have both continued to exhibit a decent respect for maintaining investment incentive, particularly with regard to rapid recovery of investments. Moreover, these are sovereign nations and their oil-taxing policy is integrated with national energy policies. In contrast, Alaska would appear to be flouting the goals of emergent U.S. energy policy. A hostile Congress has sanctioned incentive prices for incoming supply at difficult frontiers.

Alaska's perceptions may well be compared to those of many of the OPEC nations. The oil and gas will be leaving Alaska and the economic benefits conferred by these hydrocarbons will be realized by the "importing states." In contrast, Texas, Louisiana, California and other producing states have enjoyed a surge of economic development within their own borders on exploiting indigenous resources. Alaska will probably never enjoy the economic and social benefits attending major investments in refineries and petrochemical plants. (It will also be spared the social costs, such as pollution, attending these same investments.) Alaska also appears to regard the North Slope companies--industry giants--as "foreign" entities, as through OPEC's perspective. In older producing states, the small local company represents an important political and economic constituent.

Economic returns from North Slope resources that could be applied for exploration and development in Alaska, off the West Coast and off the Atlantic Coast, or applied for investment in enhanced recovery techniques or in "synthetic" energy fuels would, instead, go to fund social services in Alaska. Alaska appears prepared to seek to maximize its take from the presently proved reserves on the North Slope. The state would appear to be disregarding the disincentive it is creating for probing for additional reserves, onshore or offshore, on state leases. It may well be irrational--from the standpoint of return on capital--for the companies to drill in the Beaufort Sea, or for ARCO to continue exploration west of Prudhoe Bay. Should the excess profits tax apply only to Prudhoe Bay (i.e., to giant fields), such discrimination is not likely to be especially reassuring to other operators (whose dream is to locate "another North Slope").

Not surprisingly, then, the producers and Alaska are once again found in an adversary position. Considerations of national energy policy may before long find the Federal Government and Alaska in an adversary relationship as well. The $7 base price runs counter to the intent of national economic policy. Let us assume that with plausible escalation the base price is now not much more than the February 1 national composite of $7.66 a barrel. However, Congress has not prescribed a rollback in the benchmark price for new crude to $7.66 a barrel; the rollback has been to $11.28. As noted, Congress would permit producers of new crude at difficult frontiers to earn a superior return. One may call this incentive pricing and/or a reward for risk-taking. Alaska would take a large bite of this back.

It may also be noted that the windfall profits tax, formulated by the U.S. Senate Finance Committee before enactment of the December 1975 energy bill

(controlling prices), was to apply to old oil under control and then-exempt crude selling above $11.50 per barrel. Moreover, the base price was to gradually rise while the amount subject to tax would gradually decline. The tax was to "fade away" after a 67-month period. Plowback was to be limited to 25% of tax liability; the credit would be dollar-for-dollar for eligible investments. These investments included intangible drilling costs, geological and geophysical expenses, depreciable production equipment, outlays for gathering lines, and operating expenses for secondary and tertiary recovery. It is worth recalling that North Slope oil would probably have escaped payment of the bulk--probably all--of any windfall tax, owing to (1) the relatively low wellhead price for Prudhoe Bay oil after deducting high transportation costs; and (2) the rising price for determining windfall.

Conjecturally, the conflicting claims between the federal government and Alaska could encompass other states as well and would clearly be bearish for the entire U.S. petroleum industry. One can study the unfortunate position of the Canadian petroleum industry as Canada's Provinces and its Federal Government clash over shares in revenues. Periodically, the principal actors in Canada recall that the producers should be assured "adequate" returns.

The timing of the Alaskan proposals is unfortunate. It comes when the companies are concerned with completing financing arrangements for bringing North Slope oil to market and when the FPC has just voided the advance-payments program for much of the North Slope gas. Fortunately, the bulk of debt financing for TAPS has been completed. Financing of development expenditures is also well advanced.* From the standpoint of future requirements for external financing, there is no denying that the economic value of the operators' principal collateral--their net profits interest in the crude--has even now been diminished. We presume that the state is preoccupied with firming up its own revenue expectations in order to facilitate borrowing for its internal needs.

We profess to optimism about the ultimate outcome, perhaps naively, because we would like to believe that state and national policies will recognize the case for rewarding exploration effort at difficult frontiers. To be sure, the companies are in a poor bargaining position today, as compared with 1972. The pipeline was then a concept. Today, the principal costs for transportation are sunk or firmly committed. Development of production facilities is well underway. The price of North Slope crude, on the West Coast or in the Midwest, will be governed by FEA ceilings (or one determined by Congress) for the initial years of production, and probably longer. As already noted, given such legal and/or market constraints, the incidence of an excess-profits tax cannot be shifted.

There is some comfort in reports that many Alaskan officials were surprised at--and perhaps a bit chagrined by--the tax package unwrapped by the Special Committee. Legislators may find it difficult voting against $20 billion in state revenue in favor of, say, $10 billion. Governor Hammond regrets the timing of the tax proposals but has not declared an intention to veto any of the legislation if

*See Chapter VII, NORTH SLOPE FINANCING.

passed. Alaskan Natives' corporations, so anxious to attract oil-company investment in the evaluation of extensive acreage holdings, may present the strongest Alaskan opposition to the oil tax proposals. They are not enamoured of informal suggestions to single out prospective oil acreage owned by Alaskan natives for special exemption from some elements in the proposed tax package.

Because of the companies' weak bargaining position in Alaska, they may have no other recourse but to seek redress in the Federal courts. We do not pretend to be experts at constitutional law. We anticipate, however that a constitutional issue may be raised about the taxing of an economic value that arises beyond the state border, in the stream of interstate commerce. The companies may also allege that by creating a disincentive for further exploration effort, the excess-profits tax creates an undue restraint upon normal trade among the states. It is clear that the framers of the proposed tax changes took particular care to avoid effective legal challenges to the legislation. Congress and the Administration may choose to exert pressure on behalf of the companies also. As a developing state, Alaska is not immune to the lure of proferred federal largesse or indifferent to its denial (as constrained by law). Such pressure is most likely to be exerted if requested by the FEA or by other producing states; political realities militate against Congress responding directly to the oil companies' appeal. Equity for oil companies and their shareholders is no more attractive an issue in the Congress than in the Alaskan legislature.

EARNINGS MODELS OF NORTH SLOPE OIL

Introduction and Summary

We have constructed three models of earnings of North Slope oil--designated the "production potential," "reserves constraint," and "market constraint" cases--which we describe and analyze in this chapter. Our earnings models are differentiated as to reserve assumptions, peak production levels, and rates of production build-up. Results are expressed in terms of earnings per barrel on TAPS, main field production, and Kuparuk/Lisburne production. Under each model, the earnings possibilities will, of course, vary substantially according to assumptions regarding market values for crude over time and tax policies--notably in Alaska.

The "reserves constraint" model features production from only the 9.5 billion barrels of proved oil reserves in the main Prudhoe Bay field. Production is assumed to build up rapidly to a 1.5-million-barrel-a-day peak by 1979. The "production potential" model features production from the three Prudhoe Bay reservoirs--the Sadlerochit, Kuparuk and Lisburne formations--with assumed reserves of 13.5 billion barrels. Production builds to a peak of 2 million barrels daily by 1984. Our "market constraint" model also allows for production from all three reservoirs but production rises more slowly and reaches a peak of only 1.5 million barrels daily by 1981.

Representative earnings per barrel on combined pipeline and producing operations, given the approaching market value for Prudhoe-type crude of $11.00 per barrel and existing tax law, would approximate $3.20 per barrel (roughly $1.00 on TAPS and $2.20 at the wellhead). For an expectable market value for crude of $13.00 a barrel, integrated earnings would approximate $4.10 per barrel. Proposed changes in Alaskan tax law would reduce integrated earnings, under the $11.00-a-barrel assumption of market value, from roughly $3.20 to $2.50 per barrel, and under a $13.00-a-barrel assumption of market value from $4.10 to around $3.20 per barrel.

As expected, the contrast between returns on TAPS versus those on production is striking. We estimate the DCF rate of return on TAPS at 10%. Returns on oil production--under current tax laws--approximate 23%, given a crude price of $11.00 per barrel, and 27% if the crude price were $13.00 per barrel. The contrast between returns on production under current tax legislation versus returns arising under Alaska's proposed legislation is also noteworthy. Proposed Alaskan taxation would reduce returns on the field from 23% to 17.5% (assuming $11.00 per barrel for crude), and from 27% to 21.5% (assuming $13.00 for crude). Upon combining investment and cash flow stream for TAPS and production, the integrated return--under present tax laws--approximate 14%, assuming $11.00 per barrel for crude on the West Coast, and 17% given a $13.00-per-barrel price. Comparable returns under proposed tax changes would be 12% and 14%, respectively. In the current debate over Alaskan tax policy, the state is focusing on prospective returns on production. The companies, understandably, are emphasizing the total project rate of return.

The translation of the industry models and Alaskan tax proposals into per share results for ARCO and Sohio is the subject of the next chapter.

THE MODELS

"Reserves Constraint" Case

The "reserves constraint" case features production from only the 9.5 billion barrels of proved oil reserves in the main Prudhoe Bay field. Production is assumed to build up rapidly to a 1,500 thousand-barrel-a-day (TB/D) peak by 1979; that rate of production would be sustainable with water pressure maintenance for 6 to 8 years and would thereafter decline to approximately 1,000 TB/D by 1990. This represents the conventional model of North Slope oil production with the life of the main field assumed to be 25 years. Despite its shortcomings (see below), the model is worthy of attention--it isolates the most definitive component of North Slope production, the main reservoir. Moreover, the cost estimates in this "reserves constraint" model correlate with proved reserves estimates appearing in company prospectuses. This model will obviously translate into lower earnings for the North Slope companies than models which assume a broader production base on two accounts--lower production and pipeline throughput volumes, and lower unit earnings on integrated operations owing to assumed underutilization of TAPS. We note that the disincentive aspects of pending Alaskan tax proposals may well require emphasis upon conservative estimates of future production.

"Production Potential" Case

The "production potential" case features production from the three Prudhoe Bay reservoirs--the Sadlerochit, Kuparuk and Lisburne formations. Portions of the latter two deposits overlap with the main (Sadlerochit) reservoir. This model incorporates estimated production from the 9.5 billion barrels of proved oil reserves (our "reserves constraint" model) with highly tentative estimates of potential production from tertiary recovery in the Sadlerochit reservoir and the somewhat more assured production potential from the lesser Kuparuk and Lisburne formations.

In our "production potential" model, Sadlerochit production is assumed to build up to 1,600 TB/D by 1981: 1,500 TB/D is supportable by currently proved reserves; the assumption of an additional 100 TB/D is supported by 2.0 billion barrels of speculative reserves from eventual tertiary recovery. Incremental production from tertiary "reserves" is limited to allow for a build-up of Kuparuk/Lisburne production within the constraints of pipeline capacity--these estimates assume production beginning in 1980 and building to a peak of 400 TB/D by 1984. The tentative construction of a production profile over a 25-year reservoir life with peak production of 400 TB/D for eight years yields an estimate of Kuparuk/Lisburne reserves of some 2 billion barrels. Reserves produced from all three reservoirs over the life of production would yield 13.5 billion barrels.

Measurements at this time of the effort (in terms of investment and operating costs) and results (reserves added) of tertiary recovery and exploration of the Kuparuk/Lisburne areas are necessarily speculative. This is particularly true of tertiary recovery, although our assumptions appear conservative when compared with more authoritative speculation in the past. While technical conditions for tertiary recovery are promising, the economic parameters are in flux, and the companies are thus cautious about projecting prospects. Alaska's reconsideration of its taxation of oil and gas production will reinforce this wariness--understandably so. The assumed contribution of the Kuparuk/Lisburne formations is loosely based on a past

ALTERNATIVE TAPS THROUGHPUTS AND PRODUCTION PROFILES OF NORTH SLOPE RESERVOIRS, SELECTED YEARS

(Thousands of Barrels Daily)

	"Reserves Constraint" Case	"Production Potential" Case	"Market Constraint" Case
July-Dec.	TAPS Throughput		
1977	600	600	600
Year			
1978	1,200	1,200	1,200
1979	1,500	1,500	1,200
1980	1,500	1,550	1,200
1981	1,500	1,750	1,500
1982	1,500	1,900	1,500
1983	1,500	1,950	1,500
1984	1,500	2,000	1,500
1990	1,045	1,960	1,500
July-Dec.	Production Profiles of Main Prudhoe Reservoir		
1977	600	600	600
Year			
1978	1,200	1,200	1,200
1979	1,500	1,500	1,200
1980	1,500	1,500	1,160
1981	1,500	1,600	1,200
1982	1,500	1,600	1,200
1983	1,500	1,600	1,200
1984	1,500	1,600	1,200
1990	1,043	1,600	1,200
	Speculative Production Profiles: Kuparuk/Lisburne Formations		
1977-79	...	...	...
1980	...	50	40
1981	...	150	300
1982	...	300	300
1983	...	350	300
1984	...	400	300
1990	...	360	300

ARCO submission to Congress. The 400 TB/D estimate may, however, prove conservative.

"Market Constraint" Case

Our "market constraint" case, like our "production potential" case, allows for production from all three Prudhoe Bay reservoirs but assumes that market limitations constrain the pace and extent of production buildup and the utilization of productive capacity. This case could also represent a "pipeline constraint" model in the event that future discoveries on the North Slope (on Naval Petroleum Reserve Number 4, for example) were to require Prudhoe Bay producers to relinquish some share of TAPS total throughput. Production rises more slowly than in the two preceding cases--to a 1,500 TB/D peak in 1981--but is maintained at that level over a more prolonged period. Production from the Sadlerochit reservoir alone fulfills assumed market requirements until 1980, rising to a peak of 1,200 TB/D in 1978. Kuparuk/Lisburne production is assumed to begin in 1980 and to rise to a peak of 300 TB/D by 1984. Respective shares of total production are maintained constant over most of the remaining life of the field. Reserves produced over the estimated 25-year life of the field would total 13 billion barrels. While prorationing to market demand would appear unlikely (except perhaps in the event of weakness in worldwide crude prices), pipeline prorationing is a more probable risk. In this connection, it is important to note that plausible alternatives to our models can be constructed. For example, we assume in our market constraint case that both throughput on TAPS and Prudhoe Bay production are restricted to 1.5 million B/D by market limitations. Alternatively, one may posit that new discoveries on the North Slope (from NPR #4, for example) would constrain production from Prudhoe Bay but afford maximum rates of pipeline utilization. In that case, the per-barrel tariff for TAPS would be lower. Nevertheless, maximum utilization of TAPS would result in higher integrated margins and larger total earnings on TAPS (owing to higher throughput).

A Comment on Proved Oil Reserves

In recent months questions have been raised about the exact size of proven crude reserves in the main field at Prudhoe Bay. When all aspects of the controversy are considered, the prominent 9.5 billion barrel estimate originally made and subsequently reaffirmed by De Golyer & MacNaughton geologists remains fundamentally unchallenged.

De Golyer & MacNaughton estimate that the main field at Prudhoe Bay--including the huge Sadlerochit reservoir and the lesser Shublick and Sag River sandstone reservoirs--contains approximately 9.5 billion barrels of proved crude and condensate reserves. The total comprises 9.1 billion barrels of crude and 440 million barrels of condensate (a gaseous hydrocarbon in the reservoir, which liquefies upon production at the wellhead). The underlying reserves in place are estimated at 23.8 billion barrels; the projected recovery factor is 40%.

A recent study by H. K. Van Poollen and Associates, commissioned by the Oil and Gas Division of Alaska's Department of Natural Resources, estimated crude in place at 19.1 billion barrels. The study simulated Sadlerochit reservoir behavior

(on a computer) under conditions of varying rates of crude production, water injection into the reservoir, and natural gas production. Maximum oil recovery was estimated at 8.2 billion barrels when it was assumed that most of the gas was reinjected; the optimum producing rate was 1.2 million B/D. Alternatively, 7.9 billion barrels were deemed recoverable under conditions of only partial reinjection of the gas (with sales limited to 2 billion cubic feet a day) and limited waterflood; in this case, the oil producing rate could rise to a peak 1.6 million B/D. The study pointed out that careful reservoir management could likely prevent loss of ultimately recoverable oil reserves even if the bulk of the gas were produced.

The Van Poollen study caused some consternation. Atlantic Richfield, however, has since clarified the issue, noting that the Van Poollen estimate excluded crude reserves in the smaller reservoirs and condensate as well, and concluded that the results of the study were not at significant variance from the De Golyer & MacNaughton estimate of recoverable oil reserves.

It is important to recall that all pre-operational estimates of proved reserves from a new field are necessarily subject to revision over time. Reserves are routinely re-estimated for oil fields over their productive lives as subsequent development and operations extend knowledge of the reservoir. The early estimation of oil reserves in the main field at Prudhoe Bay has proved quite reliable upon extensive development, probably because of the concentration and uniformity of pay sands. In contrast, initial estimates of reserves in highly-fractionated, complex reservoirs, like those of the Kuparuk area, can undergo radical reevaluation as experience is gained. Annual reporting of new discoveries is often made before extensive drilling and subsequent measurement have taken place; subsequent re-estimation often results in changes which later appear as revisions to initially-estimated discoveries. As a final comment, we would add that De Golyer & MacNaughton are noted for their conservative estimation of reserves. In the following section, we observe that the major revisions of Prudhoe Bay reserves have been in regard to the companies' equities in these reserves.

TAPS Tariffs

The tariffs for TAPS in our earnings models are based on company estimates of capital costs that predate the recent revision to $7 billion for capacity of 1.2 million B/D. Our tariffs reflect capital cost of $6.8 billion for initial capacity, $1.1 billion for capitalized interest on pipeline debt during the construction period, $500 million for expansion to 1.5 million B/D, and $350 million for expansion to maximum capacity of 2.0 million B/D. The latest increase in the estimated capital cost of TAPS, plus the higher profit (and related taxes) allowed on the enlarged investment base, would raise the 1981 tariff in our "reserves constraint" case from $4.15 to $4.35 a barrel. As explained below, both tariffs reflect a somewhat lower rate of return than the maximum permitted by the Interstate Commerce Commission (I.C.C.). The suggested increase in the TAPS tariff would have the effect of lowering the wellhead price by a comparable amount--from $6.35 to $6.15 a barrel

if we assume a market price for crude on the West Coast of $11.00 a barrel.* Obviously, per-barrel cost of the integrated project would rise, and profitability would shift in favor of TAPS at the expense of earnings in the field. Interestingly, owing to this shift in the locus of earnings, per-barrel earnings on the integrated project (pipeline and field combined) would change only marginally, because of the higher incidence of taxation at the wellhead compared with TAPS. In effect, the penalty of incurring higher capital costs on TAPS would be assessed against the tax collectors rather than the companies (more below). In view of this outcome, and of the uncertainty enveloping other assumptions which underlie our tariff calculations --interest rates on debt, assumed rate of return, and Alaskan taxes--the recent increase in the estimated cost of TAPS alone hardly warrants tariff recalculation at this time, and might even suggest a specious accuracy.

The TAPS tariffs incorporated in our earnings models assume a 25-year economic life for the system. Depreciation of invested capital is arbitrarily calculated on a unit-of-throughput basis for both tax and financial accounting. The tariffs do not reflect the substantial investment tax credits that will accrue to the parents of owner-affiliates of TAPS from their investments in the pipeline. The tariffs include operating costs of $0.20 per barrel. Interest expense on TAPS debt is assumed at 9.3% per annum. Alaska's property tax is computed at 2% per annum on average invested capital (excluding interest during construction), assuming straight-line depreciation. State income tax is computed at 9.4% and federal income tax at a normalized 48%.

TAPS represents a distinct, and very important, profit (as well as cost) center in the integrated economics of North Slope oil. The locus of per-barrel profits on the North Slope is of particular interest to the companies because their current equities in TAPS may still differ somewhat from their eventual equities in production. (The July, 1974 revision of TAPS equities narrowed previous very marked discrepancies.) Such variances, however, would depend critically on the production potential of the Prudhoe Bay reservoirs, assumed rates of reservoir production, and determination of definitive equities in the three reservoirs. To the extent that eventual equities in TAPS do conform closely to equities in production, North Slope companies will have a clear preference for the highest permissible tariff and the lowest possible wellhead. This preference reflects the higher incidence of total taxation on the wellhead than on TAPS, even under current tax regimes. The elimination of statutory depletion reinforced this preference. So, too, would any higher effective rate of taxation by Alaska on production earnings.

Obviously, Alaska will have an equally keen interest in the division of earnings between TAPS and the wellhead, hence in the pipeline tariffs to be posted by the companies. Alaska will surely press for the lowest tariffs possible and the commensurately highest wellhead price, since the wellhead is the base for computing the value

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* Market price - tanker transportation - TAPS tariff = wellhead; $11.00 - $0.50 - $4.35 = $6.15.

of its royalty oil, and for computing severance tax too. An "excess profits" tax of the type now under consideration in Alaska would sever part of Alaska's taxes on oil from reference to the wellhead price, since "excess value" would by-pass the effect of pipeline tariff on production value. As noted in the chapter on tax issues, "excess value" would be determined on the West Coast--i.e. before consideration of pipeline tariff. (The tax calculation would not wholly ignore imputable production value; such value would still govern liability for severance tax.) Nevertheless, the thrust of Alaskan taxation is toward maximizing the state's near-term income from oil. Thus, Alaska will probably persist in its efforts to minimize the tariff on TAPS. Alternatively, Alaska could resume its previous although (abortive) efforts to raise taxes on earnings arising from TAPS.

The I.C.C. permits owners of interstate pipelines to receive an 8% annual return on their net "replacement" costs, with distribution of dividends limited to the equivalent of a 7% rate of return. In our "reserves constraint" model, an I.C.C. return of 7% translates into an 15% annual return on our calculation of book investment over the life of the project (see table on page IV - 9). The associated annual return on the 15% equity portion of capital averages out to 127%. We have assumed, however, that the pipeline tariffs ultimately posted by the companies will represent negotiated levels--i.e., lower than the maximum permitted by the I.C.C., but high enough to cover all costs plus a "fair" return on total capital employed.

Formalistic computation of TAPS tariffs results in significant year-to-year changes in the tariff within each model. Realistically, the companies are likely to "smooth" or average out tariffs over a period of years. The process of smoothing tariffs in such a manner as to maintain at least minimum profitability while avoiding excessive (by I.C.C. standards) profits in any year inevitably leads to tariff profiles which yield rates of return below the maximum permitted by the I.C.C. Our earnings models incorporate the assumption of smoothed tariffs.

Pipeline Economics

The economics of North Slope oil vary considerably with assumed utilization of TAPS. High levels of throughput in the pipeline make for high integrated earnings per barrel.

Maximum capacity of TAPS is estimated at 2 million B/D. In our models, throughput over the 25-year economic life of the system ranges from approximately 9.5 billion barrels in the "reserve constraint" to 13.5 billion barrels in our "production potential" case and 13 billion barrels in the "market constraint" model. In our "reserves constraint" model, TAPS throughput never exceeds 1.5 million B/D and declines to 1 million B/D by 1990. In contrast, in our "production potential" model, throughput reaches 2 million B/D by 1984 and remains at a high level through the 1990's. In our "market constraint" model, throughput again never rises above 1.5 million B/D but is sustainable at that level through the 1990's, since the underlying reserves are assumed to be 13.5 billion barrels as in our "production potential" case. (Note, however that cumulative throughput on TAPS over 25 years amounts to 13 million barrels.)

TAPS TARIFFS

(Dollars per Barrel)

	Unsmoothed Tariff[a]	Smoothed Tariff[b]
	"Reserves Constraint" Model	
1978	$5.48	$4.60
1981	4.54	4.15
1986	4.19	4.15
Average Tariff Over Project Life	4.93	4.23
	"Production Potential" Model	
1978	$5.18	$4.30
1981	3.96	3.40
1986	3.25	3.00
Average Tariff Over Project Life	3.81	3.50
	"Market Constraint" Model	
1978	$5.05	$4.85
1981	4.29	4.00
1986	3.92	3.30
Average Tariff Over Project Life	3.81	3.54

a. Tariff based on the I.C.C.'s maximum 7% return on replacement cost.

b. Tariff kept constant over extended periods, permitting at least minimum profits in every year but precluding a return above the I.C.C. maximum in any year.

Economies associated with high levels of throughput reflect marked disparities between various increments to capacity and related capital costs. Whereas the capital cost of TAPS capacity on the first 1,200 TB/D is $7.9 billion, the incremental cost on the next 800 TB/D of capacity may be only $850 million. The disparity in incremental capital cost tends to lower unit depreciation, particularly in the high volume ("production potential") model relative to non-cash charges in the other two models. However, lower unit depreciation in the "production potential" model is not mirrored in higher earnings per barrel on TAPS (as is normally the case when revenue is a datum). Quite the contrary! Earnings, like depreciation, are a separately calculated component entering the buildup of the tariff. Earnings are calculated as a percentage return on invested capital (partially adjusted upward for inflation). Capital (and returns) varies only moderately among models. Per barrel results vary greatly,

TAPS EARNINGS AND RATES OF RETURN*

(Dollars per Barrel)

	"Reserves Constraint"	"Production Potential"	"Market Constraint"
Annual Earnings per Barrel under Smoothed Tariffs:			
1978	$0.83	$0.83	$1.09
1981	0.86	0.67	0.87
1986	1.03	0.68	0.69
Average Earnings over Project Life:			
Under Smoothed Tariffs	$1.04	$0.91	$0.90
Under Unsmoothed Tariffs	1.37	1.06	1.03
	Rates of Return on TAPS		
Under Smoothed Tariffs			
Earnings/I.C.C. Valuation	5.3%	6.0%	6.1%
Earnings/Total Capital Employed	11.5	12.9	11.3
Earnings/Equity Capital	96.8	89.0	75.4
Under Unsmoothed Tariffs:			
Earnings/I.C.C. Valuation	7.0%	7.0%	7.0%
Earnings/Total Capital Employed	15.1	15.0	12.9
Earnings/Equity Capital	127.4	103.4	86.0

* See table of contents of Appendix Tables for reference to detailed calculation of earnings on TAPS.

However, owing to the more significant variations in throughput volumes. Thus, earnings per barrel tend to be lower in the highest-volume model than in the lower-volume models (particularly the "reserves constraint" case) and for essentially the same reason that depreciation is lowest in the highest volume case--the relatively greater disparity in throughput than in capital requirements. So, too, the tariff on TAPS is invariably lowest in our highest--throughput ("production potential") model, and contrastingly highest in our lowest-throughput ("reserves constraint") model. The economies implicit in high throughputs are very real, nevertheless, but are reflected in higher wellhead prices (and earnings) rather than on TAPS per se, where the economics arise. The process of smoothing tariffs distorts comparisons among tariffs in particular years, but only to a moderate degree.

TAPS Earnings per Barrel

The preceding table presents earnings per barrel on TAPS for our three earnings models in selected years (1978, 1981 and 1986). The annual earnings per barrel were calculated under smoothed tariffs and reflect returns on the I.C.C. valuation

base which range from 5.3% in our "reserves constraint" model to 6.1% in our "market constraint" model (shown in a lower panel of the table). Corresponding results are shown per barrel of throughput over project life. In addition to rates of return for each model based on the modified I.C.C. investment base, the table also presents, under smoothed tariffs, returns on total capital actually employed in TAPS as well as returns on equity capital invested. For comparison with earnings per barrel and rates of return under smoothed tariffs, the table also includes corresponding results under unsmoothed tariffs--i.e. when rates of return are calculated at the maximum 7% permitted by the I.C.C.

Wellhead Prices

The wellhead prices on which our models of production earnings are based are derived from assumed crude values in southern California of $11.00 and $13.00 per barrel less transportation charges (tanker costs and TAPS' tariff).* The price of a Prudhoe-type crude (taken as Signal Hill 27° API gravity) might approximate $11.00 per barrel by the close of 1976. If we allow for a generous increase in the average price of domestic crude in 1977 within the constraints of the Energy Conservation and Policy Act and if we also assume that the bulk of the increment accrues to upper-tier crude, then the price of a Prudhoe-type crude in California would be roughly $13.00 per barrel by early 1979, the first full-year of North Slope production.

Derivation of alternative wellhead prices in each of our models is shown in the table following. A market value for domestic crude of $11.00 a barrel nets back to the wellhead a range of $5.65 to $6.20 a barrel. The range of wellhead prices, given a market value of $13.00, is $7.65-$8.20 a barrel. Note that wellhead value in each instance is moderately below the expected average price of domestic crude of $8.43 a barrel in 1977, and far below any conceivable level of upper-tier crude prices. (Our working assumption is that whoever is President in 1977 will not move to bar any increase in crude prices at all. We assume similar rationality for the new Congress.)

As in the case of TAPS, our earnings models for crude production assume a 25-year economic life of reserves. It should be noted, however, that in the "market constraint" model the life of production would be longer, owing to the assumed restriction on output. Depreciation of invested capital is calculated on a unit-of-production basis for both tax and financial accounting. We assume that development capital is entirely equity capital--by now a tenuous assumption. Federal income taxes are normalized. Operating costs are estimated at $0.25 per barrel. Assumptions regarding Alaskan taxes are discussed below.

* Appendix tables also present the impact on production earnings of a pessimistic $9.00-a-barrel price for crude on the West Coast.

REPRESENTATIVE DERIVATION OF WELLHEAD PRICES AT PRUDHOE BAY, 1978

(Dollars per Barrel)

	"Reserves Constraint"	"Production Potential"	"Market Constraint"
	$11.00 Per Barrel Crude Price		
(1) California Price	$11.00	$11.00	$11.00
(2) Tanker Cost (Valdez-L.A.)	0.50	0.50	0.50
(3) (1-2) Price at Valdez	10.50	10.50	10.50
(4) TAPS Tariff	4.60	4.30	4.85
(5) (3-4) Wellhead Price	$ 5.90	$ 6.20	$ 5.65
	$13.00 Per Barrel Crude Price		
(1) California Price	$13.00	$13.00	$13.00
(2) Tanker Cost (Valdez-L.A.)	0.50	0.50	0.50
(3) (1-2) Price at Valdez	12.50	12.50	12.50
(4) TAPS Tariff	4.60	4.30	4.85
(5) (3-4) Wellhead Price	$ 7.90	$ 8.20	$ 7.65

Production Earnings Per Barrel

Current Tax Regimes, Alternative Crude Prices

Given the interplay between TAPS tariffs and wellhead prices, per-barrel earnings on production are highest in the "production potential" model, where the tariff and unit earnings on TAPS are lowest. Production earnings in our "production potential" model for 1978--under a market value for crude of $11.00 per barrel--approximate $2.34 per barrel, compared with $2.17 per barrel in our "reserves constraint" model and $2.07 per barrel in our "market constraint" model. An increase in the market value of crude from $11.00 to $13.00 per barrel would raise production earnings in each model by $0.87 per barrel (see table on following page).

Over time, wellhead prices increase substantially--given constant market values for crude--owing to the declines in TAPS tariffs in each model. After-tax profits on production advance at a slower rate owing to significant increases in per-barrel capital costs. As noted earlier, sizeable additions to capital investment are assumed to occur in each model over most of project life to recover proved reserves. The very large investment in tertiary recovery--assumed to yield 2 billion barrels of reserves but only a modest (100 TB/D) increment to production--is powerfully reflected in unit capital cost by 1985 in the "production potential" model.

DETAILED CALCULATION OF PROJECTED PRODUCTION EARNINGS
CURRENT TAX REGIMES,
1985 VERSUS 1978

(Dollars per Barrel)

	"Reserves Constraint" Case	"Production Potential" Case	"Market Constraint" Case
Year 1978			
		$11.00 Per Barrel Crude Price	
Wellhead Price	$5.90	$6.20	$5.65
Oper./Cap. Cost	0.67	0.59	0.65
Property Tax	0.16	0.16	0.16
Severance Tax	0.46	0.48	0.44
State Income Tax	0.43	0.47	0.41
Federal Income Tax	2.01	2.16	1.92
Production Earnings	$2.17	$2.34	$2.07
		$13.00 Per Barrel Crude Price	
Wellhead Price	$7.90	$8.20	$7.65
Oper./Cap. Cost	0.67	0.59	0.65
Property Tax	0.16	0.16	0.16
Severance Tax	0.61	0.64	0.59
State Income Tax	0.61	0.64	0.59
Federal Income Tax	2.81	2.96	2.72
Production Earnings	$3.04	$3.21	$2.94
Year 1985			
		$11.00 Per Barrel Crude Price	
Wellhead Price	$6.35	$7.10	$6.50
Oper./Cap. Cost	0.91	1.07	0.82
Property Tax	0.17	0.23	0.21
Severance Tax	0.49	0.55	0.51
State Income Tax	0.45	0.49	0.47
Federal Income Tax	2.08	2.28	2.16
Production Earnings	$2.25	$2.48	$2.33
		$13.00 Per Barrel Crude Price	
Wellhead Price	$8.35	$9.10	$8.50
Oper./Cap. Cost	0.91	1.07	0.82
Property Tax	0.17	0.23	0.21
Severance Tax	0.65	0.71	0.66
State Income Tax	0.62	0.67	0.64
Federal Income Tax	2.88	3.08	2.96
Production Earnings	$3.12	$3.34	$3.21

Alaskan Tax-Proposals

We have calculated wellhead earnings on Prudhoe Bay crude in each of our three basic models--and for the alternative crude prices discussed above--employing the following assumptions about Alaskan taxation of oil production earnings. We initially compute production earnings under Alaska's current tax regime. We then apply, as best possible, the proposed changes in Alaska's tax laws that follow upon the proposals of the Interim Committee on Taxation and Revenue (the "Huber proposals"). Our exercises allow for a varying measurement of the "excess value" subject to an excess value tax (EVT). We assume in each of the latter Alaskan-tax cases that the severance tax will rise from an average 7.8% of wellhead value to 12.6% and that the state income tax (renamed a "net proceeds" tax) of 9.4% will continue to apply. To date, the proposal for an excess value tax remains somewhat ambiguous, as regards both the measurement of excess value and the rate of taxation. We have assumed that excess value is the difference between the sanctioned (or market-determined) price in California and a variable deemed value. The excess value tax rate is taken at a flat 4% after allowance for deduction of severance tax and net proceeds (state income) tax on the excess value and after allowance for a minimum $1.00-a-barrel margin before income taxes (illustrated below). As we noted earlier, one of the nagging questions remains whether or not the escalation in deemed value will move in line with market value of comparable crude on the West Coast (or in the Midwest). In our optimistic tax case, we allow for the deemed value to move up dollar-for-dollar with market value--i.e., excess value remains unchanged. In our second, pessimistic case, we hold the deemed value at a fixed level while market price increases--i.e., excess value subject to EVT rises in line with market value.

The Huber proposals on Alaskan oil taxes--so far as we can decipher them--require both some illustration and explanation. The following table extends our "reserves constraint" case to include the proposed taxation by Alaska of earnings on North Slope crude when realizations are divided into two values--the deemed long-term value and the excess value. The market value of crude in California is assumed to be $11.00 a barrel--the approximate price of upper-tier crude (by year-end 1976). The calculation is for a net company barrel (after deduction of royalty oil).

The first column presents the computation of production earnings and taxes under current parameters. Alaskan taxes consist of an average severance tax on wellhead price of 7.8%, property tax of 2%, and state income tax of 9.4%. The next three columns present production earnings and taxes under legislation proposed by the special Huber committee.

As noted earlier, these computations split the assumed $11.00-a-barrel market value into two components--the long-term (deemed) value and excess value. With respect to calculation of taxes and earnings on the long-term value, the only change from the current rules is the increase in severance tax--from an average 7.8% to 12.6%.

IMPACT OF PROPOSED CHANGES IN ALASKAN OIL TAXATION
ON COMPANY PRODUCTION EARNINGS
"RESERVES CONSTRAINT" MODEL, 1978
$11.00 PER BARREL MARKET CRUDE VALUE

(Dollars Per Barrel)

	Current	Proposed		
		Long-Term Value	Excess Value	Combined
(1) California Price	$11.00	$7.00	$4.00	$11.00
(2) Tanker Cost	0.50	0.50	....	0.50
(3) (1-2) Price at Valdez	10.50	6.50	....	10.50
(4) TAPS Tariff	4.60	4.60	....	4.60
(5) (3-4) Wellhead	$ 5.90	$1.90	....	$ 5.90
Severance Tax (7.8%)	-0.46 (12.6%)	-0.24	-0.50	-0.74
O/C Costs, Prop. Tax	-0.83	-0.83	....	-0.83
Pre-Tax Income	$ 4.61	$0.83	$3.50	$ 4.33
State Income Tax (9.4%)	-0.43	0.08	0.33	0.41
Income after S.I.T.	$ 4.18	$0.75	$3.17	$ 3.92
(Excess Value Adj.)			(-0.67)	
Income after SIT & EVA			2.50	
Excess Value Tax (41%)			-1.03	-1.03
Income before FIT	$ 4.18	$0.75	$2.14	$ 2.89
FIT	2.01	0.36	1.03	1.39
Production Earnings	$ 2.17	$0.39	$1.11	$ 1.50

The excess value component of total market value represents the difference between federally sanctioned (or OPEC-determined) market value f.o.b. West Coast markets and the long-term (deemed) value, subject to adjustment (described below). Values are compared at the same F.O.B. location. In our illustration, we start with the current rolled-back price of crude in California and subtract long-term value ($11.00 - $7.00 = $4.00/barrel). This conforms to examples accompanying the legislation submitted in Alaska. The long-term value of $7.00 a barrel is contained

in the draft legislation of the Huber committee. It represents a suggested value for a current estimate in explanatory material, but would escalate with the wholesale price index* from the date when the legislation went into effect.

Severance tax is deductible from the unadjusted excess value (EV) before application of the excess profits tax (EVT)--$4.00 X .126 = $0.50. Excess value would apparently be subject to the new net proceeds tax--formerly the state income tax, at the same rate--$3.50 X .094 = $0.33. The final adjustment to excess value before exaction of the EVT relates to a minimum margin for the companies. The producing company would be allowed minimum "net proceeds" of $1.00 per barrel (pre-tax income in our table) from the long-term value in addition to income remaining after net proceeds tax, EVT and federal income tax). In computing net proceeds of the company, the severance tax actually paid (on the full market value of $11.00 a barrel) and operating/capital costs are deducted from long-term value netted back to the wellhead ($1.90 - $0.74 - $0.83 = $0.33). If net proceeds work out to less than $1.00 a barrel--as in our illustration--then the excess value is further reduced by the amount of the shortfall, or by $0.67 a barrel in our table. In all then, initially excess value is subject to three adjustments--for severance tax and net proceeds tax (which accrue to Alaska, of course) and for any shortfall in net proceeds to the company. EVT in our example is $1.03 a barrel [($4.00 - $0.50 - $0.33 - $0.67) X .41 - $1.03]. Total tax liability to Alaska comprises 46.5% of unadjusted excess value of $4.00 a barrel.

Under an $11.00 a-barrel assumption for crude value on the West Coast, estimated earnings on main field production would be shaved from $2.17 to $1.50 per barrel if the proposed tax changes are adopted. (Allowing for inclusion of earnings on TAPS, the integrated margin would shrink from $3.00 to $2.33 per barrel.) Concomitantly, Alaska's share of net operating income on production** would soar from 20% to 45%. The companies' share would contract from 41% to 29%, and federal take from 38% to 26%.

The following table illustrates in some detail the impact of proposed changes in Alaskan taxation on production earnings and integrated margins when we assume $13.00 per barrel as the prescribed market value for Prudhoe-type crude. The underlying model, which shapes the configuration of unit costs, is our "reserves constraint" case, allowing for the substantial increase in market price permitted under federal law by late 1977, or early 1978. For purposes of measuring excess value subject to a 41% tax rate,

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* Indexing of crude values has become a favorite method for determining "just prices" at the federal and now state level of government, but unacceptable from OPEC. It is interesting to note that under existing tax legislation in Alaska, the minimum (per-barrel) severance tax is tied to the wholesale oil price index, but this adjustment is rejected when it might affect company revenues on which excess value taxes are computed because of the surge in that index attributable to the rising cost of oil imports.

** Total Alaskan taxes (severance, property, net proceeds and EVT) ÷ wellhead less operating and capital costs.

IMPACT OF PROPOSED CHANGES IN ALASKAN OIL TAXATION
ON COMPANY PRODUCTION EARNINGS
"RESERVES CONSTRAINT" MODEL, 1978

$13.00 PER BARREL MARKET CRUDE VALUE

(Dollars Per Barrel)

	Current Tax Regime		"Optimistic"[a]	"Pessimistic"[b]
(1) California Price	$13.00		$13.00	$13.00
(2) Tanker Cost	- 0.50		- 0.50	- 0.50
(3) (1-2) Price at Valdez	$12.50		$12.50	$12.50
(4) TAPS Tariff	- 4.60		- 4.60	- 4.60
(5) (3-4) Wellhead	$ 7.90		$ 7.90	$ 7.90
Severance Tax (7.8%)	- 0.61	(12.6%)	- 1.00	- 1.00
Oper./Cap. Costs[c]	- 0.83		- 0.83	- 0.83
Pre-Tax Income	$ 6.46		$ 6.07	$ 6.07
State Income Tax (9.4%)	- 0.61		- 0.57	- 0.57
Income after S.I.T.	$ 5.85		$ 5.50	$ 5.50
Excess Value Tax (41%)	....		- 1.30	- 1.57
Income before FIT	$ 5.85		$ 4.20	$ 3.93
Federal Income Taxes	- 2.81		- 2.02	- 1.89
Production Earnings	$ 3.04		$ 2.18	$ 2.04

a. Long-term crude value for computing excess value, $9.00 per barrel in the market or $3.90 per barrel at the wellhead.
b. Long-term crude value for computing excess value, $7.00 per barrel in the market or $1.90 per barrel at the wellhead.
c. Includes property tax.

a critical question will be the rate at which base price (long-term value) will be permitted to escalate relative to the prescribed market escalation for new crude.

In the following exercise, we posit alternative assumptions about the level of long-term values associated with an increase in market value for crude from $11.00 to $13.00 per barrel. The first, or "optimistic," variation permits an initial $7.00-per-barrel deemed value to rise to $9.00 per barrel by 1978, the first full year of Prudhoe Bay production; this assumption leaves excess value unchanged at $4.00 per

barrel as market price increases.* The second, or "pessimistic", variation in long-term value holds the latter constant at $7.00 per barrel as market price rises to $13.00 per barrel, thus permitting excess value to widen to $6.00 per barrel.

Under an assumption of $13.00-a-barrel for crude value on the West Coast and an "optimistic" assumption as to escalation of long-term value for crude, estimated earnings on main field production in 1978 would be shaved from $3.04 to $2.18** per barrel on account of higher severance tax and imposition of the excess value tax. (The integrated margin would shrink from $3.87 to $3.01 per barrel.)

In our "pessimistic" case, the estimated margin on production would sink from $3.04 to $2.04 per barrel, and the integrated margin from $3.87 to $2.87 per barrel.

Investors will be interested in the sensitivity of production earnings per barrel to a $1.00-a-barrel change in the prescribed market value of crude.*** Such measurement (as noted) necessitates a concomitant assumption as to corresponding policy changes regarding long-term values--as we have done above for assumed change in market value.

The following table presents the estimated sensitivity of per-barrel profit margins in each of our three basic models to a $1.00 per-barrel change in market value. For declines in market value below $11.00 per barrel, we assume, alternatively, that (1) long-term crude values decline commensurately, leaving excess value unchanged, and (2) long-term values remain constant while excess value shrinks.

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* The draft legislation submitted by the Huber committee on the excess value tax specifies that long-term price "means any price for a barrel of oil or its energy equivalent of more than $7.00 per barrel or the amount determined by the department. In no event, may the amount determined by the department exceed $7.00 per barrel plus the increase in the national wholesale price index since the tax went into effect." The explanatory material accompanying the draft legislation hypothesized a more generous 1974 base price of $7.00 per barrel from which to escalate long-term value. If this allowance for inflation were permitted, long-term value could reach $9.00 per barrel by 1978.

** Incidentally, the per-barrel margins in this example of the $13.00-a-barrel market price under the proposed Alaskan tax regime are comparable to results in the $11.00-a-barrel case under the current tax regime.

*** The sensitivity of companies' per share earnings to a $1.00-a-barrel change in market value for crude is discussed and illustrated in the next chapter.

SENSITIVITY OF PRODUCTION EARNINGS PER $1.00/BARREL
CHANGE IN MARKET VALUE OF CRUDE

(Dollars Per Barrel)

	Alaskan Tax Regimes	
	Proposed	Existing
Margins on Production, $11.00/bbl. Crude Price, 1978		
"Reserves Constraint" Model	$1.51	$2.17
"Production Potential" Model	$1.57	$2.34
"Market Constraint" Model	$1.46	$2.07
Earnings Impact of $1.00/bbl. Change in Market Crude Value		
Assuming: $1.00/bbl. Decline in Market Value		
Excess Value Declines $1.00	-$0.24	-$0.43
Excess Value Constant	-$0.23	
$1.00/bbl. Increase in Market Value from $11.00 to $12.00/bbl.		
Optimistic: Excess Value Constant	+$0.23	+$0.43
Pessimistic: Excess Value Increases $1.00	+$0.24	
$1.00/bbl. Increase in Market Value above $12.00/bbl.		
Optimistic: Excess Value Constant	+$0.41	+$0.43
Pessimistic: Excess Value Increases $1.00	+$0.24	

For increases in market value we present similar "optimistic" and "pessimistic" constructions for determining long-term value.

Under existing petroleum taxation in Alaska, production margins vary by $0.43 per barrel for each $1.00 change in market value for crude. It is interesting to note that when market value is assumed to decline by $1.00 a barrel under the proposed tax regime in Alaska, the corresponding decline in per-barrel earnings on production is limited to $0.23-$0.24 per barrel regardless of whether excess value changes. In fact, the EVT declines when price declines although excess value is held constant. The tax reduction follows from an incremental deduction from excess value (for the worsened shortfall in net proceeds attending the assumed decline in long-term value) before applying the 41% tax. The increase in shortfall of net proceeds reduces excess value (held constant otherwise) and EVT by approximately the same amount as a decline in excess value (and EVT) attributable to holding long-term value constant when market value declines. The comparable phenomenon is apparent when we examine the impact on earnings per barrel of an increase in market value from $11.00 to $12.00 a barrel.

NORTH SLOPE EARNINGS PER BARREL IN "RESERVES CONSTRAINT" MODEL

	July-Dec. 1977	1978	1980	1985
$9.00 Crude Price		Current Tax Regime		
TAPS	$0.06	$0.83	$1.03	$1.02
Sadlerochit	1.27	1.31	1.29	1.39
Total	$1.33	$2.14	$2.32	$2.41
$11.00 Crude Price				
TAPS	$0.06	$0.83	$1.03	$1.02
Sadlerochit	2.13	2.17	2.15	2.25
Total	$2.19	$3.00	$3.18	$3.27
$13.00 Crude Price				
TAPS	$0.06	$0.83	$1.03	$1.02
Sadlerochit	3.00	3.04	3.06	3.12
Total	$3.06	$3.87	$4.09	$4.14
$9.00 Crude Price		Proposed Tax Regime		
TAPS	$0.06	$0.83	$1.03	$1.02
Sadlerochit	1.00	1.03	1.02	1.07
Total	$1.06	$1.86	$2.05	$2.09
$11.00 Crude Price				
TAPS	$0.06	$0.83	$1.03	$1.02
Sadlerochit	1.48	1.51	1.50	1.55
Total	$1.54	$2.34	$2.53	$2.57
$13.00 Crude Price[a]				
TAPS	$0.06	$0.83	$1.03	$1.02
Sadlerochit	2.14	2.18	2.16	2.26
Total	$2.20	$3.01	$3.19	$3.28

a. Assumes "optimistic" case for determination of "excess value" subject to proposed 41% tax in Alaska.

Once market value reaches $12.00 a barrel, however, net proceeds exceed $1.00 a barrel. Thus, when market value rises by $1.00 a barrel and excess value is held constant (i.e., long-term value increases commensurately with market value), earnings per barrel on production rise by $0.41 per barrel. No change occurs in excess value or EVT. In effect, incremental earnings equate with those under existing tax law in Alaska. (Of course, earnings on the full $13.00 value netted back to the wellhead will be smaller than under current tax legislation in Alaska.) However, were excess value to increase dollar-for-dollar with market price (i.e., long-term value remains unchanged), then incremental earnings on production from a $1.00 increase in crude value above $12.00 per barrel are again limited to $0.24 per barrel. (All these calculations are predicated upon the overall plausibility of critical case parameters in the earnings models.)

The "integrated earnings" shown on page IV - 19 approximate combined earnings per barrel on TAPS and main reservoir production for the companies as a group. Prospective earnings per barrel on Kuparuk/Lisburne production work out lower than margins on Sadlerochit crude owing to assumed higher capital costs. Under current tax regimes, Kuparuk/Lisburne results average out at approximately $0.40/bbl. below Sadlerochit margins; under the proposed tax regime, Kuparuk/Lisburne margins might be $0.20/bbl. lower. A market price for crude on the West Coast of $6.50-$7.00 a barrel would be required to ensure "adequate" profits on TAPS and to cover average total costs at the wellhead for Sadlerochit (main reservoir) crude. Production of Kuparuk/Lisburne reserves would probably require a minimum price for Prudhoe Bay crude of $7.50 a barrel.

Our models of industry earnings per barrel on North Slope crude encompass a requisite wide range of assumptions regarding throughput on TAPS, field production, prices and taxes. One may also posit alternative assumptions concerning Alaskan taxes, or interpolate cases within our range of assumptions. The table detailing the sensitivity of production earnings to a $1.00-a-barrel change in market value facilitates the use of alternative assumptions about market price.

Discounted-Cash-Flow Rates of Return

In this section we present DCF rates of return for our "reserves constraint" model under the alternative crude price and tax assumptions previously discussed. We have computed DCF returns for TAPS and production both separately and combined, using 1977 as the base year. Comparable calculations for our "production potential" and "market constraint" models are precluded by the conjectural basis of investment requirements and cash flows for tertiary recovery in the main (Sadlerochit) reservoir and the Kuparuk/Lisburne reservoirs.

The stream of investments in TAPS--including all participants--is based on the major companies' past and projected expenditures for capacity of 1,500 TB/D. We have reduced expenditures from 1972 through 1977 to take into account a fraction of the investment tax credits earned in the pre-production period. (The bulk of ITC accruing in this period will be taken after production begins; see below.) Cash flow from TAPS reflects the earnings derived in our "reserves constraint" model

and our assumed schedule of depreciation. Our assumptions on TAPS tariffs (and, therefore, earnings) skew integrated earnings toward the production function. Hence, the DCF return on TAPS is slightly understated compared with a return that would be based on the maximum profits permitted by the I.C.C., and returns on production are slightly overstated. The cash flow stream on TAPS was raised for the years 1977-1981 by the estimated future benefits from ITC.

The stream of investments in the Prudhoe Bay field--again including all participants--is based on the major companies' past and prospective expenditures (1964-1978) for capacity of 1,500 TB/D. We have reduced the investment stream for tax benefits from the expensing of intangible development costs and have added payments of Alaskan reserves and property taxes in appropriate (pre-production) years. Investments for post-1978 years reflect our grossing up of ARCO's rough estimate of its costs (see Chapter I, North Slope Project: Evolution of Costs and Status of Construction). Our cost assumptions for the main field after 1978 exceed those employed by Alaska in its calculations of DCF rates of return on production. Since the major differences occur after 1981, and thus are heavily discounted, they do not greatly alter comparative returns. We have calculated cash flow on production under alternative tax assumptions, and for crude prices on the West Coast of $11.00 and $13.00 per barrel. We have raised our estimates of earnings based on normalized federal taxes to include ITC. However, we have not assumed continuing tax benefits from expensing of intangible development costs, since this provision remains under serious attack in the Congress. We have also included reimbursement of Alaskan reserves taxes (after payment of federal income taxes).

As expected, the contrast between returns on TAPS versus those on production is striking. We estimate the DCF rate of return on TAPS at 10%. Returns on oil production--under current tax laws--approximate 23%, given a crude price of $11.00 per barrel, and 27% if the crude price were $13.00 per barrel. The contrast between returns on production under current tax legislation versus returns arising under Alaska's proposed legislation is also noteworthy. Proposed Alaskan taxation would reduce returns on the field from 23% to 17.5% (assuming $11.00 per barrel for crude), and from 27% to 21.5% (assuming $13.00 for crude).

Upon combining investment and cash flow streams for TAPS and production, the integrated return--under present tax laws--approximates 14%, assuming $11.00 per barrel for crude on the West Coast, and 17% given a $13.00-per-barrel price.* Comparable

*We exclude the tanker leg of transportation for lack of information on earnings. In any event, while initial expenditures on tankers are important for analysis of company financing, the subsequent sale and lease back of tankers shifts this function to third parties. Ocean transportation thus becomes a cost of service to the North Slope operators.

returns under proposed tax changes would be 12% and 14%, respectively. In the current debate over Alaskan tax policy, the state is focusing on prospective returns on production. The companies, understandably, are emphasizing the total project rate of return. Investors in ARCO and Sohio are obviously interested in which viewpoint ultimately prevails.

DCF returns for the project as a whole may be taken as representative of returns for ARCO (and for Exxon). Sohio's indicated return on TAPS and production combined, given current tax laws and $11.00 per barrel for crude, would approximate 17% (versus 14% for the project) and 21%, given $13.00 for crude (versus 18% for the project).

Addendum: Markets for North Slope Oil

This section briefly examines the scope of the West Coast market for North Slope crude during the early years of operation, the prospects for a crude surplus on the West Coast, and the implication for pricing of Prudhoe Bay crude of extending its reach to the Midwest. Sohio foresees a crude surplus of 300-600 TB/D in 1978 when TAPS capacity will be 1,200 TB/D, and as much as 600-800 TB/D in 1982, were TAPS throughput then to approach 1,800-2,000 TB/D (see table on page IV - 24).

Our three earnings models posit production of 600 TB/D for the second half of 1977, rising to 1,200 TB/D in 1978. Production in our "reserves constraint" model rises to a peak of 1,500 TB/D in 1980, as does output in our "production potential" model. The latter model's rate continues to grow, however, to a peak of 2 MM B/D in 1984. Production in our "market constraint" model holds at 1.2 MM B/D through 1980, then rises to its peak of 1.5 MM B/D in 1981.

The market for Prudhoe Bay crude on the West Coast is ascertainable only over a wide range. So, too, as noted earlier, is the prospective supply of North Slope crude. Estimates of product demand in District V are very diverse. For example, Sohio's projections of product demand on the West Coast for 1978 (2,800 TB/D) and 1982 (3,200 TB/D) are around 200 TB/D lower than earlier projections by Exxon and ARCO for those same two years. The outlook for product demand is particularly obscure, because (1) the recent recession has delayed clarification of the response of demand to quantum jumps in prices, (2) the demand pattern is expected to shift toward more rapid growth in fuel oil rather than in gasoline demand. Although not immediately relevant, it is worth noting that demand for petroleum products could slow dramatically after 1982 if El Paso's gas transmission proposal for North Slope gas is selected. In that event, any "surplus" of North Slope crude would likely persist on the West Coast into the late 1980's.

Demand for crude oil in District V will depend on the size and utilization of refinery capacity. Local refineries currently supply some 95% (2,200 TB/D) of West Coast product demand. Distillation capacity was 2,425 TB/D at the close of 1975; crude runs averaged 2,050 TB/D (for an average operating rate in 1975 of 85%). Refinery capacity will increase 415 TB/D (to 2,840 TB/D) in 1976--of which, Socal will account for 350 TB/D. Current firm projects will raise capacity by a modest 90 TB/D more by 1978-79. Sohio projects refinery capacity at 3,100-2,300 TB/D in 1982, assuming maintenance of the historic relationship between domestic and imported product supply. We would not be surprised to see capacity added at a slower rate owing to (1) persisting uncertainty over the course of demand, (2) disincentives implicit in price controls and allocations, and most important perhaps (3) the danger of divestiture. Whether tardiness in adding to refinery capacity would seriously retard expansion of North Slope production is questionable, however. Above-normal utilization of constrained capacity would allow considerable scope for growth in overall demand for crude oil.

Prospective demand for North Slope crude by West Coast refiners will, of course, reflect the aggregate effect of refiners' preferred mix of crudes. The key determinants in crude slates include (1) crude avails from alternative domestic

HYPOTHETICAL DISTRICT V CRUDE OIL BALANCE,
1975, 1978E, 1982E

(Thousands of Barrels Daily)

		1975	1978E	1982E
Product Demand		2,210	2,800	3,200
Crude Demand		2,050	2,475-2,550	2,800-2,900
Production:	Declining Fields	1,075	1,000	900
	Expansible Fields[a]	.....	175-325	350-400
Imports:	Canada	160	0-100	0
	Middle East	530	0	0
	Indonesia/Africa	320	450-550	400-500
Crude Supply ex North Slope		2,085	1,625-1,875	1,650-1,800
Crude Deficit ex North Slope		.....	600-925	1,000-1,250
North Slope Potential		.....	1,200	1,800
Crude Surplus on West Coast		.....	275-600	550-800

a. Elk Hills and Santa Ynez fields; for 1975 included in "declining field" category.

and foreign sources, (2) the flexibility of refineries for handling varying crudes (particularly, their pollutants), (3) ownership of alternative supplies and related crude-swap arrangements, (4) relative crude prices, and (5) considerations of security of supply.

As for local supply, District V crude production has been suffering natural decline for a number of years. Sohio projects a decline in production from known fields from 1,075 TB/D currently, to 1,000 TB/D in 1978, and to 900 TB/D by 1982. It estimates production from the Elk Hills naval reserves and Santa Ynez area of 175-325 TB/D in 1978 and 350-400 TB/D by 1982. New finds could add untold millions of barrels to reserves by 1982, but any number would represent sheer speculation. Given development lag on the West Coast, however, even large discoveries might not be readily expansible by the early 1980's.

The refineries clustered in the Puget Sound area will represent a prime outlet on the West Coast for Prudhoe Bay crude. Crude capacity in the area is

around 340 TB/D; runs recently averaged 310 TB/D. ARCO has a 96 TB/D refinery at Cherry Point, Washington (in addition to the 185,000-barrel-a-day plant at Watson, California). Crude supplies in this area were recently 50% from Canada (delivered via the Trans Mountain Pipeline), 50% overseas imports. Canadian supply is being phased out (Sohio projects 0-100 TB/D from Canada for 1978, 0 for 1982). Most refiners will require investment in desulphurization facilities in order to handle Prudhoe Bay crude. Those investments are in abeyance pending removal of potential impediments to tanker traffic in the Sound (i.e., limitations on tanker size and constraints on expansion of terminals). The pace at which Puget Sound refiners utilize Prudhoe Bay crude will depend on clarification of these issues.

For 1978, if one could presuppose the backing out of crude imports, the West Coast market could readily accommodate 1,200 TB/D of Prudhoe Bay crude and possibly more. Sohio does project the displacement of imported "sour" crudes.* Refiners will little direct interest in Middle East crudes should clearly prefer Prudhoe Bay crude: it will be cheaper--at least in 1977-78, and offers security of supply. At the same time, Sohio foresees an increase in imports of "sweet" crudes from 320 TB/D to 450-550 TB/D. Unless all facilities are modified to handle "sour" crudes, refiners will require access particularly to Indonesian crude. Moreover, major West Coast refiners--Socal, Union, even ARCO--are also significant crude producers in Indonesia and will have an economic (and political) preferance for the latter over Alaskan crude.

The companies have every interest in timely completion of a transportation network from the West Coast to Midwest markets so as to maximize the present value of the Prudhoe Bay earnings stream. Accordingly, the companies have been considering alternative methods of moving Prudhoe Bay to U.S. markets East of the Rockies. Among the options considered is the possibility of reversing the (Canadian) Trans-Mountain or the Four Corners pipelines; these would offer only quite limited flows of Alaskan oil. The companies have also considered construction of large diameter, trans-continental lines, originating in northern California, western Mexico to the U.S. midcontinent/midwest area. In addition, the companies have pondered largely tanker routes--trans Isthmus (with a short pipeline across Central America) and via Cape Horn to eastern U.S. markets.

Sohio, with the largest share of Prudhoe Bay crude, and no controlled outlets on the West Coast, is implementing its own plan for moving Alaskan crude across the continent. The key element of the proposal is reversal of a 30-inch El Paso (Texas to California) gas line. The project would require construction of an oil line from California to the Arizona border (or possible reversal of another gas line to link up with El Paso's system). The FPC is expected to reach

* Crude imports into District V for 1975 divided as follows: Canada 160 TB/D, Middle East (mostly "sour" crudes) 530 TB/D, Indonesian and African "sweet" crudes, 320 TB/D.

its decision on interruption of gas service on the El Paso line by mid-1976. The Department of the Interior is preparing an environmental impact statement on the project. Sohio's proposal includes expansion of the marine terminal in the Santa Barbara Channel. Several layers of California environmental bureaucracy must pass on these plans. The expansion, moreover, appears to be prohibited by the State's two-year moratorium on industrial construction in the coastal zone. Federal legislation will probably be needed to untangle the local regulatory knots; it may not come quickly enough to avoid a potential surplus and holddown on production in 1978 to less than 1.2 million B/D. Sohio's proposal has certain advantages over alternatives: (1) it represents the most economical method of reaching major markets, (2) it will require the least direct capital commitment--a prime consideration in view of the companies' already onerous financing burdens, the possible variability in utilization of the line, and the threat of eventual divestiture.

The project, as originally conceived, might require an investment of $500 million for capacity of 500 TB/D (and $300 million more for expansion to 2 million B/D). Financing requirements in 1976 might not exceed $15 million, but will jump sharply in 1977. Sohio will probably require assistance from the federal government in clearing away local obstacles to terminal and pipeline construction. We assume that by 1979 at the latest, outlets to East of Rockies markets would be in place. One may even reasonably hope for completion of such transport network in 1978. Federal assistance in attaining access to all domestic markets might appear to be a reasonable counterbalance to federal restrictions on exports of North Slope crude.

Crude Pricing Implications

Were Prudhoe Bay crude to move only to West Coast markets, then its value would be set unambiguously by the imported price (or prescribed price) of crude on the West Coast, less transportation charges from wellhead to market. Should Prudhoe Bay crude move in quantity to the Midwest, however, it would take its value from the imported (or prescribed) price in that more distant market less transportation costs from wellhead to the Midwest. The delivered value of imported crude in each of these major markets would include the same f.o.b. price (Persian Gulf) plus transportation costs to respective markets. In the case of the West Coast market, light Arabian crude would lay in at $13.00 per barrel ($11.51 f.o.b., $1.14 tanker freight at Worldscale 60, plus $0.35 import fee); in the case of the Midwest, it would lay in at $13.50 per barrel ($11.51 f.o.b., $1.24 tanker freight to Gulf Coast at Worldscale 60, $0.40 pipeline charge from Gulf Coast to Midwest, plus $0.35 import fee). The difference in transportation cost, and hence in delivered cost, of imported crude amounts to roughly $0.50 per barrel. It follows that netbacks on Prudhoe Bay crude from the Midwest and the West Coast would be identical only if the difference in transportation costs to these markets were equivalent to the difference in transportation costs on imported crude to these same markets. In fact, the cost of moving Prudhoe Bay crude from Valdez to southern California would amount to $0.50 per barrel, and from Valdez to Chicago around $1.50 per barrel ($0.50 tanker freight Valdez to California, $0.60 pipeline cost California to Midland, Texas and $0.40 pipeline cost Midland to Chicago area) for a difference of $1.00 per barrel.

NETBACKS ON PRUDHOE BAY CRUDE FROM MAJOR MARKETS

(Dollars per Barrel)

	Delivered Cost of Persian Gulf Oil[a]	Cost of Moving Alaskan Oil From Valdez To Destination	Alaskan Price at Valdez to Equate with Cost of PG Oil
Los Angeles	$13.00	$0.50	$12.50
Chicago	13.50	1.50	12.00

a. At current AFRA, Worlscale 60.

In southern California, Prudhoe Bay crude would net back from Chicago at $0.50 per barrel below the ceiling set by the delivered cost of Persian Gulf crude on the West Coast. Given the more favorable netback from West Coast markets, North Slope producers would clearly maximize their earnings by practicing classic price discrimination (by charging West Coast customers the equivalent of the cost of imports, and by charging customers in the Midwest $0.50 less--on the f.o.b. price or on pipeline transportation--so as to compete with imported crude in the Midwest). Unfortunately for the North Slope producers, such practice would confront effective regulatory and political opposition. In a free market, Prudhoe Bay crude, selling below parity with imports on the West Coast, would tend to enlarge its markets there by driving out imports and its price would tend to rise toward parity with imported crude.

However, if prices of domestic crude are constrained below import parity, as we deem likely, then the movement of Prudhoe Bay into the more distant markets would not likely result in a lower netback than if Alaskan oil were marketed solely on the West Coast. Given the umbrella of higher prices for imported crude than those prescribed for domestic crude, the price of Prudhoe Bay crude in Chicago would be its delivered cost to the West Coast plus full transportation cost to the Chicago area.

COMPANY EARNINGS ON NORTH SLOPE CRUDE

Introduction and Summary

In this section, we translate our three basic earnings models into North Slope-related earnings per share for Atlantic Richfield and Standard Oil of Ohio. For each model, we multiply per-barrel earnings on TAPS, Sadlerochit production, and Kuparuk/Lisburne production by corresponding pipeline throughputs and production volumes of the companies. The reader is urged to see Appendix Tables VI - A to VII - L for the matrix of earnings possibilities. The range of plausible earnings estimates is disturbingly large. The following analysis is deliberately neutral. A positive position on the stocks presupposes a bias toward a favorable configuration of North Slope production and crude prices and tolerable taxation in Alaska.

In our "reserves constraint" model, ARCO's pipeline throughput builds up rapidly to a peak of 315 TB/D by 1979, and its net production to 268 TB/D. In our "production potential" model, ARCO's pipeline throughput peaks in 1984 at 420 TB/D (one third higher than in the "reserves constraint" model) while its net production gains even more rapidly (+50%) to 403 TB/D. The hefty gains in throughput and production is largely attributable to tentative increments from the Kuparuk/Lisburne reservoirs.

Given $11.00 a barrel for crude on the West Coast, in our "reserves constraint" model, ARCO's earnings per share in 1978 on North Slope oil would approximate $4.30 (divided $1.34 on TAPS and $2.97 at the wellhead). Subsequent rapid expansion of TAPS throughput and production would raise ARCO's per share earnings by 1980 to $5.77 and by 1985 to $5.92. In contrast, ARCO's 1985 earnings in the "production potential" model soar to $8.42 per share (42% above 1985 results in the "reserves constraint" model) reflecting mainly the assumed buildup of Kuparuk/Lisburne production, so important to ARCO. If Alaskan tax proposals were adopted unaltered, ARCO's earning power on integrated operations would shrink by roughly 20% below the foregoing estimates. In our "reserves constraint" model for 1980, a $1.00-a-barrel increase or decrease in the market price of crude would benefit or penalize ARCO's earnings by $0.78 per share under current tax parameters, but by $0.46-$0.56 per share under proposed tax laws. In addition to "normalized" earnings discussed above, tax savings accruing to ARCO from ITC and reimbursement of Alaskan reserves taxes could approximate $1.00 per share in 1978 and 1979, and $0.50 per share in 1980 and 1981.

Sohio is the leveraged vehicle for investment in North Slope equities. In our "reserves constraint" model, Sohio's pipeline throughput builds up rapidly to a peak of 500 TB/D by 1979 and its net production to an impressive 627 TB/D. The benefit of Sohio's disproportionately large equity in main field production compared with ARCO is readily apparent. In our "production potential" model, Sohio's pipeline throughput continues to surge beyond the 500 TB/D mark to a peak of 667 TB/D by 1984; its net production also continues to grow--but at a slower pace--to 674 TB/D. The more rapid gain in TAPS throughput compared with production reflects the major role of Kuparuk/Lisburne production in expanding pipeline throughput and Sohio's minor equity in those reservoirs.

from 1.9 billion barrels). ARCO's share of Kuparuk/Lisburne crude is expected to be much higher--possibly one-third. While ARCO has speculated publicly as to the production potential of the Kuparuk/Lisburne reservoirs, it has not disclosed the assumptions about reserves underlying that estimate. Given the substantial potential of the Kuparuk/Lisburne formations, ARCO's relatively high interest in those reservoirs, and its lower interest in Sadlerochit crude, Kuparuk/Lisburne crude looms large in ARCO's overall North Slope crude potential. Nevertheless, Kuparuk/Lisburne production will not contribute quite so importantly to ARCO's aggregate earnings on North Slope crude owing to its probably higher cost as compared to Sadlerochit supply.

As noted, Sohio's acreage covers approximately 54% of the crude and condensate reserves (before deduction of Alaskan royalty oil and BP's net profits royalty interest) in the Sadlerochit reservoir. Sohio's exact equity in Sadlerochit reserves is now indeterminate since BP's net profits royalty interest depends on production levels which cannot be projected precisely. Sohio is entitled to 100% of the profits on its net production (after Alaskan royalty) up to 600 TB/D, (i.e., when gross reservoir production reaches 1,270 TB/D). On Sohio's net production above 600 TB/D to 1,000 TB/D (i.e., if gross reservoir production is between 1,270 TB/D and 2,115 TB/D), BP receives 75% of net profits and Sohio 25%. Gross production from Sadlerochit's proven reserves of 9.5 billion barrels is expected to reach 1,500 TB/D for 6 to 8 years and then to decline gradually (our "reserves constraint" model). Sohio's 54% share of Sadlerochit reserves (after deduction of Alaskan royalty oil) equals 4,490 million barrels. Given our projected profile of production from the 9.5 billion barrels of proven reserves, BP's cumulative net profits royalty interest in barrel equivalents amounts to 230 million barrels; Sohio's net reserves approximate 4,260 million barrels, or 95% of the two companies' combined reserves. A higher level of peak production, say of 1,600 TB/D for 6-8 years, would raise BP's share and reduce Sohio's net reserves by close to 100 million barrels.

Tertiary recovery would further complicate assessment of Sohio's true equity in Sadlerochit reserves. First, the size of tertiary reserves and resulting increments to production remain speculative. Second, the division of production and reserves between Sohio and BP would depend on levels of Sohio's net production in particular years. In years when primary/secondary production from the main field was already above 600 TB/D to Sohio, incremental production from tertiary reserves would accrue 75% to BP and 25% to Sohio. In contrast, in years when Sohio's net production (before tertiary production) was below 600 TB/D, increments to production from tertiary recovery would accrue 100% to Sohio until the 600 TB/D level were reached and 75% to BP and 25% to Sohio on increments above 600 TB/D. Given our profile of production in the "production potential" case, in which tertiary reserves serve to lift production from the main field by a maximum of 100 TB/D, Sohio's reserves (after deduction of royalty oil and BP's net profits interest) in the main reservoir would approximate 4,960 million barrels. Sohio's equity in the Kuparuk/Lisburne reserves is expected to be relatively small--perhaps on the order of 10%, or 175 million net barrels from assumed gross reserves of 2 billion barrels. BP might share a small fraction of Sohio's interest in the Kuparuk/Lisburne reservoirs.

COMPANY EQUITIES IN TAPS VERSUS PRUDHOE BAY PRODUCTION, 1978 and 1985

	Initial TAPS Equity	Gross Production	Net Production
	ATLANTIC RICHFIELD		
	"Reserves Constraint" Model		
1978	21.0%	20.4%	17.8%
1985	21.0	20.4	17.8
	"Production Potential" Model		
1978	21.0%	20.4%	17.8%
1985	21.0	22.3	20.1
	"Market Constraint" Model		
1978	21.0%	20.4%	17.8%
1985	21.0	23.0	20.1
	STANDARD OIL OF OHIO		
	"Reserves Constraint" Model		
1978	33.3%	54.0%	47.2%
1985	33.3	47.8	41.8
	"Production Potential" Model		
1978	33.3%	54.0%	47.2%
1985	33.3	38.5	33.7
	"Market Constraint" Model		
1978	33.3%	54.0%	47.2%
1985	33.3	45.2	39.5

Given $11.00 a barrel for crude on the West Coast, in our "reserves constraint" model, Sohio's earnings per share in 1978 would approximate $9.55 (divided $2.03 on TAPS and $7.52 at the wellhead), rising to $11.18 by 1980 and to $11.51 by 1985. In contrast, Sohio's per share earnings for 1985 in our "production potential" model approximate $13.35 (some 16% above 1985 results in the "reserves constraint" model). Adoption of proposed Alaskan taxes would effectively reduce the above estimates by 23%-25%. In our "reserves constraint" model, a $1.00-per-barrel change in crude price under current tax regimes would benefit or penalize Sohio's prospective earnings on the North Slope by $1.70 per share ($1.00-$1.24 per share under proposed taxation in Alaska). In addition to normalized earnings, Sohio's tax savings could amount to roughly $1.95 per share in 1978 and 1979 and $0.85 per share in 1980 and 1981.

Equities in TAPS

Company earnings on TAPS will, of course, depend importantly on eventual equity shares in the pipeline system. Present equities in TAPS--revised in July 1974 to more closely reflect the companies' equities in Sadlerochit crude reserves --have been agreed upon only for initial capacity of 1.2 million B/D. ARCO's 21% share is close to its 20.4% equity in the 9.5 billion barrels of proved crude and condensate reserves in the Sadlerochit (main) reservoir. In contrast, Sohio's 33.34% initial equity in TAPS remains well below its 54% equity in Sadlerochit reserves (before Alaskan royalty and BP's net profits royalty interest). Sohio and BP together, however, hold 49.2% of TAPS.

Initial equities in TAPS for both ARCO and Sohio now look to be below their shares in posited gross production from the three Prudhoe Bay reservoirs. ARCO's 21% share of TAPS compares with 22.3% of peak gross production from the three Prudhoe Bay reservoirs in our "production potential" case; Sohio's 33.34% equity in TAPS compares with our estimate of 38.5% of gross production. It is worth noting, however, that on excluding Alaskan royalty oil the companies' current equities in TAPS do not differ significantly from their indicated interests in net peak production from the three major reservoirs.

Differences between the companies' initial equities in TAPS and their equities in gross field production reflect our own assumptions as to the production potential of the Prudhoe Bay reservoirs. Moreover, final equities in Sadlerochit reserves await completion of the unitization agreement; equities in Kuparuk/Lisburne crude are much more tentative. Once equities in Prudhoe Bay crude are well-established, equities of ARCO and Sohio in TAPS might be raised upon expansion of the system from 1.2 to 2.0 million B/D. On the other hand, should Alaska prove willing, and financially capable, to participate in the expansion of TAPS, the companies might well accommodate the state's participation. (Such participation may find the state much more sympathetic towards the prospective rate of return on pipeline investment than in the past.) For the present exercise we assume no change in TAPS equities upon pipeline expansion.

Equities in Prudhoe Bay Reserves and Production

Atlantic Richfield's acreage covers approximately 20.4% of the crude and condensate reserves in the Sadlerochit reservoir; its estimated net reserves of crude and natural gas liquids are 1.72 billion barrels (revised downward in 1974

Chapter VII

Drexel Burnham & Co.

NORTH SLOPE FINANCING

duction and Summary

In this chapter we examine the captial requirements of Atlantic Richfield tandard Oil of Ohio for bringing North Slope oil on stream, the possible ibutions to these requirements of internally-generated cash flows during emaining pre-production period, and their requirements for external finan- We review the companies' borrowings to date, other sources of capital have been arranged, additional financing requirements, and possible options btaining additional funds. Our analysis of uses of funds, as for sources nds, includes the requirements of ongoing and projected operations apart the North Slope.

ARCO is fundamentally better positioned than Sohio to meet its capital rements for the North Slope without resort to ostensibly unorthodox financing troleum industry standards) in the form of extraordinary reliance on apital. Any further big increase in cost estimates or protracted delay in ting TAPS would find Sohio's capital requirements increased by a disturbingly degree. However, we regard both risks as minor. Unfunded capital require- of Atlantic Richfield for 1976-77 approximate $330 million; Sohio's approach illion. Fortunately, the real collateral behind the debt of both companies-- proved reserves of oil at Prudhoe Bay--will facilitate prospective financing ltional capital requirements during the remaining pre-production period h further additions to funded debt or the arrangement of production payments tially advance sales of crude).

The companies will probably be reluctant to resort to additional equity ing in the near future, chiefly in view of adequate recourse to other finan- ptions. They may hope for an eventual renewal of investor confidence and anying improvement in prices of their shares based on (1) possible modera- f Alaskan tax demands, (2) start-up of Prudhoe Bay production, and (3) the interim resurgence in reported earnings. However, equity financings in 8 are becoming increasingly probable in light of the growing role of debt off both companies' balance sheets and the likelihood of continued heavy ng on the North Slope and related facilities after the start-up of pro- n in mid-1977.

tc Richfield

Full-scale development of North Slope resources will find Atlantic ld ranking in the top tier of large, highly-integrated refiner/marketers United States. In the early 1980's, ARCO's refining capacity in the States will approximate 775 TB/D (after divestment of its East Chicago y); the company's net crude production could then exceed 750 TB/D.

In effect, ARCO will have attained enviable balance in the United States while integration ratios of its peers continue to erode. Already among the nation's top producers of natural gas, ARCO will achieve preeminence (surpassed only by Exxon and Texaco) in that area. Meanwhile, the company is expanding on many fronts--in domestic oil and gas exploration apart from the North Slope, in petrochemicals and in foreign exploration and development. The company is also gearing up for development of its extensive coal reserves in the West, and for possible entry into the uranium-enrichment business.

ARCO has been fundamentally better positioned than Sohio to meet its capital requirements for the North Slope project without resort to exceptional dependence on debt financing. ARCO's cumulative financial needs for the North Slope including pre-production taxes may approximate $3 billion in the period 1969-1977; Sohio's requirements, in contrast, could reach $5.2 billion. ARCO's net book value at year-end 1975 was $3.7 billion and its debt ratio was 30%; Sohio's net book value was $1.5 billion and its debt ratio already 57%. ARCO's cash flow from operations in the remaining pre-production years, 1976-77, could amount to $2.1 billion compared with Sohio's potential cash flow of $480 million.

Pre-Production Expenditures and Financing: 1976-1977

As noted, ARCO's cumulative expenditures on the North Slope project through 1977 might approach $3 billion, divided $1.7 billion (59%) on TAPS, $305 million (10%) on tankers, and $915 million (31%) on development of the main reservoir. The $915 million for development includes $770 million for capital and $145 million of Alaskan pre-production taxes.

Of ARCO's total outlay for TAPS of $1.7 billion (which includes the company's 21% share of capital and construction interest for pipeline capacity of 1.2 million B/D, and pre-start-up property taxes) through 1977, $770 million will be spent in the remaining pre-production years 1976 and 1977.*

Of the total $305 million of outlays on tankers over the 1969-77 period, roughly $120 million remains to be spent this year and next. While tanker financing is taking the form of life-of-vessel charters rather than direct ownership, and while investments in tankers do not appear on the company's balance sheet, they represent very real long-term obligations of the company.

Of ARCO's total spending of $915 million for main field development in the 1969-77 period, $565 million will be spent during the remaining pre-production period; $430 million represents capital, and $135 million, Alaskan taxes.

*We assume that full-year 1977 capital requirements will have to be financed prior to mid-year startup of TAPS.

ATLANTIC RICHFIELD

ESTIMATED CAPITAL AND OTHER EXPENDITURES
ON THE NORTH SLOPE PROJECT, 1969-1977

(Millions of Dollars)

	Spent 1969-1975	Pre-Production 1976-77	Grand Total 1969-1977
S[a]	$ 985	$ 770	$1,755
ital	900	570	1,470
struction Interest	75	155	230
perty Tax	10	45	55
kers	$ 185	$ 120	$ 305
ital	160	105	265
struction Interest	25	15	40
Bhoe Bay Field[b]	$ 350	$ 565	$ 915
ital	340	430	770
perty Tax	10	15	25
Reserves Tax	...	120	120
ject Total	$1,520	$1,455	$2,975

TAPS Capacity of 1.2 MM B/D.

Development of main field to capacity of 1.5 MM B/D.

Continued.....

ATLANTIC RICHFIELD

PROJECTED USES, INTERNAL SOURCES OF FUNDS AND EXTERNAL FINANCING REQUIREMENTS
1976-77

(Millions of Dollars)

	1976	1977	Cumulative 1976-1977
Uses of Funds:			
TAPS Capital[a]	$ 435	$ 135	$ 570
TAPS Construction Interest	100	55	155
Tankers[b]	45	75	120
Prudhoe Development[c]	330	100	430
Alaskan Taxes[d]	85	95	180
TOTAL NORTH SLOPE	$ 995	$ 460	$1,455
Other Capital Expenditures	$1,005	$1,040	$2,045
Debt Repayment	117	24	141
Dividends	145	145	290
TOTAL	$2,262	$1,669	$3,931
Internal Sources of Funds:			
Earnings	$ 366	$ 420	$ 786
Non-cash Charges	655	675	1,330
BP Notes	58	...	58
TOTAL	$1,079	$1,095	$2,174
External Financing Requirements	$1,183	$ 574	$1,757

a. For TAPS capacity of 1.2 MM B/D.

b. Includes construction interest.

c. Development of main field to capacity of 1.5 MM B/D.

d. Pre-production property and oil reserves taxes.

ARCO is employing traditional high debt financing for TAPS and, as ted, off-balance-sheet debt for tankers in the form of long-term leases on sels. The bulk of the debt required to finance its share of TAPS capacity 1.2 million B/D has already been raised. Financing of tanker requirements also been arranged.

Of the total outlay of $1.7 billion required for TAPS in 1976 and 7, we assume that 85%, or $1,445 million, will be debt and that 15%, or 5 million, will be equity capital.* To date, ARCO has raised $1,310 million ium-term debt (including a $250-million revolving credit convertible to a ear loan prior to end-1978, and $150 million in 4-year Eurodollar credits). s, ARCO has yet to raise some $135 million in debt and $255 million in equity ital for TAPS prior to 1977 startup.

ARCO's other corporate uses of funds during the remaining pre-production iod could total $3,248 million, which, when combined with remaining TAPS irements of $390 million, raise financing requirements for 1976-77 to 38 million. ARCO's sources of funds apart from TAPS debt and tanker ncing might total $3,307 million in 1976-77. The total includes estimated flow from operations ($2,116 million); outstanding BP notes ($58 million); pended debt-equivalents for chemical facilities ($300 million); sale of jor carved-out production payment ($420 million); advance sales of gas ($250 ion); sale of the East Chicago refinery; and related inventories ($140 million); sale of ARCO's petroleum operations in the Province of Saskatchewan million).**

ARCO's unfunded capital requirements in 1976 and 1977 work out to $331 mil--$196 million if unfunded debt for TAPS is excluded. ARCO could resort to riety of financing options--including additional debt or advance crude sales-- ise this relatively small amount of capital. It may also be noted that the ny is discussing the sale of its remaining petroleum operations in Canada to ational oil company. ARCO had valued its Canadian properties at $400 million r to the recent sale of its interest in Saskatchewan for $23 million.

CO may decide to fund TAPS with 10% equity capital and 90% debt.

allowance by the FPC of inclusion of advance payments for gas commitments in eline rate bases led to the cancellation of $720 million in advances to ARCO. recent advance sales of gas in the lower-48 states and sale of a production ment compensated for the bulk of this loss.

ATLANTIC RICHFIELD

TAPS AND OTHER FINANCING:
ADDITIONAL PRE-PRODUCTION FUNDING REQUIREMENTS

(Millions of Dollars)

TAPS Capital Requirements, 1969-1977	$1,700
(1) TAPS Equity Requirement	$ 255
(2) TAPS Debt Requirement	$1,445
TAPS Debt Financing	
ARCO Pipe Line 7% bank note due 3/6/78	$ 25
ARCO Pipe Line 7½% bank note due 2/5/80	25
ARCO Pipe Line 7 3/4% notes due 6/1/98	40
11/1/74 ARCO Pipe Line 8.7% notes due 11/1/81	200
1/15/75 ARCO Pipe Line 8% notes due 1/15/82	250
7/16/75 ARCO Pipe Line 8 3/8% notes due 7/15/83	250
1/1/75 ARCO Pipe Line, revolving credit convertible to 3-year term loan prior to end-1978	250
Early 1975 4-year Eurodollar credits from Canadian and European banks	150
1/27/76 ARCO Pipe Line 8% notes due 2/1/84	200
	$1,390
Less: Repayment of Short-term Bank Debt	80
(3) TAPS Debt Financing to date	$1,310
(4) (2)-(3) TAPS Debt Requirement less Financing to date	$ 135
Other Corporate Uses of Funds, 1976-1977 (ex TAPS and Tankers)	
North Slope	$ 610
Other Capital Expenditures	2,045
Purchases of 6 million Common Shares of Anaconda at $27/sh.	162
Debt Repayment	141
Dividends	290
(5) Total Other Corporate Uses of Funds	$3,248
Other Sources of Funds, 1976-1977	
Corporate Cash Flow	$2,116
BP Notes	58
Approximate Unexpended Private Debt for Chemicals	300
12/5/75 Sale of Production Payment	420
Advance Sales of Gas in Lower-48 States	250
Sale of East Chicago Refinery and inventories	140
Sale of Petroleum Interests in Saskatchewan	23
(6) Total Other Corporate Sources of Funds	$3,307
(7) (1+4+5-6) Additional Financing Requirements, 1976-1977	$ 331

ATLANTIC RICHFIELD

POSSIBLE IMPACT OF TAPS DELAY ON FINANCING REQUIREMENTS*

(Millions of Dollars)

Capital Costs[a]	$100
Construction Interest on TAPS	115
Property Taxes	40
One-half of 1978 Spending[b]	235
Increment	$490

One year delay.
Speculative.
Excludes possible expenditures on lower-48 pipeline.

We estimate that a full year's delay in bringing North Slope crude on stream ıld add approximately $490 million to ARCO's preproduction expenditures. As noted ·lier, chances of such delay--let alone a protracted delay--now appear minimal.

A Glimpse Beyond 1977

Although ARCO's prospective cash flow from North Slope operations is very ressive, continuing outlays on the project may prove to be almost equally im- ssive, particularly if the company undertakes development of the Kuparuk and burne reservoirs, tertiary recovery in the Sadlerochit reservoir, early develop- t of natural gas, and construction of a pipeline system to East-of-Rockies markets e table on next page).

ATLANTIC RICHFIELD

NORTH SLOPE CASH FLOW AND POSSIBLE CAPITAL EXPENDITURES,
1978-1983

(Millions of Dollars)

	1978	1979	1980	1981	1982	1983
"Reserves Constraint" Case						
Cash Flow[a]	415	532	507	508	484	491
Possible Capital Outlays	470	82	125	380	380	50
Main Field/TAPS/T	470	82	50	50	50	50
Gas Development	...	...	...	330	330	...
"Production Potential" Case						
Cash Flow[a]	404	519	520	618	691	722
Possible Capital Outlays	760	372	415	960	710	380
Main Field/TAPS/T	470	82	725	50	50	50
Lower-48 Pipeline	40	40	40	...	...	...
Lisburne/Kuparuk	250	250	250	250	...	...
Tertiary Recovery	...	...	...	330	330	330
Gas Development	...	...	...	330	330	...
"Market Constraint" Case						
Cash Flow[a]	412	421	393	560	516	520
Possible Capital Outlays	470	332	300	630	630	50
Main Field/TAPS/T	470	82	50	50	50	50
Lisburne/Kuparuk	...	250	250	250	250	...
Gas Development	...	...	...	330	330	...

a. Cash flow includes investment tax credits for the period 1978-1981 and reimbursement of Alaskan reserves taxes in 1978 and 1979. Earnings included in cash flow assume $11.00-per-barrel crude price and current tax laws.

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tandard Oil of Ohio

Sohio's prospective transformation from a severely crude-deficient, regional ·finer/marketer of medium size (with supporting interests in coal, chemicals, and ›reign production) into a crude-rich integrated major is being accompanied by severe ·owing pains.

Sohio's capital commitment on the North Slope is huge both in absolute terms ·d relative to its capital base. As already noted, the company's cumulative expen- tures on the North Slope project through 1977 could reach $5.2 billion. In contrast, hio's net book value at end-1975 was $1.5 billion; its debt-to-capital ratio was al- ady 57% and headed a bit higher. More disturbing to investors, Sohio's capital re- irements have continued to grow in discrete chunks owing in part to inflation and part to catch up for early delays in constructing TAPS. In addition, Alaska has posed an onerous tax on oil reserves, payable prior to the startup of North Slope erations. A major concern of investors--now ebbing--has centered on the potential- large increment to pre-production costs, and external financing requirements, from ssible delay in bringing North Slope crude on stream. If such delay were open- ed, then Sohio might face a true financial crisis. As noted earlier, the proba- ity of a protracted delay in completion of the North Slope project appears slim.

STANDARD OIL OF OHIO

ESTIMATED CAPITAL AND OTHER EXPENDITURES
ON THE NORTH SLOPE PROJECT, 1969 - 1977

(Millions of Dollars)

	Spent 1969-1975	Pre-Production 1976-1977	Grand Total 1969-1977
;[a]	$1,593	$1,252	$2,845
ital	1,407	928	2,335
truction Interest	171	254	425
perty Tax	15	70	85
ers	$ 233	$ 391	$ 624
tal	208	320	528
truction Interest	25	71	96
hoe Bay Field[b]	$ 755	$ 995	$1,750
tal	740	705	1,445
erty Tax	15	30	45
Reserves Tax	...	260	260
et Total	$2,581	$2,638	$5,219

TAPS capacity of 1.2 MM B/D.
Development of main field to capacity of 1.5 MM B/D.

STANDARD OIL OF OHIO

PROJECTED USES, INTERNAL SOURCES OF FUNDS AND EXTERNAL FINANCING REQUIREMENTS
1976-1977

(Millions of Dollars)

	1976	1977	Cumulative 1976-1977
Uses of Funds:			
TAPS Capital[a]	$ 675	$ 253	$ 928
TAPS Construction Interest	195	59	254
Tankers[b]	216	175	391
Prudhoe Development[c]	400	305	705
Alaskan Taxes[d]	175	185	360
TOTAL NORTH SLOPE	$1,661	$ 977	$2,638
Other Capital Expenditures	120	90	210
Debt Repayment	11	18	29
Dividends	50	50	100
TOTAL	$1,842	$1,135	$2,977
Internal Sources of Funds:			
Earnings	$ 131	$ 138	$ 269
Non-cash Charges	105	105	210
TOTAL	$ 236	$ 243	$ 479
External Financial Requirements	$1,606	$ 892	$2,498

a. For TAPS capacity of 1.2 MM B/D.

b. Includes construction interest.

c. Development of main field to capacity of 1.5 MM B/D.

d. Pre-production property and oil reserves taxes.

Of the $5.2 billion committed for the period 1969-77, TAPS will account for 45 million (54%), tankers for $624 million (12%), and development of the main hoe Bay field for $1,750 million (34%).

Of the TAPS total of $2,845 million (which includes Sohio's 33.34% share of tal and construction interest for a 1.2 million-B/D pipeline and pre-startup erty taxes), $1,252 million will be spent in the remaining pre-production years -77.* Of the total $624 million for tankers, $391 million will be spent in -77. Of the total $1,750 million projected for main field development, some million remained to be spent during the pre-production years 1976-77. It is h noting that of this $995 million, some $705 million represents actual capital irements, while $290 million will be for Alaskan taxes.

Thus far, Sohio has relied very heavily on debt to finance its North Slope irements. Pipeline and tanker costs account for a hefty chunk (66%) of total ncial requirements through 1977, with traditional methods of financing pipelines tankers accounting for the preponderance of debt issuance to date. High debt/ ty ratios on pipelines are typically justified by I.C.C. requirements for through- commitments over the economic life of facilities and by the assured rate of re- built into pipeline tariffs. (Alaska's past forays into the arena of prospect- profits on TAPS have, from time to time, caused some nervousness over eventual ns on this pipeline investment.) Tanker financing is following the industry of off-balance-sheet debt in the form of lease commitments for life of vessel.

As noted, Sohio's cumulative capital requirements for TAPS (including con- tion interest but excluding property taxes) in the 1969-1977 period will total 0 million, of which 85% or $2,346 million will be supplied by debt and 15% or million by equity capital. Advances by the parent to Sohio Pipe Line Company quity capital have thus far amounted to $150 million of the $414 million total irement for equity capital. To date, Sohio has raised $1,724 million in medium long-term debt.** The company also has available a revolving bank credit (con- ible into a term loan) of $600 million. Thus, total debt financing for TAPS al- arranged is almost sufficient to cover TAPS' debt needs through 1977. Other orate uses of funds in the remaining 1975-77 pre-production period could amount ,404 million of which $1,065 or 76% would represent expenditures for North exploration/development and Alaskan taxes, $210 million or 15% for other cor- te capital expenditures (mainly in the lower 48 states), and the remaining $129 ion or 9% for dividends and scheduled debt repayment.

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assume that full-year 1977 financial needs have to be met prior to mid-year artup of TAPS.

date, Sohio's term debt for TAPS has been raised mainly through Sohio/BP Trans aska Pipeline Finance Inc. (Sohio Pipe Line Co., 67.8%; BP Pipeline Inc. 32.3%) d includes the following issues: December 4, 1974, $250 million in 9 3/4% deben- res due 1999; January 29, 1975, $250 million of 8 5/8% notes due 1983; July 1975, ,750 million of privately-placed 10 5/8% notes due in 1993 and 1998. In March 76, Sohio offered $200 million of notes due October 1, 1977. The funds may be ed for North Slope facilities other than TAPS.

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INCORPORATED

STANDARD OF OHIO

TAPS AND OTHER FINANCING:
ADDITIONAL PRE-PRODUCTION FUNDING REQUIREMENTS

(Millions of Dollars)

	TAPS Capital Requirement, 1976-1977	$2,760
	TAPS Equity Requirement	$ 414
	Less: Advances by Parent to Sohio Pipeline	150
(1)	TAPS Equity Requirement less Financing to date	$ 264
(2)	TAPS Debt	$2,346
	TAPS Debt Financing	
	12/4/74 Sohio/BP $250 million 9 3/4% debentures due 1999	$ 169
	1/29/75 Sohio/BP $250 million 8 5/8% notes due 1983	169
	7/75 Sohio/BP $1,750 million 10 5/8% notes due 1993 and 1998	1,186
	Revolving Bank Credit	600
	3/76 Sohio $200 million 7.1% notes due 1/1/77[a]	200
(3)	TAPS Debt Financing to date	$2,324
(4)	(2)-(3) TAPS Debt Requirement less Financing to date	$ 22
	Other Corporate Uses of Funds 1976-1977:	
	(ex TAPS and tankers)	
	North Slope	$1,065
	Other Capital Expenditures	210
	Debt Repayment	29
	Dividends	100
(5)	Total Other Uses of Funds	$1,404
	Other Sources of Funds, 1976-1977:	
	Corporate Cash Flow	$ 479
	Bank Credit, payable from crude proceeds	300
	10/2/75 Issuance of 2 million shares of common stock	136
	Advances on Coal ($96 million) and Uranium Development ($16 million)	112
	3/76 $50 million 7.6% notes due 4/1/79, and $75 million 8% notes due 4/1/81, both for payment of Alaskan reserves tax for 1976	125
(6)	Total Other Sources of Funds	$1,152
(7)	(1+4+5-6) Additional Financing Requirements, 1976-1977	$ 533

a. We assume the entire amount ($200 million) will be spent on TAPS.

Other sources of funds--including funds from operations ($479 million), issuance of common stock ($136 million), a bank credit repayable from proceeds on North Slope crude ($300 million), advances on coal and uranium development ($112 million), and sale of notes for 1976 payment of Alaskan reserves taxes ($125 million)--may total $1,152 million in the years 1976-77. Remaining financing requirements before start-up approximate $538 million.

Sohio's options for financing the additional $538 million range widely. They include additional debt (public or private), equity financing, advance sales of crude (several modes are available), elimination of the dividend, even sale of an interest in its equity in TAPS. Sohio could issue additional debt except as constrained by restrictures attaching to existing debt, since the real collateral behind its Alaskan-related debt is the company's Prudhoe reserves, nothing else.* Obviously, Sohio's heavy reliance on debt is contingent upon a rapid build up of its cash flow from North Slope production, promising fairly prompt correction of the debt/equity imbalance. If North Slope crude were to sell for $11 a barrel on the West Coast (and if Sohio were to raise debt to cover the whole of its remaining financial requirements through 1977), Sohio's cumulative cash flow from the first four years of its North Slope operations would be sufficient to retire the company's entire outstanding debt projected for the close of 1977.

STANDARD OF OHIO

PROSPECTIVE DEBT/CAPITAL RATIOS, END 1977

(In Per Cent)

-1975	57%[a]
-1977 If 1976-77 Requirements Financed by Debt	60%[b]

Sohio's debt-to-capital ratio approximates 60% if deferred revenue (obligations) were included.

Sohio's debt-to-capital ratio would approach 63% if deferred revenue (obligations) were included.

*Sohio's leeway under those strictures for raising additional debt or for sale of reserves in the ground would be more than ample even if current cost estimates were escalate substantially or were pre-production expenditures to balloon owing to delay in completion of North Slope facilities.

This report was nearing completion, Sohio announced plans to issue $250 million Sohio Pipe Line Co. debentures due 2001.

While from Sohio's point of view the cost of additional debt might be regarded as high by conventional standards relative to the cost of an equity financing, it is understandable why Sohio is postponing a major common stock offering. (Last year's equity issue was modest, given the scale of Sohio's capital needs.) Besides the variety of other options available for raising capital, an equity financing of almost 7.7 million shares at the recent price of the common would be needed to raise the entire remaining $538 million in external financing requirements for 1976-77. (Sohio must also consider BP's financial condition in issuing common stock since BP is entitled to purchase 54% of new stock offerings by Sohio.) Undoubtedly, Sohio is looking forward to the day when the price of its stock more adequately reflects the company's earnings possibilities.

In order to avoid both additional debt and a large equity financing, Sohio could resort to advance crude sales--its ace in the hole. To raise $538 million from advance crude sales, Sohio might have to convey roughly 110 million barrels of crude, or a little over 2.5% of its net proved reserves of liquids in the main field at Prudhoe Bay.

STANDARD OIL OF OHIO

POSSIBLE IMPACT OF TAPS DELAY ON FINANCING REQUIREMENTS*

(Millions of Dollars)

Capital Costs[a]	$ 50
Construction Interest on TAPS	235
Property Taxes	80
One-half of 1978 Spending[b]	190
	$565

* One-year delay.

a. Speculative.

b. Excludes expenditures on lower-48 pipeline.

On our reckoning, a full year's delay in startup could add $565 million to Sohio's remaining pre-production financing requirements, raising the total to $1,100 million. This lofty level of external cash needs would still be tolerable, prospective debt ratios considered, provided that a plausibly assured start-up date were then foreseeable.

STANDARD OIL OF OHIO

NORTH SLOPE CASH FLOW AND POSSIBLE CAPITAL EXPENDITURES,
1978 - 1983

(Millions of Dollars)

	1978	1979	1980	1981	1982	1983
Reserves Constraint" Case						
ash Flow[a]	897	1,061	1,005	1,022	980	991
ossible Capital Outlays	382	155	130	425	425	130
Main Field/TAPS/Tankers	382	155	130	130	130	130
Gas Development	...	...	...	295	295	...
roduction Potential" Case						
sh Flow[a]	878	1,036	995	1,100	1,119	1,138
ssible Capital Outlays	507	280	370	1,005	965	670
Main Field/TAPS/Tankers	382	155	245	130	130	130
Lower-48 Pipeline	85	85	85	...	...	...
Lisburne/Kuparuk	40	40	40	40	...	...
Tertiary Recovery	...	...	...	540	540	540
Gas Developement	...	...	...	295	295	...
rket Constraint" Case						
h Flow[a]	881	896	810	963	919	924
sible Capital Outlays	382	195	170	465	465	130
Main Field/TAPS/Tankers	382	155	130	130	130	130
Lisburne/Kuparuk	...	40	40	40	40	...
Gas Development	...	...	...	295	295	...

Cash flow includes investment tax credits for the period 1978-1981 and reimbursement of Alaskan reserves taxes in 1978 and 1979. Earnings included in cash flow assume $11.00-per-barrel crude price and current tax laws.

scomm

H12:14

ALASKA
STATE LEGISLATURE

MEMORANDUM

October 6, 1975

TO: Senator John Huber, Chairman
Special Committee on Taxation and Revenue

FROM: Franklin D. Fleeks
Committee Counsel

SUBJECT: Alaska Mineral Severance Tax, SB 294.

This memo is a summary of what has happened up to this date on SB 294. It is submitted for your information.

Review of the letters submitted and testimony at the hearing held on May 9, 1975, reveals that mining industry representatives, municipal utility officials, ancillary industry representatives, and interested individuals were unanimously opposed to the tax. The only testimony in favor of the tax was from the Department of Revenue.

The Department of Revenue Position

The Department of Revenue representatives stated that there is a severance tax on all of the state's renewable and non-renewable resources, oil and gas, timber, fishing, etc., except the "hard" mineral industry. The industry, at present, is taxed through a mining license tax, which is a tax on net income. From Commissioner Gallagher's testimony, the hard mineral industry grossed $62,000,000 for the 1974 fiscal year. The sources were as follows:

Sand and Gravel	$42,000,000
Coal	14,000,000
Other	6,000,000
Total	$62,000,000

From the approximately 200 licenses issued only two paid tax. One from the coal industry and one from the platinum industry. The amount collected brought the state $30,000 in revenue. The mining license tax is considered ineffective.

The present law is an additional net income tax. The Department considers it a tax on efficient procedures. Their position is that if a graduated severance tax is imposed it will fall on all producers of hard minerals in the State except those who sever less that $100,000 worth of minerals in a year. SB 294 would serve to tax a non-renewable resource,

extract revenue from those producers who ship out-of-state or to foreign countries, provide easier administration, and would provide additional revenues from a source that other taxes may not be able to touch. Instead of $30,000 the anticipated revenue is $3,500,000.

SB 294 is considered prospective because of the low level of hard mineral activity in the State. Passage would allow the hard mineral industry to plan rationally its tax cost if further development takes place.

In answer to criticism that the bill was like the British Columbia Royalty tax, the Department of Revenue stated the following. The B.C. bill is a two step royalty linked to international price for the refined mineral and a Canadian wholesale price index. The royalty is in addition to Federal and provincial taxes and cannot be taken as a deduction in computing the taxes. The proposed mineral severance tax would be deductable on Federal and State Income Tax returns, the effect being that the tax would be paid half by the Federal and State governments and half by the taxpayer.

In talking to John Messenger, Assistant Attorney General, it was sensed that it is still the intent of the Department to go forward with the bill. Attempts will be made to make it more palatable.

Mining Industry Position

From testimony and the letters the industry's position is that passage of SB 294 will discourage current and future exploration for minerals. They consider the mineral severance tax a gross receipts tax and as such it is inherently unfair. They also stated that because the proposed tax would add another cost to the already heavy burden of exploring and developing minerals in Alaska, only those prospects having the greatest potential will be exploited. Marginal deposits would be left untouched.

Ancillary Industry Position

Testimony was given by Jim Dotson of the Alaska Air Carriers Association. He represented the view of the air taxi and air charter firms in the State. A large amount of the revenue of his members is derived from providing support to survey teams, geological teams, and others doing the summer exploration work. He had been informed that just because SB 294 had been proposed, two large summer contracts for 1975 had been cancelled. His position was that passage of SB 294 would seriously reduce the air carriers' revenue with a consequent reduction in air service in the State.

Utilities Position

Letters were received from Fairbanks Municipal Utilities System and Golden Valley Electric Corporation, since they are two of the largest consumers of coal for electric generating purposes. Their position is that the proposed tax would be passed on to them and increase their operating costs. This in turn would lead to a rate increase for their customers.

Native Corporations Position

In our Anchorage staff meeting on September 24, 1975, Representative Anderson gave the Native Corporations' position. He stated that SB 294 would make it more difficult to go to the capital market to obtain funds for exploration and development. He also stated that the proposed bill had caused delays in current negotiations with financial institutions.

It should be noted that the Adminstration, by Governor Hammond's letter of May 8, 1975, states that further hearings would be held " . . in order to jointly develop a rational tax . . "

Listed below are the names of the companies and persons who wrote to the Committee.

Mineral Severance Tax Project

Digest of Letters

Date	Correspondent
4/25/75	Dr. Johl Morris
4/17/75	Perry, Knox, Kaufman Inc. M.A. Kaufman
4/30/75	Cominco American J.C. MacLean
4/11/75	Rodney A. Blokestad
4/10/75	U.S. Borax J.E. Stephens
4/18/75	Heflinger Mining & Equipment Company Carl F. Heflinger
4/12/75	Eagle Creek Lodge Don Bennett
4/8/75	GVEA R.L. Hufman
4/4/75	Alaska Miners Association - Fairbanks Branch Mark Ringstad
4/11/75	MUS Robert Hanson
5/5/75	John E. Clark
5/6/75	Ketchkian Pulp Company Edward W. Borger, Sr.
5/6/75	Alaska Gold Company W.A. Glovinovich
5/19/75	C.C. Hawley & Association W.E. Shoemaker

460 Lovella Way
Sacramento CA 95819
26 October 1975

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

Dear John:

It was so very nice that you and Francis were able to visit us the other night, although I am sorry for both of your sakes that the occasion was so demanding physically, and sorry for all of us that it was so brief.

This letter's intent is to tell you something about the Nevada-type of tax on mineral rights (or leasehold interest, or whatever you want to call it) and give an indication of what it might mean relative to Prudhoe Bay. Here is the critical aspect of this sort of tax in contrast to the income tax: the Nevada system levies the tax on the income to the property, whereas an income tax is a tax on the income to the person (either individual or corporation). Thus, there is none of this jiggery-pokery about the geographic point at which income is realized. It is realized at the property.

Nevada has a successful 90-year history of administering this tax, which is in lieu of property taxes (Nevada has no income tax or severance tax). The tax is simple to administer, and it achieves equity because it is based on ability to pay. I should add that Nevada has a property tax on equipment, just as Alaska has, but it has no property tax on mineral rights.

Let's take a quick look at the approximate tax base that Prudhoe Bay will generate in its first year of production. You may recall that I testified in April of this year that Prudhoe Bay then had a value of about $10.3 billion; I estimated this value by escalating the price of oil and otherwise updating my 1973 appraisal made for the North Slope Borough. Employing the same escalation of price, and also escalating expenses, I estimate that the 1977-78 net income to mineral rights will be

$2,259,000,000.

Incidentally, I did not include $203 million that would otherwise be levied in severance taxes, for two reasons. One is that the severance tax complicates the issue of net income to mineral rights, and the other reason, which follows on the first, is that I do not believe that the severance tax should be levied if the net income tax to M.R. is used. It muddies the waters relative to tax equity.

The tax on net income to M.R. permits the retention of your present ad valorem property tax on equipment. The way this is done is to allow an expense against income that is an amortization charge on all the equipment. Thus, the value of the equipment is removed from the net income tax base.

There it is in a nutshell: a prospective $2 billion tax base consisting of the net income to properties, producing a tax to be paid in lieu of either severance, regular income, or ad valorem property taxes. Of course, the state's royalty income would also be reeeived, and would be a charge against income in computing the net income to M.R.

If you would like me to do a detailed job on this for you, I will (1) write a report containing tax comparisons and prospective tax bases, (2) compose forms that will be required for administration, (3) suggest the staff required for the job (it will be remarkably small), and (4) testify on the issue. Of course, I would also be happy to work for you along other lines, such as the issues encountered this last spring. If you are interested in considering a net income tax to M.R. on mines as well as oil and gas fields, I can write a parallel report on that topic.

By the way, my work for Nevada was highly successful, in that the legislature adopted all of my major recommendations. If you want to check on this, you might write James Anderson, Chief, Division of Assessment Standards, Capital Plaza, 1100 East Williams, Carson City, Nevada 89701. He is in charge of implementing Nevada' revised program

And finally: as I told you when you were here, I will be out of the country all of December.

Oh, here's another "finally": I just got a letter from Sterling Gallagher inviting me to a meeting in Anchorage on November 6 on the subject of "Mining Tax Policy." Besides the fact that I will be giving a talk that day to the California Manufacturers Association in Newport Beach, I cauldn't come to Anchorage merely on that invitation. I had earlier corresponded with Gallagner aoout doing some research for his Department on the above subject, but of course it was as a consultant and not merely as an individual visiting Alaska. Thought you might like to know.

Sincerely

Bob

Robert H. Paschall
Consulting Valuation Geologist
and Engineer

SCOMM

#12:15

KILGORE TESTIMONY I

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Test 15 severe

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

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

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

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

KILGORE TESTIMONY II

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

RICHARD KILGORE - This is SOHIO submission 1.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

the companies combine.

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

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

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

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

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

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

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

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

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SCOMM

#12:16

REPRESENTATIVE MARTY FARRELL

ALYESKA PIPELINE SERVICE COMPANY
- Testimony on Regulation and
Ownership -
Joint Senate Commerce and House
State Affairs Committees

March 6 through 10, 1972 -

SENATE BILLS NOS. 294 AND 313

RIGHT-OF-WAY LEASING

Joseph R. Cortese
Squire, Sanders & Dempsey
Cleveland, Ohio

Senate Bills 294 and 313 present a number of serious problems and, in our opinion, they conflict with federal regulatory authority and the United States Constitution.

I. THE BASIC PREMISE OF THE BILLS IS WRONG, FOR THE STATE CANNOT USE ITS LAND CONTROL TO FORCE UNCONSTITUTIONAL RESULTS.

The basic premise of these bills is that the State, in its capacity as a landowner having control over land necessary for the pipeline, can impose terms and conditions on the pipeline proprietors that it concededly could not impose in its governmental capacity. We should state at the outset that this premise is wrong. It directly conflicts with the decisions of the United States Supreme Court. For example, in Frost v. Railroad Commission of California, 271 U.S. 583, 594 (1926), the U. S. Supreme Court held that a California statute, which sought concessions from a motor carrier as to methods of operating its business as a condition of the use of state highways, was in violation of the United States Constitution because such a requirement would constitute a taking of the carrier's property without due process. The Court said:

> "If the state may compel the surrender of one constitutional right as a condition of its favor, it may, in like manner, compel a surrender of all. It is inconceivable that guaranties embedded in the Constitution of the United States may thus be manipulated out of existence."

Likewise, the attempt of a state to regulate how an interstate telegraph company may select its customers is void even where posed as a condition to use of the streets, for the state may not use its constitutional powers to achieve the unconstitutional result of interfering with interstate commerce.

> "It is suggested that the State gets the power from its power over the streets which it is necessary for the telegraph to cross. But if we assume that the plaintiffs in error under their present charters could be excluded from the streets, the consequence would not follow. Acts generally lawful may become unlawful when done to accomplish an unlawful end, United States v. Reading Co., 226 U.S. 324, 357, and a constitutional power cannot be used by way of condition to attain an unconstitutional result." Western Union Telegraph Co. v. Foster, 247 U.S. 105 (1918).

As the following will further show, a state may not use its control of land to prohibit, attempt to regulate, interfere with, or unduly burden interstate commerce, nor to exact waivers of constitutional rights. If the use of state lands is necessary for interstate transportation, the state cannot withhold the right-of-way, it cannot exact more than reasonable compensation for such right-of-way, and it cannot invade the field of federal regulation or unduly burden interstate commerce as a condition of making available the use of its land.

II. THE STATE OF ALASKA MAY NOT WITHHOLD THE NECESSARY RIGHT-OF-WAY FOR IT MAY NOT WITHHOLD THE MEANS OF TRANSPORTING THE OIL AND GAS IN INTERSTATE COMMERCE.

The State of Alaska through its oil and gas leases has granted to the lessees the right to develop, produce, process and market oil and gas. That oil and gas can only be marketed feasibly by means which utilize state-owned lands. Under these circumstances, the State may not withhold its lands from the lessees.

This principle follows from the commerce clause of the United States Constitution. In Oklahoma v. Kansas Natural Gas Company, 221 U.S. 229 (1911), the State of Oklahoma by statute prohibited companies, which were engaged in transporting gas out of the State of Oklahoma, from laying, constructing and operating gas pipe lines in, on, under, across or along the highways of the State. The gas company merely sought rights to cross the highways for purposes of a pipeline to get natural gas out of the state. Oklahoma argued that while the gas company had the right to engage in interstate commerce, it did not have a right to obtain right-of-way in the state for that purpose, and that the state could withhold from such foreign corporation the power of eminent domain and the right to cross highways. The Supreme Court held that the state could not withhold the right to use highway crossings to construct the pipeline, and rejected the state's contentions, saying:

"At this late day it is not necessary to cite cases to show that the right to engage in interstate commerce is not the gift of a State, and that it cannot be regulated or restrained by a State, or that a State cannot exclude from its limits a corporation engaged in such commerce. To attain these unauthorized ends is the purpose of the Oklahoma statute. The State through the statute seeks in every way to accomplish these ends, and all the powers that a State is conceived to possess are exerted and all the limitations upon such powers are attempted to be circumvented. * * * The use of the highways is forbidden to them [interstate pipeline companies] and the right of eminent domain is withheld from them, and the prohibitive strength which these provisions are supposed to carry is exhibited in the fact that the boundary of the State is a highway. If it cannot be passed without the consent of the State, commerce to and from the State is impossible. The situation is not underestimated by appellant [Oklahoma Attorney General], and he says: 'If the appellees had the right of way they might engage in interstate commerce, but their desire to engage in interstate commerce is a different thing from the means open to them to procure a right of way.' And it is further said, that 'the confusion of the right to engage in interstate commerce with the power to forcibly secure a right of way is the basis of appellees' case.'

"There is here and there a suggestion that the State not having granted such right the alternative is a grant of it by Congress. But this overlooks the affirmative force of the interstate commerce clause of the Constitution. The inaction of Congress is a declaration of freedom from state interference with the transportation of articles of legitimate interstate commerce, and this has been the answer of the courts to contentions like those made in the case at bar.

> "* * * No State can by action or inaction prevent, unreasonably burden, discriminate against or directly regulate interstate commerce or the right to carry it on. And in all of these inhibited particulars the statute of Oklahoma offends."

Thus, it was held that the interstate pipeline could cross state highways notwithstanding the prohibition in the Oklahoma statute.

The same Oklahoma statute was also considered, and was held to be unconstitutional in the case of Haskell v. Cowham, 187 F. 403 (8th Cir. 1911). There, the court stated as follows:

> "No state may by means of its police power, or its proprietary power, over highways or by means of any of its other powers, erect and maintain impassable barriers against interstate commerce along its borders or through its body in the face of the grant to the nation of the power to regulate that commerce; for all the powers of the state are subordinate to this power of the nation and to its will that such commerce shall be free."

Not only would the withholding by the State of a right-of-way to the lessees constitute an undue burden on interstate commerce, but it would also constitute a deprivation of the lessees' property without due process of law. A succinct statement of this principle is found in the Haskell case cited above:

> "But an owner who by virtue of his ownership of land or of mining leases thereof has the vested right to draw by means of wells or pumps natural gas from beneath the surface is the owner of valuable property which the state cannot take from him without just compensation and state laws and acts of the officers of a state which prevent him from taking it from the land and selling it and conveying it out of the state in interstate commerce, while they permit the withdrawal and sale of such gas in interstate commerce, necessarily violate the national Constitution (1) because they take his property without just compensation and (2) because they substantially discriminate against and directly regulate interstate commerce."

The right of the lessees of the North Slope oil and gas to transport it in interstate commerce without obstacles or burdensome conditions imposed by the State is

expressly apparent in view of the fact that the State invited them to bid competitively for and purchase such oil and gas rights from the State, including, as stated in the leases, the right to "market" such oil and gas.

The point to be emphasized in our consideration of House Bills 294 and 313 is that their factual premise is inconsistent with their legal premise. Factually, they assume that the only practical way of getting the oil out of Alaska is by a pipeline and that pipeline must run across State controlled lands. If that were not the fact there would be no point to the bills for the price and conditions they exact would be avoided by using other lands. Thus, the premise is that the pipeline owners must contract with the State for right-of-ways. On the other hand, the legal premise is that the State, through its proprietary capacity, can achieve by right-of-way contracts what it could not achieve in its governmental capacity because the contracts will be entered into, it is claimed, by voluntary bargaining. It has been claimed that a state as proprietor can legally obtain unusual contract terms because others may contract with it on its terms or forego contracts with the state. That legal theory is plainly irrelevant where interstate commerce would be thwarted and property rights lost if the private parties declined the state's terms.

Instances of the federal government asserting conditions and requirements in the exercise of its contract functions are beside the point. Those are in fact instances where private parties may forego contracts with the federal government without loss of property rights, and it can hardly be claimed that the federal government is unconstitutionally restraining or burdening interstate commerce since the Constitution places the power over such commerce in the federal government.

The very factual premise of House Bills 294 and 313 that the pipeline owners must get right-of-way from the State, makes it apparent under U.S. Supreme Court cases, that such right-of-way cannot be withheld and cannot be used by the State to achieve results which are otherwise prohibited.

III. THE STATE OF ALASKA MAY CHARGE A RENTAL FOR THE USE OF ITS LAND, BUT SUCH RENTAL MUST BE REASONABLE AND CONSTITUTE NO MORE THAN JUST COMPENSATION TO THE STATE.

The State may properly charge rents for the right-of-way, even when there is no other practical way to conduct the interstate commerce involved. But, the Constitution requires that such rent be reasonable and not discriminatory and bear a true relation to the actual value of the land. The leading case in this regard is St. Louis v. Western Union Telegraph Company, 148 U.S. 92 (1893), rehearing denied, 149 U.S. 465 (1893). There, the City of St. Louis imposed an annual rental of $5.00 per pole for the use of so much of its lands as were occupied by the telegraph poles of the Western Union Telegraph Company, and the Company claimed such charge could not be made at all and, in any event, was excessive. The court held that a rental charge could be imposed, but that it must be reasonable in relation to the value of the land used. The Court said:

> "Indeed, it may be observed, in the line of the thoughts heretofore expressed, that this charge is one in the nature of rental; that the occupation by this interstate commerce company of the streets cannot be denied by the city; that all that it can insist upon is, in this respect, reasonable compensation for the space in the streets thus exclusively appropriated; and it follows in the nature of things that it does not lie exclusively in its power to determine what is reasonable rental. The inquiry must be open in the courts, and it is an inquiry which must depend largely upon matters not apparent upon the face of the ordinance, but existing only in the actual state of affairs in the city."

The Court did not have sufficient evidence before it to determine whether the rental was reasonable. But, upon remanding the case, it gave clear guidance that the rental had to bear a proper relationship to the value of the land occupied.

> "The court cannot assume that such a charge is excessive, and so excessive as to make the ordinance unreasonable and void; for, as applied in certain cases, a like charge for so much appropriation of the streets may be reasonable. If within a few blocks of Wall Street, New York, the telegraph company should place on the public streets 1500 of its large telegraph poles, it would seem as though no court could declare that five dollars a pole was an excessive annual rental for the ground so exclusively appropriated; while, on the other hand, a charge for a like number of poles in a small village, where space is abundant and land of little value, would be manifestly unreasonable, and might be so excessive as to be void."

Thus, the rental must bear a proper relationship to the value of the land occupied.

Land value is most frequently determined in eminent domain cases where just compensation is based upon the value of the land taken. It is held that land value is determined by what the owner gives up, not by what the taker gains. In United States v. Miller, 317 U.S. 369 (1943), the party whose land was being condemned argued that the land should be valued in relation to the specific purpose for which it was to be used, a railroad right-of-way. The United States Supreme Court rejected this contention, and stated:

> "Since the owner is to receive no more than indemnity for his loss, his award cannot be enhanced by any gain to the taker. Thus, although the market value of the property is to be fixed with due consideration of all its available uses, its special value to the condemnor as distinguished from others who may or may not possess the power to condemn, must be excluded as an element of market value." (p. 375).

The defect of the rental formulas of Senate Bills 294 and 313 is that they bear no relationship to the value of the particular land involved, and are not limited to the value of the land itself but seek to use some measure of gross revenues or the profitability of a pipeline built with private capital. This clearly goes beyond what the Supreme Court has said could be reasonably charged, and would constitute a prohibited burden on interstate commerce. Furthermore, since these unusual charges are wholly out of keeping with the general practice in other states and in Alaska, and are largely addressed to this pipeline project, they might also be viewed as violative of the prohibitions against discrimination against interstate commerce and as constituting discriminatory taxes upon interstate commerce.

IV. OTHER PROVISIONS OF THESE BILLS ARE UNCONSTITUTIONAL.

A. Court Jurisdiction.

The Bills provide that the lessee shall agree to the jurisdiction of state courts with regard to the interpretation of the lease or resolution of disputes concerning the lease provisions. (Section .020(1) of S.B. 313 and .410 of S.B. 294.)

We are not certain of the intent of this provision. If it is only designed to insure that state courts may readily obtain personal jurisdiction over the lessee, then a provision similar to that of Section .531 (designation of service agents) in S.B. 315 would be appropriate and avoid confusion.

Similarly, if the provision is only intended to mean that the law of Alaska governs interpretation of the lease, the provision appears unnecessary, but in any event should be more clearly worded to reflect that intention.

However, if this provision is intended to require the lessee to seek relief only in state courts and to prohibit it from invoking, in appropriate circumstances, the aid of federal courts, including the removal of cases to federal court where appropriate, it is clearly unlawful. As stated by the United States Supreme Court in the case of Terral v. Burke Construction Co., 257 U.S. 529 (1922):

> "The principle established by the more recent decisions of this court is that a State may not, in imposing conditions upon the privilege upon a foreign corporation's doing business in a state, exact from it a waiver of the exercise of its constitutional right to resort to the federal courts, or thereafter withdraw the privilege of doing business because of its exercise of such right, whether waived in advance or not."

Such a requirement, if imposed by the state police power, would be unconstitutional. Even a voluntary agreement having this result would be void. Roberts v. Lexington Insurance Co., 305 F.Supp. 47 (D.C. N.C. 1969).

B. Penalty Provision.

Section .020(4) of S.B. 313 would require the lessee to agree to penalties "that the Commissioner may determine to be appropriate." It provides no standard to guide the Commissioner in the exercise of this delegated authority and would place the lessee at the mercy of the Commissioner. Such a provision is contrary to the due process requirements of the Fourteenth Amendment of the federal constitution.

The apparent reason for the option requirement is the fear that the wellhead price and royalties of the state may be reduced by the imposition of excessive pipeline charges. This fear is unfounded. The pipeline's rates will be regulated by federal regulatory agencies in whose deliberations the State may fully participate.

F. The Savings Clause.

S.B. 313 purports to escape constitutional infirmities by specifying that the lease conditions be imposed only "to the extent not pre-empted by federal law." Also, the bill defines "transporation" to include activities only "to the extent that such transportation may constitutionally be subject to the provisions of this chapter." As indicated above, the application of such exceptions would leave little, if anything, of consequence in the bill. The unconstitutional matter in S.B. 313 is so pervasive that we believe it would be held unconstitutional in its entirety. The problem is that the basic premise of the bill, that the State can exact any conditions it desires by virtue of its landowner position, is constitutionally unsound.

V. CONCLUSION.

We have not attempted to deal with every provision of Senate Bills 294 and 313, and do not mean to imply that provisions not discussed would be valid. Rather, we have shown that the basic legal premise of these bills is wrong and would produce unconstitutional results in vital respects. We do not doubt the authority of the state to provide for leasing rights-of-way over the public domain for this pipeline project and others, to obtain reasonable rentals therefore, and to provide for reasonable conditions and terms relating to the protection of the State's lands and properties to the extent not inconsistent with or pre-empted by the federal authority. However, Senate Bills 294 and 313 are not proper vehicles for such purpose for they are permeated with unconstitutional provisions developed from an unsound legal premise.

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

REMARKS OF CHARLES E. SPAHR
TO THE JOINT HEARING OF THE SENATE COMMERCE COMMITTEE
AND THE HOUSE STATE AFFAIRS COMMITTEE
ON PROPOSED ALASKAN LEGISLATION CONCERNING
PIPELINE REGULATION, RIGHT-OF-WAY AND
STATE OWNERSHIP -- MARCH 7, 1972

INTRODUCTION

GENTLEMEN: I APPRECIATE HAVING THIS OPPORTUNITY TO APPEAR BEFORE YOU. MY NAME IS CHARLES SPAHR. I AM CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF THE STANDARD OIL COMPANY (OHIO), HEADQUARTERED IN CLEVELAND ON THE SOUTHERN SHORE OF LAKE ERIE. MY COMPANY HAS A SUBSTANTIAL INTEREST IN THE PRUDHOE BAY FIELD. LIKE OUR ASSOCIATES IN THAT AREA WE ARE ANXIOUS TO DEVELOP THE FIELD AND BRING ITS OIL TO MARKET THROUGH THE PROPOSED TRANS-ALASKA PIPELINE SYSTEM AS SOON AS POSSIBLE. OF PRUDHOE BAY'S TOTAL HYDROCARBON RESERVES I BELIEVE THAT APPROXIMATELY 55% OF THE OIL AND 30% OF THE GAS ARE UNDER OUR LEASES. WE HAVE AN APPROXIMATE 28% INTEREST IN THE TAPS PROJECT.

AS YOU PROBABLY KNOW, THESE INTERESTS RESULT FROM THE AGREEMENT BETWEEN OUR COMPANY AND THE BRITISH PETROLEUM COMPANY, LIMITED OF JANUARY 1, 1970, WHEREBY BP ACQUIRED AN INITIAL 25% INTEREST IN SOHIO (AS WE CALL OUR COMPANY), AND WE ACQUIRED MOST OF BP'S INTERESTS IN PRUDHOE BAY, ITS MARKETING PROPERTIES IN THE EASTERN SEABOARD STATES, AND TWO REFINERIES SERVING THAT AREA.

UNDER THE TERMS OF OUR AGREEMENT WITH BRITISH PETROLEUM, ITS SUBSIDIARY BP ALASKA INC. IS ACTING AS OUR AGENT IN THE

DEVELOPMENT OF PRUDHOE BAY. SOHIO AND BP ALASKA HAVE LABORED JOINTLY ON THE TAPS PROBLEM AND ALL MATTERS RELATED TO IT.

LAST OCTOBER WHEN GOVERNOR EGAN DISCLOSED HIS INTEREST IN STATE OWNERSHIP OF TAPS MY REACTION TO THAT DISCLOSURE RECEIVED SOME PUBLICITY. THERE ARE SOME WHO SAID I OVER-REACTED AND OTHERS WHO CHIDED ME FOR ATTEMPTING AN OVERKILL. I HAD NO SUCH INTENTION. RATHER, THE REACTION WAS ONE OF HONEST SHOCK. MORE COSTLY DELAY ADDED TO THAT ALREADY EXPERIENCED WAS ENVISIONED. THIS PIPELINE PROJECT IS TRULY A TREMENDOUS UNDERTAKING WITHOUT PRECEDENT, ALREADY PLAGUED, WITH EXTENDED DELAYS AND THEIR ATTENDANT COSTS THAT NO ONE COULD IMAGINE WHEN PLANNING BEGAN. THE SPECTER OF SUBSTANTIAL ADDITIONAL HURDLES ARISING AS A CONSEQUENCE OF THE ADMINISTRATION'S DESIRE TO FIND A WAY TO ACQUIRE THE LINE APPALLED ME AND I SAID SO. SUBSEQUENT STUDY HAS CONFIRMED OUR INITIAL BELIEF THAT A GOOD MANY PROBLEMS ARE POSED BY THE STATE OWNERSHIP QUESTION WHICH WE WANT TO DISCUSS WITH YOU AND WITH THE ADMINISTRATION IN AS COMPLETE AND OBJECTIVE A MANNER AS POSSIBLE.

OUR PRIMARY DESIRE, I AM SURE, PARALLELS YOUR OWN AND THAT OF THE GOVERNOR--IT IS TO BUILD THE LINE EXPEDITIOUSLY AND WELL IN ORDER TO BE ABLE TO BEGIN AND SUSTAIN PRUDHOE BAY PRODUCTION AT AN OPTIMUM RATE FOR THE MUTUAL BENEFIT OF ALASKA, ITS PEOPLE, THE NATION, AND THE PRODUCERS.

TODAY I AM SPEAKING FOR MY COMPANY AND BP ALASKA, AND ON BEHALF OF THOSE OTHER COMPANIES HAVING OWNERSHIP INTERESTS IN BOTH PRUDHOE BAY AND IN TAPS. THE IDENTITIES OF THESE

COMPANIES, AND THEIR CURRENT INTEREST IN TAPS ARE AS FOLLOWS:

ATLANTIC RICHFIELD COMPANY	28%
THE HUMBLE OIL & REFINING COMPANY	25½%
MOBIL OIL CORPORATION	8½%
PHILLIPS PETROLEUM COMPANY	3½%
UNION OIL COMPANY	3½%
AMERADA-HESS	3 %

THE STATE OF ALASKA, BY VIRTUE OF ITS ROYALTY INTEREST AND PROSPECTIVE SEVERANCE TAXES HAS A SUBSTANTIAL INTEREST APPROXIMATING 20% IN ALL OF THIS OIL AND GAS.

TRADITIONALLY, AND WITHOUT EXCEPTION TO MY KNOWLEDGE, COMMERCIAL OIL AND GAS FIELDS IN OUR COUNTRY HAVE BEEN DEVELOPED BY THE COMPANIES POSSESSING THE RESERVES IN THOSE FIELDS. THEIR DESIRE TO GET THE OIL TO MARKET HAS BEEN THE COMPELLING FORCE TO GET THE JOB DONE--AS SOON AS POSSIBLE. THE SAME COMPULSION HAS PRODUCED THE NECESSARY TRANSPORTATION, EITHER BY THE PRODUCERS OR BY THOSE WHO HAVE WANTED ACCESS TO THE OIL AS BUYERS.

FREQUENTLY, THE INITIAL TRANSPORTATION SYSTEMS HAVE BEEN EXPANDED AND EXTENDED TO ACCOMMODATE THE OIL OR GAS FROM NEW DISCOVERIES, WHETHER OR NOT IT BELONGED TO THE OWNERS AND OPERATORS OF THOSE SYSTEMS.

THE PLANNING FOR THE TRANS-ALASKA PIPELINE BEGAN SOON AFTER THE DISCOVERY OF THE PRUDHOE BAY FIELD AND CONTINUED UNTIL MID-1970 UNDER THE GENERAL DIRECTION OF A COMMITTEE OF THE CONCERNED COMPANIES' REPRESENTATIVES. EARLIER IN THAT

YEAR IT HAD BECOME APPARENT THAT CONTINUED COMMITTEE DIRECTION WOULD BECOME TOO CUMBERSOME TO BE PRACTICAL, SO ALYESKA PIPELINE SERVICE COMPANY WAS CREATED AS THE AGENT OF ALL THE COMPANIES WITH INTERESTS IN TAPS AND GIVEN BROAD AUTHORITY TO DESIGN, CONSTRUCT, OPERATE AND MAINTAIN TAPS AS A COMMON CARRIER, JOINT INTEREST PIPELINE. THE VIRTUES OF THIS ORGANIZATIONAL CHANGE HAVE CONTINUED TO MANIFEST THEMSELVES IN THE MONTHS SINCE THEN.

ALYESKA ITSELF HAS NO OWNERSHIP INTEREST IN EITHER THE PRUDHOE BAY FIELD OR IN TAPS; THE OWNER COMPANIES HAVE RETAINED UNDIVIDED INTERESTS IN TAPS IN THE PERCENTAGES MENTIONED A FEW MOMENTS AGO.

THE SCOPE OF THE PROBLEMS

A MULTIPLICITY OF PROBLEMS IS ASSOCIATED WITH THE DEVELOPMENT OF PRUDHOE BAY AND THE ESTABLISHMENT OF TAPS. ALTHOUGH YOU ARE FAMILIAR WITH MANY OF THEM, I BELIEVE THEY SHOULD BE CITED BECAUSE DOING SO WILL ASSURE YOU THAT WE ARE VERY AWARE OF THEM TOO.

FOR EXAMPLE, WE KNOW OF ALASKA'S DESIRE TO DEVELOP ITS LAND AND ITS MINERAL RESOURCES. WE KNOW OF THE UNEMPLOYMENT AND REAL POVERTY OF SOME OF ALASKA'S PEOPLE, AND OF THE EXTREME DIFFICULTIES MANY ALASKAN BUSINESSMEN HAVE FACED AS A RESULT OF THE DELAYS WHICH HAVE PLAGUED TAPS. WE KNOW OF AND SHARE YOUR DESIRE TO PROTECT THE WILDERNESS AREAS AND NATURAL BEAUTY OF THE STATE; AND WE KNOW OF YOUR DESIRES FOR ADDITIONAL STATE REVENUES TO SUPPORT GOVERNMENT SERVICES TO ALASKA'S

PEOPLE, ITS INDUSTRIES AND COMMERCE.

THE OIL COMPANIES ARE FACED WITH THE TREMENDOUS UNPRECEDENTED TASKS OF DEVELOPING THE PRUDHOE BAY FIELD, ENGINEERING AND CONSTRUCTING TAPS, PROVIDING A MARINE TERMINAL AT VALDEZ, SHIPS, AND TERMINALS, AND POSSIBLY OTHER TRANSPORTATION FACILITIES IN THE LOWER 48 STATES IN ORDER TO MOVE AND PROVIDE MARKETS FOR PRUDHOE OIL. ALL OF OUR WORK MUST BE SUBSTANTIALLY FREE OF ERROR, AND IT MUST BE DONE SIMULTANEOUSLY. THE CHALLENGES WE FACE ARE UNIQUE AND GIGANTIC, AND THE RISKS THAT WE MUST ASSUME ARE SIMILARLY GREAT AND ARE NOT MITIGATED BY THE EXISTING MAZE OF LITIGATION AND GOVERNMENT REGULATION WHICH MUST BE SATISFACTORILY RESOLVED. THE REGULATORY ATMOSPHERE IS EXTREMELY COMPLEX AND DIFFICULT FOR US BECAUSE THE DEPARTMENT OF THE INTERIOR, THE INTERESTATE COMMERCE COMMISSION, THE DEPARTMENT OF JUSTICE, AND MANY OTHER INTERESTED FEDERAL AND STATE AGENCIES HAVE ASSUMED OR WILL ASSUME CONTINUING SUPERVISORY INTERESTS, SOME OF THEM OVERLAPPING AND PERHAPS CONFLICTING. REGULATION, PER SE, IS NOT NEW TO US, BUT THE MAGNITUDE AND EXTENT OF THE REGULATION IS NEW AND AWESOME.

HOWEVER, OUR COUNTRY'S GROWING ENERGY REQUIREMENTS AND RELATED CONSIDERATIONS OF NATIONAL SECURITY UNDERSCORE THE URGENCY OF OUR FINDING TOGETHER THE SOLUTIONS FOR MOVING AHEAD WITH PRUDHOE BAY DEVELOPMENTS AND TAPS CONSTRUCTION.

FIVE KEY FACTORS

THE PROBLEMS THAT I HAVE CITED CAN BE TRANSLATED INTO FIVE KEY FACTORS WHICH MUST BE TAKEN INTO ACCOUNT IN THE

DEVELOPMENT OF PRUDHOE BAY AND THE CONSTRUCTION OF TAPS. I BELIEVE THAT EACH ONE IS PERTINENT TO THE MATTERS BEFORE THIS LEGISLATURE AND ALL MUST BE CAREFULLY WEIGHED IN STRIKING THE ULTIMATE BALANCE. THE FIVE FACTORS ARE THESE:

(1) THE IMMEDIATE PROBLEMS OF ALASKA AND HER PEOPLE.

(2) THE DESIRE OF OUR COMPANIES TO DEVELOP AND PRODUCE THEIR DISCOVERED OIL AND GAS RESERVES IN ALASKA AS SOON AS POSSIBLE AND WITH A REASONABLE REWARD FOR THE RISKS THEY ASSUME.

(3) THE ENERGY SHORTAGE FACING THE UNITED STATES.

(4) THE ENVIRONMENTAL AND ECOLOGICAL CONSIDERATIONS FROM THE WELLHEAD TO THE MARKETPLACE.

(5) THE LONGER RUN, OVERALL DEVELOPMENT OF ALASKA.

WE ARE CONSIDERING THESE FACTORS IN A SERIOUS MINDED WAY, AND DO NOT DOUBT THAT THIS LEGISLATURE AND THE ADMINISTRATION OF THE STATE ARE DOING SO TOO. I EXPECT THAT ALL OF US MAY FIND THAT THE BEST ANSWERS WILL NOT ALWAYS BE IMMEDIATELY APPARENT. I CAN ASSURE YOU, HOWEVER, THAT WE ARE WILLING TO WORK TO FIND THEM. WE MAY NOT ALWAYS AGREE BUT I HOPE THAT WE CAN FIND INTELLIGENT RESOLUTIONS OF OUR DIFFERENCES. THOSE OF US WHO ARE ASSOCIATED WITH THE OIL COMPANIES CANNOT AND SHOULD NOT PRESUME TO DIRECT THE AFFAIRS OF THE STATE, BUT

WE CAN AND WILL GIVE YOU CONTINUING AND, HOPEFULLY, CONSTRUCTIVE COMMENT ON THESE MATTERS OF MUTUAL INTEREST. NO OTHER APPROACH MAKES MUCH SENSE TO ME.

NOW, WITH YOUR PERMISSION, I WILL OUTLINE THE SUBSTANCE OF THE PRESENTATION WE WILL MAKE TODAY ON THE PROPOSED LEGISLATION BEFORE YOU. AFTERWARD I WILL SPEAK BRIEFLY ON TWO OR THREE MATTERS ABOUT WHICH YOU MAY BE CONCERNED. THEN I'D LIKE TO SUGGEST A GENERAL DIRECTION IN WHICH WE MIGHT MOVE.

THE PENDING LEGISLATION

WITH ME TODAY IS A GROUP OF MEN WHO ARE EXPERTLY QUALIFIED TO DISCUSS THE FACTUAL, FINANCIAL AND LEGAL ASPECTS OF THE LEGISLATION YOU ARE CONSIDERING. THEY ARE READY TO PROVIDE YOU WITH INFORMATION AND COMMENTS DESIGNED TO BE USEFUL TO YOU. AFTER TESTIFYING ON PRINCIPAL POINTS, EACH WITNESS WILL BE GLAD TO ANSWER QUESTIONS AND WILL GIVE YOU A MEMORANDUM ON HIS AREA OF EXPERT KNOWLEDGE WHICH MAY BE USEFUL TO YOU AS A REFERENCE DOCUMENT.

ON THE SUBJECTS OF PIPELINE REGULATION AND RIGHT-OF-WAY, OUR FIRST WITNESS WILL BE MR. W. J. WILLIAMSON, PROFESSOR OF LAW AT THE UNIVERSITY OF HOUSTON, WHO SERVED IN THE GENERAL COUNSEL'S OFFICE OF THE U. S. DEPARTMENT OF THE TREASURY BEFORE JOINING THE SHELL OIL COMPANY IN 1941. HE WAS AN ATTORNEY AND DIRECTOR OF SHELL PIPE LINE CORPORATION FOR 16 OF HIS 31 YEARS WITH THE SHELL COMPANIES. PROFESSOR WILLIAMSON WILL DESCRIBE HOW JOINT INTEREST, COMMON CARRIER

PIPELINES OPERATE AND HOW A SHIPPER WHO HAS NO OWNERSHIP INTEREST IN A PIPELINE ARRANGES FOR TRANSPORTATION OF HIS OIL.

I WISH TO MAKE ONLY ONE POINT RELATED TO THIS GENERAL AREA OF DISCUSSION, WHICH IS THAT THE TAPS COMPANIES INTEND TO SEE TO IT THAT IT WILL BE POSSIBLE FOR ANY PRODUCER AT PRUDHOE BAY, WHETHER AN OWNER IN TAPS OR NOT, TO ARRANGE FOR TRANSPORTATION OF HIS OIL THROUGH TAPS AT ONE LOCATION IN ALASKA.

OUR SECOND WITNESS WILL BE MR. HARRY R. JONES, PARTNER IN THE LAW FIRM OF ANDREWS, KURTH, CAMPBELL AND JONES OF HOUSTON, TEXAS, WHO HAS PRACTICED LAW FOR MANY YEARS IN THE FIELDS OF STATE AND INTERSTATE COMMERCE. MR. JONES WILL DISCUSS THE EXTENT OF FEDERAL JURISDICTION OVER INTERSTATE SHIPMENTS OF OIL THROUGH FACILITIES SUCH AS TAPS. AS YOU PROBABLY KNOW, THE FEDERAL PREEMPTION INCLUDES ALL INTERSTATE OIL TRANSPORTATION, AND THE IMPORTANT QUESTION IS NOT WHAT DIFFERENCES MAY EXIST IN THE JURISDICTION EXERCISED BY THE INTERSTATE COMMERCE COMMISSION OVER DIFFERENT TYPES OF CARRIERS, BUT WHAT REMAINS IN THE CASE OF OIL PIPELINES THAT MAY BE PROPERLY REGULATED BY A STATE OR LOCAL AUTHORITY. YOU WILL ALSO HEAR THAT THE EXTENT OF THIS FEDERAL JURISDICTION IS CONSISTENT AND TOTAL. WHETHER A CARRIER IS OWNED AND OPERATED BY AN INDUSTRIAL ORGANIZATION OR BY A STATE OR LOCAL GOVERNMENT. I AM AWARE OF THE CONCERN OF SOME ALASKANS THAT ICC REGULATION MAY NOT BE AS EFFECTIVE AS THEY THINK IT SHOULD

BE. I BELIEVE THAT THE ICC HAS SERVED THE PUBLIC INTEREST WELL OVER THE YEARS AND THAT IT IS PREPARED TO CONTINUE TO DO SO. PERHAPS THE ANSWERS TO THE STATE'S CONCERN ABOUT THE PUBLIC INTEREST LIE IN FINDING WAYS TO MAKE ALL NECESSARY INFORMATION AVAILABLE TO THE STATE FOR ITS TIMELY REVIEW AND IN ITS PARTICIPATION IN ANY ICC PROCEEDINGS THAT IT MAY THINK APPROPRIATE. I WOULD EXPECT THAT SUCH INFORMATION WOULD INCLUDE BOTH THE CAPITAL COSTS AND THE OPERATING COSTS OF TAPS. FRANKLY, WE DREAD ANY PROSPECT OF GETTING BOGGED DOWN IN A JURISDICTIONAL DISPUTE BETWEEN THE FEDERAL GOVERNMENT AND THE STATE WHICH WOULD FURTHER DELAY US ALL, AND HOPE TO FIND A WAY TO AVOID SUCH A COSTLY AND FRUSTRATING DIFFICULTY.

OUR THIRD WITNESS WILL BE MR. DONALD M. MARKHAM, ATTORNEY-AT-LAW IN WASHINGTON, D.C. MR. MARKHAM HAS BEEN ENGAGED IN GENERAL PRACTICE IN AVIATION, INTERSTATE COMMERCE, TRANSPORTATION AND CORPORATE LAW SINCE 1939. HE WAS AN ASSISTANT PROFESSOR OF LAW AT THE UNIVERSITY OF NORTH CAROLINA, AN ATTORNEY FOR THE U.S. TREASURY DEPARTMENT AND ASSISTANT GENERAL COUNSEL FOR THE AIR TRANSPORTATION ASSOCIATION OF AMERICA. MR. MARKHAM WILL COMMENT ON THE LEGAL REQUIREMENT OF JUST AND REASONABLE RATES AND DISCUSS THE HISTORICAL RECORD OF THE ICC IN THIS REGARD.

OUR FOURTH WITNESS IS GEORGE A. SEYMOUR OF DALLAS, TEXAS. MR. SEYMOUR IS MANAGER OF PART INTEREST PIPELINES FOR MOBIL PIPE LINE COMPANY, THE COMMON CARRIER PIPELINE AFFILIATE OF MOBIL OIL CORPORATION, AND HAS BEEN A DIRECTOR AND VICE PRESIDENT OF COOK INLET PIPE LINE COMPANY SINCE MARCH, 1970, WITH STAFF RESPONSIBILITY

FOR THE OPERATIONS OF THE COMPANY. A PROFESSIONAL ENGINEER, HE HAS BEEN ENGAGED IN PIPELINE ENGINEERING AND MANAGEMENT WITH MOBIL FOR 24 YEARS. HE WILL SPEAK TO YOU ABOUT THE FINANCIAL INFORMATION ON CAPITAL AND OPERATING COSTS THAT WILL BE AVAILABLE TO THE STATE ON TAPS.

OUR FIFTH WITNESS IS MR. EDWARD L. PATTON, THE PRESIDENT OF ALYESKA PIPE LINE SERVICE COMPANY, WHO HAS HAD 34 YEARS OF EXPERIENCE IN THE OIL INDUSTRY IN PIPELINE AND REFINERY MANAGEMENT AND CONSTRUCTION. HIS EXPERIENCE INCLUDES RESPONSIBILITY FOR BUILDING, STAFFING, STARTING UP AND OPERATING TWO COMPLETE MAJOR REFINING FACILITIES. MANY OF YOU KNOW HIM ALREADY. HE WILL SPEAK ON THE OPERATING ASPECTS OF THE PROPOSED PIPELINE REGULATION AND RIGHT-OF-WAY LEGISLATION. HE WILL ALSO GIVE YOU SOME INFORMATION ON INDUSTRY EXPERIENCE ON RIGHT-OF-WAY COSTS THAT WE HAVE BEEN ABLE TO COLLECT IN RECENT WEEKS.

OUR SIXTH WITNESS IS MR. JOSEPH R. CORTESE, A GENERAL PARTNER IN THE LAW FIRM OF SQUIRE, SANDERS AND DEMPSEY OF CLEVELAND, OHIO. MR. CORTESE IS A SPECIALIST IN THE AREA OF LAW CONCERNED WITH THE POWERS OF STATE AND LOCAL GOVERNMENTS AND IN TAX-EXEMPT FINANCING. OF THE 119 LAWYERS IN HIS FIRM, 20 DEVOTE FULL TIME TO THE PRACTICE OF LAW INVOLVING STATES, POLITICAL SUBDIVISIONS AND OTHER PUBLIC ENTITIES. SINCE 1903 THE FIRM HAS DRAFTED AND INTERPRETED MANY STATE STATUTES AND CONSTITUTIONAL PROVISIONS, CONDUCTED LITIGATION ON VALIDITY AND RENDERED APPROVING OPINIONS ON STATE AND LOCAL BOND ISSUES ALONG WITH THEIR TAX STATUS.

MR. CORTESE WILL DISCUSS SOME OF THE LEGAL PROBLEMS IN THE LEGISLATION BEFORE YOU THAT GIVE US REAL CONCERN. FOR EXAMPLE, WHEN THE COST OF RIGHT-OF-WAY FAR EXCEEDS ANY FAIR MARKET VALUE FOR THE LAND, IT PROBABLY BECOMES A TAX AND A BURDEN ON INTERSTATE COMMERCE OF DOUBTFUL VALIDITY. HISTORICALLY, RIGHT-OF-WAY ACQUISITION HAS NOT BEEN A REVENUE PRODUCING DEVICE. IN ADDITION, THE PROPOSED LEGISLATION WOULD SEEM TO SEEK JURISDICTION OVER INTERSTATE CARRIERS INDIRECTLY THAT CANNOT BE EXERCISED DIRECTLY. HERE, WITH RESPECT TO THIS ISSUE, I AGAIN WANT TO EVIDENCE MY CONCERN OVER THE POTENTIAL DELAY THAT A JURISDICTIONAL DONNYBROOK CAN CREATE.

SEVENTH, MR. RAYMOND B. GARY OF NEW YORK CITY WILL DISCUSS THE FINANCIAL IMPACT OF THE RIGHT-OF-WAY LEGISLATION ON TAPS.

MR. GARY IS A GENERAL PARTNER OF MORGAN STANLEY AND CO. AND A MANAGING DIRECTOR OF MORGAN STANLEY AND COMPANY, INC. HE HAS BEEN WITH HIS INVESTMENT BANKING FIRM SINCE 1935. MORGAN STANLEY IS ENGAGED IN ALL PHASES OF UNDERWRITING AND DISTRIBUTION OF SECURITIES OF INDUSTRIAL CORPORATIONS, PUBLIC UTILITIES, TRANSPORTATION COMPANIES INCLUDING AIRLINES, RAILROADS AND PIPELINES, AND FOREIGN CORPORATIONS AND GOVERNMENTS.

YOU WILL FIND THAT HIS REMARKS DESERVE SOME CAREFUL CONSIDERATION.

ON THE SUBJECT OF STATE OWNERSHIP OF TAPS, WE HAVE FIVE WITNESSES WHO WILL SUMMARIZE THE EXTENSIVE STUDY WE HAVE CONDUCTED OVER THE LAST FEW MONTHS ON THE GOVERNOR'S PROPOSAL AND ON THE DRAFT LEGISLATION AFTER IT WAS INTRODUCED.

THE FIRST IS MR. GARY WHO WILL CONTINUE HIS TESTIMONY WITH A REVIEW OF THE FINANCIAL ASPECTS OF THE MATTER. FROM THE VERY OUTSET, OUR REVIEW OF THE GENERAL PROPOSAL CONFIRMED AGAIN AND AGAIN THAT THE FINANCIAL BACKING OF THE COMPANIES IN TAPS WILL BE REQUIRED TO BUILD THE LINE. I REALIZE THAT NO ONE LIKES TO BE TOLD "NO" ON WHAT TO HIM SEEMS A GOOD IDEA, BUT I HOPE YOU WILL APPRECIATE THE UNTENABLE POSITION WE EXPERIENCED WHEN WE WERE ASKED TO ASSUME A VERY LARGE RISK AND TO MAKE A MAJOR COMMITMENT OF OUR CREDIT, WITHOUT A PROSPECT OF A REASONABLE REWARD FOR THE RISK TO BE ASSUMED.

ANOTHER PART OF THIS STUDY CONCERNED THE RELATIVE PROFITABILITY OF PIPELINES AND WAS PARTICULARLY CONCERNED WITH THE VERY REAL PROBLEMS OF ADEQUATE CASH FLOW AND PROFITS DURING THE EARLY YEARS OF OPERATION. I BELIEVE THAT THIS IS INFORMATION THAT THE LEGISLATURE MAY WISH TO HAVE AND I HAVE ASKED MR. GEORGE A. SEYMOUR TO SPEAK ABOUT THIS.

OTHER QUESTIONS PERTAIN TO THE POSSIBLE TAX BENEFITS TO THE STATE AND TO THE COMPANIES NOT IN TAPS. A LOT OF HARD WORK INDICATES THAT THE TAX BENEFITS EITHER COULD NOT BE OBTAINED OR WERE REMOTE AT BEST. MR. THOMAS A. COATS AND, A SPECIALIST IN TAXATION AND A MEMBER OF THE TAX DEPARTMENT OF THE ATLANTIC RICHFIELD COMPANY, WHO FLEW HERE FROM NEW YORK CITY TO LOS ANGELES, WILL REVIEW THESE FIGURES FOR YOU.

ONE VERY PRACTICAL PROBLEM CONCERNS THE STATE'S CAPABILITY TO MANAGE SUCH A COMPLEX OPERATION AS TAPS AND THE QUESTION AS TO HOW THE PRESENT TECHNICAL TEAM THAT WE HAVE ASSEMBLED COULD BE HELD TOGETHER UNDER SOME SORT OF CONTRACT WITH THE STATE. ON THE LATTER POINT, MR. PATTON HAS PUBLICLY EXPRESSED HIS DOUBTS AND WILL GIVE YOU HIS PERSONAL COMMENTS HERE.

THEN, THERE APPEAR TO BE SOME LEGAL PROBLEMS ASSOCIATED WITH THE PROPOSAL FOR STATE OWNERSHIP THAT MR. CORTESE WILL DISCUSS.

FINALLY, MR. RICHARD H. DONALDSON, VICE PRESIDENT AND GENERAL COUNSEL OF SOHIO WILL PRESENT SOME CONCLUDING REMARKS.

THREE GENERAL SUBJECTS OF INTEREST

BEFORE I TURN TO MY SUGGESTION AS TO THE DIRECTION THE STATE AND THE TAPS COMPANIES MIGHT TAKE, I WOULD LIKE TO COMMENT ON THREE SUBJECTS THAT I UNDERSTAND ARE OF CURRENT GENERAL INTEREST HERE.

THE FIRST IS A QUESTION: "WHAT WILL THE COMPANIES IN TAPS REALLY HAVE INVESTED IN THE LINE?" OR, MORE DIRECTLY, "ISN'T THEIR INVESTMENT LIMITED TO THE EQUITY AND SHOULDN'T THEIR RETURN BE BASED ON THAT?" IF AN EQUITY REPRESENTED THE ENTIRE RISK THAT A PIPELINE OWNER HAD IN A PROJECT, THE MATHEMATICS ON THE INVESTMENT RETURN WOULD RUN PRETTY HIGH. BUT PLEASE, MAKE NO MISTAKE, OUR RESPONSIBILITY IN TAPS IS THE ENTIRE FINANCIAL RESPONSIBILITY TO SERVICE ALL THE DEBT AS WELL AS TO PROVIDE THE EQUITY. OUR CREDIT MUST SUPPORT THE ENTIRE LIABILITY FOR THE PROJECT. THIS IS TYPICAL OF PIPELINE FINANCING AND THE REASON WHY THE ICC, THE JUSTICE DEPARTMENT, AND THE U.S. SUPREME COURT HAVE RECOGNIZED FOR MANY YEARS THAT A FAIR AND REASONABLE RETURN SHOULD BE BASED ON THE ENTIRE VALUATION OF THE LINE. OUR FINANCIAL EXPERT MR. GARY WILL COMMENT MORE SPECIFICALLY ON THIS POINT IN ORDER THAT

THIS MATTER MAY BE FULLY UNDERSTOOD.

THE SECOND SUBJECT IS ALSO A QUESTION: "WHY DO THE TAPS COMPANIES OBJECT TO A RIGHT-OF-WAY PERMIT FROM THE STATE THAT RUNS 5 OR 10 YEARS, SINCE AT PRESENT THE PERMIT THAT THEY EXPECT TO OBTAIN FROM THE FEDERAL GOVERNMENT WILL BE REVOCABLE AT ANY TIME IF THAT GOVERNMENT FINDS THE PIPELINE DOES NOT CONFORM IN SOME WAY TO ALL THE REQUIREMENTS THAT IT DECREES MUST BE MET?"

I DO NOT WANT TO SHRUG OFF SUCH A QUESTION, WHICH IS A VERY FAIR ONE. I AM CONCERNED ABOUT THE PROVISIONS OF FEDERAL LAW THAT ENABLE THE FEDERAL GOVERNMENT TO SHUT DOWN THE PIPELINE IF ITS REPRESENTATIVES BELIEVE THAT SOME TECHNICAL OR ENGINEERING REQUIREMENT IS NOT FULLY SATISFIED. AT THE SAME TIME I BELIEVE THAT THE FEDERAL GOVERNMENT WILL WORK HARD AND CONTINUOUSLY TO AVOID ANY SUCH SHUTDOWN.

OUR OBJECTION TO A LIMITED TERM PERMIT FROM THE STATE STEMS FROM THE REVELATION OF THE SUBSTANTIAL CHANGE IN PERMIT PHILOSOPHY THAT THE PROPOSED RIGHT-OF-WAY LEGISLATION IMPLIES. HISTORICALLY, PIPELINE COMPANIES HAVE SECURED PERMANENT RIGHTS-OF-WAY FOR RELATIVELY LOW COSTS. THIS WAS IN THE INTEREST OF THE STATES AND TERRITORIES GRANTING THE RIGHTS-OF-WAY BECAUSE IT HELPED STIMULATE THE ECONOMIC DEVELOPMENT OF NEW AREAS. THERE IS SOME PARALLEL IN ALASKA'S SITUATION TODAY. IT WAS ALSO IN THE INTEREST OF THE PIPELINE COMPANIES BECAUSE THIS COST WAS THEN DEFINED AND THE RISK MEASURABLE. THE PROPOSED RIGHT-OF-WAY LEGISLATION HOLDS OUT THE PROSPECT OF CONTINUING NEGOTIATIONS FOR VERY SUBSTANTIAL RIGHT-OF-WAY REVENUES OVER MANY YEARS, LONG AFTER THE PIPELINE IS IN PLACE, AND ADDS SUBSTANTIALLY TO THE

UNKNOWN RISKS IN THE PROJECT.

CONSEQUENTLY, THE PROSPECT OF IMMEDIATE HIGH COST RIGHT-OF-WAY PLUS THAT OF EVEN HIGHER COSTS BEING IMPOSED LATER, AFTER ALL INVESTMENTS HAVE BEEN MADE, MAKES A PROSPECTIVE INVESTOR OR LENDER VERY WARY. THIS MEANS HE WILL VIEW THE PROJECT AS AN EXTREMELY HIGH RISK ONE; THAT HE MAY NOT BE WILLING TO ACCEPT SUCH A RISK, OR, AT BEST, HE WILL IMPOSE A HIGHER INTEREST REQUIREMENT AND OTHER RESTRICTIONS AS HE MAY DEEM NECESSARY FOR HIS PROTECTION.

WHILE WE ARE AWARE OF ALASKA'S NEEDS FOR REVENUES, WE FIND THE LIMITED TERM, HIGH COST RIGHT-OF-WAY PERMIT OR LEASE A MOST DIFFICULT DEVICE TO ACCEPT.

THE THIRD SUBJECT CONCERNS ANTITRUST. FOR A GOOD MANY YEARS, THE DEPARTMENT OF JUSTICE HAS ROUTINELY INVESTIGATED ANY MAJOR PROJECT AFFECTING INTERSTATE COMMERCE AND PARTICULARLY INVOLVING COMPANIES OF SUBSTANTIAL SIZE. OUR INDUSTRY IS SELDOM OVERLOOKED AND THE DEPARTMENT OF JUSTICE HAS MADE AND IS MAKING A THOROUGH INQUIRY INTO TAPS, AS IT SHOULD. OUR COMPANY HAS RESPONDED AND IS CONTINUING TO RESPOND TO THE DEPARTMENT'S INQUIRY. I WOULD BE SURPRISED IF ALL THE OTHER COMPANIES IN THE PROJECT ARE NOT DOING LIKEWISE. I CAN SPEAK ONLY FOR MY COMPANY, HOWEVER ON THIS PARTICULAR SUBJECT. TYPICAL OF ANY SUCH ANTITRUST INQUIRY ARE THE QUESTIONS: "WHY IS YOUR COMPANY PARTICIPATING?" AND, IN THE PRESENT SITUATION, "WHY DO YOU PLAN TO SHIP YOUR OIL TO WEST COAST MARKETS?" I WILL ANSWER THESE QUESTIONS HERE, AS I HAVE ALREADY ANSWERED THE DEPARTMENT OF JUSTICE. STANDARD OIL OF OHIO IS INTERESTED IN PRUDHOE BAY AND TAPS BECAUSE IT WANTS OIL FOR ITS REFINERIES

AND WANTS TO REALIZE A REASONABLE RETURN ON ITS INVESTMENT FROM MARKETING ITS OIL. OUR COMPANY HAS ALWAYS HAD TO PURCHASE MORE OIL FOR ITS OWN NEEDS THAN IT WAS ABLE TO FIND AND PRODUCE. WITH AN EXPECTATION OF A GROWING ENERGY SHORTAGE IN THE UNITED STATES, WE SEIZED THE OPPORTUNITY TO COVER OUR FUTURE REQUIREMENTS BY OBTAINING A SIGNIFICANT INTEREST IN PRUDHOE. WE MAY OR MAY NOT REFINE ALASKAN OIL IN OUR MIDWEST, GULF COAST OR EASTERN REFINERIES, BUT WE DO EXPECT TO BE ABLE TO NEGOTIATE REASONABLE EXCHANGES BASED ON OUR ALASKAN PRODUCTION. THE WEST COAST STATES APPEAR TO US TO BE THE LARGEST, NEAREST MARKET WHERE SUBSTANTIALLY ALL OF OUR ALASKAN OIL CAN BE SOLD AT THE HIGHEST PRICE. THERE IS NO ANTITRUST MYSTERY TO OUR INTEREST, OR ALASKA'S, IN THIS MARKET. IT'S A MATTER OF ECONOMICS.

A SUGGESTION OF DIRECTION

IT IS UNDERSTANDABLE TO ME THAT THERE CAN BE A REAL AND CONTINUING TEMPTATION TO SOLVE ALL THE STATE'S FINANCIAL PROBLEMS WITH ONE OR MORE REVENUE MEASURES DIRECTED AT PRUDHOE BAY AND/OR TAPS. THE BUSINESS AND INDUSTRIAL COMMUNITY IN ALL OF THE LOWER FORTY-EIGHT STATES AS WELL AS ALASKA IS WATCHING TO SEE HOW ALASKA WILL ACT. I THINK IT'S FAIR TO SAY THAT INDUSTRY GENERALLY EXPECTS TO PAY FOR THE PRIVILEGE OF DOING BUSINESS HERE, AND THAT, IN THE CASE OF THE OIL INDUSTRY, IT EXPECTS TO CONTRIBUTE A REASONABLY SUBSTANTIAL PART OF ALASKA'S REVENUES.

THE MEMBERS OF THE OIL INDUSTRY ARE WILLING TO PAY THEIR FAIR SHARE, BUT IF THEY ARE REQUIRED TO PAY AN UNDULY LARGE AND BURDENSOME SHARE, TO TAKE HUGE RISKS WITH LITTLE PROSPECT

OF ADEQUATE REWARD FOR DOING SO, THEN ALASKA'S FUTURE DEVELOPMENT MAY BE SLOWED AND PARTICIPATION IN IT MAY BE LIMITED TO A FEW VERY LARGE COMPANIES THAT CAN ACCEPT THE HIGHER RISKS THAT STEM FROM HIGH TAX BURDENS.

CONSIDER, FOR EXAMPLE, THE PROBLEM AS VIEWED BY THE PROSPECTIVE EXPLORER FOR OIL AND GAS. HE IS ALREADY STALLED IN ALASKA, SPENDING VERY LITTLE IF ANY MONEY FOR DRILLING EVEN ON THE EXPENSIVE LEASES ACQUIRED IN THE 1969 SALE BECAUSE HE CAN MAKE NO RELIABLE ESTIMATE AS TO WHEN HE CAN GET ANY OIL THAT HE MAY FIND TO MARKET, OR AS TO THE COST OF DOING SO. THOSE WHO HAVE THE OPPORTUNITY OR THE COMPULSION TO MAKE A CHOICE BETWEEN ALASKA AND CANADA, WHERE A GREAT DEAL OF EXPLORATION IS GOING ON, WILL SURELY DECIDE IN FAVOR OF CANADA, ASSUMING EXPLORATION PROSPECTS THERE ARE COMPARABLE TO THOSE IN ALASKA, IF ALASKA, BY LEGISLATIVE ACTION MAKES THE COST-RISK PROSPECT HERE TOO HIGH BY COMPARISON, OR BY INACTION ARISING FROM AN INABILITY TO PUT SOME OF THE MATTERS THAT ARE CURRENTLY FACING IT TO REST, CAUSES THE COST-RISK PROSPECT TO CONTINUE TO BE UNDEFINED.

ON THE OTHER HAND, IF A BROADER BASE FOR DEVELOPMENT IS SOUGHT AND IS TO BE OBTAINED; IF THE STATE MUST HAVE MORE REVENUE DURING THE NEXT FOUR YEARS, BEFORE THE OIL FIELDS AND THE PIPELINE CAN GENERATE ANY INCOME, THE BURDEN OF MEETING ALASKA'S REVENUE NEEDS SHOULD BE SPREAD AS EQUITABLY AS POSSIBLE OVER ALL INCOME PRODUCERS AND PROPERTY OWNERS. THIS IS MY SUGGESTION. IT IS NOT NOVEL. IT HAS WORKED IN THE PAST. AND

WHAT MAY MAKE IT MORE APPEALING TO ALASKA IS THAT IT CAN REVIEW AND RECONSIDER ITS JUDGMENT YEAR BY YEAR, AND, IF THE DEVELOPMENT DESIRED DOESN'T COME, IT CAN EITHER TAKE STEPS TO STIMULATE IT FURTHER OR DRAW ON THE VARIETY OF TAXING APPROACHES AVAILABLE TO IT. AT THIS POINT IN TIME, NO ONE KNOWS WHAT THE PIPELINE WILL COST. WE ONLY HAVE ESTIMATES. WE DON'T KNOW TODAY WHAT THE VALUE OF OIL IN THE MARKETPLACE WILL BE IN 1974 OR 1975 OR 1976. WE WILL KNOW MORE WHEN CONTRACTORS BIDS ARE OBTAINED AND CONTRACTS ARE LET. EVERYONE WILL ALSO HAVE A MUCH BETTER BASIS FOR DETERMINING FINANCING REQUIREMENTS AND COSTS, PIPELINE REVENUE REQUIREMENTS AND TAX BASES THAN THEY DO NOW. YOU WILL HAVE A BETTER FEEL OF OIL VALUES FOR 1976 A YEAR FROM NOW THAN YOU DO TODAY. SUCH INFORMATION SURELY WILL ENABLE THE LEGISLATURE, IN TIMELY FASHION, TO DEVELOP BETTER TAX LEGISLATION THAN IS POSSIBLE NOW, WITH LESS DISCOURAGEMENT TO BUSINESS PEOPLE WHO WANT TO HAVE A SHARE IN MAKING ALASKA'S FUTURE AS BRIGHT AS POSSIBLE.

HOWEVER, IF ANY PROGRESS IS TO BE MADE MEANWHILE, FINANCING MUST BE ACCOMPLISHED. SOME OF US HAVE ALREADY HAD TO DELAY PLANNED FINANCING BECAUSE THE THREE QUESTIONS OF STATE OWNERSHIP, THE STATE'S POWER TO FIX RATES AND THE STATE'S CONSIDERATION OF LIMITED TERM, HIGH COST RIGHT-OF-WAY LEASE PERMITS EXIST. IF WE ARE TO BE ABLE TO PROCEED WITH AND SUCCEED IN OUR EFFORTS TO ARRANGE FINANCING THESE ISSUES CAN NOT BE ALLOWED TO REMAIN AS A CLOUD HANGING OVER THE FINANCIABILITY OF THE ENTIRE PROJECT. THEY OUGHT TO BE ELIMINATED FROM FURTHER CONSIDERATION AS SOON AS POSSIBLE.

ONE PROBLEM IN THE SHORTER RUN SHOULD BE ACKNOWLEDGED. ALASKA LIKE OURSELVES WAS ANTICIPATING SUBSTANTIAL OIL REVENUES FROM THE NORTH SLOPE IN 1972. WE ARE BOTH BITTERLY DISAPPOINTED. IT MAY BE THAT ALASKA'S OTHER REVENUES WILL NOT BE SUFFICIENT TO COVER THE MINIMUM STATE SERVICES REQUIRED BEFORE THIS OIL ACTUALLY BEGINS TO FLOW. ONE ALTERNATIVE TO KEEP IN MIND IS THE POSSIBLE ASSISTANCE THAT ONE OR MORE COMPANIES IN TAPS CAN PROVIDE THE STATE BY ARRANGING AN ADVANCE SALE OR SALES OF CRUDE OIL FOR THE STATE OUT OF ITS ROYALTY INTEREST WHEN AND IF IT NEEDS IT FOR A FEW YEARS FROM NOW. SUCH TRANSACTIONS WOULD OBTAIN FOR THE STATE SOME OF THE OIL REVENUES IT EXPECTED IN 1972 AND THE FOLLOWING YEARS, DISCOUNTED ONLY BY THE COST OF MONEY REPRESENTED BY THE ADVANCE SALE. SUCH SOLUTIONS TO MONEY NEEDS OF THE PRESENT OR NEAR TERM FUTURE ALLOW TIME AND FLEXIBILITY TO THE STATE IN SOLVING ITS LONGER RANGE PROBLEMS AND DO NOT HAMPER THE DEVELOPMENT OF PRUDHOE BAY AND TAPS.

IN CLOSING MY REMARKS I WANT TO REPEAT WHAT I SAID IN THE BEGINNING: OUR PRIMARY DESIRE, I AM SURE, PARALLELS YOUR OWN AND THAT OF THE GOVERNOR--IT IS TO BUILD THE LINE EXPEDITIOUSLY AND WELL IN ORDER TO BE ABLE TO BEGIN AND SUSTAIN PRUDHOE BAY PRODUCTION AT AN OPTIMUM RATE FOR THE MUTUAL BENEFIT OF ALASKA, ITS PEOPLE, THE NATION, AND THE PRODUCERS.

I FEEL SUBSTANTIALLY ENCOURAGED IN THIS BELIEF BY THE KNOWLEDGE THAT ONLY LAST MONTH CHAIRMAN RETTIG OF THE SENATE COMMERCE COMMITTEE EXPRESSED HIS OWN PHILOSOPHY IN THE INVITATION

THAT HE EXTENDED TO THE MEMBERS OF THE OIL INDUSTRY TO APPEAR BEFORE YOU. HE SAID:

> "IN THE SPIRIT OF COMMON INTERESTS, WE IN THE SENATE COMMERCE COMMITTEE ARE ESPECIALLY ANXIOUS TO LEARN HOW THE LEGISLATURE AND THE STATE CAN BE OF HELP IN YOUR COMPANY'S EFFORTS TO DEVELOP THE RESOURCES OF ALASKA. ACCORDINGLY, YOU ARE ESPECIALLY INVITED TO OFFER SUGGESTIONS AND ADVICE CONCERNING OUR PRIME INTEREST: 'HOW CAN ALASKA HELP?'. IT IS HOPED THAT THIS FEATURE OF THE HEARINGS WILL PRODUCE SUFFICIENT IMPACT TO OFFSET OR OVERSHADOW THE RESTRICTIVE CHARACTER OF SOME OF THE PROPOSED LEGISLATION. MORE AND MORE OF US ARE BECOMING KEENLY AWARE THAT THIS STATE MUST BE AND REMAIN AN ATTRACTIVE AREA FOR BUSINESS AND INVESTMENT."

I APPRECIATE THIS OPPORTUNITY TO APPEAR BEFORE YOU AND WILL BE GLAD TO ANSWER ANY QUESTIONS YOU HAVE, IF I CAN. THANK YOU.

STATEMENT OF DONALD W. MARKHAM

My name is Donald W. Markham. I am a practicing attorney in Washington, D.C. Since graduating from law school, I have held legal positions with two government agencies and a trade association; I taught law for a brief period; and I have practiced law for a number of years, first with a law firm specializing in transportation matters and, since 1966, by myself. Virtually all of my professional activities for the past 30-odd years have been concentrated in the field of transportation law, and they have enabled me to devote considerable study to, and to acquire some familiarity with, the regulation of oil pipelines, as well as airlines, railroads, motor carriers and freight forwarders. (Let me interject, however, that although I am "from Washington", I do not claim to be an expert; in fact, I deny it, if anyone is thinking of the old Air Force definition of an expert.)

I understand that some of the people who have been studying the proposed Trans Alaska Pipeline have expressed concern as to whether, if the pipeline is privately owned and operated, the owners could be expected - or required under existing law - to maintain rates at a reasonable level. Questions have also been raised, I am told, as to whether shippers, who were not part-owners of the pipeline, would be served on a nondiscriminatory basis, and, more generally, whether the existing regulatory system, under which the pipeline would operate, is adequate and effective. I have been asked to comment on those questions,

with particular attention to the area of rate regulation.

As a premise for my discussion, I start with the proposition that Mr. Jones has developed at length: that, for the indefinite future, most, if not all, of the oil moving through the pipeline will be moving in interstate or foreign commerce, and that, as a result, the pipeline will be, both as a matter of law and by stipulation filed by the owners with the Department of the Interior, a common carrier within the meaning of the Interstate Commerce Act and subject to regulation by the Interstate Commerce Commission. (And I might add, parenthetically, that its status as a common carrier subject to regulation by the Interstate Commerce Commission would, I believe, be the same even if it were owned and operated by the State.) Our first inquiry, therefore, should be into the adequacy of the regulatory system under the Interstate Commerce Act.

The Interstate Commerce Commission has had long experience, and has developed great expertise, in dealing with rate and discrimination problems. It was created in 1887, and in an opinion handed down by the Supreme Court five years later,* Mr. Justice Brown listed the "principal objects" of the act creating it as follows:

> " * * * to secure just and reasonable charges for transportation; to prohibit unjust discriminations in the rendition of like services under similar circumstances and conditions; to prevent undue or unreasonable preferences to persons, corporations, or localities; to

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* Interstate Commerce Commission v. Baltimore & O. R. Co., 145 U.S. 263 (1892).

> inhibit greater compensation for a shorter than for a longer distance over the same line; and to abolish combinations for the pooling of freights."

You will note that four of those five objectives relate directly to the maintenance of reasonable and nondiscriminatory rates and the elimination of other forms of discrimination. And Professor Sharfman, in his classic study of the Interstate Commerce Commission, noted that rate regulation "has constituted from the outset the Commission's central task and most prolific activity."*

Not only has the Commission devoted a large share of its time, over a period of more than 80 years, to an intensive study of transportation rates; it has been provided with a steadily growing arsenal of regulatory weapons which give it virtually complete control over the rates of regulated carriers. Professor Sharfman commented that

> "The mandatory power over transportation charges expressly conferred by * * * [the Hepburn Act of 1906 - the same act, incidentally, which brought pipelines under the Interstate Commerce Act] was sufficient, in itself, * * * to elevate * * * [the Commission] to a position of practical authority enjoyed by few governmental agencies."**

But he went on to note that

> "Subsequent grants of power, especially through the Transportation Act of 1920, extended its regulatory jurisdiction in striking fashion and rendered its dominating status secure."***

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* IIIB Sharfman, The Interstate Commerce Commission 3 (1931).

** Ibid.

*** Ibid.

That was written in 1931, and there have been still further additions to the Commission's array of powers since that time.

To be sure that we appreciate the full significance of Professor Sharfman's conclusion, let me take a minute to review some of the specific controls to which a carrier's rates are subject under the Interstate Commerce Act.

Before a carrier can put a rate into effect, it must file it with the Commission, and publish it, at least 30 days in advance, unless the Commission gives special permission to file it on shorter notice. The rate must be just and reasonable and must not be unjustly discriminatory or unduly preferential or prejudicial to any person, locality, etc. Moreover, the rules and regulations governing the application of the rate must also be filed and published in the carrier's tariffs.

If anyone - including a state - thinks that the rate is unlawful in any respect, he may file a protest with the Commission, and if the Commission, either on the basis of a protest or on its own initiative, decides that there is a serious question as to the lawfulness of the rate, it may suspend the rate, before it takes effect, for a period of not more than seven months, while it conducts a formal investigation into the lawfulness of the rate. It may also decline to suspend, but still go forward with a formal investigation. And, if the Commission decides, neither to suspend nor to start an investigation, anyone - again including a state - may file a formal complaint and force the Commission to hold a full hearing on the issues raised by the complaint.

At the conclusion of a formal proceeding concerning the lawfulness of a rate, the Commission may, if it finds the rate unlawful, prescribe a minimum or a maximum rate for the future, or both; or it may prescribe the exact rate which the carrier must charge. It may also, in an appropriate proceeding, award damages to a shipper who has been charged an unreasonably high or an unlawfully discriminatory rate. And if a shipper or other party is dissatisfied with the Commission's final decision in any formal investigation, it can appeal the decision to the appropriate court for judicial review.

Not only does the Commission have this wide selection of powers directly over the carrier's rates; it has a large assortment of ancillary powers which enable it to keep itself and the public informed and to maintain surveillance over a carrier's affairs and financial practices. It may inspect a carrier's property and records, audit its books, require the carrier to submit regular and special reports and supply information in response to specific inquiries. It may - and does - prescribe a uniform system of accounts which the carrier must observe and prescribe the rates of depreciation which the carrier may charge. And it not only may, but is required to, make periodic valuations of the carrier's entire property and to give interested parties, including the states in which the property is located, an opportunity to be heard if they object to the Commission's determination.

Finally, there are both civil remedies and criminal penalties which are available for use in enforcing the Commission's orders and the carrier's obligations under the act.

It is apparent, therefore, that Professor Sharfman did not exaggerate when he referred to the Commission's "mandatory power" and its "dominating status" with respect to carrier rates. Indeed, it would be hard to conceive of broader regulatory powers than the Commission already has - unless one thinks in terms of direct governmental rate-fixing - and one could hardly hope to find an agency with more experience in regulating transportation rates than the Commission has acquired in the past 84 years.

There is another consideration, however, which should help to allay any lingering concern as to the Commission's ability to deal with any rate problem that might arise in the operation of Trans Alaska Pipeline. That factor is the relative simplicity of regulating the rates through a line that handles only one kind of traffic, from a single origin to a single destination, and - at least for the foreseeable future - with no competiton from other forms of transportation. There would be none of the baffling complications with which the Commission is frequently faced in rate cases, involving, for example, questions as to the proper relationships between rates on different types of traffic, or between competitive producing areas or markets, or between competitive carriers of different types with different costs of operation, etc. If the Trans Alaska line were treated as a unit, as I think it should be (even though there may be

several owner-carriers providing service through it), the problem would not involve the regulation of a complex "rate structure" (where the Commission would be concerned with the relationships among the various rates making up the structure); instead, the problem would involve merely the regulation of the "rate level", or the level of the earnings produced by the rates in the aggregate. This would be a far less complicated and less difficult problem than the Commission is used to dealing with - but it is still not so simple that it can be answered automatically. Professor Sharfman describes the nature of the problem in the following words:

> "A twofold purpose, each phase of which has played an important part in the definition of the Commission's powers and in the administration of its policies, is served by the regulation of the rate level. Negatively, the task is one of preventing the carriers from exacting excessive charges, and thus, indirectly, of restricting the earnings which the * * * [carriers] may realize at the expense of the users of the transportation service; positively, the task is one of initiating or approving such charges as will not only satisfy the constitutional guarantees against confiscatory adjustments, but will tend, through the resulting operating income, to preserve * * * [carrier] credit and attract necessary capital, in the interest of maintaining an adequate transportation system. Both of these ends appear to be indispensable and are definitely held in view * * *."*

Obviously, the solution to such a problem calls for wisdom, experience and complete fairness - and the Commission has a record of all three.

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* Id., at pages 6-7.

It is true that out of the thousands of rate cases which have been before the Commission during its 84-year history, only a few - perhaps 20 or 30 - have involved pipeline rates. To anyone not familiar with the history of pipeline regulation, that fact is sufficiently startling to call for some explanation. I believe that the explanation is basically twofold:

First: Once the extent of the Commission's jurisdiction over the pipelines had been clarified in some early litigation, the pipelines, in recognition of their status as common carriers and of the Commission's powers over them, adopted rates and other policies which, with only occasional exceptions, were accepted as reasonable by their shippers, their competitors and the Commission. As a result, very few complaints were filed with the Commission and the Commission rarely found it necessary to initiate formal proceedings on its own motion.

Second: Since December, 1941, many of the pipelines, and their owners, have been subject to a consent decree which was entered in an action brought by the Department of Justice. The decree, in effect, limits the dividends which can be paid by most pipelines to seven percent of the pipeline's valuation as determined by the Interstate Commerce Commission. If a carrier should have earnings above that level, they are to be "frozen" in a special reserve and can be used only for limited purposes and under severe restrictions. Compliance with the decree is monitored by the Department of Justice, both through annual reports which the carriers are required to file, and

through audits by the FBI. As was probably intended, the practical effect of the decree has been to hold the earnings of the pipelines at a level below seven percent of the value of their property, as determined by the Interstate Commerce Commission; and this earnings record, in turn, helps to account for the small number of pipeline rate cases which have come before the Commission during the last 30 years.

As we have seen, then, there have been at least three forces at work over the years - in addition to the ever-present stimulus of competition - which have affected the level of pipeline rates: (1) the comprehensive regulatory powers of the Interstate Commerce Commission; (2) the consent decree; and (3) the adoption of restrained and responsible rate policies by the pipelines themselves. And I think that a quick look at a few pertinent facts will demonstrate that these forces have combined to produce effective control over pipeline rates.

It is common knowledge that the pipelines have been, for many years, the principal means of overland transportation for crude oil and petroleum products - and that status could not, of course, have been achieved unless pipeline rates were substantially lower than those of other forms of transportation. But many people are not aware of the extent to which the pipelines have succeeded in developing their traffic and reducing their rates. According to figures published by the Transportation Association of America,* the pipelines, in 1969, carried

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* Transport Facts and Trends, April, 1971.

21.6 percent (measured in ton miles) of all intercity freight of all kinds, moving by all modes of transportation in both for-hire and private carriage - the second largest share handled by any form of transportation. However, for handling more than 21.5 percent of the volume, the pipelines received only 1.5 percent of the amount spent for the movement of the total volume. Pipeline revenues during that year averaged only .266¢ per ton mile, as compared with 1.35¢ for railroads, 7.21¢ for trucks and 21.09¢ for air.

It is significant, also, that contrary to the trend in other forms of transportation and in business generally, pipeline rates have continued to decrease during recent years. According to official figures published by the Interstate Commerce Commission,* the average revenue yield per thousand-barrel miles decreased from 65¢ in 1955, to 60¢ in 1960, to 52¢ in 1965, and to 48¢ in 1969.

One final statistic may be of particular interest. Shortly prior to the entry of the consent decree, the Interstate Commerce Commission had decided that a return of eight percent on valuation was the maximum which could be regarded as reasonable for crude-oil pipelines under the circumstances existing at that time.** I am informed that, as compared with the eight

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* Transportation Statistics in the United States for the Year Ended December 31, 1969, Part 6 Oil Pipe Lines, Bureau of Accounts, Interstate Commerce Commission.

** Reduced Pipe Line Rates and Gathering Charges, 243 I.C.C. 115 (1940).

percent allowable by the Interstate Commerce Commission, the seven owners of the Trans Alaska Pipeline, combined, have had earnings during the past five years which averaged only 5.6 percent per year.

These few facts are sufficient, I think, to demonstrate the effectiveness of the controls over pipeline rates which have been exercised by the Interstate Commerce Commission, the consent decree and the pipelines themselves. In view of the historical record, I do not believe that there is any real basis for concern as to the power and the competence of the Interstate Commerce Commission to deal with any rate problems which might arise in the operation of the Trans Alaska Pipeline. I should think that the chances are excellent that no such problems would even develop. The owners are large and responsible companies, and they have pledged themselves to operate the line as a true common-carrier enterprise. They certainly know the obligations they are assuming; they know the risks of disregarding them; and their past record offers solid assurance that they will endeavor to avoid controversies with their shippers and public agencies. But the record also offers assurance that if such controversies do arise, the Interstate Commerce Commission has ample power and the experience to settle them, wisely and fairly.

I should probably make one additional comment, however, to be sure that my earlier discussion is not misunderstood. If the Interstate Commerce Commission were to start an investigation

of the rates of the Trans Alaska Pipeline, either in response to a complaint or on its own initiative - or if the propriety of an eight-percent return for crude-oil pipelines were to be questioned in some other proceeding before the Commission -, I would not attempt to forecast how the Commission would decide the matter. The Commission would undoubtedly feel obliged to take into consideration all of the changes in economic factors (such as the cost of capital) which have taken place since the 1940's (when the eight-percent figure was established), as well as the elements of risk involved in the construction and operation of the particular line or lines in question. And, among the elements of risk to be considered, I should expect the Commission to examine, with care, a characteristic of the oil-pipeline business which has developed, largely if not entirely, since the 1940 decision and which, so far as I am aware, is not found in any other type of transportation or public-utility business. I am referring to the type of commitments which the owners of a pipeline are required to give in order to borrow the necessary capital with which to construct the line. As Mr. Gary will, I believe, explain in more detail, the owners of a pipeline company must, in order to raise debt capital, in effect guarantee repayment of the debt in full, with interest. The necessity to make such commitments in order to borrow capital is a factor which unquestionably affects the risks assumed by pipeline carriers, and would, I feel sure, be taken into consideration by the Commission in determining what rate of return

pipelines should be permitted to earn. But, I repeat, I could not - and I don't believe that anyone could - give you a reliable forecast as to what conclusion the Commission would reach.

So much for the subject of rate regulation.

Let me add just a word on the question of discrimination against shippers who do not own an interest in the pipeline. If any such discrimination were to be reflected in the rates filed with the Interstate Commerce Commission, it would have to face the battery of powers and remedies I have already discussed. If the discrimination were to take some other form - refusal to provide equal service or equal facilities, for example -, there are equally broad powers and effective remedies which the Commission has and knows how to use in eradicating such abuses. Again, it is well to remember that the various forms of discrimination practiced by the railroads during the period following the Civil War were among the principal targets of the Interstate Commerce Act when it was originally enacted, and the Commission has had long experience and has been provided with ample powers for dealing with all forms of discrimination. I cannot believe, therefore, that any problem of this sort could arise, or could remain uncorrected very long if it did.

Thank you for the opportunity to appear before you and for your courtesy.

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State Jurisdiction and Regulation

Senate Bill 315

Testimony of
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Senate Bill 315 would subject to regulation by a newly created Alaska Oil and Gas Transportation Commission (the "Commission") "every oil or gas transportation facility engaged or proposing to engage in such a business inside the state." This raises the question of the extent to which, if at all, the proposed Trans Alaska Pipeline System (TAPS) will be subject to the jurisdiction of the Commission with respect to the regulatory matters contained in the proposed statute. The question of jurisdiction for regulatory purposes will first be treated and, in light of the conclusions there drawn, consideration will be given to some of the provisions of the proposed regulatory statute.

Jurisdiction - Nature of the Commerce

Jurisdiction over transportation of crude oil by TAPS will be governed by whether the commerce is intrastate or interstate in nature. This requires consideration of the facts relating to the proposed transportation.

During 1968, oil was discovered on the North slope of Alaska. Through further development since that time it has

been established that this is a tremendous reservoir or reservoirs. There are no refineries and no consumption of crude oil in Alaska of any consequence. To market the oil, it is essential that it be moved from the remote areas of production to refineries in the South 48 states in the United States. For this purpose, the participants and owners of interests in TAPS plan to construct a pipeline some 800 miles in length, extending from Prudhoe Bay on the North slope of Alaska southward across Alaska to the Port of Valdez. Adequate storage will be provided by the participants to permit receipt of crude oil at Valdez, and to provide storage there in common carrier storage pending accumulation of cargoes and arrival of vessels. From Valdez the oil will move by tank vessels to ultimate destinations outside the State of Alaska. There will be no delivery of oil to any shipper or consignee at Valdez for local use or consumption.

TAPS will be a joint ownership line in which each participant will own an undivided interest. Of necessity there will be unit operation of the line, which Alyeska will provide, but each participant will receive tenders from its own shippers, will fix its own rates for the transportation and will file and publish its own tariffs, rules and regulations. Each participant will be responsible for the transportation to its own shippers and will

collect its own charges. The rules and regulations contained in the tariff will permit (in the nature of a transit privilege) storage for the purpose of accumulating cargoes and pending arrival of vessels, and for subsequent reshipment by water, subject, of course, to reasonable restrictions. Vessels for the movement of the tonnage beyond Valdez will be provided by the shippers.

These facts demonstrate that the situation here presented is one in which tremendous volumes of oil will be tendered to the pipeline carriers involved, all of which is intended at the outset for movement to points beyond the borders of Alaska, and none of which, either now or in the foreseeable future, will be diverted to a state destination for use or consumption. After a thorough review of the decisions, it seems clear that this movement should and would be regarded as interstate commerce within the meaning of Coe vs. Errol, 117 U.S. 517, decided in 1886, and the many cases that have since followed it. The movement constitutes literally a great stream of oil moving to and through the Port with a manifest certainty of a destination outside the state, a situation comparable to the stream of grain in Lemke vs. Farmers Grain Co., 258 U.S. 50, the stream of oil in Ureka Pipeline Co. vs. Hallanan, 257 U.S. 265, and the stream of gas in United Fuel Gas Co. vs. Hallanan, 257 U.S. 277.

The nature of the transportation is virtually identical to that considered in the Lake Cargo Coal case, Railroad Commission of Ohio vs. Worthington, 225 U.S. 101. That case involved the validity of an order of the Ohio Commission establishing rates on lake cargo coal moving from a state origin by common carrier rail lines to a lake port in Ohio for transportation by water in vessels supplied by the shipper to interstate points. In striking down the order, the Court described the interstate nature of the commerce as follows:

> "There is testimony to the effect that when the coal leaves the mines it is not known in what vessel it will be loaded, nor to what particular ultimate destination it will go; and that sometimes such coal is sold and vessels arranged for after the coal is at Huron, but it is subject to demurrage charge if it remains on the cars beyond a specified time.
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> "All coal thus loaded in vessels is, and must practically be, carried to points in other states - or to Canada."
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> "It is true, as argued by the learned counsel for the commission, that this coal may be accumulated in large quantities at Huron, and only taken out of the accumulated lots from time to time, when it is to be put upon vessels and shipped out of the state, but it must always be remembered that this 70 cent rate applies solely to such coal as is in fact placed upon vessels for carriage to beyond the state points; and, as the circuit court said, the substance of things is not changed by the fact that a small part may be unloaded at one of the Ohio Islands in Lake Erie. The situation then comes to this: that the rate put in force is applicable only to coal which is to be carried

> from the mine in Ohio to the lake, there placed upon vessels, and thence carried to upper lake ports beyond the state. By every fair test the transportation of this coal from the mine to the upper lake ports is an interstate carriage, intended by the parties to be such, and the rate fixed by the commission, which is in controversy here, is applicable alone to coal which is thus, from the beginning to the end of its transportation, in interstate carriage, and such rate is intended to and does cover an integral part of that carriage, the transportation from the mine to the Lake Erie port, the placing upon the vessel, and the trimming or distributing in the hold, if required, so that the vessel may complete the interstate carriage."

It is clear, of course, that any oil moving locally within Alaska and having its ultimate and final destination there would unquestionably be intrastate, would be subject to the jurisdiction of the State of Alaska, and of any state regulatory agency which may be established by the legislature and vested with jurisdiction. As an illustration, if refineries should be constructed along the TAPS line, and oil should be delivered through TAPS to them, the movement would be clearly intrastate in character. But there are no such refineries now and none may ever be constructed. Even if and when a refinery may be constructed along the line to which deliveries might be made, this could not and would not affect the essential nature of the great stream of tonnage moving to and through the Port. In United Fuel Gas Co. vs. Hallanan, 257 U.S. 277, the Court said:

"In short, the great body of the gas starts for points outside the state and goes to them. That the necessities of business require a much smaller amount destined to points within the state to be carried undistinguished in the same pipes does not affect the character of the major transportation. Neither is the case as to the gas sold to the three companies changed by the fact that the plaintiff, as owner of the gas, and the purchasers, after they receive it, might change their minds before the gas leaves the state, and that the precise proportions between local and outside deliveries may not have been fixed, although they seem to have been. The typical and actual course of events marks the carriage of the greater part as commerce among the states, and theoretical possibilities may be left out of account. There is no break, no period of deliberation, but a steady flow, ending, as contemplated from the beginning, beyond the state line."

Under many decisions it has been made plain that the temporary stoppage and storage of oil at the port for the accumulation of cargo or awaiting the arrival of vessels does not affect or interrupt the interstate nature of the movement. Texas & N.O. RR Co. vs. Sabine Tram Co., 227 U.S. 111; Southern Pac. Terminal Co. vs. I.C.C., 219 U.S. 498; Carson Petrol. Co. vs. Vial, 279 U.S. 95; Railroad Commission vs. Texas & Pac. Ry. Co., 229 U.S. 336; State vs. Anderson Clayton & Co., 92 F.2d 704.

The Interstate Commerce Act, 49 U.S.C. §1(b), as amended, applies to:

"The transportation of oil or other commodity, except water and except natural or artificial gas, by pipe line, or partly by pipe line and partly by railroad or by water

* * *

"From one State or Territory . . . to any other State or Territory of the United States . . . or from or to any place in the United States to or from a foreign country . . . ."

Based upon the facts relating to the transportation involved and application of the constitutional precepts set forth in the cases above cited, TAPS will be clearly subject under this Section to the jurisdiction of the Interstate Commerce Commission.

There is no question that the Interstate Commerce Commission would also have jurisdiction even though the pipeline were owned and operated by the State of Alaska or any authority or instrumentality created by the state for that purpose. California v. Taylor, 353 U.S. 553; Schmitt v. War Emergency Pipelines, Inc. 72 F.Supp. 156, aff'd 175 F.2d 335, cert denied 338 U.S. 869. In California v. Taylor, the Court considered whether the State Belt Railroad, an interstate common carrier owned and operated by the State of California, was subject to the Interstate Commerce Act:

> "The Interstate Commerce Act, 24 Stat. 379, as amended, 49 USC §1(1), applies to all common carriers by railroad engaged in interstate transportation. The Belt Railroad concededly is a common carrier engaged in interstate transportation. It files its tariffs with the Interstate Commerce Commission, and the Commission has treated it and other state-owned interstate rail carriers as subject to its jurisdiction. See California Canneries Co. v. Southern Pacific Co. 51 ICC 500, 502, 503; United States v. Belt Line R. Co. 56 ICC 121; Texas State R. Co. 34 ICC Val. R. 276. Finally, this Court has recognized that practice. United States v. California, 297 US 175, 186, 80 L.ed. 567, 573; 56 S.Ct. 421. See also, New Orleans v. Texas & P.R. Co. (CA5th La.) 195 F.2d 887, 889."

State Regulation - Senate Bill 315

In light of the foregoing conclusion and faced as the project has been and still is with a multitude of problems from many directions, it would be regrettable if the State of Alaska should further cloud the picture at this juncture by the adoption of Senate Bill 315. Such action would pose troublesome problems of dual control, state and interstate, and of the extent to which the Act was intended to apply, and could legally be applied, to TAPS. If any regulatory measure is to be adopted, the Legislature should endeavor to remove doubts and uncertainties in these areas. Senate Bill 315 falls far short of the mark in these respects.

To begin with no effort is made in Senate Bill 315 to draw a distinction between pipelines engaged solely in interstate commerce on the one hand, and those performing an intrastate service on the other. As previously noted, the Alaska Oil and Gas Transportation Commission is empowered and directed to regulate "every oil and gas transportation facility engaged or proposing to engage in such a business inside the state." (Sec. 42.06.141(1)). The Act nowhere contains any limitation of this broad statement.

Yet it is clear that state action insofar as an interstate carrier is involved is subject to paramount federal

authority. The doctrine of federal preemption of interstate commerce is well defined by the Circuit Court of Appeals for the 8th Circuit in Haskell vs. Cowham, 187 Fed. 403, which invalidated state legislation the effect of which was to prevent the interstate sale and movement of gas by preventing the laying of pipelines across highways in the state. In an opinion by Judge Sanborn the Court said:

> "The power to regulate commerce among the states was carved out of the general sovereign power when the national government was formed and granted by the people by means of the Constitution to the Congress of the United States. Article 1, §8. That grant is exclusive. The nation may exercise the power thus given to its utmost extent, and no state may lawfully restrict or infringe this grant or the plenary exertion of this power, for they are paramount to all the powers of the state, and they inhere in the supreme law of the land. Interstate commerce in natural gas including therein its transportation among the states by pipe line is a subject national in its character and susceptible of regulation by uniform rules. The silence or inaction of Congress relative to such a subject is a conclusive indication that it intends that interstate commerce therein shall be free, and any law or act of a state or of its officers which prohibits it or substantially restrains its freedom is violative of the Constitution and void."

Substantially the same question was presented in West vs. Kansas Natural Gas Co., 221 U.S. 229. Citing Haskell vs. Cowham, the Court said:

"We place our decision on the character and purpose of the Oklahoma statute. The state, as we have seen, grants the use of the highways to domestic corporations engaged in intrastate transportation of natural gas, giving such corporations even the right to the longitudinal use of the highways. It denies to appellees the lesser right to pass under them or over them, notwithstanding it is conceded in the pleadings that the greater use given to domestic corporation is no obstruction to them. This discrimination is beyond the power of the state to make. As said by the circuit court of appeals in the eighth circuit, no state can by action or inaction prevent, unreasonably burden, discriminate against or directly regulate, interstate commerce or the right to carry it on. And in all of these inhibited particulars the statute of Oklahoma offends." [Emphasis added.]

TAPS is not exempt from all state action by reason of its interstate character. Any requirements, however, must serve a legitimate state purpose and they cannot directly regulate or unduly burden the carrier. As an illustration, in Atlas Pipe Line Co. vs. Sterling, 4 F.Supp. 441, a three judge court sustained the validity of an order of the Railroad Commission of Texas requiring certain metering and reporting procedures upon movements that were admittedly interstate in nature. The Court did so upon the ground that the orders were necessary or appropriate to control the movement of contraband oil during the hot oil problem in Texas, and upon a finding that the orders imposed no undue burden upon Interstate Commerce or upon the carriers involved. In so holding the court said:

"We think it perfectly clear that, as applied to plaintiff, the complained of statutes are valid; that the requirements they make in no manner infringe upon any of its constitutional rights. They merely provide for such regulatory steps and measures as are reasonable, necessary, and proper to prevent the handling of oil made by the statute contraband for handling, and their terms in no sense impose any burdensome restrictions upon interstate commerce, or take plaintiff's property without due process, or deny it the equal protection of the laws. Plaintiff's broad position comes in the end to no more than an insistence upon its right to transport, in violation of the express prohibitions of the statute, oil which has been illegally produced. No reason presents itself to our minds for believing that the Legislature, having the authority to conserve the natural resources of the state, is without power to impose upon common carriers by pipeline, interstate and intrastate, police regulations to make its prohibition against wasteful production effective."

At the other extreme, in Lemke vs. Farmer's Grain Co., 258 U.S. 50, the court struck down a statute of the State of North Dakota which sought to regulate the buying of grain, requiring state licensing of dealers and fixing the profit that they might realize. The court said:

"It is contended that these regulations may stand upon the principles recognized in decisions of this court which permit the state to make local laws under its police power, in the interest of the welfare of its people, which are valid, although affecting interstate commerce, and may stand, at least until Congress takes possession of the field under its superior authority to regulate commerce among the states. This principle has no application where the state passes beyond the exercise of its legitimate authority, and undertakes to regulate interstate

commerce by imposing burdens upon it. This court stated the principle and its limitations in the discussion of the subject in the Minnesota Rate Cases (Simpson v. Shepard) 230 U.S. 352 . . . . In the course of the opinion in that case, we said (p. 400):

> 'The principle which determines this classification [between Federal and state power] underlies the doctrine that the states cannot, under any guise, impose direct burdens upon interstate commerce. For this is but to hold that the states are not permitted directly to regulate or restrain that which, from its nature, should be under the control of the one authority and be free from restriction, save as it is governed in the manner that the national legislature constitutionally ordains.'"

Thus, while of necessity under the law, state action under Senate Bill 315 would be limited to areas that the state can legally control or regulate, the statute leaves for later judicial determination the nature and extent of those limitations. The participants in TAPS could find themselves involved in burdensome and troublesome litigation as a result of proposed action by the Commission under the Act, or efforts to apply the terms of that Act to TAPS.

For example, the Commission is directed by the Act to "make or require just, fair and reasonable rates, classifications, rules, regulations, practices, services and facilities for an oil or gas transportation facility," Section 42.06.141 (4), and its authority in this regard is detailed in Article

5 of the Act, "Rates and Rate Schedules." If it is the legislative purpose to vest the Commission with authority to fix rates to be observed by TAPS, such action is clearly beyond the State's power to so provide. If the Commission should endeavor to establish rates to be applied to the movement of crude oil to and through Valdez it would find itself in precisely the same position as was the Ohio State Commission in the Lake Cargo Coal case previously referred to. After determining that the transportation involved was interstate in nature, the Court considered the effect and validity of the state order fixing rates:

> "It is contended that this transportation of the coal under the rate fixed by the Railroad Commission is not within the power and authority of the Interstate Commerce Commission under §1 of the act to regulate commerce, which makes the provisions of the act inapplicable to the transportation of property wholly within one state and not shipped to or from a foreign country, from or to a state or territory; and, furthermore, that a transportation of the character here in question is only within the jurisdiction of the Interstate Commerce Commission when it is a transportation partly by railroad and partly by water, when both are used under a common control, management, or arrangement for a continuous carriage or shipment; and therefore that the subject matter in question is left within the state jurisdiction. On the other hand, it is contended that this transportation is within the jurisdiction of the Commission under the act to regulate commerce. It is enough to now hold, as we do, that the establishing of the rate in question is an attempt to regulate interstate commerce, and is therefore beyond the power of the state or a commission assuming to act under its authority."

The Act further requires that a pipeline make application and obtain from the Commission a "certificate of convenience and necessity", the issuance of which is conditioned upon a finding that "the services are required for the efficient production and marketing of oil or gas." Section 42.06.241. The Commission's approval is also required before any pipeline "may discontinue or abandon a service for which a certificate has been issued . . ." Section 42.06.261(A). Of course, a carrier must secure the right to cross all lands its line will traverse. TAPS is now engaged in obtaining a permit to cross federal lands from the Secretary of the Interior, and it will be necessary for it to obtain a lease or permit to cross any state lands the line may traverse. The crossing of state lands and legal and practical considerations relating to the proposed State Right of Way Leasing Act, Senate Bill 313, will be detailed in later testimony. Senate Bill 315 in effect provides, however, that even though the right to cross such lands has been obtained, the carrier must still apply to the Commission for a certificate, and obtain its approval, before operating or abandoning its lines, and issuance of such certificates is conditioned upon various findings, including the equivalent of a finding of public convenience and necessity. In this respect the state is

invading areas that have been reserved exclusively for federal control. The decision of the Supreme Court of Kansas in State vs. Sinclair Pipeline Co., 304 P.2d 930 is in point. There the State of Kansas sought by mandamus to compel an interstate pipeline carrier to obtain State Commission approval before abandoning operation of a part of its line. In denying relief the Supreme Court of Kansas said:

> "Once we have established that the Pipe Line Company was engaged exclusively in transportation of crude oil in interstate commerce, the conclusion is inescapable that the commission has no power or authority to regulate it. The third clause of article 1, section 8 of the federal constitution places the control of commerce among the several states in congress. About as many opinions have been written about that clause as any other. Among the early ones was Gibbons v. Ogden, 9 Wheat 1, 6 L.Ed 23. To come to a more recent date we have State of Missouri ex rel. Barrett v. Kansas Natural Gas Co., D.C., 282 F.341 and Central Trust Co. of New York v. Consumers Light, Heat & Power Co., D.C., 282 F. 680. These cases were affirmed by the United States Supreme Court. See Missouri ex rel. Barrett v. Kansas Natural Gas Co., 265 U.S. 298, 44 S.Ct. 544, 545, 68 L.Ed 1027. There the Court said:
>
> * * *"If a state enactment imposed a direct burden upon interstate commerce, it must fall, regardless of federal legislation. The point of such an objection is not that Congress has acted, but that the state has directly restrained that which in the absence of federal regulation should be free.
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> * * *

"The contention that, in the public interest, the business is one requiring regulation, need not be challenged. But Congress thus far has not seen fit to regulate it, and its silence, where it has the sole power to speak, is equivalent to a declaration that that particular commerce shall be free from regulation. * * *"

"By the Hepburn amendment the interstate commerce act was extended to include common carriers engaged in the transportation of oil by pipe line from one state to another. 49 U.S. C.A. §1. This amendment did not impose upon carriers by oil by pipe line the requirement that they obtain certificates of public convenience and necessity, neither did the amendment impose upon such carriers the requirement that they obtain a permit to discontinue the use of interstate pipe line facilities although such permits were at the time of the amendment required of carriers by rail. This is indicative that congress did not intend to make such requirements."

In Buck vs. Kuykendall, 267 U.S. 307, the Court struck down a statute of the State of Washington which would have required a common carrier engaged exclusively in interstate commerce in the operation of a bus line, to first obtain a permit from the state based upon a finding of public convenience and necessity. The Court said:

"Thus, the provision of the Washington statute is a regulation, not of the use of its own highways, but of interstate commerce. Its effect upon such commerce is not merely to burden but to obstruct it. Such state action is forbidden by the commerce clause."

See also Castle vs. Hayes Freight Lines, 348 U.S. 61. It seems clear that as applied to TAPS, both the certificate to operate

and abandonment provisions of the Act would fall within the condemnation of these authorities.

Article 4 of Senate Bill 315, dealing with "Services and Facilities", authorizes the Commission to prescribe by order, extensions and improvements in facilities that are "reasonable, necessary and proper for the safety, accomodation and convenience of the public and the users." Section 42.06.291 (b). To the extent that the Commission may seek to utilize this authority to compel a transportation facility to extend its lines beyond the area it has committed itself to serve, such action would be innefective even as to an intrastate carrier. In Interstate Com. Comm'n vs. Oregon Wash. R & N Co., 288 U.S. 14, the Interstate Commerce Commission entered an order requiring the Railroad Company to extend its line to serve an area of some 33,000 square miles within the State of Oregon. The substance of the case before the Commission was thus stated by the Court:

> "The failure and refusal to provide railroad facilities to a large area of central Oregon was the gravamen of the complaint. Consequences of the neglect to build this line were enumerated as prevention of the development of a vast area, hindrance of exploitation of the natural resources of the State, unreasonably circuitous routes, with consequent delays, and car shortages, all causing losses to the people of Oregon."

In striking down the order, the Court said:

"The cases above cited, dealing with the powers of state authorities in the matter of extensions of lines and service, furnish a background which must have been in the minds both of the Commission and of the Congress at the time of the passage of the Transportation Act. Those decisions show that due process is denied by requiring service which goes beyond the undertaking of the carrier. Orders for extensions of line were sustained whenever reasonably required in the interest of car service and for interchange of traffic. No extension order for the service of new territory has been approved."

* * *

"The railroads, though dedicated to a public use, remain the private property of their owners, and their assets may not be taken without just compensation. The Transportation Act has not abolished this proprietorship. State courts have uniformly held that to require extension of existing lines beyond the scope of the carrier's commitment to the public service is a taking of property in violation of the federal constitution. The decisions of this court would be searched in vain for the announcement of any principle of constitutional interpretation which would support the order of the commission."

* * *

"Assuming, without deciding, that the Commission was entitled to treat the Oregon-Washington company as an instrument of the Union Pacific System, and the required extension, therefore, as one adding only a small percentage to the present mileage of the system, still the purpose is to compel a new investment for the development of a new area at the request and in the interest of the State of Oregon, whose desire is that its natural resources shall be exploited."

See also Atchison, T & S.F. Ry. vs. Railroad Comm'n, 160 Pac. 828, cert. denied 245 U.S. 638.

As applied to TAPS the invalidity of the Section is even more readily apparent. Engaged as it is in interstate commerce, an order requiring it to extend its lines would constitute an obvious effort to directly regulate, and would impose a direct burden upon, interstate commerce and would therefore fall within the condemnation not only of the cases above cited, but those previously referred to in this memorandum relating to state efforts to regulate, or which impose burdens upon, interstate commerce.

This same infirmity inheres in other provisions of the Act, to the extent that the Commission may seek to apply them to a transportation facility which is engaged in interstate commerce. For example, the Act authorizes the Commission, in case of discrimination, to "prescribe rules to end the discrimination or the commission may itself manage the allocation of the service until it determines the discrimination can be avoided by appropriate rules or agreements." Section 42.06.321. The Commission is empowered to order "the joint use or interconnection of oil or gas transportation facilities . . . ." Section 42.06.321. These are matters specifically covered by the Interstate Commerce Act, 49 U.S.C. §§1 (4), 3 (4), as amended. Further, any corrective order by the Commission under its authority to

"investigate the management of an oil and gas transportation facility, including but not limited to staffing patterns, wage and salary scales and agreements, investment policies and practices and payment arrangement with affiliated interests . . . ," Section 42.06.511, would necessarily fall within the condemnation of the Commerce Clause.

Conclusion

The foregoing analysis is not exhaustive, nor have we sought to elaborate upon those areas in which the legitimate local concern may justify requirements of the interstate carrier which only "incidentally affect" but do not unreasonably burden or directly regulate interstate commerce. Generally, to the extent that the Commission may utilize authority granted by the Act to adopt regulations or prescribe orders the effect of which, directly or indirectly, would be to regulate, burden or obstruct the interstate operations of TAPS, such regulations or orders in light of the Commerce Clause precepts previously discussed would be invalid.

March 3, 1972

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

REMARKS OF GEORGE A. SEYMOUR
TO ALASKA SENATE AND HOUSE COMMITTEES
WEEK OF MARCH 6, 1972

I AM GEORGE A. SEYMOUR. I AM MANAGER OF PART INTEREST PIPELINES FOR MOBIL PIPE LINE COMPANY. I WOULD LIKE TO REVIEW THE TYPE AND FORMAT OF PIPELINE INDUSTRY FINANCIAL REPORTING WHICH COULD SERVE THE NEEDS OF THE STATE OF ALASKA IN CONNECTION WITH THE TAPS PROJECT.

THE TYPE AND DETAIL OF FINANCIAL DATA ON PIPELINES THAT THE OWNER COMPANIES HAVE TRADITIONALLY FURNISHED AND THAT SHOULD SERVE ADEQUATELY FOR TAPS CAN BE ILLUSTRATED BY THE USE OF SOME REPORTS THAT ARE REQUIRED BY OTHER REGULATORY COMMISSIONS. ATTACHED IS A COPY OF COOK INLET PIPE LINE COMPANY'S 1970 ANNUAL REPORT TO THE INTERSTATE COMMERCE COMMISSION. THIS REPORT, ALONG WITH IDENTICAL REPORTS FROM ALL OTHER COMMON CARRIERS SUBJECT TO THE JURISDICTION OF THE ICC, IS ON FILE IN WASHINGTON AND IS AVAILABLE TO ANYONE WHO WISHES TO SEE IT. A COPY OF THIS REPORT, KNOWN AS THE FORM P, IS ALSO REQUIRED BY MOST STATE REGULATORY AGENCIES WHICH HAVE JURISDICTION OVER COMMON CARRIER PIPELINE COMPANIES. IN FACT, FORMS P FOR COOK INLET PIPE LINE COMPANY WERE, UPON REQUEST, TRANSMITTED TO MR. GREG K. ERICKSON OF THE ALASKA JOINT PIPELINE IMPACT COMMITTEE IN SEPTEMBER, 1971, FOR THE YEARS 1967 THROUGH 1970. WE WOULD EXPECT THAT ALASKA WILL ALSO REQUIRE THIS REPORT TO BE FILED WITH THE APPROPRIATE STATE AGENCY BECAUSE ITS 56 PAGES WOULD CONTAIN RATHER DETAILED CORPORATE, FINANCIAL AND OPERATING INFORMATION CONCERNING TAPS.

IF YOU HAVE NOT PREVIOUSLY SEEN ONE OF THESE REPORTS, YOU ARE INVITED TO REVIEW IT IN ITS ENTIRETY TO SEE WHAT INFORMATION IS INCLUDED. I WOULD LIKE NOW, HOWEVER, TO DISCUSS SOME OF THE

AGO 531714

SCHEDULES AND RELATE THEM TO POSSIBLE TAPS REPORTS. ON PAGES 20 AND 21 IS A DETAIL OF INVESTMENT IN CARRIER PROPERTY. CARRIER INVESTMENT MUST BE REPORTED FOR GATHERING, TRUNK AND GENERAL FACILITIES AND EACH OF THESE CATEGORIES MUST BE BROKEN DOWN INTO THE VARIOUS TYPES OF INVESTMENTS, SUCH AS LAND, RIGHT-OF-WAY, LINE PIPE, PIPELINE CONSTRUCTION, ETC.

IF YOU WILL TURN TO PAGE 24, YOU WILL SEE ANOTHER SCHEDULE QUITE SIMILAR TO THE ONE WE JUST REVIEWED. YOU CAN SEE THAT THE BASIC FORMAT OF THIS PAGE IS ESSENTIALLY THE SAME. HOWEVER, THE COLUMNS CONTAIN DEPRECIATION INFORMATION RATHER THAN ORIGINAL INVESTMENT COST.

BOTH OF THESE SCHEDULES WE HAVE JUST REVIEWED WERE FOR THE COMPANY'S TOTAL INVESTMENT. HOWEVER, I WANTED TO GO THROUGH THESE SCHEDULES BECAUSE THE DETAIL SEEMS TO BE VERY SIMILAR TO THAT WHICH MIGHT BE REPORTED TO THE STATE FOR TAPS.

IF YOU WILL TURN BACK TO PAGE 23, YOU WILL SEE A FORM THAT MIGHT BE USED TO REPORT TO THE STATE. THIS PAGE, WHICH IS INCLUDED TO REPORT ON ANY SYSTEM SPECIFIED BY THE ICC, IS BLANK IN THE CASE OF COOK INLET. HOWEVER, WE HAVE RECEIVED AN INDICATION THAT THE ICC WILL REQUIRE THIS PAGE TO BE COMPLETED FOR TAPS, AND THE ICC CURRENTLY REQUIRES THIS PAGE TO BE COMPLETED BY SOME OTHER COMPANIES WHICH PARTICIPATE IN UNDIVIDED INTEREST PIPELINES.

IF YOU WILL NOW TURN TO PAGE 25, YOU WILL SEE ANOTHER BLANK PAGE -- ONE WHICH COULD BE USED IN CONJUNCTION WITH THE ONE WE JUST REVIEWED

TO REPORT CURRENT YEAR'S AND CUMULATIVE DEPRECIATION.

BY REQUESTING THESE TWO SCHEDULES TO BE COMPLETED, OR SCHEDULES SIMILAR TO THEM, IT WOULD SEEM THAT THE STATE WOULD RECEIVE EVERYTHING IT WOULD WANT REGARDING THE OWNER COMPANIES' INVESTMENT IN TAPS.

IF YOU WILL TURN TO PAGE 42, WE WILL TALK ABOUT THE REPORTING OF TAPS EXPENSES. IN THE SCHEDULE AT THE BOTTOM OF THE PAGE YOU WILL SEE THAT EXPENSES MUST BE BROKEN DOWN INTO OPERATIONS, MAINTENANCE AND GENERAL CATEGORIES AND FURTHER DETAILED BY TYPE OF EXPENSE, SUCH AS SALARIES AND WAGES, SUPPLIES AND EXPENSES, OUTSIDE SERVICES, ETC. AGAIN, THIS SCHEDULE CONTAINS TOTAL COMPANY INFORMATION BUT IT IS AVAILABLE AND COULD BE REPORTED FOR TAPS AT THE REQUEST OF THE STATE.

TURNING BACK TO PAGE 41, THIS SCHEDULE IS THE COMPANY'S TOTAL INCOME STATEMENT. NOTICE THAT THE AMOUNT OF EXPENSES SHOWN ON THE SECOND LINE IS THE TOTAL SHOWN ON THE SCHEDULE WE JUST REVIEWED. IN ADDITION TO OPERATING EXPENSES, THIS SCHEDULE SETS OUT OPERATING REVENUES, INCOME FROM NONCARRIER OPERATIONS, INTEREST AND DIVIDEND INCOME, MISCELLANEOUS INCOME, INTEREST EXPENSE, MISCELLANEOUS INCOME CHARGES, INCOME BEFORE FEDERAL INCOME TAXES, FEDERAL INCOME TAXES, AND TOTAL NET INCOME. AS WITH INVESTMENT AND EXPENSE INFORMATION WE HAVE PREVIOUSLY DISCUSSED, THIS SCHEDULE COULD BE USED TO REPORT ONLY THE INFORMATION RELATING TO TAPS.

As to revenue, this schedule would set out TAPS revenue separately. If further detail would be desired by the State, a schedule that summarized such data could be prepared.

Any necessary additional operating information desired by the State could also be provided on this or a similar page.

The State would also be interested in the valuation of TAPS carrier property. As you know, the Interstate Commerce Commission determines a company's original valuation and traditionally brings it down to date each year. A copy of a company's valuation report, which sets out the valuation of properties located in each state, is sent to each state by the ICC. In addition, because of the magnitude of investment in TAPS, we expect that the ICC will determine the valuation of TAPS facilities separate from the valuation of the owner companies' other carrier facilities. This information would also be provided to the State of Alaska by the ICC.

To summarize, we have reviewed schedules or samples of schedules which could be used to report required TAPS financial and operating information to the State. The TAPS owner companies have previously stipulated that it was their intent to arrange to provide the State with complete financial and operating statistics on TAPS. Information of the type we have just reviewed--which seems to be consistent with what the TAPS owner companies have offered to furnish--appears adequate to fulfill the State's total need for corporate, financial and operating data.

CARRIERS BY PIPE LINE

Annual Report Form P

BUDGET BUREAU
No. 60-R0108
Approval expires 12-31-74

ANNUAL REPORT

OF

COOK INLET PIPE LINE COMPANY

ANCHORAGE, ALASKA

TO THE

INTERSTATE COMMERCE COMMISSION

FOR THE

YEAR ENDED DECEMBER 31, 1970

AGO 531718

NOTICE

1. This Form for annual report should be filled out in triplicate and two copies returned to the *Interstate Commerce Commission, Bureau of Accounts*, Washington, D.C. 20423, by *March 31 of the year following that for which the report is made.* Attention is specially directed to the following provisions of Part I of the Interstate Commerce Act:

SEC. 20. (1) The Commission is hereby authorized to require annual, periodical, or special reports from carriers, lessors, * * * (as defined in this section), to prescribe the manner and form in which such reports shall be made, and to require from such carriers, lessors, * * * specific and full, true, and correct answers to all questions upon which the Commission may deem information to be necessary, classifying such carriers, lessors, * * * as it may deem proper for any of these purposes. Such annual reports shall give an account of the affairs of the carrier, lessor, * * * in such form and detail as may be prescribed by the Commission.

(2) Said annual reports shall contain all the required information for the period of twelve months ending on the 31st day of December in each year, unless the Commission shall specify a different date, and shall be made out under oath and filed with the Commission at its office in Washington within three months after the close of the year for which report is made, unless additional time be granted in any case by the Commission.

(7) (b). Any person who shall knowingly and willfully make, cause to be made, or participate in the making of, any false entry in any annual or other report required under this section to be filed, * * * or shall knowingly or willfully file with the Commission any false report or other document, shall be deemed guilty of a misdemeanor and shall be subject, upon conviction in any court of the United States of competent jurisdiction to a fine of not more than five thousand dollars or imprisonment for not more than two years, or both such fine and imprisonment: * * *.

(7) (c). Any carrier or lessor, * * * or any officer, agent, employee, or representative thereof, who shall fail to make and file an annual or other report with the Commission within the time fixed by the Commission, or to make specific and full, true, and correct answer to any question within thirty days from the time it is lawfully required by the Commission so to do, shall forfeit to the United States the sum of one hundred dollars for each and every day it shall continue to be in default with respect thereto.

(8) As used in this section * * * the term "carrier" means a common carrier subject to this part, and includes a receiver or trustee of such carrier; and the term "lessor" means a person owning a railroad, a water line or a pipe line, leased to and operated by a common carrier subject to this part, and includes a receiver or trustee of such lessor, * * *.

The respondent is further required to send to the Bureau of Accounts, immediately upon publication, two copies of its latest printed annual report to stockholders. See Schedule 108A, page 104.

2. The instructions in this Form should be carefully observed, and *each question should be answered fully and accurately*, whether it has been answered in a previous annual report or not. Except in cases where they are specifically authorized, cancellations, arbitrary check marks, and the like should not be used either as partial or as entire answers to inquiries. If any inquiry, based on a preceding inquiry in the present report form, is, because of the answer rendered to such preceding inquiry, inapplicable to the person or corporation in whose behalf the report is made, such notation as "Not applicable; see page ——, schedule (or line) number ——" should be used in answer thereto, giving *precise reference to the portion of the report showing the facts which make the inquiry inapplicable.* Where the word "None" truly and completely states the fact, it should be given as the answer to any particular inquiry or any particular portion of an inquiry. Where dates are called for, the month and day should be stated as well as the year. Customary abbreviations may be used in stating dates.

3. *Every annual report should, in all particulars, be complete in itself*, and references to the returns of former years should not be made to take the place of required entries except as herein otherwise specifically directed or authorized.

4. If it be necessary or desirable to insert additional statements, typewritten or other, in a report, they should be legibly made on durable paper and, wherever practicable, on sheets not larger than a page of the Form. *Inserted sheets should be securely attached, preferably at the inner margin; attachment by pins or clips is insufficient.*

5. All entries should be made in a permanent black ink. Those of a contrary character should be indicated in parenthesis. Items of an unusual character should be indicated by appropriate symbol and footnote.

Money items throughout this annual report form should be shown in units of dollars adjusted to accord with footings.

6. Each respondent should make its annual report to this Commission in triplicate, retaining one copy in its files for reference in case correspondence with regard to such report becomes necessary. For this reason three copies of the Form are sent to each company concerned.

7. Except where the context clearly indicates some other meaning, the following terms when used in this Form have the meanings below stated:

Commission means *the Interstate Commerce Commission.* Respondent means *the person or company in whose behalf the report is made.* The year means *the year ended December 31 for which the report is made.* The close of the year means *the close of business on December 31 of the year for which the report is made;* or, in case the report is made for a shorter period than one year, it means *the close of the period covered by the report.* The beginning of the year means *the beginning of business on January 1 of the year for which the report is made;* or, in case the report is made for a shorter period than one year, it means *the beginning of the period covered by the report.* The preceding year means *the year ended December 31 of the year next preceding the year for which the report is made.* The Uniform System of Accounts for Pipe Lines means *the system of accounts in Part 1204 of Title 49, Code of Federal Regulations, as amended*

FOR THE INDEX SEE THE INSIDE OF BACK COVER

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 Price $1.50

ANNUAL REPORT

OF

COOK INLET PIPE LINE COMPANY

ANCHORAGE, ALASKA

FOR THE

YEAR ENDED DECEMBER 31, 1970

Name, official title, telephone number, and office address of officer in charge of correspondence with the Commission regarding this report:

(Name) A. R. THOMPSON (Title) SECRETARY-TREASURER

(Telephone number) [redacted] (Area code) [redacted] (Telephone number)

(Office address) [redacted] Dallas, Texas 75202 (Street and number, City, State, and ZIP code)

AGO 531720

INSTRUCTIONS FOR MAKING RETURNS ON OPPOSITE PAGE

There should appear on the opposite page entries or notations sufficient to show that no question or item has been overlooked. If returns are not made as required, some reference, as, "See page 100", should be made to this page, on which a statement of the reason for the variation or omission should be given.

Answers to the questions asked should be made in full, without reference to data returned on the corresponding page of previous reports. Only changes during the year are required, under items 4, 5, and 6.

1. *Give in full the exact name of the respondent.* Use the words "The" and "Company" only when they are parts of the corporate name. The corporate name should also be given uniformly throughout the report, notably on the cover, on the title page, and in the "Verification" (p. 533). If the report is made by receivers, trustees, a committee of bondholders, or individuals otherwise in possession of the property, state names and facts with precision.

2. If incorporated under a special charter, give date of passage of the act; if under a general law, give date of filing certificate of organization; if a reorganization has been effected, give date of reorganization. If a receivership or other trust, give also date when such receivership or other possession began. If a partnership, give date of formation and also names in full of present partners.

3. Give *specific* reference to laws of each State or Territory under which organized, citing chapter and section. Include all grants of corporate powers by the United States, or by Canada or other foreign country; also, all amendments to charter.

4. Give *specific* reference to special or general laws under which each consolidation or merger or combination of other form was effected during the year, citing chapter and section. Specify Government, State, or Territory under the laws of which each company consolidated or merged or otherwise combined during the year into the present company was organized; give reference to the charters of each, and to all amendments of them. *Distinguish carefully between mergers and consolidations.* For the purpose of this report, a *merger* may be defined as the *absorption* of one of two existing corporations by the other in such wise that the absorbed or merged corporation ceases to exist as a legal entity, its property passing to the merging or absorbing corporation, which assumes all of the merged corporation's obligations. A *consolidation* may be defined as the *union* of two or more existing corporations into a new corporation, which, through the consolidation, acquires all of the property of the uniting corporations, assumes all of their obligations, and issues its capital stocks in exchange for those of the uniting corporations in ratios fixed in the agreement for consolidations, after completion of which both or all of the consolidating corporations cease to exist as legal entities. Combinations that are not classifiable as mergers or consolidations should be fully explained. Cases in which corporations have become inactive and have been practically absorbed through ownership or control of their entire capital stock, through leases of long duration (under which the lessor companies *do not* keep up independent organizations for financial purposes), or otherwise, so that no distinction is made in operating or in accounting by reason of the original separate incorporation, *should be included here in a separate list and fully explained* in answering this and the next following inquiry.

6. State the occasion for the reorganization, whether by reason of foreclosure of mortgage or otherwise, according to the fact. Give date of organization of original corporation and refer to laws under which organized.

EXPLANATORY REMARKS

SPECIAL NOTICE

The attention of the respondent is directed below to certain particulars, if any, in which this report form differs from the corresponding form for the preceding year. It should be understood that mention is not made of necessary substitutions of dates or, in general, such other things as simple modifications intended to make requirements clearer, other minor adjustments, and typographical corrections.

Page 200: Schedule 200A. Comparative Balance Sheet Statement - Asset Side

Instructions have been amended to provide for inclusion of accrued depreciation of system property in account 31, Accrued Depreciation - Carrier Property.

Page 212: Schedule 230. Carrier Property

Instructions amended to include system property investments.

Page 214: Schedule 231. Accrued Depreciation - Carrier Property

Schedule renumbered 232 and transferred to new page 214B.

Page 214A: Schedule 231A. Depreciation Base and Rates - System Property
214C: Schedule 232A. Accrued Depreciation - System Property

These are new pages and schedules provided for disclosure of depreciation data related to carrier investments in system property.

Page 215: Schedule 232. Depreciation Base and Rates

Schedule renumbered 231, redesignated Depreciation Base and Rates - Carrier Property, and transferred to page 214.

Page 226. Schedule 270. Capital Stock

Instructions have been amended to assist in furnishing clearer and more complete data.

Page 304: Schedule 330. Pipe-Line Taxes

Reference to Federal transportation tax has been deleted.

101. IDENTITY OF RESPONDENT

1. Exact name of pipe-line company making this report. (See Instructions, p. 100) Cook Inlet Pipe Line Company

2. Date of incorporation March 21, 1966

3. Under laws of what Government, State, or territory organized? If more than one, name all. Give specific reference to each statute and all amendments thereof, effected during the year. If previously effected show the year(s) of the report(s) setting forth the details. If in bankruptcy, give court of jurisdiction and dates of beginning of receivership or trusteeship and of appointment of receivers or trustees.

Organized under the "General Corporation Law of the State of Delaware".

4. If a consolidated or a merging company, name all constituent and all merged companies absorbed during the year. Give specific reference to charters or general laws governing organization of each, and all amendments of same.

Not applicable

5. Date and authority for each consolidation and for each merger effected during the year.

Not Applicable

6. If a reorganized company, give name of original corporation, refer to laws under which it was organized, and state the occasion for any reorganization effected during the year.

Not Applicable

7. State whether or not the respondent during the year conducted any part of its business under a name or names other than that shown in response to inquiry No. 1, above; if so, give full particulars.

Business conducted under above name only.

INSTRUCTIONS FOR MAKING RETURNS ON PAGES 102 AND 103

There should appear on these pages entries or notations sufficient to show that no question or item has been overlooked. The word "None" may be used wherever applicable.

If returns are not made as required, some reference, as, "See page 102", should be made to this page, on which a statement of the reason for the variation or omission should be given.

Give particulars of the various directors and officers of the respondent at the close of the year. In schedule No. 103 give the title, name, and address of the principal general officers having system jurisdiction by departments, as follows: Executive, Legal, Fiscal and Accounting, Purchasing, Operating, Construction, Maintenance, Engineering, Commercial, and Traffic. If there are receivers, trustees, or committees, who are recognized as in the controlling management of the company or of some department of it, give also their names and titles, and the location of their offices. If the duties of an officer extend to more than one department, or if his duties are not in accordance with the customary acceptance of his given title, state briefly the facts under Explanatory Remarks below.

EXPLANATORY REMARKS

102. DIRECTORS

Name of director (a)	Office address (b)	Date of beginning of term (c)	Date of expiration of term (d)	Remarks (e)
L. E. Cheney	445 South Figueroa St. Los Angeles, Calif. 90017	3/16/70	6/15/71	The annual meeting of the stockholders scheduled for the third Tuesday in March, according to the By-Laws, has been postponed and tentatively rescheduled for June 15, 1971.
R. G. Dulaney	600 - 5th Avenue New York, N.Y. 10020	3/16/70	6/15/71	
W. P. Bush	539 South Main St. Findlay, Ohio 45840	3/16/70	6/15/71	
A. D. Lodge	539 South Main St. Findlay, Ohio 45840	3/16/70	6/15/71	
G. A. Seymour	108 S. Akard Street Dallas, Texas 75202	3/16/70	6/15/71	
E. J. Wacker, Jr.	108 S. Akard Street Dallas, Texas 75202	3/16/70	6/15/71	
John M. Hopkins	P.O. Box 7600 Los Angeles, Calif. 90054	3/16/70	6/15/71	
W. S. McConnor	200 East Golf Road Palantine, Ill. 60067	3/16/70	6/15/71	

21. Give the names (and titles) of all *officers* of the *Board of Directors* of the respondent at the close of the year:
Chairman of Board None Secretary (or clerk) of Board C. R. Thompson

22. Name the members of the *executive committee* of the *Board of Directors* of the respondent at the close of the year (naming first the chairman), and state briefly the powers and duties of that committee:
None

AGO 531724

103. PRINCIPAL GENERAL OFFICERS

Line No.	Title of general officer (a)	Department or departments over which jurisdiction is exercised (b)	Name of person holding office at close of year (c)	Office address (d)
1	President	Executive	E. J. Wacker, Jr.	108 S. Akard Street Dallas, Texas 75202
2	Vice President	Executive	W. P. Bush	539 S. Main Street Findlay, Ohio 45840
3	Vice President	Executive	R. G. Dulaney	600 - 5th Avenue New York, New York 10020
4	Vice President	Executive	W. S. McConnor	200 E. Golf Road Palantine, Ill. 60067
5	Vice President	Executive	G. A. Seymour	108 S. Akard Street Dallas, Texas 75202
6	Vice President	Operating	D. L. Dennard	P. O. Box 4-XX Anchorage, Alaska 99503
7	Secretary-Treasurer	Secretarial and Fiscal	C. R. Thompson	108 S. Akard Street Dallas, Texas 75202
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108. CORPORATE CONTROL OVER RESPONDENT *

61. Did any corporation or corporations, pipe line or other, hold control over the respondent at the close of the year? Yes

If control was so held, state:

(a) The form of control, whether sole or joint Joint

(b) The name of the controlling corporation or corporations Atlantic Richfield Co., Mobil Pipe Line Co., Marathon Oil Co. and Union Oil Co. of California

(c) The manner in which control was established Stock ownership

(d) The extent of control Atlantic and Mobil Pipe Line 20% each; Marathon and Union 30% each

(e) Whether control was direct or indirect Direct

(f) The name of the intermediary through which control, if indirect, was established None

62. Did any individual, association, or corporation hold control, as trustee, over the respondent at the close of the year? No

If control was so held, state:

(a) The name of the trustee

(b) The name of the beneficiary or beneficiaries for whom the trust was maintained

(c) The purpose of the trust

108A. STOCKHOLDERS REPORTS

1. The respondent is required to send the Bureau of Accounts, immediately upon preparation, two copies of its latest annual report to stockholders.

Check appropriate box:

[X] Two copies are attached to this report.

[ ] Two copies will be submitted _____ (date)

[ ] No annual report to stockholders is prepared.

AGO 531725

109. VOTING POWERS AND ELECTIONS

1. State whether or not each share of stock has the right to one vote; if not, give full particulars in a footnote ....Yes....

2. Are voting rights proportional to holdings? ...Yes..... If not, state in a footnote the relation between holdings and corresponding voting rights.

3. Are voting rights attached to any securities other than stock? ...No..... If so, name in a footnote each security, other than stock, to which ting rights are attached (as of the close of the year), and state in detail the relation between holdings and corresponding voting rights, stating ether voting rights are actual or contingent, and if contingent showing the contingency.

4. Has any class or issue of securities any special privileges in the election of directors, trustees, or managers, or in the determination of corporate tion by a, y method? .... No..... If so, describe fully (in a footnote) each such class or issue and give a succinct statement showing clearly the aracter and extent of such privileges.

5. Give the date and state the purpose of the closing of the stock book or compilation of list of stockholders and their holdings at the latest date ior to the preparation of this report (even though such date be after the close of the year): ....
March 16, 1970 Annual Meeting*

6. State the total voting power of all security holders of the respondent at the date given in answer to inquiry No. 5, if within 1 year of the te of such preparation; if not, state as of the close of the year ....40,000.... votes, as of ...March 16, 1970... (Date)

7. State the total number of stockholders of record, as of the date shown in answer to inquiry No. 6. ....4.... stockholders.

8. Give the names of the 30 security holders of the respondent who, at the date of the closing of the stock book or compilation of list of stockolders of the respondent (if within 1 year of the preparation of this report), had the highest voting powers in the respondent, showing for each s address, the number of votes which he would have had a right to cast on that date had a meeting then been in order, and the classification of the umber of votes to which he was entitled, with respect to securities held by him, such securities being classified as common stock, second preferred ock, first preferred stock, and other securities, stating in a footnote the names of such other securities (if any). If any such holder held in trust, ve (in a footnote) the particulars of the trust. *If the stock book was not closed or the list of stockholders compiled within such year, show such 30 security lders as of the close of the year.*

Name of security holder (a)	Address of security holder (b)	Number of votes to which security holder was entitled (c)	Number of Votes, Classified with Respect to Securities on Which Based			
			Stocks			Other securities with voting power (g)
			Common (d)	Preferred		
				Second (e)	First (f)	
Atlantic Richfield Co.	717 Fifth Avenue	8,000	8,000			
	New York, New York					
Marathon Oil Co.	539 S. Main Street	12,000	12,000			
	Findlay, Ohio					
Union Oil Co. of Calif.	Union Oil Center	12,000	12,000			
	Los Angeles, Calif.					
Mobil Pipe Line Co.	P. O. Box 900	8,000	8,000			
	Dallas, Texas					
*June 25, 1970	Mobil Oil Corp. sold its stock to Mobil Pipe Line Company					
March 6, 1970	Cities Service Company sold its stock to Marathon Oil Company					
	and Union Oil Co. of California, each purchasing 50% of 8,000 shares.					

AGO 531726

9. State the total number of votes cast at the *latest* general meeting for the election of directors of the respondent ..40,000.... votes cast.

10. Give the date and place of such meeting ..March 16, 1970 at Pebble Beach, California...

110. GUARANTIES AND SURETYSHIPS

7.

1. If the respondent was under obligation as guarantor or surety for the performance by any other corporation or other association of any agreement or obligation, show for each such contract of guaranty or suretyship in effect at the close of the year, or entered into and expired during the year, the particulars called for hereunder.

This inquiry does not cover the case of ordinary commercial paper maturing on demand or not later than two years after date of issue.

Line No.	Names of all parties principally and primarily liable (a)	Description of agreement or obligation (b)	Amount of contingent liability (c)	Sole or joint contingent liability (d)
1	None			
2				
3				
4				
5				
6				
7				
8				
9				
10				
11				
12				
13				
14				
15				
16				
17				
18				
19				
20				
21				
22				
23				
24				
25				
26				
27				
28				

2. If any corporation or other association was under obligation as guarantor or surety for the performance by the respondent of any agreement or obligation, show for each such contract of guaranty or suretyship in effect at the close of the year, or entered into and expired during the year, the particulars called for hereunder.

This inquiry does not cover the case of ordinary commercial paper maturing on demand or not later than two years after date of issue, nor does it include ordinary surety bonds or undertakings on appeals in court proceedings.

Line No.	Description of agreement or obligation (a)	Names of all guarantors and sureties (b)	Amount of contingent liability of guarantors (c)	Sole or joint contingent liability (d)
31	Throughput Agreement dated	Atlantic Richfield Company	See conditions	Joint
32	December 1, 1967 which requires	Standard Oil Company	set forth under	
33	Guarantors to provide carrier	Union Oil Co. of California	Section (A)	
34	with sufficient amount of such	Shell Pipe Line Company	hereof.	
35	revenue which, when added to			
36	initial [illegible] where such carriers			
37	will be sufficient to pay the			
38	[illegible] cost of carrier's			
39	obligations during the year			
40	payable out of the aforesaid			
41	period and [illegible]			
42	[illegible] of the throughput			
43	[illegible]			
44				
45				
46				
47				
48				

200A. COMPARATIVE BALANCE SHEET STATEMENT—ASSET SIDE

For instructions covering this schedule, see the text and instructions pertaining to Balance Sheet Accounts in the Uniform System of Accounts for Pipe Lines. The entries in this balance sheet should be consistent with those in the supporting schedules on the pages indicated.

All contra entries hereunder should be indicated in parentheses.

On line 31, column (a) and short-column (b), include depreciation applicable to investment in system property.

Balance at beginning of year (a)			Item (b)	Balance at close of year (c)		
$				$		
x x	x x	x x	CURRENT ASSETS	x x	x x	x x
	376	994	(10) Cash		605	734
	570	078	(11) Temporary investments	2	669	353
			(12) Notes receivable (p. 202)			
1	239	333	(13) Receivables from affiliated companies (p. 202)	1	806	766
	137	098	(14) Accounts receivable (p. 202)		266	655
		632	(15) Interest and dividends receivable		5	265
			(16) Oil inventory			
	174	795	(17) Material and supplies		180	931
	25	140	(18) Prepayments		91	642
	113	807	(19) Other current assets		114	371
2	638	243	TOTAL CURRENT ASSETS	5	740	717
x x	x x	x x	INVESTMENTS AND SPECIAL FUNDS	x x	x x	x x
x x	x x	x x	(20) Investments in affiliated companies:	x x	x x	x x
			Stocks (pp. 204, 205)			
			Bonds (pp. 204, 205)			
			Other secured obligations (pp. 204, 205)			
			Unsecured notes (pp. 204, 205)			
			Investment advances (pp. 204, 205)			
x x	x x	x x	(21) Other investments:	x x	x x	x x
			Stocks (pp. 206, 207)			
			Bonds (pp. 206, 207)			
			Other secured obligations (pp. 206, 207)			
			Unsecured notes (pp. 206, 207)			
			Investment advances (pp. 206, 207)			
			(22) Sinking and other funds (p. 210)			
			(23) Reductions in security values—Credit			
			TOTAL INVESTMENTS AND SPECIAL FUNDS			
x x	x x	x x	TANGIBLE PROPERTY	x x	x x	x x
40	867	774	(30) Carrier property (pp. 212, 213)	$ 41 323 674	x x	x x	x x
(2	983	169)	(31) Accrued depreciation—Carrier property (pp. 214B, 214C)	(4 537 492)	x x	x x	x x
			(32) Accrued amortization—Carrier property (p. 216)		36	786	182
			(33) Operating oil supply				
			(34) Noncarrier property (p. 217)	$			
			(35) Accrued depreciation—Noncarrier property				
37	904	624	TOTAL TANGIBLE PROPERTY		36	786	182
x x	x x	x x	OTHER ASSETS AND DEFERRED CHARGES	x x	x x	x x
	1	247	(40) Organization costs and other intangibles	$ 1 247	x x	x x	x x
			(41) Accrued amortization of intangibles			1	247
			(42) Unamortized discount and interest on long-term debt				
		35	(43) Miscellaneous other assets				35
	2	858	(44) Other deferred charges (p. 218)				380
	4	140	TOTAL OTHER ASSETS AND DEFERRED CHARGES			1	662
40	50	497	TOTAL ASSETS		42	528	561

AGO 531728

200L. COMPARATIVE BALANCE SHEET STATEMENT—LIABILITY SIDE

For instructions covering this schedule, see the text and instructions pertaining to Balance Sheet Accounts in the Uniform System of Accounts for Pipe Lines. The entries in this balance sheet should be consistent with those in the supporting schedules on the pages indicated.
All contra entries hereunder should be indicated in parentheses.

No.	Balance at beginning of year (a)	Item (b)	Balance at close of year (c)
	$		$
1	x x	CURRENT LIABILITIES	x x
2		(50) Notes payable (p. 219)	
3	102 911	(51) Payables to affiliated companies (p. 219)	55 710
4	40 212	(52) Accounts payable (p. 219)	20 210
5		(53) Salaries and wages payable	
6	267 534	(54) Interest payable	226 356
7		(55) Dividends payable	
8	360	(56) Taxes payable	465
9	11 000 000	(57) Long-term debt payable within one year (pp. 220, 221)	3 500 000
10	21 093	(58) Other current liabilities	
11	11 432 110	TOTAL CURRENT LIABILITIES	3 802 741
12	x x	NONCURRENT LIABILITIES	x x
13	25 000 000	(60) Long-term debt payable after one year (pp. 222, 223)	*32 500 000
14		(61) Unamortized premium on long-term debt	
15		(63) Other noncurrent liabilities	
16	25 000 000	TOTAL NONCURRENT LIABILITIES	32 500 000
17	36 432 110	TOTAL LIABILITIES	36 302 741
18	x x	STOCKHOLDERS' EQUITY	x x
19	4 000 000	(70) Capital stock (p. 226)	4 000 000
20		(71) Premiums on capital stock	
21		(72) Capital stock subscriptions	
22		(73) Additional paid in capital (p. 228)	
23		(74) Appropriated retained income (p. 229)	
24	114 887	(75) Unappropriated retained income (p. 300)	2 225 820
25	4 114 887	TOTAL STOCKHOLDERS' EQUITY	6 225 820
26	40 546 997	TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	42 528 561

1. Estimated accumulated net Federal income tax reduction realized since December 31, 1949, under section 168 (formerly section 124 A) of the Internal Revenue Code because of accelerated amortization of emergency facilities in excess of recorded depreciation . . . . $ None

2. Estimated accumulated net Federal income tax reduction realized since December 31, 1953, because of accelerated depreciation of facilities in excess of recorded depreciation under provisions of section 167 of the Internal Revenue Code and depreciation deductions resulting from the use of guideline lives since December 31, 1961, pursuant to Revenue Procedure 62-21 in excess of recorded depreciation . . . . $ None

3. Estimated accumulated net income tax reduction realized since December 31, 1961, because of the investment tax credit authorized in the Revenue Act of 1962 compared with the income taxes that would otherwise have been payable without such investment tax credit . . . . . $ None

4. Estimated amount of future earnings which can be realized before paying Federal income taxes because of unused and available net operating loss carryover on January 1, 1971 . . . . . $ 270,822

*Due within one year but is expected to be refinanced.

Give particulars of the various debtors and the character of the transactions involved in the current asset account No. 12, "Notes receivable." List every item in excess of $100,000 and state its date of issue and date of maturity.

For debtors whose balances were severally less than $100,000, a single entry may be made under a caption "Minor accounts, each less than $100,000."

Name of debtor (a)	Character of assets or of transaction (b)	Date of issue (c)	Date of maturity (d)	Balance at close of year (e)		
				$		
None						
			Total			

211. RECEIVABLES FROM AFFILIATED COMPANIES

Give particulars of the various affiliated company debtors and the character of the transactions involved in the current asset account No. 3, "Receivables from affiliated companies."

List every item in excess of $100,000.

For debtors whose balances were severally less than $100,000, a single entry may be made under a caption "Minor accounts, each less than $100,000."

Name of debtor (a)	Character of assets or of transaction (b)	Balance at close of year (e)		
		$		
Atlantic Richfield Co.	Revenue Receivable-Transportation & Demurrage		360	815
Marathon Oil Co.	Revenue Receivable-Transportation & Demurrage		571	935
Union Oil Co. of Calif.	Revenue Receivable-Transportation & Demurrage		806	912
Minor accounts, each less than $100,000			67	104
	Total	1	806	766

212. ACCOUNTS RECEIVABLE

Give particulars of the various debtors and the character of the transactions involved in the current asset account No. 11, "Accounts receivable."

List every item in excess of $100,000.

For debtors whose balances were severally less than $100,000, a single entry may be made under a caption "Minor accounts, each less than $100,000."

Name of debtor (a)	Character of assets or of transaction (b)	Balance at close of year (e)		
		$		
Minor accounts, each less than $100,000			266	655
	Total		266	655

GENERAL INSTRUCTIONS CONCERNING RETURNS IN SCHEDULES 220 AND 221

1. Schedules 220 and 221 should give particulars of stocks, bonds, notes, advances, and miscellaneous securities of affiliated and nonaffiliated companies held by respondent at close of year specifically as investments, investments made or disposed of during the year; and dividends and interest credited to income. They should exclude securities issued or assumed by respondent.

2. Two companies are affiliated, as the term is here used, when one directly or indirectly controls the other, or when they are subject to a common control.

3. By "control," as the term is here used, is meant the ability to determine the action of a company. Attention is specifically directed to section 1 (3) (*b*) of Part I of the Interstate Commerce Act which provides that, "For the purposes of sections 5, 12 (1), 20, 204 (*a*) (7), 210, 220, 304 (*b*), 310, and 313 of this Act, where reference is made to control (in referring to a relationship between any person or persons and another person or persons), such reference shall be construed to include actual as well as legal control, whether maintained or exercised through or by reason of the method of or circumstances surrounding organization or operation, through or by common directors, officers, or stockholders, a voting trust or trusts, a holding or investment company or companies, or through or by any other direct or indirect means; and to include the power to exercise control.

4. For the purposes of this report, the following are to be considered forms of control:

(*a*) Right through title to securities issued or assumed to exercise the major part of the voting power in the controlled company;

(*b*) Right through agreement or through sources other than title to securities to name the majority of the board of directors, managers, or trustees of the controlled company;

(*c*) Right to foreclose a priority lien upon all or a major part in value of the tangible property of the controlled company;

(*d*) Right to secure control in consequence of advances made for construction of the property of the controlled company.

Indirect control is that exercised through an intermediary.

5. A leasehold interest in the property of a company is not for the purpose of these accounts to be classed as a form of control over the lessor company.

6. These investments should be subdivided to show the par value pledged, unpledged, and held in fund accounts. Under "pledged" include the par value of securities recorded in accounts Nos. 20, "Investments in affiliated companies," and 21, "Other investments," which are deposited with some pledgee or other trustee, or held subject to the lien of a chattel mortgage, or subject to any other restriction or condition which makes them unavailable for general corporate purposes. "Unpledged" should include all securities held by or for the respondent free from any lien or restriction recorded in the accounts mentioned above. Under "In sinking, insurance and other funds" include the par value of securities recorded in account No. 22, "Sinking and other funds."

7. List the investments in the following order and show a total for each group and each class of investments by accounts in numerical order:

(A) Stocks:
1. Pipe-line companies—active.
2. Pipe-line companies—inactive.
3. Non-pipe-line companies—active.
4. Non-pipe-line companies—inactive.

(B) Bonds (including U. S. Government Bonds).

(C) Other secured obligations.

(D) Unsecured notes.

(E) Investment advances.

8. The subclassification of classes (B), (C), (D), and (E) should be the same as that provided for class (A).

9. By an active corporation is meant one which maintains an organization for operating property or administering its financial affairs. An inactive corporation is one which has been practically absorbed in a controlling corporation, and which neither operates property nor administers its financial affairs, if it maintains an organization it does so only for the purpose of complying with legal requirements and maintaining title to property or franchises.

220. INVESTMENTS IN AFFILIATED COMPANIES

Give particulars of investments included in accounts Nos. 20, "Investments in affiliated companies" and 22, "Sinking and other funds."

Entries in this schedule should be made in accordance with the definitions and general instructions given on page 203, classifying the investments by means of letters and figures in columns (a) and (b).

Indicate by means of an arbitrary mark in column (c) the obligation in support of which any security is pledged, mortgaged, or otherwise encumbered, giving names and other important particulars of such obligations in footnotes.

Give totals for each class and for each subclass, and a grand total for each account.

Entries in column (c) should show date of maturity of bonds and other evidences of indebtedness. In case obligations of the same designation mature serially, the date in column (c) may be reported as "Serially 19 ..... to 19 ....." In making entries in this column, abbreviations in common use in standard financial publications may be used where necessary on account of limited space.

Account No. (a)	Class No. (b)	Name of issuing company and description of security held, also lien reference, if any (c)	Extent of control (d)	Investments at Close of Year — Par value of amount held at close of year: Pledged (e)	Unpledged (f)	In sinking, insurance, and other funds (g)	Total par value (h)
			%	$	$	$	$
		None					

AGO 531732

If any of the companies included in this schedule are controlled by respondent, the percent of control should be given in column (d). In case any company listed is controlled other than through actual ownership of securities, give particulars in a footnote. In cases of joint control, give names of other parties and particulars of control.

For nonpar stock, show the number of shares in lieu of the par value in columns (e), (f), (g), (h), (j), and (l).

In reporting advances, columns (e), (f), (g), (h), (j), and (l) should be left blank. If any advances are pledged, give particulars in a footnote.

Particulars of investments made, disposed of, or written down during the year should be given in columns (j) to (n), inclusive. If the cost of any investment made during the year differs from the book value reported in column (k), explain the matter in a footnote. By "cost" is meant the consideration given minus accrued interest or dividends included therein. If the consideration given or received for such investments was other than cash, describe the transaction in a footnote.

This schedule should not include issued securities or assumed by respondent.

Investments at Close of Year	Investments Made During Year		Investments Disposed of or Written Down During Year			Dividends or Interest		
Total book value	Par value	Book value	Par value	Book value	Selling price	Rate	Amount credited to income	
(i)	(j)	(k)	(l)	(m)	(n)	(o)	(p)	
$	$	$	$	$	$	%	$	

AGO 531733

221. OTHER INVESTMENTS

1. Give particulars of investments in all corporations other than filiated companies included in accounts Nos. 21, "Other investments" nd 22, "Sinking and other funds."

2. Entries in this schedule should be made in accordance with the efinitions and general instructions given on page 203, classifying the vestments by means of letters and figures in columns (a) and (b). vestments in U. S. Treasury bills and notes may be reported as one item.

3 Indicate by means of an arbitrary mark in column (c) the obligation in support of which any security is pledged, mortgaged, or otherwise encumbered, giving names and other important particulars of such obligations in footnotes

4 Give totals for each class and for each subclass, and a grand total for each account.

5. Entries in column (c) should show date of maturity of bonds and other evidences of indebtedness. In case obligations of the same designation

Account No. (a)	Class No. (b)	Name of issuing company and description of security held, also lien reference, if any (c)	Investments at Close of Year — Par value of amount held at close of year			
			Pledged (d)	Unpledged (e)	In sinking, insurance, and other funds (f)	Total par value (g)
		None	$	$	$	$

AGO 531734

221. OTHER INVESTMENTS—Concluded

mature serially, the date in column (c) may be reported as "Serially 19...... to 19......." In making entries in this column, abbreviations in common use in standard financial publications may be used where necessary on account of limited space.

6. For nonpar stock, show the number of shares in lieu of the par value in columns (d), (e), (f), (g), (i), and (k).

7. In reporting advances, columns (d), (e), (f), (g), (i), and (k) should be left blank. If any advances are pledged, give particulars in a footnote.

8. Particulars of investments made, disposed of, or written down during the year should be given in columns (i) to (m), inclusive. If the cost of any investment made during the year differs from the book value reported in column (j) explain the matter in a footnote. By "cost" is meant the consideration given minus accrued interest or dividends included therein. If the consideration given or received for such investments was other than cash, describe the transaction in a footnote.

Investments at Close of Year	Investments Made During Year		Investments Disposed of or Written Down During Year			Dividends or Interest		Line No.
Total book value (h)	Par value (i)	Book value (j)	Par value (k)	Book value (l)	Selling price (m)	Rate (n)	Amount credited to income (o)	
	$	$	$	$	$	%	$	

AGO 531735

222. COMPANIES CONTROLLED DIRECTLY BY RESPONDENT OTHER THAN THROUGH TITLE TO SECURITIES

(For definition of control, see instructions on p. 203)

Name of company controlled (a)	Character of Control				Remarks (f)
	Sole or joint (b)	Other parties, if any, to joint agreement for control (c)	How established (d)	Extent (e)	
ne					

223. COMPANIES CONTROLLED THROUGH NONREPORTING INTERMEDIARIES

(For definition of control, see instructions on p. 203)

Name of company controlled (a)	Character of Control				Name of intermediary through which indirect control exists (f)
	Sole or joint (b)	Other parties, if any, to joint agreement for control (c)	How established (d)	Extent (e)	
one					

4. SECURITIES, ADVANCES, AND OTHER INTANGIBLES OWNED OR CONTROLLED THROUGH NONREPORTING CARRIER AND NONCARRIER SUBSIDIARIES

Give particulars of investments represented by securities and advances (including securities issued or assumed by respondent), and of other intangible property, indirectly owned or controlled by respondent through any subsidiary which does not report to the Commission under the provisions of Part I of the Interstate Commerce Act, without regard to any question of whether the company issuing the securities, or the obligor, is controlled by the subsidiary.

This schedule should include all securities, open account advances, and other intangible property owned or controlled by nonreporting companies shown in schedules 220, 222, and 223, as well as those owned or controlled by any other organization or individual whose action respondent is enabled to determine.

Investments in U. S. Treasury obligations may be combined in a single item.

Class No. (a)	Name of issuing company and security or other intangible thing in which investment is made. (List on same line in second section and in same order as in first section.) (b)	Investments at Close of Year: Total par value (c)	Investments at Close of Year: Total book value (d)	Investments Made During Year: Par value (e)	Investments Made During Year: Book value (f)
	None	$	$	$	$

Investments Disposed of or Written Down During Year: Par value (g)	Book value (h)	Selling price (i)	Names of subsidiaries in connection with things owned or controlled through them (j)
$	$	$	

225. SINKING AND OTHER FUNDS

Give the particulars called for with respect to funds included in account No. 22, "Sinking and other funds."

In column (b) give the name by which the fund is designated in the respondent's records, the kind of fund, such as sinking, capital, property insurance, pension, and relief; the rate of interest (if any); and the date of maturity.

Entries in column (g) should be the sums of corresponding entries in columns (d) and (e), less those shown in column (f), and the sum of entries in columns (h), (j), and (l) should equal those in column (g).

All conversions of cash into securities, or vice versa, shall be treated as withdrawals from the fund in column (f) and as additions to the fund in column (e).

Account No. (a)	Name, kind, and purpose of fund. (List on same line in second section and in same order as in first section) (b)	Name of trustee or depositary (c)	Balance at beginning of year—Book value (d)
	None		$

Additions during the year—Book value (e)	Withdrawals during the year—Book value (f)	Balance at close of year—Book value (g)	Assets in Funds at Close of Year				
			Cash (h)	Securities issued or assumed by respondent: Par value (i)	Securities issued or assumed by respondent: Book value (j)	Other securities and invested assets: Par value (k)	Other securities and invested assets: Book value (l)
$	$	$	$	$	$	$	$

INSTRUCTIONS

Give an analysis of changes during the year in account No. 30, "Carrier Property," by carrier-property accounts, including investments in system properties.

Show in column (c) the debits representing newly constructed property, and additions and improvements made to existing property. Both the debits and credits involved in the distribution to carrier property primary accounts of amounts previously charged to account No. 187 should be entered in column (c). In column (d) show expenditures for existing pipe line property purchased or otherwise acquired. Show in column (e) the total credits representing property sold, abandoned, or otherwise retired during the year.

If during the year pipe line operating property was acquired from or sold to some other company, the purchase or sales price for which was recorded at $100, state in a footnote the name of the company, the nature (whether purchased or disposed of), and the date of acquisition or disposal, giving terminal and the cost of the property to the company. Also furnish a statement of the amount included in or credited to each primary account representing such property acquired or disposed of.

Show in column (g) for each primary account the net of all accounting adjustments, transfers, and clearances applicable to prior years' accounting.

Each adjustment, clearance, or transfer in excess of $100,000 should be fully explained in a footnote, except that transfers to or from account No. 31, "Noncarrier property," should be explained in schedule 31.

An entry in column (f), (g), or (h) which represents an excess of credits over debits should be indicated

Line No.	Account (a)	Balance at beginning of year (b)		
		$		
1	GATHERING LINES	x x	x x	x x
2	(101) Land			
3	(102) Right of way			
4	(103) Line pipe			
5	(104) Line pipe fittings			
6	(105) Pipeline construction			
7	(106) Buildings			
8	(107) Boilers			
9	(108) Pumping equipment			
10	(109) Machine tools and machinery			
11	(110) Other station equipment			
12	(111) Oil tanks			
13	(112) Delivery facilities			
14	(113) Communication systems			
15	(114) Office furniture and equipment			
16	(115) Vehicles and other work equipment			
17	(116) Other property			
18	TOTAL			
19	TRUNK LINES	x x	x x	x x
20	(151) Land		44	891
21	(152) Right of way		3	390
22	(153) Line pipe	1	613	755
23	(154) Line pipe fittings		322	276
24	(155) Pipeline construction	5	993	613
25	(156) Buildings	1	992	045
26	(157) Boilers		10	849
27	(158) Pumping equipment		637	699
28	(159) Machine tools and machinery		7	010
29	(160) Other station equipment	1	828	825
30	(161) Oil tanks	5	934	082
31	(162) Delivery facilities	21	858	535
32	(163) Communication systems		303	006
33	(164) Office furniture and equipment		34	029
34	(165) Vehicles and other work equipment		195	729
35	(166) Other property	40	779	734
36	TOTAL			
37	GENERAL	x x	x x	x x
38	(171) Land		4	327
39	(176) Buildings		13	558
40	(179) Machine tools and machinery			
41	(180) Communication systems		39	851
42	(181) Office furniture and equipment		8	026
43	(182) Vehicles and other work equipment		4	892
44	(186) Other property			
45	(182) Construction work in progress		37	386
46	TOTAL		108	040
47	GRAND TOTAL	40	887	774

236. CARRIER PROPERTY—Concluded

Property Changes During the Year																			
Expenditures for new construction and improvements (c)			Expenditures for existing property purchased or otherwise acquired (d)			Credits for property sold, abandoned, or otherwise retired during the year (e)			Net (f)			Other adjustments, transfers and clearances (g)			Increase or decrease during the year (h)			Balance at close of year (i)		
$			$			$			$			$			$			$		
																			44	891
																			3	390
	10	272						(740)		9	532					9	532	1	623	287
	24	919					(1 | 675)		23	244					23	244		345	520
	51	790						(349)		51	441					51	441	6	045	054
	3	706					(22	760)		(19	054)					(19	054)	1	972	991
																			10	849
	25	718					(33	062)		(7	344)					(7	344)		630	355
																			7	010
	54	160					(1 | 034)		53	126					53	126	1	881	951
	10	100								10	100					10	100	5	944	182
	188	310					(7 | 983)		180	327					180	327	22	038	862
																			303	006
	1	366								1	366					1	366		35	395
	15	[illegible]					(56	910)		(41	685)					(41	685)		154	044
	385	[illegible]					(124 | 513)		261	053					261	053	41	040	787
																			4	327
																			13	558
	1	527								1	527					1	527		41	378
		180						(878)			(698)						(698)		7	328
	3	102					(3 | 215)			(113)						(113)		4	779
	174	131								174	131					174	131		211	517
	178	940					(4 | 093)		174	847					174	847		282	887
	564	506					(128 | 606)		435	900					435	900	41	323	674

231. DEPRECIATION BASE AND RATES - CARRIER PROPERTY (EXCLUSIVE OF SYSTEM PROPERTY REPORTED IN SCHEDULE 231A)

Show in columns (b) and (c) for each depreciable property account the balance at the beginning and end of the year, respectively, used in computing depreciation charges. The average depreciation base shown in column (d) should be determined for each such depreciable account by adding together the base used for each month during the year and dividing the total by 12.

If composite annual depreciation rates are prescribed, those in effect at the close of the year should be shown in column (e). If composite rates are prescribed, the composite rates to be shown in column (e) should be computed from the charges developed for December by application of the prescribed component rates. Whether component or composite rates are prescribed, the entries on lines 16, 32, 39, and 40 of column (e) should be computed from December depreciation charges.

3. Information to be included in columns (b) and (c) of lines 41 to 45 inclusive, is for reconciliation of the returns in these schedules with those in schedule 230.

4. Entries on line 43 should agree with totals for the beginning and end of the year in columns (b) and (c), respectively, of schedule 233, "Amortization Base and Reserve." Amounts included in line 43, "Values being amortized," should be excluded from items shown on lines 41 and 42.

Account (a)	Depreciation Base: Balance at beginning of year (b)	Depreciation Base: Balance at close of year (c)	Depreciation Base: Average balance for the year (d)	Annual composite rates (e)
	$	$	$	%
DEPRECIABLE CARRIER PROPERTY - GATHERING LINES				
(102) Right of way				
(103) Line pipe				
(104) Line pipe fittings				
(105) Pipeline construction				
(106) Buildings				
(107) Boilers				
(108) Pumping equipment				
(109) Machine tools and machinery				
(110) Other station equipment				
(111) Oil tanks				
(112) Delivery facilities				
(113) Communication systems				
(114) Office furniture and equipment				
(115) Vehicles and other work equipment				
(116) Other property				
All depreciable gathering lines accounts				
DEPRECIABLE CARRIER PROPERTY - TRUNK LINES				
(152) Right of way	3 390	3 390	3 390	4 00
(153) Line pipe	1 613 745	1 623 287	1 618 521	4 00
(154) Line pipe fittings	332 276	345 520	333 898	4 00
(155) Pipeline construction	5 993 613	6 045 056	6 019 334	4 00
(156) Buildings	1 992 044	1 972 991	1 982 518	4 00
(157) Boilers	10 859	10 859	10 849	4 00
(158) Pumping equipment	632 [illegible]	650 [illegible]	634 027	4 00
(159) Machine tools and machinery	7 010	7 010	7 010	4 00
(160) Other station equipment	1 [illegible]	1 851 [illegible]	1 855 388	4 00
(161) Oil tanks	5 934 [illegible]	5 [illegible]	5 939 132	4 00
(162) Delivery facilities	22 [illegible]	22 048 [illegible]	21 968 698	4 00
(163) Communication systems	303 [illegible]	303 [illegible]	303 006	10 00
(164) Office furniture and equipment	34 [illegible]	34 [illegible]	34 712	5 00
(165) Vehicles and other work equipment	174 [illegible]	174 [illegible]	174 986	8 90
(166) Other property				
All depreciable trunk line accounts	40 [illegible]	40 [illegible]	40 865 369	4 06
DEPRECIABLE CARRIER PROPERTY - GENERAL				
(176) Buildings	13 [illegible]	14 [illegible]	13 558	4 00
(179) Machine tools and machinery				
(183) Communication systems	40 [illegible]	41 [illegible]	40 614	10 00
(184) Office furniture and equipment	7 [illegible]	7 [illegible]	7 677	5 00
(185) Vehicles and other work equipment	4 [illegible]	5 [illegible]	4 836	18 75
(186) Other property				
All depreciable general accounts	66 [illegible]	67 [illegible]	66 685	8 57
All depreciable accounts	40 [illegible]	41 062 [illegible]	40 932 054	4 97
NONDEPRECIABLE CARRIER PROPERTY (Exclusive of System Property)				
(191) Land	59 [illegible]	59 [illegible]	* * *	* * *
(192) Construction work in progress	37 [illegible]	211 [illegible]	* * *	* * *
Value of property leased to others			* * *	* * *
All nondepreciable other property	96 [illegible]	269 [illegible]	* * *	* * *
Total carrier property	41 [illegible]	41 [illegible]	* * *	

231A. DEPRECIATION BASE AND RATES - SYSTEM PROPERTY
(THIS SCHEDULE IS FOR USE ONLY WHEN SPECIFICALLY DIRECTED BY THE COMMISSION)

Follow instructions for Schedule 231, Depreciation Base and Rates - Carrier Property

Name of system: .....

No.	Account (a)	Depreciation Base: Balance at beginning of year (b)	Depreciation Base: Balance at close of year (c)	Depreciation Base: Average balance for the year (d)	Annual composite rates (e)
		$	$	$	%
	DEPRECIABLE SYSTEM PROPERTY—GATHERING LINES				
	(102) Right of way				
	(103) Line pipe				
	(104) Line pipe fittings				
	(105) Pipeline construction				
	(106) Buildings				
	(107) Boilers				
	(108) Pumping equipment				
	(109) Machine tools and machinery				
	(110) Other station equipment				
	(111) Oil tanks				
	(112) Delivery facilities				
	(113) Communication systems				
	(114) Office furniture and equipment				
	(115) Vehicles and other work equipment				
	(116) Other property				
	All depreciable gathering lines accounts				
	DEPRECIABLE SYSTEM PROPERTY—TRUNK LINES				
	(152) Right of way				
	(153) Line pipe				
	(154) Line pipe fittings				
	(155) Pipeline construction				
	(156) Buildings				
	(157) Boilers				
	(158) Pumping equipment				
	(159) Machine tools and machinery				
	(160) Other station equipment				
	(161) Oil tanks				
	(162) Delivery facilities				
	(163) Communication systems				
	(164) Office furniture and equipment				
	(165) Vehicles and other work equipment				
	(166) Other property				
	All depreciable trunk lines accounts				
	DEPRECIABLE SYSTEM PROPERTY—GENERAL				
	(176) Buildings				
	(179) Machine tools and machinery				
	(183) Communication systems				
	(184) Office furniture and equipment				
	(185) Vehicles and other work equipment				
	(186) Other property				
	All depreciable general accounts				
	All depreciable system property accounts				
	NONDEPRECIABLE SYSTEM PROPERTY (see instruction 11)				
	(101, 151, 171) Land				
	Total investment in system property				

232. ACCRUED DEPRECIATION—CARRIER PROPERTY (EXCLUSIVE OF DEPRECIATION ON SYSTEM PROPERTY REPORTED IN SCHEDULE 232A)

particulars of the credits and debits to account No. 31, "Accrued depreciation—carrier property," during the year. All contra
s the respective columns herein should be indicated in parentheses.

Account (a)	Balance at beginning of year (b)	Charged to account No. 5xx (c)	Net charge from retirement of carrier property (d)	Other debits and credits—Net (e)	Balance at close of year (f)
	$	$	$	$	$
Gathering Lines					
Right of way					
Line pipe					
Line pipe fittings					
Pipeline construction					
Buildings					
Boilers					
Pumping equipment					
Machine tools and machinery					
Other station equipment					
Oil tanks					
Delivery facilities					
Communication systems					
Office furniture and equipment					
Vehicles and other work equipment					
Other property					
Total					
Trunk Lines					
Right of way	320	132			452
Line pipe	145 325	64 553	(206)		209 672
Line pipe fittings	20 659	12 896	(945)		32 610
Pipeline construction	534 167	240 987	(349)		774 805
Buildings	115 895	79 456	(23 443)		171 908
Boilers	939	432			1 371
Pumping equipment	(89 637)	25 522	(18 733)		(82 848)
Machine tools and machinery	503	276			779
Other station equipment	126 849	74 055	(84)		200 820
Oil tanks	347 151	237 662			584 813
Delivery facilities	1 723 330	873 639	(3 923)		2 593 046
Communication systems	30 640	30 300			60 940
Office furniture and equipment	2 249	1 719	(189)		3 779
Vehicles and other work equipment	22 462	13 353	(55 532)		(19 717)
Other property					
Total	2 981 852	1 654 782	(103 604)		4 532 430
General					
Buildings	441	540			981
Machine tools and machinery					
Communication systems	196	4 023			4 219
Office furniture and equipment	718	399	(378)		739
Vehicles and other work equipment	753	860	(2 490)		(877)
Other property					
Total	2 108	5 822	(2 868)		5 062
Grand Total	2 983 960	1 660 604	(106 272)		4 537 492

AGO 531743

232A. ACCRUED DEPRECIATION - SYSTEM PROPERTY
(THIS SCHEDULE IS FOR USE ONLY WHEN SPECIFICALLY DIRECTED BY THE COMMISSION)

Follow instructions for Schedule 232, Accrued Depreciation - Carrier Property

Name of system:----------

Account (a)	Balance at beginning of year (b)	Charged to account (c)	Net charge from retirement of system property (d)	Other debits and credits - Net (e)	Balance at close of year (f)
GATHERING LINES	$	$	$	$	$
(102) Right of way					
(103) Line pipe					
(104) Line pipe fittings					
(105) Pipeline construction					
(106) Buildings					
(107) Boilers					
(108) Pumping equipment					
(109) Machine tools and machinery					
(110) Other station equipment					
(111) Oil tanks					
(112) Delivery facilities					
(113) Communication systems					
(114) Other furniture and equipment					
(115) Vehicles and other work equipment					
(116) Other property					
TOTAL					
TRUNK LINES					
(152) Right of way					
(153) Line pipe					
(154) Line pipe fittings					
(155) Pipeline construction					
(156) Buildings					
(157) Boilers					
(158) Pumping equipment					
(159) Machine tools and machinery					
(160) Other station equipment					
(161) Oil tanks					
(162) Delivery facilities					
(163) Communication systems					
(164) Other furniture and equipment					
(165) Vehicles and other work equipment					
(166) Other property					
TOTAL					
GENERAL					
(176) Buildings					
(177) Machine tools and machinery					
(183) Communication systems					
(184) Other furniture and equipment					
(185) Vehicles and other work equipment					
(186) Other property					
TOTAL					
GRAND TOTAL					

233. AMORTIZATION BASE AND RESERVE

Show in columns (b) to (e) the cost of pipeline property as the base in computing amortization charges included in Act No. 540, "Depreciation and amortization," of the accounting company.

Show in columns (f) to (i) the balances at the beginning and close of the year and the total credits and debits during the year in account No. 32, "Accrued amortization—Carrier property."

3. The information requested for columns (b) to (i), inclusive, may be shown by projects, or for totals only.

4. If amounts represented in column (g) are different from corresponding charges to account No. 540, for the same property, such differences should be explained in detail.

5. Adjustments included in column (h), affecting operating expenses, should be fully explained.

6. Should respondent elect to report by projects, each project amounting to $10,000 or more should be briefly described as to kind of property. Location of property should not be stated. Items less than $10,000 should be combined in a single entry designated "Minor items ... in number, each less than $10,000."

Item	Base				Reserve			
	Balance at beginning of year	Debits during year	Credits during year	Balance at close of year	Balance at beginning of year	Credits during year	Debits during year	Balance at close of year
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
	$	$	$	$	$	$	$	$
None								

AGO 5811745

234. NONCARRIER PROPERTY

27.

Give particulars of all investments of the respondent in physical property includable in account No. 34, "Noncarrier property," in the Uniform System of Accounts for Pipe Lines. The description of the property in column (a) should give the location and other identification of it with a reasonable degree of particularity.

Each item amounting to $100,000 or more should be stated; items less than $100,000 may be combined in a single entry designated "Minor items, each less than $100,000."

If any property of the character provided for in this schedule was disposed of during the year, or by reclassification was transferred to or from the carrier property accounts, give particulars in a footnote.

The revenues, expenses, and taxes of operated properties should be summarized in schedule 340 on page 305.

Name and description of physical property held at close of year as an investment (a)	Date included in account No. 34 (b)	Book cost at close of year (c)	Remarks (d)
None		$	
	Total		

AGO 531746

240. OTHER DEFERRED CHARGES

[Gi]ve an analysis of the balance in account No. 44, "Other deferred [char]ges," at the close of the year, showing in detail each item or subaccount [amou]nting to $20,000 or more. Items less than $20,000 may be combined in a single entry designated "Minor items, each less than $20,000." In case the character of any item is not fully disclosed by the entries in the columns hereunder, make a full explanation in a footnote.

Description and character of items, and names of debtor (or class of debtors), if any (a)	Amount at close of year (b)
Minor items, each less than $20,000	$ 380
TOTAL	380

250. NOTES PAYABLE

Give particulars of the various creditors and the character of the transactions involved in the current liability account No. 50, "Notes payable."

List every item in excess of $100,000 and state its date of issue and date of maturity.

For creditors whose balances were severally less than $100,000, a single entry may be made under a caption "Minor accounts, each less than $100,000."

Entries in columns (g) and (h) should include interest accruals and interest payments on notes payable retired during the year, even though no portion of the obligation remained outstanding at the close of the year.

Name of creditor (a)	Character of liability or of transaction (b)	Date of issue (c)	Date of maturity (d)	Rate of interest (e)	Balance at close of year (f)	Interest accrued during year (g)	Interest paid during year (h)
None				%	$	$	$
				Total			

251. PAYABLES TO AFFILIATED COMPANIES

Give particulars of the various affiliated company creditors and the character of the transactions involved in the current liability account No. 51, "Payables to affiliated companies."

List every item in excess of $100,000.

For creditors whose balances were severally less than $100,000, a single entry may be made under a caption "Minor accounts, each less than $100,000."

Name of creditor (a)	Character of liability or of transaction (b)	Balance at close of year (c)
Minor accounts, each less than $100,000		$ 55,710
	Total	55,710

252. ACCOUNTS PAYABLE

Give particulars of the various creditors and the character of the transactions involved in the current liability account No. 52, "Accounts payable."

List every item in excess of $100,000.

For creditors whose balances were severally less than $100,000, a single entry may be made under a caption "Minor accounts, each less than $100,000."

Name of creditor (a)	Character of liability or of transaction (b)	Balance at close of year (c)
Minor accounts, each less than $100,000		$ 20,210
	Total	20,210

253. LONG-TERM DEBT PAYABLE WITHIN ONE YEAR

Give particulars of the various unmatured bonds and other evidences of long-term debt of the respondent included in account No. 57, "Long-term debt payable within one year" at the close of the year.

In column (a) show the name of each bond or other obligation as it is designated in the records of the respondent.

In case obligations of the same designation mature serially or otherwise at various dates, enter in column (e) the latest date of maturity and explain the matter in a footnote.

Column (d) calls for the par value of the amount of debt authorized to be incurred, as it termined by the final authority whose assent is necessary to the legal validity of the issue. In case such final authority is some public officer or board, attach a footnote showing such officer or board and the date when assent was given.

Name and character of obligation (a)	Nominal date of issue (b)	Date of maturity (c)	Par value of amount authorized (d)	Total par value issued and not retired at close of year (e)	Total Par Value Nominally Issued		
					In treasury (f)	Pledged as collateral (g)	In sinking or other funds (h)
MORTGAGE BONDS			$	$	$	$	$
None							
Total for mortgage bonds							
COLLATERAL TRUST BONDS							
None							
Total for collateral trust bonds							
INCOME BONDS							
None							
Total for income bonds							
MISCELLANEOUS OBLIGATIONS							
Promissory Notes							
A, [illegible]	5/22/69	5/20/71		1,944,444			
V, [illegible] Z	5/20/	5/20/71		1,555,556			
Total for miscellaneous obligations				3,500,000			
NOMINALLY ISSUED SECURITIES							
None							
				3,500,000			

253 LONG-TERM DEBT PAYABLE WITHIN ONE YEAR—Concluded

Entries in column (e) should include long-term debt nominally issued, nominally outstanding, and actually outstanding.

Entries should conform to the definitions of "nominally issued", "actually issued", etc., as given in the last paragraph of instructions on page 226.

If the interest accrued during the year as entered in columns (o) and (p) does not aggregate the total accrual for the year on any security, explain the discrepancy. Entries in these columns should include interest accrued on long term debt reacquired or retired during the year, although no portion of the issue is actually outstanding at the close of the year.

In determining the entries for column (q), do not treat any interest as paid unless the liability of the respondent in respect to it is extinguished. Deposits of cash with banks and other fiscal agents for the payment of interest coupons should not be reported as payments of such interest until actually paid to coupon holders or others under such circumstances as to relieve the respondent from further liability.

Total Par Value Nominally Outstanding			Total par value actually outstanding at close of year	Interest Provisions		Amount of interest accrued during year charged to income	Amount of interest charged to construction or other investment account	Amount of interest paid during year	Line No.
In treasury	Pledged as collateral	In sinking or other funds		Rate per cent per annum	Dates due				
(g)	(j)	(k)	(l)	(m)	(n)	(o)	(p)	(q)	
$	$	$	$			$	$	$	1
									2
									3
									4
									5
									6
									7
									8
									9
									10
									11
									12
									13
									14
									15
									16
									17
									18
									19
									20
									21
									22
									23
									24
									25
									26
			1 954 444	A	7/28;5/31 8/31;11/30	158 659		160 883	27
									28
			1 545 556	A	7/28;5/31 8/31;11/30	126 927		128 704	29
									30
									31
									32
									33
									34
			3 500 000			285 586		289 589	35
									36
									37
									38
									39
									40
									41
									42
									43
									44
									45
			3 500 000			285 586		289 589	46

At a rate equal to 1/2 per annum above the best rate of the bank on a 90 day loan to substantial and responsible borrowers.

260. LONG-TERM DEBT PAYABLE AFTER ONE YEAR

Give particulars of the various unmatured bonds and other evidences of long term debt of the respondent included in account No. 60, "Long-term debt payable after one year," maturing more than one year from the date of the balance sheet.

In column (a) show the name of each bond or other obligation as it is designated in the records of the respondent.

In case obligations of the same designation mature serially or otherwise at various dates, enter in column (c) the latest date of maturity and explain the matter in a footnote.

Column (d) calls for the par value of the amount of debt authorized to be incurred, as determined by the final authority whose assent is necessary to the legal validity of the issue. In case such final authority is some public officer or board, attach a footnote showing such officer or board and the date when assent was given. In all cases where any issues, whether actual or merely nominal, were made during the year, state on page 224 the purposes for which such issues were authorized as expressed in the resolution of the final authority passing on the matter.

Line No.	Name and Character of Obligation (a)	Nominal date of issue (b)	Date of maturity (c)	Par value of amount authorized (d)	Total par value issued and not retired at close of year (e)	Total Par Value Nominally Issued: In treasury (f)	Pledged as collateral (g)	In sinking or other funds (h)
1	MORTGAGE BONDS			$	$	$	$	$
2	None							
3								
4								
5								
6								
7								
8								
9								
10								
11								
12	Total for mortgage bonds							
13	COLLATERAL TRUST BONDS							
14	None							
15								
16								
17								
18								
19	Total for collateral trust bonds							
20	INCOME BONDS							
21	None							
22								
23								
24	Total for income bonds							
25	MISCELLANEOUS OBLIGATIONS							
26	Promissory Notes							
27	*A, B, C, D, E	3/22/66	2/28/71		18 055 556			
28								
29	*V, W, X, Y, Z	3/17/67	2/28/71		14 444 444			
30								
31								
32								
33								
34								
35	Total miscellaneous obligations				32 500 000			
36	Total long-term debt payable after one year							
37	None							
38								
39								
40								
41								
42								
43								
44								
45								
46	TOTAL				32 500 000			

* A, B, C, D, E expected to be refinanced.

Entries in column (e) should include long-term debt nominally issued, nominally outstanding, and actually outstanding.

Entries should conform to the definitions of "nominally issued", "actually issued", etc., as given in the list paragraph of instructions on page 226.

If the interest accrued during the year as entered in columns (o) and (p) does not aggregate the total accrual for the year on any security, explain the discrepancy. Entries in these columns should include interest accrued on long-term debt reacquired or retired during the year, although no portion of the issue is actually outstanding at the close of the year.

In determining the entries for column (q), do not treat any interest as paid unless the liability of the respondent in respect to it is extinguished. Deposits of cash with banks and other fiscal agents for the payment of interest coupons should not be reported as payments of such interest until actually paid to coupon holders or others under such circumstances as to relieve the respondent from further liability.

Total Par Value Nominally Outstanding				Interest Provisions					Line No
In treasury (g)	Pledged as collateral (j)	In sinking or other funds (k)	Total par value actually outstanding at close of year (l)	Rate per cent per annum (m)	Dates due (n)	Amount of interest accrued during year charged to income (o)	Amount of interest charged to construction or other investment account (p)	Amount of interest paid during year (q)	
			$			$	$	$	1
									2
									3
									4
									5
									6
									7
									8
									9
									10
									11
									12
									13
									14
									15
									16
									17
									18
									19
									20
									21
									22
									23
									24
									25
									26
			18 055 556	**	2/28;5/31 6/31;11/30	1 473 259		1 493 912	27
									28
			14 444 444	**	2/28;5/31 8/31;11/30	1 178 607		1 195 129	29
									30
									31
									32
									33
									34
			32 500 000			2 651 866		2 689 041	35
									36
									37
									38
									39
									40
									41
									42
									43
									44
									45
			32 500 000			2 651 866		2 689 041	46

**At a rate equal to 1/2% per annum above the best rate of the bank on a 90 day loan to substantial and responsible borrowers.

261. LONG-TERM DEBT CHANGES DURING THE YEAR

Give particulars of long-term debt actually or nominally issued (either original issues or reissues), long-term debt assumed, and long-term debt reacquired or canceled during the year. Include matured and unmatured long-term debt changes during the year. In column (c) state whether issued for the purchase of a complete pipeline, constructing and equipping new plant, or improvements to or extension of existing plant, for refunding or paying outstanding securities, for acquisition of securities, for reorganization, or for cash, etc. If an issue of securities was authorized for more than one purpose, state amount applicable to each purpose. Also give the number and date of authorization by the public authority under whose control such issue was made, naming such authority. In column (e) include as cash all money, checks, drafts, bills of exchange, and other commercial paper payable at par on demand. For nominally issued securities show returns in columns (a), (b), (c), and (d) only.

For each class of long-term debt actually issued, the sum of the entries in columns (e), (f), and (h), plus discounts or less premiums in column (g), should equal the entry in column (d). For definition of expense, reportable in column (h), see definition 14 on page 3 of the Uniform System of Accounts for Pipe Lines.

Line No.	Name of obligation (a)	Long Term Debt Issued During Year: Date of issue (b)	Purpose of the issue and authority (c)	Par value (d)	Net proceeds received for issue (cash or its equivalent) (e)
				$	$
1	None				
2					
3					
4					
5					
6					
7					
8					
9					
10					
11					
12					
13					
14					
15					
16					
17					
18			Total		

Line No.	Long Term Debt Issued During Year (Concluded): Cash value of other property acquired or services rendered (f)	Net discounts on long-term debt issued (g)	Expense of issuing long-term debt (h)	Long Term Debt Reacquired During Year and Still Unreacquired: Par value (i)	Purchase price (j)	Remarks (k)
	$	$	$	$	$	
1						
2						
3						
4						
5						
6						
7						
8						
9						
10						
11						
12						
13						
14						
15						
16						
17						
18						

262. SECURITY FOR LONG-TERM DEBT

particulars of the property of the respondent mortgaged, pledged, or otherwise encumbered as security for the unmatured principal of the respondent at the close of the year.

Make reference to each sinking fund required to be created for the redemption or retirement of long-term debt, and give reference to the page and schedule of this report where particulars of such fund are shown. If no such fund has been established, state fully the reasons why the sinking fund requirements have not been complied with. Give an abstract or synopsis of the contract provisions governing the establishment and maintenance of each such fund.

The respondent may, in lieu of giving the particulars called for in this schedule, furnish copies of all mortgages, trust deeds, and equivalent instruments in force at the close of the year, or give reference to copies of such instruments previously filed with the Commission. All instruments, copies of which are filed or referred to, should be listed in column (a).

If the respondent has mortgaged or pledged any of its property for the purpose of securing the payment of any debt for which some other company is primarily responsible, give particulars of such mortgage or pledge, and state the name of the primary debtor. Show what security has been taken by the respondent in connection with the assumption of its credit.

Description of the security interest of other lien a	Plant or equipment mortgaged b	Securities (income, etc.) pledged or posted c
Promissory Notes secured by Throughput Agreement between Cook Inlet Pipe Line Company and Atlantic Richfield Co., Marathon Oil Co., Mobil Pipe Line, and Union Oil Co. of Calif., which agreement assigned to First National City Bank of New York as collateral. For details see Confirmed Copy of Throughput Agreement at Page 10, of the 1967 Annual Report.		

AGO 531754

1. Give particulars of the various issues of capital stock of the respondent, distinguishing separate issues of any general class, if different in any respect.

2. In the second section list particulars of the various issues on the same lines and in the same order as in the first section.

3. Identify the entries in columns (m) to (s), inclusive, in a manner which will indicate whether par value or the number of shares is shown.

4. In stating the date of an authorization the date of the latest assent or ratification necessary to its validity should be shown; e.g., in case an authorization is required to be ratified by stockholders after action by the board of directors, but is not required to be approved by any State or other governmental board or officer, give the date of approval by stockholders. If the assent of a State railroad commission or other public board or officer is necessary, give the date of such assent, or if subsequent to such assent notice has to be filed with a secretary of state or other public officer and a tax or other fee has to be paid as a *condition precedent* to the validity of the issue, give the date of such payment. In case some *condition precedent* has to be complied with after the approval and ratification of the stockholders has been obtained, state, in a footnote, the particulars of such condition and of the respondent's compliance therewith.

5. For the purposes of this report, capital stock and other securities are considered to be *nominally issued* when certificates are signed and sealed and placed with the proper officer for sale and delivery or are pledged or otherwise placed in some special fund of the respondent. They are considered to be *actually issued* when sold to a bona fide purchaser for a valuable consideration, and such purchaser holds free from control by the respondent. All securities actually issued and not reacquired by or for the respondent are considered to be actually outstanding. If reacquired by or for the respondent under such circumstances as require them to be considered as held alive, and not canceled or retired, they are considered to be nominally outstanding.

6. Column (d) refers to the initial preference dividend [illegible] before any common dividend [illegible] and [illegible] to participations in excess of initial preference dividend [illegible] percentage or amount [illegible] column (k) [illegible] age or proportion of the profits [illegible]

7. "Authenticated" as applied to column (n) of this schedule means the total par value of certificates of par value [illegible] total number of shares of [illegible] stock that have been [illegible] and signed and placed [illegible] [illegible] of other [illegible] is the sum total of the amounts [illegible] actually issued [illegible]

8. [illegible]

Class of stock (a)	Date issue was authorized (b)	Par value per share (c)	Dividend rate specified in contract (d)	Total amount of accumulated dividends (e)	Cumulative: To extent earned [illegible] (f)	Cumulative: Fixed rate [illegible] (g)	Noncumulative (h)	Other [illegible] (i)	Other [illegible] (j)	Participating [illegible] (k)	[illegible] (l)
Common	11/20/67	$ 100		$							
Preferred											
Debenture											
Receipts outstanding for installments paid											
Total											

PAR VALUE OF PAR VALUE STOCK OR NUMBER OF SHARES OF NONPAR STOCK

Authorized as of date shown in column (b) (m)	Authenticated (n)	Nominally issued: Held in special funds or in treasury or pledged (Identify pledged securities by symbol "P") (o)	Nominally issued: Canceled (p)	Actually issued (q)	Reacquired: Canceled (r)	Reacquired: [illegible] (s)	[illegible] (t)	[illegible] (u)	[illegible] (v)
4 000 000	4 000 000			4 000 000				$	
								[illegible] 000	[illegible] 000

AGO 531755

271. CAPITAL STOCK CHANGES DURING THE YEAR 37.

Give full particulars of stocks actually or nominally issued (either original issues or reissues) and of stocks reacquired or canceled during the year.

In the second section of the schedule show the particulars of the several issues on the same lines and in the same order as in the first section.

In column (c) state whether issued for construction of new properties, for additions and betterments, for purchase of pipe line or other property, for conversion, for acquisition of securities, for reorganization, or for other corporate purposes. If an issue of securities was authorized for more than one purpose, state amount applicable to each purpose. Also give the number and date of the authorization by the public authority under whose control such issue was made, naming such authority. In column (e) include as cash all money, checks, drafts, bills of exchange, and other commercial paper payable at par on demand. For nominally issued stock, show returns in columns (a), (b), (c), and (d) only. For each class of par stock actually issued the sum of the entries in columns (e), (f), and (h), plus discounts or less premiums in column (g), should equal the entry in column (d).

No.	Class of stock (a)	Stocks Issued During Year: Date of issue (b)	Purpose of the issue and authority (c)	Par value (For nonpar stock show the number of shares) (d)	Net proceeds received for issue (cash or its equivalent) (e)
1	None			$	$
2					
3					
4					
5					
6					
7					
8					
9					
10					
11					
12					
13					
14					
15			Total		

No.	Stocks Issued During Year Concluded: Cash value of other property acquired or services received as consideration for issue (f)	Net total discounts on stock or premiums thereon (Indicate which) (g)	Expenses of issuing capital stock (h)	Stocks Reacquired During Year: Par value (For nonpar stock show the number of shares) (i)	Purchase price (j)	Remarks (k)
1	$	$	$	$	$	
2						
3						
4						
5						
6						
7						
8						
9						
10						
11						
12						
13						
14						
15						

272. STOCK LIABILITY FOR CONVERSION OF SECURITIES OF OTHER COMPANIES

If at the close of the year respondent was subject to any liability to issue its own capital stock in exchange for outstanding securities of constituent or other companies, explain fully the particulars thereof hereunder, including names of parties to contracts and abstracts of terms of contracts whereunder such liability exists.

274. ADDITIONAL PAID-IN CAPITAL

Give an analysis in the form called for below of account No. 73, "Additional paid-in capital." In column (a) give a brief description of the items added or deducted and in column (b) insert the contra account number to which the amount stated in column (c) was charged or credited.

Item (a)	Contra account number (b)	Amount (c) $
Balance at beginning of year None	X X X	
Additions during the year (describe)		
TOTAL ADDITIONS DURING THE YEAR	X X X	
Deductions during the year (describe)		
TOTAL DEDUCTIONS	X X X	
Balance at close of year None	X X X	

275. APPROPRIATED RETAINED INCOME

Give an analysis of the amount in account No. 74, "Appropriated retained income," at the close of the year. 39.

Class of appropriation (a)	Balance at close of year (b)		
Additions to property through retained income			
Debt retired through retained income			
Sinking funds			
Other funds			
Appropriated retained income not specifically invested			
Other appropriations (specify)			
None			
TOTAL			

300. UNAPPROPRIATED RETAINED INCOME STATEMENT

Show hereunder the amounts included in the "Retained income" accounts of the respondent for the year, classified in accordance with Uniform System of Accounts for Pipe Lines.

Item (a)	Amount (b)
(75) Unappropriated retained income at beginning of year (p. 201)	$ 114,887
CREDITS	x x x x x x
(700) Net balance transferred from income (p. 301)	5,210,933
(710) Other credits to retained income* (p. 307)	
Total	5,210,933
DEBITS	x x x x x x
(700) Net balance transferred from income (p. 301)	
(720) Other debits to retained income* (p. 307)	
(740) Appropriations of retained income	
(750) Dividend appropriations of retained income (p. 300)	3,100,000
TOTAL	3,100,000
Net increase or decrease during year	2,110,933
(75) Unappropriated retained income at end of year (p. 201)	2,225,820
* Notes: Amount of accrued Federal income tax consequences:	
Account 710	None
Account 720	None

301. DIVIDEND APPROPRIATIONS OF RETAINED INCOME

1. Give particulars of each dividend declared. If any dividend was payable in anything other than cash, the consideration shall be described in a footnote with sufficient particulars to identify it.

2. If an obligation of any character has been incurred for the purpose of procuring funds for the payment of any dividend or for the purpose of placing the treasury of the company in position to pay any dividend, give full particulars in a footnote. Returns for dividends on common stock should show the amount declared per share in columns (b) and (c), and in column (d) the number of shares on which the dividends were declared. If any class of stock received a return not reportable in this schedule, or if any special comment regarding "Rate percent" is deemed, give particulars in a footnote.

3. The sum of the dividends stated in column (e) should equal those shown in schedule No. 300.

Class of security on which dividend was declared (a)	Rate percent of par value (b)	Rate percent of par value (c)	Par value of number of shares of class on which dividend was declared (d)	Amount of dividend (e)	Date declared (f)	Date payable (g)
			$	$		
Common Stock Issued	25.00		4 000 000	1 000 000	4/21/70	4/30/70
Common Stock Issued	25.00		4 000 000	1 000 000	6/22/70	6/30/70
Common Stock Issued	27.50		4 000 000	1 100 000	9/11/70	9/30/70
Total	x x	x x	x x	x x x	3 100 000	x x x

Give the particulars called for from the Income Accounts of the respondent for the year. The entries in this statement should be determined in accordance with the rules prescribed in the Uniform System of Accounts for Pipe Lines, and should be consistent with the details stated on the pages referred to. All entries called for under should be indicated in parentheses.

Item (a)	Amount (b)		
ORDINARY ITEMS	$		
Carrier Operating Income	x x	x x	x x
(600) Operating revenues (p. 302)	11	399	504
(610) Operating expenses (p. 303)	(3	421	991)
Net carrier operating income	7	977	513
Other Income and Deductions	x x	x x	x x
(620) Income (net) from noncarrier property (p. 305)			
(630) Interest and dividend income (p. 306)		173	106
(640) Miscellaneous income (p. 307)			44
(650) Interest expense	(2	937	452)
(660) Miscellaneous income charges (p. 307)		(2	278)
Total other income and deductions	(2	766	580)
Ordinary income before Federal income taxes	5	210	933
(670) Federal income taxes on ordinary income			
Ordinary Income	5	210	933
EXTRAORDINARY AND PRIOR PERIOD ITEMS	x x	x x	x x
(680) Extraordinary items-Net Credit (Debit) (p. 307)			
(690) Prior period items - Net Credit (Debit) (p. 307)			
(695) Federal income taxes on extraordinary and prior period items - Debit (Credit) (p. 307)			
Total extraordinary and prior period items - Credit (Debit)			
Net income for the year	5	210	933

1. Net reduction in charges to account 670, for Federal income taxes to be reported in the tax return for the current year and corresponding increase in net income because of accelerated amortization of emergency facilities under section 168 of the Internal Revenue Code in excess of recorded depreciation ..... $ None

net effect is an increase, this should be so indicated.)

2. Net reduction or increase in charges to account 670, during the current year and corresponding increase or decrease in net income because of accelerated depreciation of facilities under section 167 of the Internal Revenue Code and depreciation deductions ulting from the use of guideline lives pursuant to Revenue Procedure 62-21 in excess of recorded depreciation ..... $ None

net effect is an increase, this should be so indicated.)

3. Amount by which charges to account 670, during the current year were decreased and the reported net income correspondingly reased because of claim for refund of Federal income taxes due to carryback of current losses to the year(s) ... $ None

4. Amount by which charges to account 670, during the current year were decreased and the reported net income correspondingly reased because of reduction in Federal income taxes due to carryover of prior year(s) losses to current year ..... $ None

5. Amount by which charges to account 670, for payment of Federal income taxes during the current year were decreased and the orted net income correspondingly increased because of the investment tax credit authorized in the Revenue Act of 1962, compared amount that could otherwise have been payable without such investment tax credit ..... $ None

MARKS:

During the current year, there were no charges or credits to Account 670 because the pany was not in the paying position due to carry-over losses from prior years to current ar. Following is a reconciliation of Book Income to Tax Income:

Net Income per book	$ 5,210,933
Less: Excess of Tax Depreciation over Book Depreciation	(1,322,775)
Interest Capitalized for Books and Expense for Tax	3,037
Intangible Drilling Expense Capitalized	(2,499)
Carryover Losses from prior Year to Current Year	(3,890,956)

AGO 531760

310. OPERATING REVENUE ACCOUNTS

State the pipeline operating revenues of the respondent for the year, classified in accordance with the Uniform System of Accounts for Pipe Lines.

Operating revenue accounts (a)	Crude oil (b)	Products (c)	Total (d)
	$	$	$
(200) Gathering revenues			
(210) Trunk revenues	3 210 521		3 210 521
(220) Delivery revenues	7 561 336		7 561 336
(230) Allowance oil revenue			
(240) Storage and demurrage revenue	627 647		627 647
(250) Rental revenue			
(260) Incidental revenue			
Total	11 399 504		11 399 504

320. OPERATING EXPENSE ACCOUNTS

State the pipeline operating expenses of the respondent for the year.

Operating expense account (a)	Gathering (b)	Trunk (c)	Delivery (d)	Total (e)
	$	$	$	$
Operations				
(300) Salaries and wages				
(310) Supplies and expenses		34 597	61 624	96 221
(320) Outside services		184 133	319 451	503 584
(330) Operating fuel and power		15 305	17 752	33 057
(340) Oil losses and shortages				
Total Operations Expense		234 035	398 827	632 862
Maintenance				
(400) Salaries and wages				
(410) Supplies and expenses		13 797	14 280	28 077
(420) Outside services		148 846	147 932	296 778
(430) Maintenance of tanks		63 293	49 057	112 350
Total Maintenance Expense		225 936	211 269	437 205
General				
(500) Salaries and wages				
(510) Supplies and expenses		1 228	13 276	14 504
(520) Outside services		93 508	140 613	234 121
(530) Rentals (net)		10 179	3 407	13 586
(540) Depreciation and amortization		768 860	891 744 1	660 604
(550) Pensions and benefits				
(560) Insurance		118 294	137 200	255 494
(570) Casualties and other losses			668	668
(580) Pipeline taxes (net)		80 075	92 871	172 947
Total General Expense	1	072 143 1	279 781 2	351 924
Total Expenses	1	532 114 1	889 877 3	421 991

320. OPERATING EXPENSE ACCOUNTS—Continued

classifying them in accordance with the Uniform System of Accounts for Pipe Lines

Gathering	Trunk	Delivery	Total	Gathering	Trunk	Delivery	Total
(j)	(k)	(l)	(m)	(j)	(k)	(l)	(m)
$	$	$	$	$	$	$	$
					34 597	61 624	96 221
					184 133	319 451	503 584
					15 805	17 752	33 057
					234 044	398 827	632 862
					13 797	14 280	28 077
					148 840	147 932	296 778
					63 284	49 057	112 341
					225 921	211 289	437 202
					1 258	13 276	14 534
					93 508	140 613	234 121
					10 179	3 507	13 686
					263 031	891 744	1 660
					118 296	137 200	225 494
						663	663
					80 074	92 871	172 945
					1 [illegible]	1 279 481	[illegible]
					1 [illegible]	1 869 877	3 421 991

Delivery

Give the particulars called for with respect to the taxes accrued on carrier properties and charged to account No. 580, "Pipeline taxes," of the ondent's Income Account for the year

If during the year an important adjustment was made in account No. 580 for taxes applicable to a prior year, state in a footnote full particulars erning same.

A. Other Than U. S. Government Taxes

Name of State (a)	Amount (b)		Name of State (c)	Amount (d)		
	$			$		
Alabama			New Mexico			
Alaska	172	720	New York			
Arizona			North Carolina			
Arkansas			North Dakota			
California			Ohio			
Colorado			Oklahoma			
Connecticut			Oregon			
Delaware		161	Pennsylvania			
Florida			Rhode Island			
Georgia			South Carolina			
Hawaii			South Dakota			
Idaho			Tennessee			
Illinois			Texas			
Indiana			Utah			
Iowa			Vermont			
Kansas			Virginia			
Kentucky			Washington			
Louisiana			West Virginia			
Maine			Wisconsin			
Maryland			Wyoming			
Massachusetts			District of Columbia			
Michigan			Other (specify)	x x	x x	x x
Minnesota						
Mississippi						
Missouri						
Montana						
Nebraska						
Nevada						
New Hampshire						
New Jersey			TOTAL Other Than U. S. Government Taxes		172	881

B. U. S. Government Taxes (Except Income Taxes)

Kind of tax (a)	Amount (b)		
	$		
Old age retirement			
Unemployment insurance			
Other U. S. taxes (specify, except income taxes) U.S. Federal Documentary Stamp Tax			66
TOTAL U. S. Government Taxes			
GRAND TOTAL (account 580)		172	947

340. INCOME FROM NONCARRIER PROPERTY

1. State the revenues, expenses, and net income of the respondent during the year from each class of nonoperated properties of the character provided for in account No. 620, "Income from noncarrier property," in the Uniform System of Accounts for Pipe Lines.

2. If the income relates to only a part of the year, give particulars in a footnote.

Line No.	General description of property (a)	Total revenues (b)	Total expenses (c)	Net income (d)
1	None	$	$	$
2				
3				
4				
5				
6				
7				
8				
9				
10				
11				
12				
13				
14	TOTAL			

342. ABSTRACTS OF TERMS AND CONDITIONS OF LEASES

Give briefly any changes since the beginning of the year in the terms and conditions of the important leases under which the above-stated income is derived. For any important leases executed during the year give a brief abstract of the terms and conditions, showing particularly (1) the date of the grant, (2) the chain of title (in case of assignment or subletting) and date of transfer connecting the original parties with the present parties, (3) the basis on which the amount of the annual rent is determined, and (4) the date when the lease will terminate, or, if the date of termination has not yet been fixed, the provisions governing the termination of the lease.

Copies of leases may be filed in lieu of abstracts above called for.

None

345. INTEREST AND DIVIDEND INCOME

Give a detailed analysis of amounts credited to account No. 630, "Interest and dividend income", classified in accordance with the Uniform System of Accounts for Pipe Lines.

Line No.	Item (a)	Dividend Income (b)			Interest Income (c)		
		$			$		
1	Income from securities shown in schedule 220						
2	Income from securities shown in schedule 221						
3	Income from temporary cash investments					173	106
4	Other credits (specified):						
5							
6							
7							
8							
9							
10							
	TOTAL					173	106

360. MISCELLANEOUS ITEMS IN INCOME AND RETAINED INCOME ACCOUNTS FOR THE YEAR

Give a detailed analysis of the items in accounts 640, "Miscellaneous Income"; 660, "Miscellaneous Income charges"; 680, "Extraordinary items"; 690, "Prior period items"; 695, "Federal income taxes on extraordinary and prior period items"; 710, "Other credits to retained income"; and 720, "Other debits to retained income", for the year. The classification should be made in accordance with the Uniform System of Accounts for Pipe Lines. For accounts 640 and 660, each item amounting to $100,000 or more should be stated; items less than $100,000 in these accounts may be combined in a single entry designated "Minor items, each less than $100,000." Insert a total for each account.

Line No.	Account No. (a)	Item (b)	Debits (c) $			Credits (d) $		
1	640	Minor items, each less than $100,000						44
2	660	Minor items, each less than $100,000		2	278			
3								
4								
5								
6								
7								
8								
9								
10								
11								
12								
13								
14								
15								
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46								
47								
48								

...tive particulars by States of origin for crude oil and for ...kind of product received and transported during the year. ...) and list in column (a) by States of origin the refined ...s transported in the following order: 29111 Gasoline, ... and other high volatile petroleum fuels, except natural ...); 29112 Kerosene; 29113 Distillate fuel oil; 29114 ...ting and similar oils and derivatives; 29117 Residual ... and other low volatile petroleum fuels; 29119 Products ...leum refining, n. e. s.—Specify; and Total—products ...s used herein, the term crude oil means oil in its natural state, not altered, refined, or prepared for use by any process; and products means oils that have been refined, altered, or processed for use, such as fuel oil and gasoline.

3. Natural gasoline or other similar products, whenever blended with crude oil in transit, should be classified and reported as crude oil in this schedule.

4. In column (e) show all oils received by the respondent from connecting carriers reporting to the Interstate Commerce Commission. In column (d) show all oils originated on respondent's gathering lines and in column (e) all oils received into respondent's system from all sources, except receipts shown in columns (b) and (c). Entries in column (e) should be the sums of corresponding entries in columns (b), (c), and (d). In columns (f) show all oils delivered to connecting carriers reporting to Interstate Commerce Commission. In column (g) show oils terminated on respondent's gathering lines, and in column (h) all oils delivered out of respondent's system, except deliveries shown under columns (f) and (g). Entries in column (i) should be the sums of corresponding entries in columns (f), (g), and (h).

5. Returns in "Note" should be estimated if not actually shown on respondent's records.

State of origin	Number of Barrels Received Into System				Number of Barrels Delivered Out of System			
	From connecting carriers	Originated		Total received into system	To connecting carriers	Terminated		Total delivered out of system
		On gathering lines	On trunk lines			On gathering lines	On trunk lines	
a	b	c	d	e	f	g	h	i
Crude Oil								
Alaska			53,625,043	53,625,043			54,009,540	54,009,540
Total			53,625,043	53,625,043			54,009,540	54,009,540
Products (State of origin and product carried)								
Total								
Grand Total			53,625,043	53,625,043			54,009,540	54,009,540

...s.—Total number of barrel-miles (trunk lines only): Crude oil 2,383,232,832, Products

Total number of barrels of oil having trunk-line movement: Crude oil 53,625,043 Products

AGO 531767

610. MILES OF PIPE LINE OPERATED AT CLOSE OF YEAR

[illegible] owned but, by states and counties, covering the miles of all pipe [illegible], and size of each line, at close of year, according to following classification: [illegible] line which, owned & operated by respondent. B. Owned in undivided [illegible] respondent. C. Owned by others but operated by respondent. [illegible] operated should be reported to the nearest whole mile, except in [illegible], the mileage figures for each line are to be rounded to the nearest whole mile and the aggregate [illegible] mileage. Fractional size lines should be reported in the next [illegible], e.g. 2 1/2" and 4 1/2" lines should be included as 4" and 6" lines. Size [illegible] is defined as inside diameter.

[illegible] columns (f) and (h) information following gathering lines should be given in columns (d) and (e); trunk lines used for the transportation of crude oil in columns (f) and (g) and trunk lines devoted to the movement of products in columns (h) and (i). In columns (k), (l) and (p) should be shown all increases in pipe line operated; and in columns (m), (n) and (o) show all decreases in pipe line operated. 4. Report under (A), Lines wholly owned and operated by respondent, including wholly owned minor facilities temporarily idle or in standby service.

5. Report under (B), The total miles for each system owned in undivided interests and operated by respondent. The name of each such system should be given and the names of the owning companies in each instance. Carriers owning an undivided interest in a system but not operating the system should include in this report only [illegible] system operated by others, but should furnish a memorandum form showing the mileage represented by respondent's undivided ownership in the system [illegible] other carriers are not included in this Schedule. Such systems being "A" Systems owned by "X" Company, "B" System operated by "Y" Company, etc."

6. Report under (C), A respondent operating lines not owned by it, but leased from others when leases are for reasonably long terms and consist of substantially all of respondent's system. The lessor companies should be named in this report and the mileages leased from each. The lessor companies should report all mileages leased to others from this classification. The report should include such lines in which owned and operated by others.

7. Minor gathering line mileages under terminals or at detached leases should not be reported from this classification. The report should include such lines in which owned and operated by others.

Name of company and State	Termini		Operated at Close of Year						Changes During the Year					
			Gathering lines		Trunk lines				Increases			Decreases		
					For crude oil		For products		Gathering lines	Trunk lines		Gathering lines	Trunk lines	
	From—	To—	Miles	Size of line	Miles	Size of line	Miles	Size of line		For crude oil	For products		For crude oil	For products
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)	(l)	(m)	(n)	(o)
(A) Owned and Operated By Respondent														
Cook Inlet Pipe Line Company	Granite Point	Drift River			42	20"								
Alaska	West Foreland	20"M.			2	12"								
	Forelands Jct.	Drift River			3	20"								
	Drift River	Platform "			5	30"								
	Drift River	Platform "			1	42"								
	Other				2	Misc.								
Total					55									
(B) Owned In Undivided Interests and Operated By Respondent														
Total														
(C) Owned By Others But Operated By Respondent														

420. RENTALS

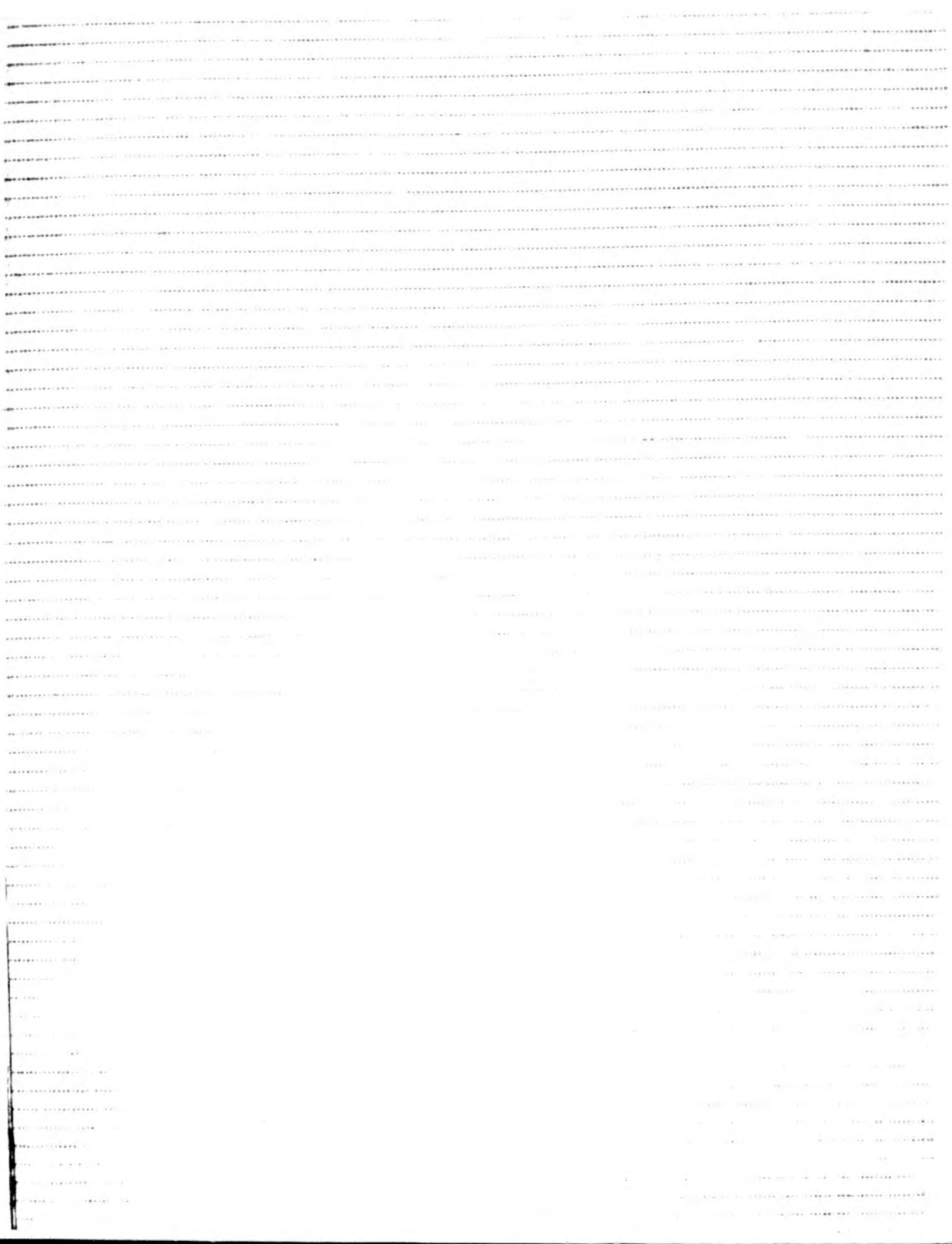
Give particulars of the rents payable during the year, for property used in transportation service, included in account No. 530 as defined in the Uniform System of Accounts for Pipe Lines. Each item amounting to $5,000 or more should be listed, all others may be combined in a single entry designated "Minor items, each less than $5,000."

Name of lessor (a)	Location of property (b)	Description of property (c)	Rent accrued during year (d)		
			$		
Painter's Local Union #1140	Anchorage, Alaska	General Offices		7	002
Minor Items, each less than	$5,000			6	584
		TOTAL		13	586

422. ABSTRACTS OF LEASEHOLD CONTRACTS

Give briefly any changes since the beginning of the year in the terms and conditions of the leases under which the respondent rents a complete pipe line or section thereof. If any such leases have been executed during the year, give brief abstracts of the terms and conditions thereof, showing particularly (1) the date of the lease, (2) the chain of title and dates of transfers connecting the original lessee with the respondent in case of assignment or subletting, (3) the basis on which the amount of the annual rent is determined, and (4) the date when the lease is to terminate, or, if such date has not yet been determined, the provisions governing its determination.

In lieu of the abstracts here called for, the respondent may file copies of lease agreements and give specific references to copies heretofore filed with the Commission.



561. EMPLOYEES AND THEIR COMPENSATION

Give the number of employees, by classes, in the service of the respondent and state the total compensation, including payments of every character made to each class of employees during the year. If any compensation was paid or is payable under labor awards of the current year, include the amount applicable to the current year in column (c) and show the portion applicable to prior years (back pay) in a footnote, by classes of employees. For purposes of this report, labor awards are intended to cover adjustments resulting from the decisions of Wage Boards and voluntary awards by the respondent incident thereto. The assignment of employees should accord as nearly as possible with the classes listed. If the regular duties of an employee are such as to make him includible in two or more classes, he should be assigned to the class that is indicated by the greater part of his duties, and his compensation assigned to the same class.

For the purpose of the subjoined statement the word "employees" is intended to include every person in the service of the respondent subject to its continuing authority to supervise and direct the manner of rendition of his service. Persons engaged to render only specifically defined service and not subject to the continuing authority of the respondent to supervise and control their acts, such as lawyers retained only for specific cases and not under general or continuing retainer, are not to be included as employees.

The number of employees in service for entry in column (b) is obtained by adding the number of employees on the payroll in each of the stated classes during the payroll period containing the 12th day of each month and dividing by 12. Every count should cover not only employees actually on duty during the period of the count, but also employees under pay not so on duty if absent from service on sick or other leave or held subject to call for duty.

Each person jointly employed shall, if carried on the payrolls of the several joint employers, be counted by each employer and represented in its return of number of employees by a fraction based on the number of employers reporting him; if a person, for example, is reportable by three employers, each should include him in its number of employees as one-third of an employee. When the entire compensation of a joint employee is shown on the payroll of a single joint employer and is paid to the employee by that employer such employee should, for the purpose of returns, be treated as if employed solely by such employer.

Line No.	Class of employees (a)	Average number of employees in service (b)	Total compensation during year (c)
			$
1	Executives, general officers, and assistants		
2	General office clerks		
3	Other general office employees		
4	Field clerks		
5	Field superintendents		
6	Professional and subprofessional employees (engineers, chemists, etc.)		
7	Foremen and assistant foremen		
8	Station engineers and pumpers		
9	Station firemen and oilers		
10	Gagers, Deliverymen and oil receivers		
11	Telegraph operators		
12	Telegraph and telephone line repairmen		
13	Line riders, walkers, or patrolmen		
14	Pipeline repairmen		
15	Carpenters		
16	Machinists		
17	Electricians		
18	Other mechanics (skilled trades)		
19	Apprentices and helpers (skilled trades)		
20	Truck drivers and teamsters		
21	Laborers, not laborers, etc.		
22	All other employees		
23	TOTAL		

562. COMPENSATION OF OFFICERS, DIRECTORS, ETC.

Give the name, position, salary, and other compensation, such as bonus, commission, gift, reward, or fee, of each of the five persons named in schedules 102 and 103 of this report to whom the respondent paid the largest amounts during the year covered by this report as compensation for current or past service over and above necessary expenses incurred in discharge of duties, and in addition, all other officers, directors, pensioners, or employees, if any, to whom the respondent similarly paid $30,000 or more. If more convenient, this schedule may be filled out for a group of companies considered as one system and shown only in the report of the principal company in the system, with references thereto in the reports of the other companies. Any large "other compensation" should be explained in a footnote. If salary of an individual was changed during the year, show salary before each change as well as at close of year. If an officer, director, etc., receives compensation from more than one pipe line company (whether a subsidiary or not) or from a subsidiary company, reference to this fact should be made if his aggregate compensation amounts to $30,000 or more, and detail as to division of the salary should be stated. By salary (column (c)) is meant the annual rate at which an employee is paid, rather than the amount actually paid for a part of a year when the salary is changed. Also, when a 10 percent (or other percent) reduction is made, the net rate, and not the basic rate, should be shown.

Name of person (a)	Title (b)	Salary per annum as of close of year (See instructions) (c)	Other compensation during the year (d)
		$	$
No compensation paid to Officers or			
Directors in 1970			
	Total		

563. PAYMENTS FOR SERVICES RENDERED BY OTHER THAN EMPLOYEES

In the form below give information concerning payments, fees, retainers, commissions, gifts, contributions, [illegible] allowance for expenses, or any form of payment amounting in the aggregate to $10,000 or more during the year to [illegible] institution, association, firm, partnership, committee, or any person (other than one of respondent's employees covered in schedule 562 in this annual report) for services or as a donation. In the case of contributions of less than $10,000 which are made in common with other carriers under a joint arrangement in payment for the performance of services or as a donation, [illegible] contributions shall be reported [illegible] of the amount thereof, if the total amount paid by all carriers [illegible] for the performance of the [illegible] services [illegible] $10,000 or more.

To be [illegible] are, among others, payments, directly or indirectly, for legal, medical, [illegible] services, advertising, valuation, accounting, [illegible], financial, [illegible], educational, entertainment, charitable, advisory, [illegible], detective, [illegible], appraisal, registration, purchasing, architectural, and hospital [illegible] payments [illegible] for [illegible] wage [illegible], and [illegible] for services of banks, bankers, trust companies, [illegible] companies, brokers, [illegible] tors, consultants, actuaries, investigators, inspectors, and efficiency engineers. *The enumeration of these kinds of payments should not be understood as excluding other payments for services not excluded below.*

To be excluded are: Rent of buildings or other property, taxes payable to the Federal, State, or local governments, payments for heat, light, power, telegraph, and telephone services, and payments to other carriers on the basis of lawful tariff charges, as well as other payments for services which both as to their nature and amount may reasonably be regarded as ordinarily connected with the routine operation, maintenance, or construction of a pipe line, but any special and unusual payments for services should be reported.

If more convenient, this schedule may be filled out for a group of companies considered as one system and shown only in the report of the principal company in the system, with references thereto in the reports of the other companies.

If any doubt exists in the mind of the reporting officer as to the reportability of any type of payment, request should be made for a ruling before filing this report.

Name of recipient (a)	Nature of service (b)	Amount of payment (c)
		$
Mobil Oil Corporation	Services in connection with Operating Management	
	etc.	75,200

AGO 531771

591. IMPORTANT CHANGES DURING THE YEAR

Hereunder state the following matters, numbering the statements in accordance with the inquiries, and if no changes of the character below indicated have occurred during the year, state that fact:

1. All important physical changes not elsewhere provided for.
2. All important financial changes not elsewhere provided for.
3. All changes in and all additions to franchise rights, describing fully (*a*) the actual consideration given therefor, and stating (*b*) the parties from whom acquired; if no consideration was given, state that fact.
4. All additional matters of fact not elsewhere provided for which the respondent may desire to include in its report.

1. None
2. None
3. None
4. None

VERIFICATION

The foregoing report must be verified by the oath of the officer having control of the accounting of the respondent. It should be verified, also, by the oath of the president or other chief officer of the respondent, unless the respondent states on the last preceding page of this report that such chief officer has no control over the accounting of the respondent. The oath required may be taken before any person authorized to administer an oath by the laws of the State in which the same is taken.

OATH

(To be made by the officer having control of the accounting of the respondent)

State of Texas }
County of Dallas } ss:

C. R. Thompson (Insert here the name of the affiant) makes oath and says that he is Secretary - Treasurer (Insert here the official title of the affiant)

of Cook Inlet Pipe Line Company (Insert here the exact legal title or name of the respondent)

that it is his duty to have supervision over the books of account of the respondent and to control the manner in which such books are kept; that he knows that such books have, during the period covered by the foregoing report, been kept in good faith in accordance with the accounting and other orders of the Interstate Commerce Commission, effective during the said period; that he has carefully examined the said report, and to the best of his knowledge and belief the entries contained in the said report have, so far as they relate to matters of account, been accurately taken from the said books of account and are in exact accordance therewith; that he believes that all other statements of fact contained in the said report are true, and that the said report is a correct and complete statement of the business and affairs of the above-named respondent during the period of time from and including January 1, 1970, to and including December 31, 1970

C R Thompson
(Signature of affiant)

Subscribed and sworn to before me, a Notary Public, in and for the State and county above named, this day of March, 1971

My commission expires My commission expires June 1, 1971

Use an L S impression seal

D C Kennedy
(Signature of officer authorized to administer oaths)
D. C. KENNEDY, Notary Public
In and for Dallas County, Texas

SUPPLEMENTAL OATH

(By the president or other chief officer of the respondent)

State of Texas }
County of Dallas } ss:

G. A. Seymour (Insert here the name of the affiant) makes oath and says that he is Vice President (Insert here the official title of the affiant)

of Cook Inlet Pipe Line Company (Insert here the exact legal title or name of the respondent)

that he has carefully examined the foregoing report, that he believes that all statements of fact contained in the said report are true, and that the said report is a correct and complete statement of the business and affairs of the above named respondent during the period of time from and including January 1, 1970 to and including December 31, 1970

G A Seymour
(Signature of affiant)

Subscribed and sworn to before me, a Notary Public, in and for the State and county above named, this day of March, 1971

My commission expires My commission expires June 1, 1971

Use an L S impression seal

D C Kennedy
(Signature of officer authorized to administer oaths)
D. C. KENNEDY, Notary Public
In and for Dallas County, Texas

AGO 531773

Examinations

No	Examination or Computation Date: Month	Day	Year	Page	Subject Examined	Memorandum of Errors: Page	Clerk Making Examination: Name
1					History, etc		
2					Mileage and Corporate Relations		
3					Securities Owned		
4					Capitalization		
5					Property Investments		
6					Operating Revenues and Operating Expenses		
7					Income and Surplus Accounts		
8					General Balance Sheet		
9					Statistics, Employees, and Changes		
10					Taxes		

Computations

1					Additions, Cross-Additions, etc		
2					Averages, etc		

Correspondence

Officer Addressed: Name	Title	Date of Letter or Telegram: Month	Day	Year	Subject: Page	Answer needed	Answer: Date of Letter: Month	Day	Year	File Number of Ltr or Telegram

Corrections

Date of Correction: Month	Day	Year	Page	Authority: Letter or Telegram: Month	Day	Year	Officer Sending Letter or Telegram: Name	Title	Commission File Number	Clerk Making Correction: Name

INDEX

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

TESTIMONY

of

E. L. PATTON

at

Juneau, Alaska

March 1972

E. L. PATTON

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE, MY NAME IS EDWARD L. PATTON AND I APPEAR HERE TODAY IN RESPONSE TO YOUR INVITATION TO CONSIDER WITH YOU SENATE BILLS 294 (THE JOINT PIPELINE IMPACT COMMITTEE'S LEASING BILL), 313 (THE R.O.W. LEASING BILL INTRODUCED AT THE REQUEST OF THE GOVERNOR), AND 315 (THE ALASKA OIL & GAS TRANSPORTATION COMMISSION BILL).

AS MOST OF YOU KNOW, I AM AN ENGINEER BY PROFESSION AND HAVE BEEN ASSOCIATED WITH THE OIL INDUSTRY FOR ABOUT 34 YEARS IN VARIOUS PROFESSIONAL AND MANAGERIAL ASSIGNMENTS HAVING TO DO WITH DESIGN, CONSTRUCTION AND OPERATION OF OIL REFINERIES, PETROCHEMICAL PLANTS, AND NOW A PIPELINE. THE PAST 10-12 YEARS HAVE BEEN ENGAGED PRIMARILY IN BRINGING TO FRUITION SO-CALLED "GRASS ROOTS" PROJECTS IN ENVIRONMENTALLY SENSITIVE AREAS BOTH OVERSEAS AND DOMESTICALLY. OBVIOUSLY, IN THESE YEARS I HAVE HAD TO WORK WITH MANY GOVERNMENT ENTITIES AND THE VAST MAJORITY HAVE TRIED TO BE HELPFUL.

MY REMARKS TODAY ARE FROM THE STANDPOINT OF ALYESKA PIPELINE SERVICE COMPANY, THE COMPANY WHICH WAS FORMED IN 1970 TO DESIGN, CONSTRUCT AND OPERATE THE TRANS ALASKA PIPELINE. HOWEVER, IT IS PROBABLY INEVITABLE THAT SOME OF MY THINKING IS TEMPERED BY THE BROAD BUSINESS EXPERIENCE ACQUIRED OVER THE YEARS.

AS THESE COMMITTEES KNOW, ALYESKA PROPOSES TO CONSTRUCT A 48" DIAMETER PIPELINE FROM PRUDHOE BAY TO VALDEZ. THE LINE WOULD BE MOSTLY OVER FEDERAL LAND, BUT SOME STATE AND PRIVATE AND IS INVOLVED. I MENTION THIS BECAUSE IT IS IMPORTANT TO REMEMBER THAT OTHER ENTITIES BESIDES THE STATE ARE INVOLVED, AND WHAT THE STATE DOES IS LIKELY TO BE ATTEMPTED BY OTHER ENTITIES AND ALL OF THESE POSSIBLE ACTIONS HAVE TO BE CONSIDERED IN LIGHT OF OUR DESIGN, CONSTRUCTION, OPERATION AND ECONOMICS.

YOU HAVE HEARD FROM OTHER WITNESSES THE U'NION THAT, IF PASSED, STATE PIPELINE REGULATORY BILLS IN THEIR PRESENT FORM WOULD BE FOUND UNCONSTITUTIONAL. CONSTITUTIONALITY IS NOT MY AREA OF EXPERTISE, BUT I CAN POINT OUT THAT UNTIL THE LEGAL ARGUMENTS HAD BEEN ADJUDICATED, ALYESKA WOULD HAVE TO CONDUCT ITSELF IN A MANNER WHICH WOULD HAVE US IN CONFORMITY WITH BOTH THE I.C.C. REGULATIONS AND WHATEVER FORM THE STATE LAW MIGHT TAKE. I CAN ASSURE YOU THAT THE EXERCISE WILL, BEYOND ANY DOUBT, DETRACT FROM OUR CONSTRUCTIVE EFFORTS, WILL INCREASE OUR MANPOWER REQUIREMENTS, AND WILL RESULT IN SCHEDULE DELAYS -- ALL OF WHICH ESCALATE COSTS.

AMONG THE STAFF ARGUMENTS FOR SB-294 WAS A LENGTHY ONE FOR INVOLVING THE STATE IN PIPELINE ROUTE SELECTION. THE ARGUMENTS SAID SUCH STATE INVOLVEMENT WOULD CONTROL THE ENVIRONMENTAL IMPACT, EXPLOIT THE LOCAL LABOR MARKETS, PROMOTE GENERAL FACILITIES (AIRPORTS, ROADS AND COMMUNICATIONS), CATALYZE THE ECONOMIC DEVELOPMENT IN OTHER SECTORS AND OPTIMIZE THE CONSTRUCTION SCHEDULE.

ALL OF THOSE ARGUMENTS OVERLOOK THE FUNDAMENTAL ENGINEERING OBJECTIVE OF ROUTE SELECTION AND THAT IS TO BUILD A SAFE AND EFFICIENT PIPELINE. SAFE AND EFFICIENT MEANS SOUND ENGINEERING AND ECONOMICS GIVING DUE RECOGNITION TO THE SAFEGUARDING OF THE ENVIRONMENT.

NO ALASKAN SHOULD LOSE SIGHT OF THE BASIC OBJECTIVE OF THE ALYESKA PROJECT, AND THAT IS TO TRANSPORT OIL -- NOT TO BUILD ROADS OR AIRPORTS OR ANYTHING ELSE UNLESS THEY SERVE A PURPOSE TO THE PIPELINE; BUT EVEN SO, OUR RECORD OF VOLUNTARY COOPERATION WITH THE STATE IS GOOD, AS EVIDENCED BY THE AGREEMENTS ON THE YUKON BRIDGE AND THE HIGHWAY NORTH OF THE YUKON.

FRANKLY, I AM AT A LOSS TO KNOW HOW ROUTING A TRUNK PIPELINE UNDER ANY SET OF RULES OTHER THAN SOUND ENGINEERING IS GOING TO DO ANYTHING OTHER THAN INCREASE THE COST OF THIS PROJECT.

AS FOR THE PROVISIONS CONCERNING PERSONAL AND EQUIPMENT SAFETY AND PROTECTION OF THE ENVIRONMENT, I QUESTION THAT THE STATE HAS THE MANPOWER AND EXPERTISE IN THESE AREAS THAT ALYESKA HAS. YOU HAVE BUT TO GLANCE AT THE LAST TWO REFINERIES I HAVE BEEN INVOLVED WITH TO KNOW WHAT PRIVATE INDUSTRY CAN AND DOES DO ENVIRONMENTALLY AND AESTHETICALLY IN THE ABSENCE OF ANY GOVERNMENT REGULATION BEYOND THE SETTING OF LOCAL AIR AND WATER QUALITY STANDARDS. AND AS FOR PERSONAL AND EQUIPMENT SAFETY, I'LL STACK THE RECORD OF THE U.S. OIL INDUSTRY AGAINST THAT OF ANY GOVERNMENT ENTITY ANYWHERE WITH THE POSSIBLE EXCEPTION OF N.A.S.A. THE FACTS OF LIFE ARE THAT WE WILL BE HELD RESPONSIBLE BY THE FEDERAL GOVERNMENT FOR THE SAFE CONSTRUCTION AND OPERATION OF THE PIPELINE AND FOR THE PROTECTION OF THE ENVIRONMENT. THESE RESPONSIBILITIES ARE CLEARLY SET FORTH IN THE STIPULATIONS WHICH WILL BE PART OF ANY D.O.I. PERMIT. HOWEVER, EVEN WITH THESE SPECIAL STIPULATIONS, WE ARE STILL SUBJECT TO THE PROVISIONS OF THE FEDERAL PIPELINE SAFETY ACT, AND WE WOULD EXPECT THAT ACT TO PRE-EMPT ANY REASONABLE STATE SAFETY ACT. WE RECOGNIZE THAT, IN MANY LOCATIONS, THE FEDERAL AND STATE SAFETY AGENCIES REACH WORKING AGREEMENTS SO THAT DUPLICATION OF EFFORT IS MINIMIZED. THIS IS A REASONABLE APPROACH, SO WE DO NOT SEE THE VALIDITY OF THE ARGUMENTS THAT THE STATE NEEDS BETTER CONTORL OF SAFETY AND ENVIRONMENTAL ASPECTS THAN IT ALREADY HAS.

AS A MATTER OF FACT, WHAT THIS PROJECT BADLY NEEDS IS LESS -- NOT MORE -- REGULATION. BECAUSE OF THE GREAT FRUSTRATIONS GENERATED IN THE PAST TWO YEARS, IT HAS ALREADY BECOME VERY DIFFICULT TO RECRUIT AND KEEP THE HIGH-QUALITY PEOPLE WE NEED IN THIS PROJECT. TO PROVIDE STILL ANOTHER GROUP OF AGENCIES LOOKING OVER OUR SHOULDER JUST GETS THAT MUCH CLOSER TO AN INTOLERABLE SITUATION, AND IT INEVITABLY RAISES COSTS AND CREATES DELAYS.

ONE OF THE ARGUMENTS ADVANCED FOR STATE CONTROL IS THAT SUCH CONTROL WILL PROMOTE INCREASED JOB OPPORTUNITIES FOR ALL ALASKANS. SB-294 EVEN GOES SO FAR AS TO SAY "ACHIEVE FULL EMPLOYMENT". I LIKE TO THINK YOU ARE NOT TALKING ABOUT A STATE POLICY FURTHERING FEATHERBEDDING, BUT THE BILL CAN BE INTERPRETED THAT WAY. I HAVE TESTIFIED TO THE JOINT PIPELINE IMPACT COMMITTEE THAT WE INTEND TO MAXIMIZE THE HIRING OF RESIDENT ALASKANS FOR BOTH CONSTRUCTION AND OPERATION TO THE EXTENT THAT RESIDENT ALASKANS ARE QUALIFIED OR CAN BE QUALIFIED IN REASONABLE TIME TO HANDLE THESE JOBS. WE INTEND TO MAXIMIZE THE EMPLOYMENT OF RESIDENT ALASKANS FOR THE VERY ELEMENTARY REASON THAT IT WOULD BE STUPID TO DO OTHERWISE. ALASKANS ARE ACCLIMATED TO THE ALASKAN ENVIRONMENT AND CULTURE; THEY ARE MORE READILY AVAILABLE FOR INTERVIEWS AND TESTING AND TRAINING; AND THEY DO NOT POSE THE PROBLEMS ASSOCIATED WITH HAVING TO PROVIDE PERIODIC VISITS TO THE "LOWER 48". BUT I HAVE SAID BEFORE -- AND I WILL CONTINUE TO REMIND YOU -- THAT WE WILL NOT EMPLOY UNQUALIFIED PEOPLE IN EITHER CONSTRUCTION OR OPERATIONS AND THAT WE -- IN HAVING RESPONSIBILITY FOR THE SAFE AND EFFICIENT CONSTRUCTION AND OPERATION OF THE FACILITY -- WILL BE THE JUDGE AS TO JOB QUALIFICATIONS. SO, I SEE MANY PROBLEMS ASSOCIATED WITH ATTEMPTING TO LEGISLATE RESIDENT ALASKANS INTO JOBS. PERHAPS THE MOST USEFUL EFFORT THE LEGISLATURE MIGHT MAKE IN THIS AREA IS TO ASCERTAIN THAT RESIDENTS ARE NOT DENIED JOB OPPORTUNITIES BECAUSE OF RESTRICTIVE WORK PRACTICES.

TO THIS POINT, I HAVE TOUCHED ON THE AREAS OF ENGINEERING, SAFETY AND PEOPLE PROBLEMS AND I HAVE NOT BEEN ABLE TO IDENTIFY INSTANCES IN WHICH THE PROVISIONS OF 294, 313 AND 315 WOULD ASSIST IN ANY WAY GETTING THIS OR ANY OTHER PIPELINE BUILT MORE QUICKLY OR AT LOWER COST.

THE OTHER MAJOR AREA INVOLVED IS IN R.O.W. LEASING. AS CONCERNS R.O.W.'s, MOST STATES OF THE U.S. AND THE FOREIGN COUNTRIES I HAVE DEALT

WITH RECOGNIZE THAT THE PROVISION OF RIGHTS-OF-WAY IS TO THE STATE'S ADVANTAGE AS IT RESULTS IN THE AVAILABILITY OF A TRANSPORTATION SYSTEM WHICH, IN TURN, BENEFITS THE ECONOMY AND PEOPLE OF THE STATE. AGAINST THESE OBJECTIVES, MOST STATES HAVE MADE R.O.W. PROCUREMENT RATHER SIMPLE AND INEXPENSIVE. THE UPPER LIMIT OF R.O.W. ACQUISITION COST HAS BEEN, OF COURSE, THE PRICE OF OUTRIGHT PURCHASE OF THE LAND; BUT WHERE FEE OWNERSHIP IS NOT AVAILABLE, THE UPPER LIMIT OF R.O.W. LEASE PAYMENTS HAS BEEN A SINGLE PAYMENT EQUAL TO ABOUT ONE-HALF THE APPRAISED VALUE OF THE LAND FOR BURIED PIPELINE AND A SINGLE PAYMENT EQUAL TO THE FULL APPRAISED LAND VALUE FOR ABOVEGROUND LINES. FROM THESE UPPER PRICES, THE RATES FOR "LOWER 48" R.O.W. LEASES DROP OFF TO VERY MINOR AMOUNTS AS SHOWN BY THE TABLES WHICH I WILL ENTER INTO THIS RECORD.

HOWEVER, THE BILLS WE ARE NOW CONSIDERING HAVE DEPARTED FROM ANY CONSIDERATION RELATED TO ACTUAL LAND VALUES AND HAVE TAKEN THE FORM OF REVENUE MEASURES. INDEED, IF THEY ARE REALLY REPRESENTATIVE OF THE ATTITUDE OF THIS LEGISLATIVE BODY, I CAN ONLY FORECAST THAT BUSINESS AND INDUSTRY WILL BE DISCOURAGED FROM INVESTING IN ALASKA. SB-313, FOR EXAMPLE, WOULD ESTABLISH AN ANNUAL CHARGE OF 1/20 OF GROSS PIPELINE REVENUE PLUS $656/ACRE. WITHOUT HAVING TO ESTABLISH PRECISELY WHAT GROSS REVENUE WILL BE OR WHAT THE EXACT AMOUNT OF STATE LANDS WILL BE, THAT FORMULA EQUATES TO AN ANNUAL CHARGE OF SEVERAL THOUSAND DOLLARS PER ACRE. WHAT MAKES IT EXASPERATING IS THAT WE ALREADY HAVE A SOLID HISTORY OF FEE TITLE ACQUISITION ALONG THE R.O.W. AT A FRACTION OF THAT PER ACRE.

SB-294 IS EVEN MORE EXPENSIVE. AN EXAMPLE I HAVE SEEN RESULTED IN A RENTAL OF OVER $11,000,000/YEAR, OR BETWEEN $7,000 AND $12,000/YEAR/ACRE (DEPENDENT UPON THE ULTIMATE STATE MILEAGE). NUMBERS LIKE THESE WOULD, OF COURSE, COMMAND GREAT RESPECT IN DOWNTOWN

LOS ANGELES. OBVIOUSLY, IF ANY FORMULAS LIKE THESE PASS THE LEGISLATURE, IT WOULD BE IN OUR INTEREST TO ACQUIRE FEE TITLE TO ALL OF THE STATE MILEAGE INVOLVED.

SOMEONE HAS ADVANCED THE ARGUMENT THAT THE "LOWER 48" LEASING * FORMULAS AVERAGE OUT TO A R.O.W. COST OF ABOUT 4% OF THE COST OF AN AS-BUILT LINE, SO ALASKA SHOULD DO AT LEAST AS WELL. IT'S A RATHER WEAK ARGUMENT BECAUSE CONSTRUCTION COSTS IN THE REMOTE AREAS OF ALASKA ARE AT LEAST 2-3 TIMES THE "LOWER 48" AVERAGE, WHEREAS THOSE REMOTE AREA LAND VALUES ARE PRACTICALLY NEGLIGIBLE COMPARED WITH "LOWER 48" LAND VALUES. IN EFFECT THE SB-294 FORMULA SAYS THE MORE DESOLATE AND FOREBODING LAND IS, THE MORE ONE SHOULD PAY FOR IT. I DON'T AGREE.

MR. CHAIRMAN, YOU HAVE ASKED ME "WHAT CAN ALASKA DO TO HELP?". I HAVE ANSWERED THAT QUESTION IN A NEGATIVE SENSE TO THIS POINT. ALASKA HAS ALREADY HELPED. THE CONCERNED STATE AGENCIES HAVE CONTRIBUTED GREATLY TO THE WILDLIFE AND ENVIRONMENTAL STUDIES, AND THEY ARE WORKING TOWARD MEANINGFUL AIR AND WATER QUALITY STANDARDS. YOUR UNIVERSITY HAS BEEN OF IMMEASURABLE HELP IN THE SOLUTION TO MANY OF OUR PROBLEMS. I THINK THIS LEGISLATURE CAN ASSIST NOT ONLY THIS PROJECT, BUT THOSE TO COME IN THE FUTURE, BY CONTRIBUTING TO STATUTES WHICH ARE EASILY UNDERSTANDABLE, WHICH ARE EMINENTLY LOGICAL AND FAIR, AND WHICH ARE NOT SUBJECT TO CHANGE BECAUSE OF POLITICAL OR MONETARY EXPEDIENCY. NO ONE IS GOING TO MAKE MAJOR INVESTMENTS IN THIS STATE WITHOUT ASSURANCE THAT THAT INVESTMENT WILL NOT BE REGULATED OUT OF EXISTENCE.

ALL OF YOU KNOW OF OUR INTENSE FRUSTRATION. ANYTHING WHICH MIGHT RELIEVE THAT FRUSTRATION WILL BE HELPFUL. WE WANT TO GET GOING, SO WE URGE YOU -- IN FOOTBALL LANGUAGE -- TO GET OUT THERE AND BLOCK FOR US.

ELP/nl
3/3/72

E. L. PATTON

* Attachment

LARGE PIPELINE RIGHT-OF-WAY LEASE RATES

STATE OWNED LANDS

(All Rates Shown Are for Single Payments for Life of Project Unless Otherwise Indicated)

	Basic Approach	Rate $ Per Acre	Rate $ Per Mile	Rate Other	Remarks
Arizona	Negotiated	10-12			10-year Period Perpetual Lease May Be Negotiated During Primary Term
California		400			Annually
Indiana	Standard Rate		3200		
Louisiana	Standard Rate		3200		
Michigan	Standard Rate		3200 320		Developed Areas Undeveloped Areas
Minnesota	Standard Rate		320		
Montana	Standard Rate		200		
New Mexico	Appraisal	15			
Texas					
General	Standard Rate		480		10-year Period
University	Standard Rate		1120		10-year Period
Washington	Negotiated	10			
Wisconsin	Standard Rate		320		
B.L.M.	Standard Rate		5		

ELP/nl
3/6/72

ALTHOUGH IT IS NOT A PART OF MY PREPARED STATEMENT WHICH WILL BE HANDED OUT, I WOULD LIKE TO COMMENT ON SOME REMARKS MADE BY MR. GILDEHOUSE YESTERDAY. IN PART OF HIS TESTIMONY, HE ALLUDED TO THE FACT THAT IT WOULD BE A BASIC REQUIREMENT OF THE STATE OWNERSHIP CASE THAT ALYESKA AGREE TO AND EXECUTE A CONTRACT CALLING FOR GUARANTEED CONSTRUCTION AND OPERATING PERFORMANCE. THIS IS A SUBJECT THAT I CAN ADDRESS WITH SOME FAMILIARITY. AS OF 1966 WHEN I ATTEMPTED TO NEGOTIATE A LUMP-SUM CONTRACT (AND THESE ARE THE WORDS USED BY MR. GILDEHOUSE) FOR A PROJECT AT THAT TIME INVOLVING ABOUT $140 MILLION, THE PROSPECTIVE CONTRACTORS INDICATED THEIR INABILITY TO ACCEPT THIS RISK BECAUSE THERE HAD NOT UP TO THAT TIME EVER BEEN A LUMP-SUM CONTRACT OF THAT MAGNITUDE, AND THE PROSPECTIVE CONTRACTORS DID NOT HAVE THE FINANCIAL RESOURCES TO UNDERTAKE THAT KIND OF RISK. WE ARE NOW TALKING ABOUT A FACILITY COSTING ABOUT 20 TIMES AS MUCH AS THAT 1966 CONTRACT, AND THE STATE OR THE STATE'S REPRESENTATIVES ARE IMPLYING THAT WE SHOULD TAKE ON THIS LUMP-SUM OBLIGATION; AND IT HAS BEEN SAID IN A MANNER WHICH WOULD IMPLY THAT THIS DOES NOT REQUIRE THE FULL FAITH AND CREDIT OF THE OIL COMPANIES. THIS JUST CANNOT BE. FOR ME, AS PRESIDENT OF ALYESKA, TO AGREE TO A LUMP-SUM CONTRACT I WOULD FIRST HAVE TO ADD A CONTINGENCY TO THE COST ESTIMATE TO BE SURE THAT I HAD COVERED ALL OF THE UNFORESEEN POSSIBILITIES -- AND THE HISTORY OF THIS PROJECT HAS SHOWN THAT THERE ARE MANY -- AND, THEN, I'D HAVE TO ADD A PROFIT WHICH IS NOT NOW UNDER CONTEMPLATION BECAUSE IF WE WERE GOING TO EXPOSE THE OWNERS OF ALYESKA TO THIS RISK THEY THEN DESERVE A PROFIT. AND, I MIGHT ALSO ADD THAT THE FORCE MAJEURE PARAGRAPH IN THIS CONTRACT WOULD BE SOMETHING THAT HAS NOT BEEN SEEN UP TO NOW, BECAUSE IT WOULD HAVE TO INVOLVE ENVIRONMENTAL CONTINGENCIES AND PROSPECTIVE LAWSUITS IN ADDITION TO THE NORMAL FORCES OF NATURE, ACTS OF GOD, ACTS OF GOVERNMENT ETC.

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

HOUSE BILLS 569 and 570

STATE OR AUTHORITY FINANCING OF TRANS-ALASKA PIPELINE

LEGAL ASPECTS

Testimony of Joseph R. Cortese, Squire, Sanders & Dempsey, Bond Attorneys, Cleveland, Ohio (by invitation)

Introduction.

The legal aspects of the financing of the pipeline by the State or a state authority are important considerations, for the legal problems involved materially enlarge the serious doubts as to the ability of the State to provide public financing of the facility. However, as we discuss those legal problems, it should be borne in mind that even if there were no legal questions concerning state financing, a most serious, persistent and unavoidable concern is that the State simply cannot market this massive volume of financing within the time frame required. Cogent testimony has been presented on that aspect. At this point some of the legal problems will be discussed to further illustrate the sincere concerns of the producers that the State financing package being considered would cause further substantial delays and ultimately founder.

A. Test Litigation - Substantial Questions.

Alaska, in recent years, has undertaken bond financing in relatively novel areas, such as through the Alaska State Mortgage Association, Alaska State Development Corporation, and for the Alaska Mortgage Adjustment Plan in connection with the 1964 earthquake. In each of these instances the State has privately taken the basic questions of law to the Alaska Supreme Court to remove any doubt that the bonds would be valid when issued so that concerns as to legality would not further burden or thwart the marketing of them. It seems most likely that such test litigation would be important with reference to House Bills 569 and 570.

Among the legal propositions which would need to be negated by such litigation are the following:

(1) That the use of the state credit to finance the pipeline project is unwarranted in view of the availability of private financing, and use of state credit for such a facility in the circumstances would not serve a public purpose as required by Article IX, Section 6, Alaska Constitution.

(2) That the State guarantee of the bonds of the Trans-Alaska Authority provided for in House Bill 569 would create a State debt contrary to Article IX, Section 8.

(3) That the leasing of the pipeline by the Authority to the State as provided in House Bill 569 would result in a State debt under Article IX, Section 8, not qualifying under the exceptions provided in Section 11.

(4) That House Bill 569 would be a local or special act in violation of Article II, Section 19, Alaska Constitution.

(5) That House Bill 569 involves unlawful delegation of legislative powers to the proposed Trans-Alaska Authority and to other executive and administrative officers.

These and other legal aspects of House Bills 569 and 570 will be discussed further below.

The course and outcome of such test litigation cannot be reliably predicted. Since the proposed [illegible] financing of the pipeline may be an active public issue, this [illegible] different from the test litigation of the past. It is conceivable that [illegible] would intervene in the litigation, such that the schedule [illegible] not be [illegible] expected. Actions, demands for [illegible] could produce extraordinary delays. [illegible] litigation consumed [illegible] years. [illegible] rare, for bond litigation elsewhere has been [illegible], a recurring factor involves a controversial issue, as with the [illegible] which took over 9 years, and Cincinnati and Louisiana [illegible] years each.

B. Independent Litigation - The No-Litigation Requirement for Bond Financing.

Even if the State and its bond counsel should decide that test litigation is not necessary, the basis for adverse legal contentions is sufficiently present to indicate that others, acting independently of such determination, might nevertheless file litigation. This would pose a very serious problem in the marketing of the bonds because of the normal requirement for successful marketing that a no-litigation certificate be delivered with the bonds. The no-litigation certificate is to the effect that no litigation is pending questioning the validity of the bonds, the authority under which they are to be issued, or the authority to provide for payment from the general or special funds committed thereto. The simple point of such certificate requirement is that a prospective bond purchaser does not want to buy litigation. In this context it would appear that the pendency of such litigation would preclude giving the accepted form of certificate and thereby prevent the marketing of the bonds.

C. Four Types of Bonds.

House Bills 569 and 570 would authorize what might be depicted as four categories of bonds:

(1) General obligation bonds of the State, backed by the full faith and credit and the taxing power of the State in the normal fashion;

(2) Bonds of the Trans-Alaska Authority guaranteed by the State;

(3) Bonds of the Trans-Alaska Authority backed by the general credit of the State through the device of leasing the pipeline to the State with the State paying rentals from its general funds in sufficient amounts to subsidize any operating losses, pay principal and interest on the bonds and establish and maintain reserves to further secure the bonds.

(4) Bonds of the Authority payable solely out of such net operating revenues of the Authority as might be generated over the life of the bonds, with the bondholders taking the full risk of any inability to pay by reason of inadequacy of revenues resulting from delays or interruption in construction, inadequacy of funds to complete the project, any interruption in operation, or changed economic conditions.

D. Public Purpose Question - Is There A Need For The State To Use Its Credit?

In view of the fact that private capital is ready, willing and able to finance the pipeline project, there is a substantial question whether the use and consequent burdening of the State's credit for this project would be for a public purpose within the constitutional prohibition against use of the credit of the State for other than a public purpose.

Alaska Constitution, Article IX, Section 6, provides:

> "No tax shall be levied, or appropriation of public money made, or public property transferred, nor shall the public credit be used, except for a public purpose."

In Ault v. Alaska State Mortgage Association, 387 P. 2d 698 (1963), the Alaska Supreme Court held [illegible] the Court's [illegible] of public purpose in an act of the Legislature did not foreclose determination by the Court of the question of whether the act would serve a public purpose, and the Supreme Court remanded the case to the Superior Court for a taking of evidence pertinent to the question. There, the Alaska State Mortgage Association was to issue revenue bonds to provide moneys in the secondary mortgage market to stimulate housing construction. The Supreme Court said it wanted to see evidence as to the adequacy or lack of private funds in the secondary mortgage market, the effect thereon of termination of a federal program, and how the Association would reduce or eliminate adverse effects.

After the case was remanded to the Superior Court and detailed testimony taken, upon a second appeal the Supreme Court approved the program, two and one-half years after its original submission. Ault v. Alaska State Mortgage Association, 416 P. 2d 249 (1966). The Court ruled that a public purpose existed [illegible] there was a need for public financing in view of the [illegible] private funds, as shown by the evidence, and that the project would [illegible] private funds because the Association would make moneys available [illegible] which would not be obtained in the private market.

Likewise, in Wilson v. Alaska State Housing Authority, 376 P. 2d 717 (1962), the Court [illegible] to be provided by the [illegible] revenue bonds, did not [illegible] that private financing was not sufficiently available for [illegible] Loans.

In Wright v. City of Palmer, 468 P. 2d 326 (1970), the City's issuance of general obligation bonds to construct a plant to be leased to a manufacturer was approved upon evidence that the object and effect would be to encourage industrial development which was urgently needed because the City's economic growth was nil, high year-round unemployment existed, jobs had been lost by the closing of mining and lumbering enterprises, there was no manufacturing in the City, and businesses were moving out of the City. The need for the City itself to take an active role in financing was apparent.

It has been held that industrial development financing serves no public purpose where the facts make it plain that private funds will provide for the project without the injection of public financing; that no public purpose is served by substituting public credit for private funds. Manning v. Fiscal Court of Jefferson County, 405 S.W. 2d 755 (Ky. 1966). There private capital had already been committed to the facility.

That result appears to be consistent with the approaches taken by the Alaska Supreme Court in the cases mentioned above.

From an examination of the proposed statement of legislative findings and policies contained in House Bill 569, it is difficult to perceive any necessity whatever for State financing in order to achieve the objects stated, especially when it is apparent that the planning, development, and expertise represented in Alyeska Pipeline Service Company are essential to the early achievement of the pipeline project consistent with those objectives, and in view of the substantial questions as to the practical ability of the State to finance the project. It should be borne in mind that private capital has already spent or encumbered a half billion dollars for this pipeline project, and is ready, willing and able to provide the balance needed.

In short, the ability to obtain the objectives through private financing and ownership presents a material question of whether the use of the State's credit for this project is unwarranted and impermissible under the Alaska Constitution.

E. State Guarantee of Authority Bonds - Unconstitutional State Debt.

The State guarantee to be placed upon an unlimited amount of bonds of the Trans-Alaska Authority merely upon signature by the Governor pursuant to Section 44.58.260 of House Bill 569, would constitute State debt which is not authorized under either Section 8 or 11 of Article IX, Alaska Constitution.

Section 8 of Article IX prohibits State debt except as ratified by the voters of the State with certain exceptions not relevant here. Section 11 provides an exception for revenue bonds issued by a public enterprise or public corporation "when the only security is the revenues of the enterprise or corporation." The State guarantee clearly would provide security beyond those revenues, and would be inconsistent with this Section 11.

The bill itself acknowledges the creation of State debt. Section .260(e) states, "The state is liable on notes or bonds guaranteed under this section but is not liable on notes or bonds not guaranteed by the state, which may not be debt of the state." It might be noted in this connection that the section would not inhibit issuance of non-guaranteed bonds on a parity with the guaranteed bonds so that revenues could be siphoned off for the non-guaranteed bonds leaving the State with full liability on the guaranteed bonds. No provision is made as to how the State would make good on its guarantees. Perhaps this omission is compelled by the Constitution's prohibition against the dedication of any tax or license to any special purpose. Article IX, Section 7. Thus, the entire financial resources of the State would be obligated. It should be noted that the annual principal and interest requirements on $4.5 billion of bonds would be approximately equal to the total annual revenues of the State at the present time.

House Bill 570, providing for ratification of $3,500,000,000 general obligation bonds of the State to be issued by the State Bond Committee, would not serve to give constitutional authorization for the guarantee of revenue bonds of the Trans-Alaska Authority. Further, it is questionable whether Article IX, Section 8, contemplates any State debt created by way of guarantee. Rather, it may be that an amendment of the Constitution would be needed for that purpose.

In any event, it seems clear that a State guarantee of the Authority bonds could not be given without authorization thereof by vote of the people, and any attempt to vest such power in the Trans-Alaska Authority and the Governor merely by legislative act would be unconstitutional.

F. State Lease Rental Commitment - Unconstitutional State Debt.

The provisions of Section .250 of House Bill 569 for the Trans-Alaska Authority to lease the project to the State and for the State to operate or sublease the project pose serious questions as to whether State debt would be unconstitutionally created thereby.

Section .250 would authorize the Governor to enter into such a lease in connection with the Authority's financing of the project, and to agree that the State would pay the Authority sufficient amounts to pay the principal and interest on the bonds, the operating and maintenance expenses of the project, and to provide reserves for debt service and operating and maintenance expenses. No limitation of amount is provided and the lease may be for any agreed term or may be unlimited in time. Under the lease, the Governor may also commit the State to subsidize costs of the project in any amount agreed upon.

No restriction is provided as to the sources of funds of the State which would be needed to pay the rentals.

The only apparent object of these provisions is to place the State in the middle so that purchasers of the Authority's bonds might view the State's credit as standing behind the bonds, and thus obtain the benefit of the State credit without a vote of the people.

Such lease-type financing has been used or tried in other states and has been sustained in some and declared unconstitutional in others as creating a state debt without constitutional authorization. Still other states have adopted constitutional amendments to permit such financing. The validity of such financing has not been determined by the Alaska Supreme Court.

The legal question is clearly presented where a unique single purpose project is involved, such as this crude oil pipeline. For example the Illinois Supreme Court, in Rosemont Building Supply, Inc. v. Illinois Highway Trust Authority, 258 N.E. 2d 569 (1970), held invalid a plan whereby the Authority would issue bonds, which the act said were not to be deemed obligations of the State, to finance highways, bridges and related facilities. The Authority was to pay off its bonds from its own revenues, but its principal source was to be rentals to be received from the State through leasing the projects to the State. The State was not to be committed to pay rentals except as periodically appropriated, and if rentals were not paid the Authority could undertake operation and charge tolls or lease the projects to others.

The Illinois Supreme Court had previously approved that type of financing for various buildings, but here it distinguished those cases as involving the type of facilities which were readily adaptable to other uses so that it could be assumed that other lessees could be found to pay sufficient sums if the State ceased to pay rentals. However, here it was apparent to the Supreme Court that while the State was not legally obligated to continue appropriations, there would be no real alternatives for use of such highway facilities. Thus, the Court concluded that an unconstitutional State debt would be created by such leasing program.

Much the same can be said of the proposed lease commitment of the State of Alaska in connection with the pipeline project; for if at any time the pipeline was not earning enough to cover the debt, there would be no practical way to avoid a burden on the State general fund for there would be no takers for a losing facility which has no other practical use.

Thus with the vast cost, and consequent heavy debt service burden, of this single purpose facility, the type of financing involving a lease commitment by the State poses substantial constitutional questions.

G. Local or Special Law.

House Bill No. 569 should also be considered in light of Article II, Section 19 of the Constitution which provides that "the legislature shall pass no local or special act if a general act can be made applicable. Whether a general act can be made applicable shall be subject to judicial determination." Provisions of the bill pertaining to the issuance of bonds and notes, the State guarantee of such obligations, and the

entering into of leases and agreements are all limited to the "project", which is defined in Section 44.58.500 as a pipeline from Prudhoe Bay and adjacent areas to the Port of Valdez and other ports and related facilities.

These key provisions of the bill, therefore, relate only to a single pipeline project, which suggests that the bill is a local and special act when a general act providing for pipeline projects anywhere in the State could be made applicable. This point of law has been the subject of litigation which delayed financing for five years. In State, ex rel. Saxbe v. Underground Parking Commission, 155 N.E. 2d 678 (1959), the Ohio Supreme Court held unconstitutional a state providing for the construction and financing of a public parking garage under the grounds of the state capitol building in Columbus under a similar constitutional provision. The applicable provision of the Ohio Constitution, Article II, Section 26, provides in part that "all laws, of a general nature, shall have a uniform operation throughout the state." The court said that the construction of underground parking facilities was a matter which could affect other areas of the state and not just the City of Columbus and that, therefore, the law was a law that dealt with a subject of general nature and was invalid because of its limited application.

Thus, it appears that these important features of House Bill 569 are subject to constitutional challenge and necessitate judicial determination before reliance upon them.

H. Unlawful Delegation of Legislative Powers.

A serious question also exists as to the validity of H.B. No. 569 when considered in relation to Article II, Section 1 of the Alaska Constitution which provides that "the legislative power of the State is vested in a legislature." This bill purports to do more than delegate just rule-making power to an agency or officer, which is a form of permitted delegation of legislative authority, when appropriate standards are provided. Kelly v. Zamarello, 486 P. 2d 906 (1971). This bill is lacking in standards for limitation of rule-making authority, but even more than that, it would take out of the hands of the elected law-making representatives of the people the power to make decisions for the State on matters of the utmost importance concerning State policy and finances.

Consideration of just a few of the more notable examples of attempts to confer unlimited or nearly unlimited powers and discretion upon executive and administrative officers under this bill should suffice to illustrate the manner in which this proposed law might violate Article II, Section 1 of the Alaska Constitution.

1. Section 44.58.055. This section, which is duplicated in identical language in Section 44.58.330, purports to confer on the Authority "sole and exclusive jurisdiction, control and supervision of all pipelines and other transportation facilities for the transportation of oil and natural gas produced in the state," and to authorize the Authority to "do whatever necessary or convenient to carry out its purposes, including without limitation the specific powers enumerated in this chapter." Any such attempt to so regulate and control a pipeline engaged in interstate commerce is clearly violative of the U.S. Constitution. But quite apart from the question whether the State, under the United States or Alaska Constitutions, could assume "sole and exclusive jurisdiction, control and supervision" of the types of facilities named, nowhere in House Bill No. 569 are there to be found any standards or limitations under which the Authority is to be governed in the exercise of this sweeping and all-inclusive grant of power. The entire bill, and this section in particular, would attempt to turn over to an appointed public corporation consisting of three members, which in most matters may act by the votes of two members, power to undertake and carry out, without further action by the legislature of the State, a project which probably would constitute the most massive public works project ever undertaken by any State.

2. Section 44.58.250. This section would authorize the Authority and the Governor, acting on behalf of the State, to enter into leases or agreements for lease of the project by the Authority to the State and for the operation and maintenance of the project by the State. The State could also, acting again through the Governor alone, sublease or enter into any agreement with any person, firm or corporation for the operation and management of the project. A purely permissive provision is made that the amount payable under any lease or agreement between the Authority and the State may include provision for all or any part or share of the amounts necessary to pay debt service on bonds issued to finance the project, to pay costs of operation and maintenance or to

maintain reserves or sinking funds for the purpose of payment of debt service or operation and maintenance. The Governor would also be authorized in such an agreement or lease to commit the State to pay to the Authority, for an unlimited time and in unlimited amounts, the cost of financing the project. No standards or guidelines or restrictions on such leases, subleases and agreements are provided, however, and it would be difficult to imagine a more unlimited grant of discretion to executive or administrative officers than the provision in this section, which is made applicable both to agreements with the Authority and with sublessees or others entered into by the Governor, that "the agreement or lease may be made for a specified or unlimited time on terms and conditions which may be approved by the governor."

3. Section 44.58.260. This section would permit the Authority, by so providing in a bond agreement, to commit the State to guarantee the payment of principal and interest on any bonds or notes issued by the Authority. Even if such a State guarantee were permitted by the Alaska Constitution, this section is of questionable validity in permitting executive and administrative officers, in their unlimited discretion, to make such a guarantee.

These examples of unrestrained power in executive officers are of such vast scope that no truly comparable legislative efforts at delegation of powers can be found in the Alaska cases. Thus, these would appear to be unreliable aspects of the bill in the absence of a court determination addressed directly to them.

Conclusion.

It appears that House Bills 569 and 570 raise many substantial legal problems that could keep a large number of lawyers busy for many years; and there are justifiable concerns that they would do precisely that if enacted. In view of the delays of the project already experienced, and the economic cost thereby to the State, the concerns over legal problems under House Bills 569 and 570 and the further delays they can cause are important considerations for the legislature. Again it should be emphasized that, as previously testified to, even in the complete absence of any legal question, the patent inability of the State or a public corporation of the State to successfully market such a huge volume of bonds in the short time required, presents a direct, practical, and critical problem which strongly indicates that House Bills 569 and 570 are not practical approaches for achievement of the objectives of the State.

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

REMARKS OF GEORGE A. SEYMOUR
TO ALASKAN SENATE AND HOUSE COMMITTEES
ON PROPOSED ALASKAN PIPELINE LEGISLATION
WEEK OF MARCH 6, 1972

INTRODUCTION

I AM GEORGE A. SEYMOUR. I AM MANAGER OF PART-INTEREST PIPELINES FOR MOBIL PIPE LINE COMPANY, THE COMMON CARRIER PIPELINE AFFILIATE OF MOBIL OIL CORPORATION. I AM AN ENGINEER BY PROFESSION AND HAVE BEEN EMPLOYED BY MOBIL FOR TWENTY-FOUR YEARS, DURING WHICH TIME I HAVE BEEN PRIMARILY ENGAGED IN PIPELINE ENGINEERING AND MANAGEMENT. MOBIL OIL CORPORATION OPERATES COOK INLET PIPE LINE COMPANY UNDER AN AGENCY MANAGEMENT AGREEMENT. I AM A DIRECTOR OF AND HAVE BEEN A VICE-PRESIDENT OF COOK INLET PIPE LINE COMPANY SINCE MARCH, 1970, WITH STAFF RESPONSIBILITY FOR THE OPERATIONS OF THAT COMPANY.

RATIONALE OF TESTIMONY

IN RESPONSE TO YOUR INVITATION TO APPEAR AT THIS HEARING, I WOULD LIKE TO SHARE WITH YOU THAT COMPANY'S OPERATING HISTORY WHICH

WILL, WE FEEL, UNDERSCORE THE ECONOMIC RISK INVOLVED IN THE TRANS ALASKA PIPELINE PROJECT, AND ALSO POINT UP THE SIGNIFICANT DIFFERENCES BETWEEN A COMMON CARRIER CRUDE OIL PIPELINE AND A PUBLIC UTILITY.

DESCRIPTION OF COOK INLET PIPE LINE COMPANY FACILITIES

COOK INLET PIPE LINE COMPANY WAS INCORPORATED IN MARCH, 1966. ITS STOCK IS OWNED BY ATLANTIC RICHFIELD COMPANY, MARATHON OIL COMPANY, MOBIL PIPE LINE COMPANY AND UNION OIL COMPANY OF CALIFORNIA. THE COOK INLET PIPE LINE FACILITIES WERE COMPLETED IN THE FALL OF 1967 TO OPERATE AS A CRUDE OIL PIPELINE SYSTEM ON THE WEST SIDE OF COOK INLET, KENAI BOROUGH, ALASKA. THE MAIN LINE OF THIS PIPELINE SYSTEM CONSISTS OF FORTY-TWO MILES OF TWENTY-INCH PIPE FROM GRANITE POINT TO DRIFT RIVER. A TERMINAL COMPLEX LOCATED AT DRIFT RIVER CONSISTS OF SEVEN 270,000 BARREL CRUDE OIL STORAGE TANKS, DEBALLASTING AND BALLAST WATER TREATMENT FACILITIES, LIVING QUARTERS, OFFICES AND MAINTENANCE SHOP, AND AN AIRSTRIP AND HANGAR. OIL TRANSPORTED TO THE DRIFT RIVER TERMINAL BY THE PIPELINE IS

LOADED INTO OCEANGOING TANKERS AT A LOADING PLATFORM TWO MILES OFF SHORE AND CONNECTED TO THE ONSHORE TANKAGE BY DUAL THIRTY-INCH SUBMARINE PIPELINES. THIS PIPELINE SYSTEM SERVES FIVE OFFSHORE PRODUCING FIELDS IN COOK INLET -- TRADING BAY UNIT, TRADING BAY FIELD, TEXACO NORTH TRADING BAY FIELD, ATLANTIC NORTH TRADING BAY FIELD, AND GRANITE POINT FIELD. THE LOCATION OF THE PIPELINE FACILITIES AND CONNECTED PRODUCING FIELDS ARE SHOWN ON EXHIBIT I.

CONSTRUCTION OF FACILITIES

DESIGN AND CONSTRUCTION OF THE COOK INLET FACILITIES COMMENCED IN MARCH OF 1966. THE FIRST TANKER WAS LOADED IN NOVEMBER, 1967. THE PIPELINE, THE DRIFT RIVER TERMINAL COMPLEX AND THE TANKER LOADING PLATFORM ARE CONSTRUCTED ON LANDS ACQUIRED FROM THE STATE OF ALASKA. COOK INLET OBTAINED A RIGHT-OF-WAY PERMIT OVER STATE LANDS FOR THE PIPELINE, PURCHASED 898 ACRES OF LAND AT DRIFT RIVER FOR THE TERMINAL SITE, AND ACQUIRED A TIDELANDS LEASE ON 392 ACRES OF THE FLOOR OF COOK INLET ENCOMPASSING THE OFFSHORE TANKER LOADING PLATFORM.

PIPELINE PROJECT JUSTIFICATION

THE ECONOMIC JUSTIFICATION TO CONSTRUCT THE COOK INLET PIPE LINE SYSTEM WAS BASED UPON THE THEN ESTIMATED PROSPECTIVE DISCOVERY OF 800 MILLION BARRELS OF RECOVERABLE CRUDE OIL RESERVES IN THE AREA TO BE SERVED BY THE PIPELINE AND WHICH WOULD BE PRODUCED AND TRANSPORTED IN THE PIPELINE DURING A THIRTY-YEAR PERIOD. INITIAL COST ESTIMATES INDICATED THAT THE CONTEMPLATED PIPELINE FACILITIES COULD BE CONSTRUCTED FOR $32 MILLION. THE FACILITIES ACTUALLY COST $42 MILLION, AN INCREASE OF 31% CAUSED BY THE HIGH COST OF CONSTRUCTION IN ALASKA AND THE NEED FOR MORE STRINGENT DESIGN TO MEET ICE CONDITIONS AFFECTING THE TANKER LOADING PLATFORM.

PIPELINE THROUGHPUT

SINCE THE CONSTRUCTION OF THE COOK INLET FACILITIES, THE RESULTS OF DRILLING AND EXPLORATION IN THE AREA HAVE FALLEN FAR SHORT OF INITIAL EXPECTATIONS. MORE THAN THIRTY-FIVE DRY HOLES HAVE BEEN DRILLED WHICH, IF PRODUCTIVE, WOULD HAVE BEEN SERVED BY THE COOK INLET PIPE LINE SYSTEM. PRODUCERS' CURRENT ESTIMATES ARE

THAT RECOVERABLE CRUDE RESERVES ACCESSIBLE TO THE COOK INLET PIPE LINE SYSTEM WILL BE NO MORE THAN 500 MILLION BARRELS. THIS IS 38% LESS THAN THE RECOVERABLE RESERVE ESTIMATE UTILIZED FOR PROJECT ECONOMICS. AS A RESULT, PIPELINE THROUGHPUT HAS BEEN AND IS NOW PROJECTED TO BE SUBSTANTIALLY LESS THAN ORIGINALLY ANTICIPATED AS IS SHOWN ON EXHIBIT II. UNLESS ADDITIONAL CRUDE OIL RESERVES ARE DISCOVERED IN THE AREA CONTIGUOUS TO THE COOK INLET PIPE LINE SYSTEM, IT IS HIGHLY UNLIKELY THAT THE PIPELINE CAN CONTINUE TO BE OPERATED ECONOMICALLY AT THE THROUGHPUT LEVEL NOW PROJECTED FOR 1987.

TARIFF AND FINANCIAL POLICY

THE COOK INLET TARIFF POLICY WAS INITIALLY ESTABLISHED TO SET TARIFFS FILED WITH THE INTERSTATE COMMERCE COMMISSION AT A LEVEL WHICH WOULD RECOVER ALL COSTS AND PROVIDE AN OWNER'S RETURN OF 7% ON I.C.C. VALUATION. UTILIZING THE ORIGINAL CRUDE OIL PRODUCTION FORECAST (ORIGINAL PROJECTION, EXHIBIT II), THE TARIFF WAS SET AT 21-CENTS PER BARREL. INITIAL PRODUCTION EXCEEDED

EXPECTATIONS AND PRODUCERS' RE-EVALUATIONS OF RESERVES INDICATED THAT PRODUCTION WAS GOING TO EXCEED THE ORIGINAL PROJECTION, PARTICULARLY IN THE FIRST FEW YEARS. BASED ON EXPECTED INCREASED PRODUCTION AND THE ESTABLISHED TARIFF POLICY, THE TARIFF WAS REDUCED TO 16-CENTS PER BARREL IN MAY, 1968. PRODUCTION FELL BELOW FORECAST AND COOK INLET PIPE LINE COMPANY ENDED THE YEAR 1968 WITH A BOOK LOSS OF $123,000 AND A CUMULATIVE LOSS OF $1 MILLION. IN MAY, 1969, THE TARIFF WAS INCREASED TO 20-CENTS WHICH PERMITTED COOK INLET TO OVERCOME THE BOOK DEFICIT. IN APRIL, 1970, IT HAD BECOME EVIDENT THAT CONNECTED RECOVERABLE CRUDE RESERVES WOULD PROBABLY BE NO MORE THAN 500 MILLION BARRELS, AND THE OWNERS AGREED THAT COOK INLET'S FINANCIAL POLICY SHOULD PLACE EMPHASIS UPON RETIREMENT OF INDEBTEDNESS WITHIN THE LIFE EXPECTANCY INDICATED BY CURRENT ESTIMATES OF CRUDE PRODUCTION (CURRENT PROJECTION, EXHIBIT II). THE TARIFF WAS ACCORDINGLY INCREASED TO 22 1/2-CENTS EFFECTIVE JANUARY, 1971, WITH THAT RATE SCHEDULED TO REMAIN IN EFFECT UNTIL SUCH TIME (PROBABLY 1978) AS IT BECOMES NECESSARY TO FURTHER INCREASE THE TARIFF TO MAINTAIN A BREAKEVEN POSITION. THE

CURRENT COOK INLET FINANCIAL POLICY PROVIDES NO DIVIDENDS TO THE OWNERS AND ALL CASH INCOME IN EXCESS OF WORKING CAPITAL REQUIREMENTS IS UTILIZED TO RETIRE DEBT. THE GOAL OF THIS FINANCIAL POLICY IS TO GENERATE SUFFICIENT FUNDS DURING THE REMAINING ECONOMIC LIFE OF THE COOK INLET FACILITY TO REPAY THE INDEBTEDNESS INCURRED TO CONSTRUCT THE FACILITY, AND TO RETURN THE OWNERS' ORIGINAL EQUITY INVESTMENT WITH NO EARNINGS THEREON.

OIL PRODUCTION AND PIPELINE THROUGHPUT

THE ANNUAL THROUGHPUT VOLUMES OF COOK INLET SHOWN ON EXHIBIT II PARALLEL THE CLASSIC PRODUCTION CURVE OF A SINGLE OIL FIELD OR GROUP OF FIELDS DISCOVERED AT APPROXIMATELY THE SAME TIME. PRODUCTION GRADUALLY INCREASES AS FIELD DEVELOPMENT WELLS ARE DRILLED FOLLOWING A PIPELINE CONNECTION TO THE FIELD. SOMETIME AFTER ALL PRODUCTIVE WELLS DRILLED IN THE AREA ARE CONNECTED TO THE PIPELINE, PRODUCTION WILL REACH A PEAK UNLESS PRODUCTION IS OTHERWISE LIMITED FOR A PERIOD OF TIME BY PIPELINE CAPACITY, PRORATIONING OF PRODUCTION, OR RESERVOIR FACTORS. THEREAFTER, PRODUCTION WILL

GRADUALLY DECLINE OVER THE PRODUCING LIFE OF THE FIELD. UNLESS ADDITIONAL RESERVES ARE DISCOVERED IN THE AREA SERVED BY THE PIPELINE, THE THROUGHPUT OF THE PIPELINE WILL DECREASE AS THE CRUDE OIL IS PRODUCED. IN THE ABSENCE OF NEWLY DISCOVERED RESERVES, THE COMBINATION OF DECLINING THROUGHPUT VOLUMES AND INCREASING OPERATING COSTS PER BARREL WILL ULTIMATELY RESULT IN AN UNECONOMICAL PIPELINE OPERATION EVEN IF TRANSPORTATION CHARGES ARE SUBSTANTIALLY INCREASED. ULTIMATELY, PRODUCING AND PIPELINE OPERATING COSTS WILL EXCEED THE VALUE OF THE CRUDE OIL AND BOTH THE OIL FIELD AND THE PIPELINE FACILITY WILL BE ABANDONED.

CRUDE OIL PIPELINES VERSUS PUBLIC UTILITIES

A COMMON CARRIER CRUDE OIL PIPELINE FACILITY CONSTRUCTED TO TRANSPORT PRODUCTION FROM ONE OR MORE NEWLY DISCOVERED OIL FIELDS DIFFERS SUBSTANTIALLY FROM A PUBLIC UTILITY FACILITY. A CRUDE OIL PIPELINE IS A SUBSTANTIALLY MORE RISKY BUSINESS VENTURE THAN A PUBLIC UTILITY ENTERPRISE OR EVEN OTHER TYPES OF COMMON CARRIER TRANSPORTATION OPERATIONS. A PUBLIC UTILITY FACILITY IS ORDINARILY

CONSTRUCTED TO PROVIDE A BASIC SERVICE TO A SEGMENT OF THE GENERAL PUBLIC, OR TO ALL MEMBERS OF THE GENERAL PUBLIC IN A GIVEN AREA. BECAUSE OF POPULATION GROWTH, A PUBLIC UTILITY NORMALLY HAS ASSURED GROWTH IN ITS BUSINESS FROM A FIXED BASE FOR AN INDEFINITE PERIOD OF TIME WITH VERY LITTLE LIKELIHOOD OF ULTIMATE ABANDONMENT OF ITS FACILITIES, AND WITH, TYPICALLY, PERIODIC RATE INCREASES TO MAINTAIN PROFITABILITY. ON THE OTHER HAND, A CRUDE OIL PIPELINE, PARTICULARLY IN A REMOTE PRODUCING AREA SUCH AS ALASKA, WILL BE CONSTRUCTED ONLY TO MEET A SPECIFIC NEED -- THE TRANSPORTATION OF LARGE VOLUMES OF NEWLY DISCOVERED CRUDE OIL RESERVES. CONSEQUENTLY, SUBSTANTIAL INITIAL CAPITAL INVESTMENT IN THE PIPELINE FACILITY IS REQUIRED AT ONE TIME AS CONTRASTED WITH THE MORE GRADUAL INCREMENTAL CAPITAL INVESTMENT OVER A PERIOD OF YEARS BY A PUBLIC UTILITY TO MEET THE INCREASING SERVICE DEMANDS OF A GROWING POPULATION. SUCH A CRUDE OIL PIPELINE FACILITY IS DESIGNED SOLELY TO TRANSPORT THE DISCOVERED AND PROSPECTIVE OIL RESERVES IN THE AREA IN WHICH THE PIPELINE IS CONSTRUCTED. THERE IS NO ASSURANCE THAT ADDITIONAL OIL FIELDS WILL BE DISCOVERED IN THE AREA SERVED BY THE PIPELINE OR

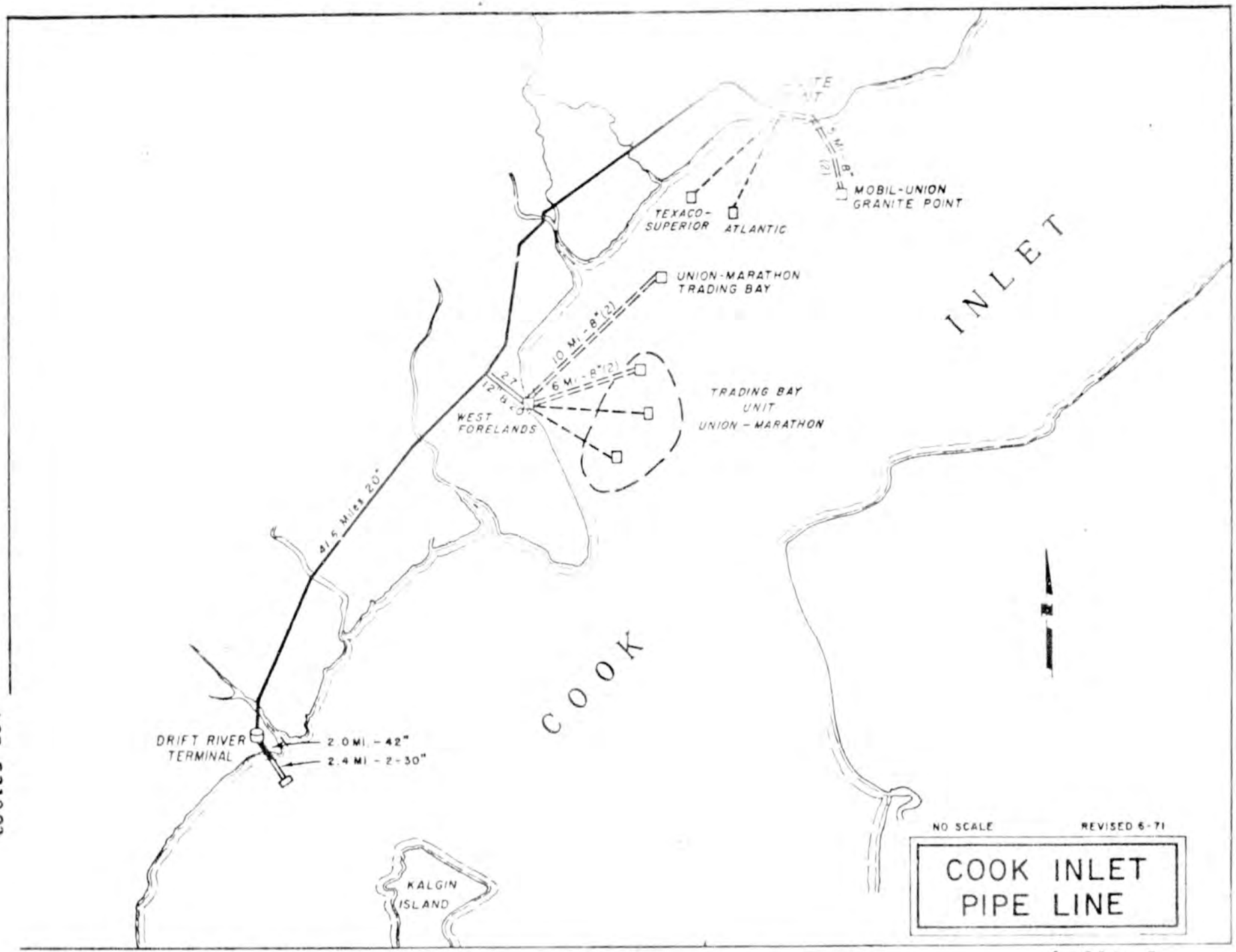
EVEN THAT THE ANTICIPATED PROSPECTIVE CRUDE OIL RESERVES WILL ULTIMATELY BE PRODUCED AND TRANSPORTED IN THE PIPELINE. THE ABANDONMENT OF THE PIPELINE FACILITY WHEN OIL RESERVES ARE DEPLETED IS A CONCRETE PROBABILITY FROM THE VERY INCEPTION OF THE PIPELINE PROJECT. THESE UNUSUAL CRUDE OIL PIPELINE RISK FACTORS RESULTING FROM THE CHANCE LOCATIONS OF UNDERGROUND OIL RESERVOIRS ARE INEVITABLE AND ACCEPTED IN THE OIL INDUSTRY. BECAUSE THESE HIGH RISK FACTORS CANNOT BE AVOIDED, CRITERIA FOR DETERMINING REASONABLE RATES OF RETURN ON OIL PIPELINE INVESTMENTS HAVE ALWAYS RECOGNIZED THAT TRADITIONAL PUBLIC UTILITY RATE-MAKING CONCEPTS CANNOT BE REALISTICALLY APPLIED TO OIL PIPELINE COMMON CARRIERS.

RECOGNITION OF RISK

THE WILLINGNESS OF OIL COMPANIES TO CONSTRUCT THE COOK INLET PIPE LINE SYSTEM WITHOUT ASSURANCE OF AN ACCEPTABLE LEVEL OF PROFITABILITY ON THE INVESTMENT IN THE FACILITY DEMONSTRATES THE ECONOMIC RISK ASSUMED IN CRUDE OIL PIPELINE INVESTMENTS BY ENTERPRISES IN THE PETROLEUM INDUSTRY. THE PARTICIPANTS IN THE

TRANS ALASKA PIPELINE SYSTEM PROJECT SIMILARLY HAVE NO ASSURANCE THAT THE PIPELINE FACILITY WILL BE A PROFITABLE INVESTMENT OVER ITS LIFE. NEVERTHELESS, THE TAPS OWNERS ARE WILLING TO ASSUME THE RISK INHERENT IN THE PROJECT. FUTURE DEVELOPMENTS WILL DETERMINE WHETHER THE TRANS ALASKA PIPELINE SYSTEM WILL BE A PROFITABLE INVESTMENT OVER THE LIFE OF THE PROJECT.

JRK-GAS/JV
MARCH 3, 1972



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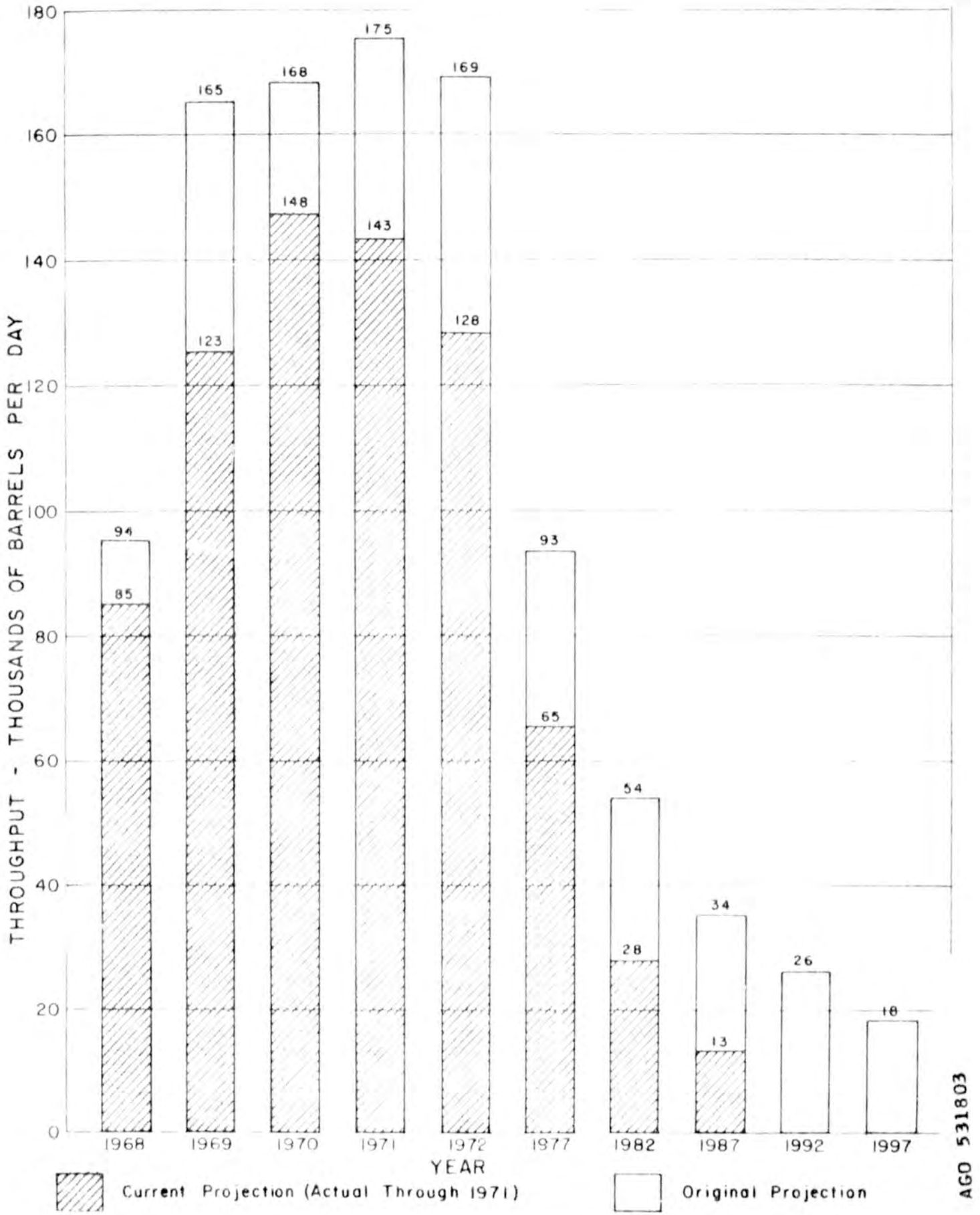
COOK INLET PIPE LINE COMPANY
ANNUAL THROUGHPUT VOLUMES



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

REMARKS OF THOMAS BROUSSARD
TO THE JOINT HEARING OF THE SENATE COMMERCE COMMITTEE
AND THE HOUSE STATE AFFAIRS COMMITTEE
ON PROPOSED ALASKAN LEGISLATION CONCERNING
PIPELINE REGULATION, RIGHT-OF-WAY AND
STATE OWNERSHIP -- MARCH 6, 7, & 8, 1972

MR. CHAIRMAN: MY NAME IS THOMAS BROUSSARD, AND I AM A TAX ATTORNEY IN THE LEGAL DEPARTMENT OF ATLANTIC-RICHFIELD COMPANY.

TOGETHER WITH COUNSEL REPRESENTING SEVERAL OTHER OIL COMPANIES, INCLUDING COUNSEL FROM SEVERAL LAW FIRMS, I HAVE STUDIED THE QUESTIONS OF FEDERAL TAXATION OF THE STATE OF ALASKA ON POTENTIAL PROFITS TO BE DERIVED FROM OWNERSHIP OF A TRANS-ALASKA PIPELINE AND THE SEPARATE QUESTION OF THE TAXATION OF INTEREST RECEIVED BY BONDHOLDERS FROM ANY BONDS THAT MIGHT BE ISSUED BY THE STATE OR A PUBLIC AUTHORITY FOR THE PURPOSE OF BUILDING THE PIPELINE. IT IS MY OPINION AND THAT OF MY COLLEAGUES THAT IT IS VERY DOUBTFUL THAT EITHER THE STATE OR ITS BONDHOLDERS, UNDER THE BILLS INTRODUCED BY THE ADMINISTRATION, WILL BE EXEMPT FROM FEDERAL INCOME TAX.

THE PROPOSAL FOR PIPELINE OWNERSHIP AS DESCRIBED TO THE COMMITTEES SEEKS TWO TAX ADVANTAGES TO INCREASE STATE REVENUES AT THE EXPENSE OF THE FEDERAL TREASURY. THE FIRST ASSUMED ADVANTAGE IS FOR THE STATE ITSELF TO RECEIVE AS PIPELINE PROFIT AN AMOUNT EQUAL TO THE FEDERAL INCOME TAX WHICH WOULD BE PAID BY THE OIL COMPANIES ON ANY INCOME EARNED FROM THE PIPELINE. THE SECOND

HOPED FOR ADVANTAGE IS TO REDUCE THE INTEREST COST ON DEBT FINANCING OF THE LINE BY AN AMOUNT EQUAL TO THE FEDERAL INCOME TAX WHICH WOULD BE PAID BY HOLDERS OF PRIVATE COMPANIES' BONDS.

CONSIDERING THE LIKELIHOOD OF THE STATE'S EXEMPTION FROM FEDERAL INCOME TAX ON PROFIT FROM THE PIPELINE, THERE IS NO QUESTION THAT CONGRESS HAS THE CONSTITUTIONAL POWER TO TAX THE STATE ON ITS INCOME FROM BUSINESS OPERATIONS. THE PAST POSITION OF THE IRS HAS BEEN THAT CONGRESS HAS NOT IMPOSED THE FEDERAL INCOME TAX ON A STATE DIRECTLY ENGAGED IN A BUSINESS ACTIVITY FOR THE PURPOSE OF PROVIDING A PUBLIC NECESSITY OR IN THE EXERCISE OF ITS POLICE POWER. HOWEVER, IT IS DOUBTFUL THAT THE IRS WILL MAINTAIN THAT POSITION IF ASKED TO RULE ON THE QUESTION OF THE STATE OF ALASKA OPERATING A 3.5 BILLION DOLLAR PIPELINE TO CARRY OIL FOR A LIMITED NUMBER OF PRIVATE OIL COMPANIES.

IF THE IRS DID GRANT A FAVORABLE RULING, WHERE, AS STATED BEFORE THIS COMMITTEE, THE INTENTION OF THE STATE IS TO SUBSTITUTE ITSELF FOR PRIVATE BUSINESSES WHICH ARE READY, ABLE AND WILLING TO ENGAGE IN A COMMERCIAL ACTIVITY FOR THE BENEFIT OF RELATIVELY FEW PRIVATE USERS, AND PASS ON TO THOSE COMPANIES ALL OR A MAJOR PORTION OF THE SAVINGS FROM ITS PRIVILEGE OF TAX EXEMPTION, CONGRESS IS ALMOST CERTAIN TO EXAMINE WHETHER THE PRIVILEGE OF TAX IMMUNITY SHOULD BE CONTINUED. THE RESULT, I AM SURE, WOULD BE AN AMENDMENT TO THE STATUTE TO MAKE CLEAR THE INTENTION OF CONGRESS THAT SUCH INCOME SHOULD NOT ESCAPE FEDERAL TAXATION. IN FACT, IT IS DOUBTFUL THAT CONGRESSIONAL REACTION WOULD BE LIMITED TO THIS STATE ACTIVITY.

WITH RESPECT TO THE POSSIBILITY OF THE EXEMPTION FROM FEDERAL INCOME TAX OF INTEREST RECEIVED BY THE HOLDERS OF BONDS ISSUED BY A

STATE AUTHORITY TO FINANCE THE PIPELINE, THE ANSWER IS CLEAR. INTEREST ON STATE BONDS IS EXEMPT FROM FEDERAL TAX SOLELY BY VIRTUE OF SECTION 103(A) OF THE INTERNAL REVENUE CODE.

IN THE WORDS EARLIER THIS YEAR OF AN ATTORNEY-ADVISOR IN THE OFFICE OF TAX LEGISLATIVE COUNSEL OF THE U.S. TREASURY DEPARTMENT "THE INCREASING USE OF TAX-EXEMPT FINANCING FOR PURPOSES BEYOND THOSE ORIGINALLY CONTEMPLATED BY SECTION 103(A) HAS LED TO A SERIES OF ACTIONS BY THE TREASURY AND THE CONGRESS TO RESTRICT SUCH FINANCING TO THE PURPOSES FOR WHICH THE EXEMPTION WAS ORIGINALLY GRANTED."

THE ABUSE WHICH PROMPTED CONGRESS IN 1968 TO AMEND SECTION 103 WAS PRIMARILY THE USE BY STATES OF THE TAX EXEMPTION TO FINANCE INDUSTRIAL PROJECTS FOR PRIVATE COMPANIES. TO MY KNOWLEDGE, THE LARGEST SUCH PROJECT INVOLVED STATE BONDS OF LESS THAN 100 MILLION DOLLARS. THE PROPOSED LEGISLATION WOULD UTILIZE THIS PRIVILEGE FOR A PROJECT ESTIMATED AT 35 TIMES THAT AMOUNT. THE PREVIOUS CONCERNS EXPRESSED BY CONGRESS AND THE TREASURY THAT EARLIER ISSUES WERE CREATING UNINTENDED BENEFITS FOR PRIVATE BUSINESS AND REDUCING THE MARKET FOR MUNICIPAL BONDS FOR NEEDED GOVERNMENTAL SERVICES ARE DWARFED BY THE MAGNITUDE OF THIS PROPOSAL.

THE ACTION BY CONGRESS TO RESTRICT THE TAX EXEMPTION OF INTEREST ON MUNICIPAL BONDS ARE CONTAINED IN SECTION 103(C) OF THE INTERNAL REVENUE CODE, WHICH DENIES TAX EXEMPTION FOR INTEREST ON INDUSTRIAL DEVELOPMENT BONDS. FOR OUR PURPOSES AN INDUSTRIAL DEVELOPMENT BOND MAY BE DEFINED TO MEAN ANY OBLIGATION ISSUED AS A PART OF AN ISSUE, ALL OR A MAJOR PORTION

OF THE PROCEEDS OF WHICH ARE TO BE USED DIRECTLY OR INDIRECTLY IN ANY TRADE OR BUSINESS CARRIED ON BY ANY NON-TAX-EXEMPT PERSON AND THE PRINCIPAL OR INTEREST OF WHICH IS SECURED OR TO BE DERIVED FROM ANY INTEREST IN PROPERTY USED IN A TRADE OR BUSINESS OR FROM PAYMENTS IN RESPECT OF SUCH PROPERTY.

THIS LATTER TEST, CALLED THE SECURITY INTEREST TEST, IS CLEARLY SATISFIED WHEN THE BOND SERVICE IS TO BE PAID FROM THE REVENUES OF THE PIPELINE AS PROPOSED, PROVIDED THE PIPELINE IS USED IN THE TRADE OR BUSINESS OF THE OIL COMPANIES.

THE FIRST TEST, CALLED THE TRADE OR BUSINESS TEST, IS THE CRITICAL ONE. THE PROPOSED REGULATIONS INTERPRETING THIS LANGUAGE ARE SUBJECT TO CHANGE, BUT AT PRESENT PROVIDE THAT THE TRADE OR BUSINESS TEST IS MET "IN THE CASE OF A FACILITY CONSTRUCTED. . .OR ACQUIRED WITH THE PROCEEDS OF AN ISSUE WHICH IS OSTENSIBLY OWNED AND OPERATED BY AN EXEMPT PERSON (SUCH AS THE PROPOSED TRANS ALASKA AUTHORITY) BUT WHERE ONE OR MORE NON-EXEMPT PERSONS (SUCH AS THE OIL COMPANIES) AGREE, PURSUANT TO ONE OR MORE LONG-TERM CONTRACTS, TO TAKE, OR TO TAKE OR PAY FOR, A MAJOR PORTION (MORE THAN 25%) OF THE OUTPUT OF SUCH FACILITY (WHETHER OR NOT CONDITIONED UPON THE PRODUCTION OF SUCH OUTPUT) FOR PERIODS OF TIME WHICH ARE SUBSTANTIAL IN RELATION TO THE TERMS OF THE BONDS."

ALTHOUGH THE REGULATION SPEAKS OF OUTPUT OR PRODUCTION FROM A FACILITY, THE SAME RULE WOULD APPLY TO GUARANTEEING INPUT TO A FACILITY SUCH AS A PIPELINE IN WHICH THE REVENUE IS EARNED FROM CARRYING CRUDE OIL.

FROM DISCUSSIONS WITH PERSONS EXPERIENCED IN PUBLIC FINANCING OF PIPELINES, WE HAVE BEEN CONSISTENTLY ADVISED THAT LONG-TERM

COMMITMENTS TO SUPPLY CRUDE TO THE LINE UNDER A TAKE OR PAY THROUGHPUT AGREEMENT WILL BE NECESSARY TO SELL THE BONDS.

INDEED THE MINIMUM SHIPPING AGREEMENTS DESCRIBED BY MR. GUILDEHOUS (WHILE NOT SUFFICIENT TO SATISFY INVESTORS IN THE VIEW OF MR. GARY) IS IN MY OPINION SUFFICIENT TO SATISFY THE TRADE OR BUSINESS TEST OF SECTION 103(c) AND, THUS, TO MAKE THE PROPOSED BONDS INDUSTRIAL DEVELOPMENT BONDS NOT ENTITLED TO TAX EXEMPTION. UNDER SUCH A PLAN (WHICH THE TEMPLE REPRESENTATIVES SAID HAS NOT BEEN ACCEPTED BY THE STATE OR ITS FINANCIAL ADVISORS), THE COMPANIES WOULD BE ASKED TO MAKE A LONG-TERM CONTRACT TO GUARANTEE TO PROVIDE MORE THAN 25% OF THE CRUDE TO BE TRANSPORTED THROUGH THE LINE WHICH IS THE EQUIVALENT OF GUARANTEEING TO TAKE OR PAY FOR MORE THAN 25% OF THE TRANSPORTATION SERVICE.

MR. CADES STATED THAT THE VOLUME OF THE LINE AVAILABLE TO THE OWNER COMPANIES IS SUBJECT TO REDUCTION FOR OTHER USERS, WHICH CHANGES THE TAKE OR PAY NATURE OF THE CONTRACT. BUT, SINCE ANY ADDITIONAL USERS ARE UNLIKELY TO REDUCE THE ORIGINAL COMPANIES' COMMITMENT BELOW 25% AND SUCH USERS ARE THEMSELVES NON-EXEMPT PERSONS, I FAIL TO SEE HOW THIS WOULD ESCAPE THE DEFINITION OF INDUSTRIAL REVENUE BONDS SET FORTH IN THE REGULATIONS.

THERE IS AN EXCEPTION THAT "FACILITIES WILL NOT BE TREATED AS INDIRECTLY USED IN THE TRADES OR BUSINESSES OF NON-EXEMPT PERSONS WHERE SUCH PERSONS PURCHASE THE OUTPUT OF THE FACILITIES ON TERMS WHICH ARE CUSTOMARY IN THE INDUSTRY FOR SALE OF SUCH OUTPUT AND WHICH DO NOT HAVE THE EFFECT OF TRANSFERRING TO THEM THE BENEFITS AND BURDENS OF OWNERSHIP OF SUCH FACILITIES."

AS A SAFE HAVEN FROM THE TEST OF WHETHER THE BENEFITS AND BURDENS OF OWNERSHIP HAVE BEEN TRANSFERRED, THE REGULATIONS PROVIDE THAT THE TRADE OR BUSINESS WILL NOT BE MET IF THE OUTPUT "IS SOLD TO A SUBSTANTIAL NUMBER OF UNRELATED CUSTOMERS UNDER A RATE SCHEDULE OF GENERAL APPLICATIONS PROVIDED THAT NO SINGLE CUSTOMER PAYS ANNUALLY A DEMAND CHARGE OR GUARANTEED MINIMUM PAYMENT WHICH EXCEEDS 2-1/2% OF THE AVERAGE ANNUAL DEBT SERVICE." THE ILLUSTRATION UNDER THIS EXCEPTION DEALS WITH A FACILITY FOR SUPPLYING ELECTRIC ENERGY.

IN OUR OPINION, THE MINIMUM SHIPPING AGREEMENTS CAN HARDLY BE SAID EITHER TO BE TERMS OF SALE CUSTOMARY IN THE INDUSTRY OR NOT TO HAVE THE EFFECT OF TRANSFERRING THE BURDENS OF OWNERSHIP TO THE COMPANIES. MR. GARY HAS ALREADY EXPLAINED WHY THE BURDENS OF OWNERSHIP (IN THE FORM OF THE PLEDGE OF COMPANY CREDIT) ARE OF NECESSITY PLACED ON THE COMPANIES. EARLIER TESTIMONY BY THE ADMINISTRATION HAS STATED THAT SOME OF THE BENEFITS OF OWNERSHIP WILL BE PASSED ON TO THE COMPANIES AS WELL. THEREFORE, THE TEMPLE PLAN WILL NOT FIT WITHIN THE EXCEPTION.

THUS, IT IS OUR CONCLUSION THAT IT IS EXTREMELY UNLIKELY THAT A FAVORABLE RULING COULD BE OBTAINED FROM THE INTERNAL REVENUE SERVICE THAT INTEREST ON THESE PROPOSED BONDS WOULD BE TAX EXEMPT. ALTHOUGH RULINGS, ONCE OBTAINED AND ACTED UPON BY THE RECIPIENT, ARE SELDOM, IF EVER, RETROACTIVELY REVERSED, IT SEEMS UNLIKELY THAT CONGRESS, IN VIEW OF ITS POSITION IN 1968, WOULD NOT ACT TO NULLIFY SUCH A RULING BEFORE ANY COMMITMENT HAD BEEN MADE IN RELIANCE ON THE RULING. IN FACT, LEGISLATION WOULD PROBABLY BE

INTRODUCED AS SOON AS ANY APPLICATION FOR A REVENUE RULING BECAME KNOWN WHICH WOULD CAUSE THE IRS TO SUSPEND ACTION ON THE RULING REQUEST.

TWO ADDITIONAL MATTERS SHOULD BE MENTIONED. IT HAS BEEN SUGGESTED THAT IF THE STATE COULD OBTAIN THE TAX BENEFITS UPON WHICH THE ADMINISTRATION'S PROJECTIONS ARE BASED, THESE BENEFITS WOULD BE PASSED ON TO THE OIL COMPANIES. THE MAGNITUDE OF ANY DIFFERENTIAL IN INTEREST RATES HAS BEEN DISCUSSED EARLIER BY ADMINISTRATION WITNESSES AS BEING QUITE SMALL OR NON-EXISTENT. BUT EVEN IF SOME TAX SAVINGS WERE PASSED ON TO THE OIL COMPANIES BY REDUCED TARIFF, WHETHER ORDERED BY THE ICC OR OTHERWISE, THE BENEFIT TO THE COMPANIES WOULD STILL BE SUBSTANTIALLY REDUCED BY THE INCREASED INCOME TAX PAYMENTS ON THE HIGHER PROFITS RESULTING FROM LOWER TRANSPORTATION COSTS.

SECONDLY, THE OWNERSHIP BILL IS DESIGNED TO PROVIDE FINANCING FOR SEVERAL FACILITIES SEPARATE FROM THE PIPELINE IN AN EFFORT TO TAKE ADVANTAGE OF CERTAIN EXEMPTIONS FROM THE INDUSTRIAL REVENUE BOND PROVISIONS OF SECTION 103(c).

WHERE AN OBLIGATION MEETS THE TESTS OF AN INDUSTRIAL DEVELOPMENT BOND, THE INTEREST MAY STILL BE EXEMPT FROM TAX IF THE PROCEEDS ARE USED FOR CERTAIN FACILITIES LISTED IN SECTION 103(c)(4). THOSE FACILITIES ARE:

"(A) RESIDENTIAL REAL PROPERTY FOR FAMILY UNITS;

(B) SPORT FACILITIES;

(C) CONVENTION OR TRADE SHOW FACILITIES;

(D) AIRPORTS, DOCKS, WHARVES, MASS COMMUTING FACILITIES, PARKING FACILITIES, OR STORAGE OR TRAINING FACILITIES DIRECTLY RELATED TO ANY OF THE FOREGOING;

(E) SEWAGE OR SOLID WASTE DISPOSAL FACILITIES OR FACILITIES FOR THE LOCAL FURNISHING OF ELECTRIC ENERGY OR GAS;

(F) AIR OR WATER POLLUTION CONTROL FACILITIES, OR

(G) FACILITIES FOR THE FURNISHING OF WATER, IF AVAILABLE ON REASONABLE DEMAND TO MEMBERS OF THE GENERAL PUBLIC."

YOU WILL NOTICE THAT SECTION 1 OF HB 579 LISTS SEVERAL OF THESE EXEMPT FACILITIES. HOWEVER, FOR MOST OF THOSE FACILITIES RELATED TO THE PIPELINE IT IS UNLIKELY THAT THE EXEMPTION WILL APPLY. THE PROPOSED REGULATIONS PROVIDE THAT "TO QUALIFY UNDER SECTION 103(c)(1) AND THIS SECTION AS AN EXEMPT FACILITY, A FACILITY MUST SERVE OR BE AVAILABLE FOR GENERAL PUBLIC USE, OR BE A PART OF A FACILITY SO USED, AS CONTRASTED WITH SIMILAR TYPES OF FACILITIES WHICH ARE CONSTRUCTED FOR THE EXCLUSIVE USE OF A LIMITED NUMBER OF NON-EXEMPT PERSONS IN THEIR TRADES OR BUSINESSES."

THE BULK OF THE FACILITIES ASSOCIATED WITH THE PIPELINE ARE FOR THE USE OF A LIMITED NUMBER OF PRIVATE COMPANIES. HOWEVER,

THIS RULE DOES NOT APPLY TO POLLUTION CONTROL FACILITIES.

IN CONCLUSION, THE REQUIREMENTS OF GUARANTEES BY THE OIL COMPANIES OF THROUGHPUT TO THE PIPELINE NECESSARY FOR SUCCESSFUL MARKETING OF STATE BONDS TO CONSTRUCT THE PIPELINE, AMPLY DESCRIBED BY MR. GARY, WILL MAKE THE INTEREST ON SUCH BONDS SUBJECT TO FEDERAL INCOME TAX. FURTHER, IT IS QUITE POSSIBLE THAT THE STATE'S INCOME FROM OPERATION OF THE PIPELINE WILL BE TAXED BY THE FEDERAL GOVERNMENT. THUS TO THE EXTENT THAT TAX EXEMPTION IS ESSENTIAL TO THE ATTRACTIVENESS OF THE OWNERSHIP BILL, THAT BILL IS UNLIKELY TO SATISFY THE STATE'S REVENUE NEEDS. IN THE MEANTIME, IT CREATES A CONTINUING CLOUD OVER THE PRIVATE FINANCES NEEDED BY THE COMPANIES IN ORDER TO PLACE THE TRANS ALASKA PIPELINE IN SERVICE AS SOON AS POSSIBLE.

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

REMARKS OF RAYMOND B. GARY
PARTNER, MORGAN STANLEY & CO.
TO ALASKAN SENATE AND HOUSE COMMITTEES
ON PROPOSED LEGISLATION CONCERNING
PIPELINE REGULATION, RIGHT-OF-WAY AND
STATE OWNERSHIP -- MARCH 6, 7 & 8

INTRODUCTION

MY NAME IS RAYMOND B. GARY AND MY BUSINESS ADDRESS IS 140 BROADWAY, NEW YORK, NEW YORK. I JOINED MORGAN STANLEY & CO. IN 1955, FOLLOWING UNDERGRADUATE STUDIES AT YALE, GRADUATE WORK AT HARVARD, AND SERVICE IN THE U. S. NAVY. I HAVE BEEN A GENERAL PARTNER IN THE FIRM SINCE 1964. I AM ALSO A MANAGING DIRECTOR OF MORGAN STANLEY & CO. INCORPORATED, A PARALLEL CORPORATION WHICH CONDUCTS OUR UNDERWRITING AND BROKERAGE ACTIVITIES.

MORGAN STANLEY IS AN INVESTMENT BANKING FIRM ENGAGED IN ALL PHASES OF THE UNDERWRITING AND DISTRIBUTION OF SECURITIES OF INDUSTRIAL CORPORATIONS, PUBLIC UTILITIES, FINANCIAL CORPORATIONS, TRANSPORTATION COMPANIES INCLUDING AIRLINES AND PIPELINES, AND FOREIGN CORPORATIONS AND GOVERNMENTS. WE ARE MEMBERS OF THE NEW YORK STOCK EXCHANGE AND ASSOCIATE MEMBERS OF THE AMERICAN STOCK EXCHANGE. SINCE 1935, THE YEAR MORGAN STANLEY & CO. WAS FOUNDED, THE FIRM, INCLUDING ITS FOREIGN AFFILIATE, MORGAN & CIE

INTERNATIONAL S. A., HAS MANAGED OR CO-MANAGED A TOTAL OF APPROXIMATELY $60 BILLION OF SECURITY OFFERINGS. IN ADDITION TO ACTIVITIES RELATED TO UNDERWRITING AND PRIVATE PLACEMENTS, MORGAN STANLEY PROVIDES GENERAL FINANCIAL ADVISORY SERVICES ON A WIDE RANGE OF MATTERS INCLUDING LONG-RANGE FINANCIAL POLICY AND PLANNING.

THE $60 BILLION TOTAL FINANCING VOLUME I MENTIONED INCLUDES OVER $2 BILLION OF ISSUES DONE BY OUR FIRM FOR 18 PIPELINE COMPANIES. IT ALSO INCLUDES THE LARGEST PUBLIC CORPORATE BOND OFFERING EVER MADE, $1.6 BILLION OF AMERICAN TELEPHONE & TELEGRAPH COMPANY DEBENTURES WITH WARRANTS ATTACHED, AND THE LARGEST PRIVATE PLACEMENT EVER DONE. WE ALSO HANDLED THE PRIVATE PLACEMENT OF $550 MILLION FOR CONSTRUCTION OF A HYDROELECTRIC PROJECT IN LABRADOR BY CHURCHILL FALLS (LABRADOR) CORPORATION LIMITED, WHICH IS THE LARGEST PROJECT EVER PRIVATELY FINANCED. THESE RECORD-SIZED CORPORATE FINANCINGS EXCEED IN SIZE ANY LONG-TERM ISSUE SOLD BY A STATE GOVERNMENT. THE ONLY LARGER BOND ISSUES HAVE BEEN THOSE OF NATIONAL GOVERNMENTS, WITH THEIR UNLIMITED TAXING POWER AND ABILITY TO ISSUE MONEY.

HENCE, THE PERSPECTIVE FROM WHICH I SPEAK IS THAT OF A MANAGING DIRECTOR OF A LEADING UNDERWRITER WHOSE PRINCIPAL BUSINESS IS THE RAISING OF CAPITAL, WITH EXPERIENCE IN RAISING VERY LARGE SUMS OF MONEY SUCH AS WOULD BE INVOLVED IN THE

FINANCING OF THE TRANS ALASKA PIPELINE SYSTEM. I AM PLEASED TO HAVE THIS OPPORTUNITY TO SPEAK BEFORE THE COMMITTEE. I SPEAK NOT AS PROPONENT OF ANY FIXED POINT OF VIEW, BUT AS ONE WHO, I BELIEVE, SHARES THE COMMON OBJECTIVES OF ALASKANS AND THE OIL COMPANIES, ALL OF WHOM WISH TO SEE THE PIPELINE CONSTRUCTED IN THE MOST EFFICIENT MANNER, AT THE LOWEST COST, AND AS SOON AS POSSIBLE - IN ORDER TO (1) OPEN UP ONE OF ALASKA'S GREAT NATURAL RESOURCES, (2) HELP MEET THE GROWING NEED FOR ENERGY IN ALL OF THE UNITED STATES, AND (3) MAKE A SIGNIFICANT FAVORABLE CONTRIBUTION TO THE COUNTRY'S BALANCE OF PAYMENTS.

I HOPE THAT BY SHARING WITH YOU MY FIRM'S EXPERIENCE IN FINANCING MANY LARGE UNDERTAKINGS I CAN BE OF ASSISTANCE IN REACHING A SATISFACTORY SOLUTION CONCERNING THE PENDING LEGISLATION.

THE BILLS BEFORE YOUR COMMITTEE, BROADLY SPEAKING, INVOLVE LEGISLATION WHICH WOULD REGULATE THE OPERATION OF THE PIPELINE AND WHICH WOULD PROVIDE FOR POSSIBLE OWNERSHIP OF THE PIPELINE BY THE STATE. I WISH TO DIRECT MYSELF TO DISCUSSING THE POTENTIAL IMPACT OF THESE BILLS UPON THE SUCCESSFUL FINANCING OF THE PIPELINE.

CONVENTIONAL FINANCING OF PIPELINES

I THINK IT MIGHT BE USEFUL IF I TALK BRIEFLY ABOUT HOW JOINTLY-OWNED PIPELINES ARE CUSTOMARILY FINANCED. JOINTLY-

OWNED COMMON CARRIER PIPELINES HAVE BEEN CONVENTIONALLY ORGANIZED AND FINANCED IN ONE OF TWO WAYS, EITHER AS SO-CALLED "PROJECT FINANCING" OF PIPELINE COMPANIES ORGANIZED TO OWN PIPELINES IN CORPORATE FORM, OR, AS IS THE CASE IN TRANS ALASKA PIPELINE SYSTEM, AS UNDIVIDED JOINT INTEREST SYSTEMS.

IN THE FIRST CASE, WHERE PROJECT FINANCING IS DONE, THE CONVENTIONAL PRACTICE IS TO FORM A PIPELINE COMPANY WHICH CONSTRUCTS AND OPERATES THE SYSTEM AND ISSUES DEBT FOR VIRTUALLY ALL OF THE COST OF CONSTRUCTION, THE TYPICAL AMOUNT BEING 90% OF FINAL COST. THE DEBT IS SECURED BY THE PLEDGE OF COMPLETION AGREEMENTS AND THROUGHPUT AGREEMENTS UNDERTAKEN BY THE SEVERAL SHIPPER-OWNERS OF THE PIPELINE. THE TYPICAL SECURITY ARRANGEMENTS INCLUDE UNCONDITIONAL COMMITMENTS OF THE SHIPPER-OWNERS TO COMPLETE THE FACILITIES TO OPERATE THEM, AND IF OPERATION IS INTERRUPTED FOR ANY REASON, TO TAKE NECESSARY STEPS TO RESTORE THE FACILITIES TO OPERATION. AS PART OF THE THROUGHPUT AGREEMENTS, THE "CASH DEFICIENCY OBLIGATIONS" INEVITABLY CONTINUE REGARDLESS OF FORCE MAJEURE (ANY EVENT INTERFERING WITH OPERATION OF THE LINE). IN EFFECT, THEY REQUIRE THE SHIPPER-OWNERS TO MAINTAIN THE PIPELINE'S FUNDS AT A LEVEL WHICH WOULD ENABLE IT TO MEET ALL ITS OBLIGATIONS WHEN THEY BECOME DUE AND PAYABLE. AS SUCH, THEY ARE FIRM APPLICATIONS OF THE FULL CREDIT OF THE OIL COMPANIES INVOLVED AND, FOR THE

PURPOSES OF FINANCING, ARE EQUIVALENT TO GUARANTEES OF THE PIPELINE COMPANY'S INDEBTEDNESS.

IN THIS TYPE OF FINANCING, THE PROJECT ITSELF MUST BE DEMONSTRATED TO BE ECONOMIC AND VIABLE, AND THE QUALITY OF THE OBLIGATIONS IS MEASURED BY THE COMPOSITE CREDIT OF THE SEVERAL OIL COMPANIES INVOLVED. IN OTHER WORDS, THE INVESTORS ARE CONCERNED, FIRST THAT THE PROJECT STANDS ON ITS OWN FEET, BUT ALSO THEY LOOK THROUGH THE PROJECT TO THE ULTIMATE GUARANTORS. THIS TYPE OF FINANCING IS STANDARD AND WELL UNDERSTOOD BY PROFESSIONAL INVESTORS, AND HAS BEEN IN COMMON USE SINCE THE TIME OF THE ELKINS ACT - PIPELINE CONSENT DECREE ENTERED INTO IN 1941.

YOU MIGHT WONDER WHY OIL COMPANIES WISH TO RAISE AND LENDERS READILY PROVIDE INDEBTEDNESS AS HIGH AS 90% OF TOTAL CAPITALIZATION. THE FIRST ANSWER IS THAT THE CONSENT DECREE HAS LIMITED THE RETURN FROM PIPELINE OPERATIONS TO A SPECIFIED PERCENTAGE OF PIPELINE VALUATION. THIS INVARIABLY DICTATES THAT OIL COMPANIES MAXIMIZE THE USE OF DEBT, THE OBJECTIVE BEING TO MATCH AS CLOSELY AS POSSIBLE PERMITTED ICC DEPRECIATION WITH REPAYMENT OF DEBT. THE REASON THAT LENDERS ACCEPT HIGH DEBT RATIOS ON PIPELINES IS THAT THEY RECOGNIZE THE THROUGHPUT UNDERTAKINGS TO BE FULL APPLICATION OF THE CREDIT OF THE OIL COMPANY OR COMPANIES INVOLVED. CONSEQUENTLY, THE LENDERS ARE NOT TAKING THE RISKS OF FAILURE OF THE PIPELINE

OPERATION. THESE RISKS ARE BORNE BY THE OIL COMPANIES IN THE FORM OF THEIR BACKSTOPPING, AS WELL AS THEIR EQUITY INTEREST. THE END RESULT IS THAT THE OIL COMPANY HAS DEDICATED ONE OF ITS VALUABLE ASSETS, NAMELY ITS CREDIT, TO OBTAIN USE OF A PIPELINE SYSTEM AND A REGULATED PROFIT ON ITS INVESTMENT.

THE SECOND WAY OF ORGANIZING AND FINANCING JOINTLY OWNED PIPELINES IS AS UNDIVIDED JOINT INTEREST SYSTEMS. THIS IS HOW TRANS ALASKA PIPELINE SYSTEM IS ORGANIZED. FOR CONSENT DECREE REASONS OWNERSHIP IS CUSTOMARILY INVESTED IN, AND THE INDEBTEDNESS IS USUALLY RAISED BY, A WHOLLY-OWNED PIPELINE SUBSIDIARY OF EACH OWNER, BUT THE ARRANGEMENT STILL AMOUNTS TO A FULL USE OF THE OWNER COMPANY'S CREDIT.

IN A JOINT VENTURE, EACH OF THE OIL COMPANIES OWNS A SHARE OF THE FACILITIES, EITHER DIRECTLY OR THROUGH ITS PIPELINE SUBSIDIARY. THE PIPELINE IS NOT FINANCED AS A PROJECT; EACH OWNER COMPANY COMPLETES ITS OWN SHARE OF THE SYSTEM AND FINANCES ITS SHARE OF THE COST IN THE SAME WAY IT DOES OTHER ITEMS IN ITS CORPORATE BUDGET. THESE ARE FINANCED OUT OF ALL CORPORATE RESOURCES, INCLUDING WORKING CAPITAL, INTERNAL CASH FLOW AND ISSUANCE OF SECURITIES - IN EFFECT REFLECTING ITS OVERALL CAPITAL STRUCTURE AND DEBT/EQUITY MIX. THE EFFECT ON THE OIL COMPANY

IS THE SAME AS IN PROJECT FINANCING - IT HAS COMMITTED AN IMPORTANT AMOUNT OF ITS RESOURCES AND CREDIT TO AN UNDERTAKING THAT HAS ASSOCIATED WITH IT SIGNIFICANT RISKS. THIS IS AS REAL A USE OF CREDIT AS ANY OTHER, AND PRE-EMPTS ITS USE FOR OTHER INVESTMENTS. THEREFORE, TO COMPENSATE FOR THESE RISKS, AN OIL COMPANY MUST BE ABLE TO CONTROL THE OPERATION OF THE FACILITIES AND MUST HAVE PROSPECTS OF EARNING A FAIR RETURN ON ITS INVESTMENT COMPARABLE TO THE POTENTIAL RETURN AVAILABLE TO IT ON ALTERNATIVE INVESTMENTS.

FINANCING OF TAPS

NOW LET ME TURN TO THE FINANCING OF TAPS AND WHY WE HAVE CONSIDERABLE CONCERN ABOUT THE PROPOSED LEGISLATION AND ITS POSSIBLE EFFECT ON THE FEASIBILITY OF FINANCING TAPS.

WE ARE ADDRESSING OURSELVES TO THE FINANCING OVER A PERIOD OF YEARS OF EXPENDITURES WHICH MAY AMOUNT TO AS MUCH AS $3 1/2 BILLION. I WOULD LIKE TO EMPHASIZE AGAIN THAT WE HAVE A HEALTHY RESPECT FOR THE AMOUNT OF MONEY INVOLVED HERE. THE CHURCHILL FALLS PROJECT, TO WHICH I HAVE ALREADY REFERRED, IS THE LARGEST PRIVATELY FINANCED PROJECT IN HISTORY, AND TAPS IS 3 TO 5 TIMES AS LARGE DEPENDING UPON HOW YOU MEASURE IT.

THESE EXPENDITURES ARE TO BE BORNE BY SEVEN OIL COMPANIES, WHICH DIFFER IN SIZE AND CAPABILITY TO SUPPORT

THE COMMITMENTS INVOLVED. WE HAVE STUDIED EACH COMPANY AND MADE AN ASSESSMENT OF THE FINANCIAL CAPABILITY OF EACH TO DISCHARGE THESE COMMITMENTS WITHIN THE LIMITS OF ITS INDIVIDUAL FINANCIAL STRENGTH. TO PUT THIS IN PERSPECTIVE, I MIGHT POINT OUT THAT THE THREE COMPANIES THAT WILL OWN OVER 80% OF THE UNDIVIDED JOINT INTEREST ARE ASSUMING AN AGGREGATE CONSTRUCTION LIABILITY OF 80% OF $3.5 BILLION, OR OVER $2.8 BILLION. IF THIS AMOUNT WERE RAISED BY DEBT, IT WOULD REPRESENT AN INCREASE OF 170% OVER THE AGGREGATE INDEBTEDNESS THOSE THREE COMPANIES HAD OUTSTANDING ON DECEMBER 31, 1970.

DESPITE OUR RESPECT FOR THE SIZE OF THE TAPS PROJECT, WE HAVE COME TO THE OPINION THAT - ABSENT THE PROPOSED LEGISLATION - THE EXPENDITURES NECESSARY TO CONSTRUCT THE PIPELINE CAN BE SUCCESSFULLY FINANCED BY THE OIL COMPANIES INVOLVED. HOWEVER, THE BILLS HERE UNDER CONSIDERATION REPRESENT A SERIOUS IMPEDIMENT TO THAT FINANCING, AND I SHOULD LIKE TO SHARE WITH YOU MY CONCERN ABOUT THE EFFECT THIS LEGISLATION WOULD HAVE UPON THE ABILITY OF THE OIL COMPANIES TO CONDUCT THE NECESSARY FINANCING AND BUILD THE PIPELINE. THERE ARE SOME MAJOR PROBLEMS WHICH ARISE OUT OF THESE PROPOSALS:

1. <u>THE LIMITATION OF THE LEASE TO FIVE YEARS DURATION</u>: NORMAL PRACTICE WOULD BE FOR A PIPELINE TO HAVE

UNDISPUTED RIGHT-OF-WAY PRIVILEGES FOR THE EXPECTED ECONOMIC AND PHYSICAL LIFE OF THE SYSTEM, BUT IN NO EVENT LESS THAN THE PERIOD OF TIME REQUIRED TO RECOVER THE COST ON REASONABLE TERMS. LENDERS WOULD REGARD THE 5-YEAR LEASE LIMITATION AS A MAJOR INFIRMITY IMPAIRING THE ECONOMIC VIABILITY OF THE SYSTEM. OIL COMPANIES COULD NOT PRUDENTLY COMMIT FUNDS FOR WHAT IS IN ESSENCE A LONG-TERM VENTURE IF THERE WAS A THREAT THAT THE ECONOMIC LIFE COULD BE TERMINATED OR MODIFIED AT THE END OF THE FIVE-YEAR PERIOD.

REGARDLESS OF THE LENGTH OF THE LEASE, I THINK IT IS IMPORTANT TO EMPHASIZE THAT WHERE A PORTION OF THE RIGHT-OF-WAY OF A PIPELINE IS GOVERNMENT-OWNED, THE GENERAL ATTITUDE OF THE HOST GOVERNMENT TOWARD THE PIPELINE WILL ENTER IMPORTANTLY INTO THE CONSIDERATIONS OF LENDERS.

2. Loss of Ownership: THE PROSPECT THAT OWNERSHIP MIGHT BE TAKEN AWAY FROM SHIPPER-OWNERS AT SOME INDETERMINATE TIME IN THE FUTURE NULLIFIES ANY ECONOMIC JUSTIFICATION FOR TAKING THE RISKS INVOLVED IN COMMITTING THE SUBSTANTIAL FUNDS NECESSARY TO COMPLETE THE PROJECT. AS MENTIONED BEFORE, IF AN OIL COMPANY HAS USED ITS CREDIT IN THIS CONNECTION, IT HAS FOREGONE ITS USE IN OTHER PROFITABLE INVESTMENTS. IT MUST, THEREFORE, HAVE THE EXPECTATION OF MAKING A RETURN ON ITS INVESTMENT.

FURTHERMORE, BECAUSE THE SYSTEM IS TO BE A COMMON CARRIER AVAILABLE TO ALL PRODUCERS, OWNERS WILL BE SHARING THEIR SPACE WITH OTHER SHIPPERS. THEREFORE, IT SEEMS TO US THAT THOSE THAT HAVE ASSUMED THE COST AND RISK OF BUILDING THE SYSTEM MUST BE IN POSITION TO RECOVER THEIR INVESTMENT IN PART THROUGH PROFITS DERIVED FROM USE OF THE SYSTEM BY OTHERS. OTHERWISE, THE COMPANIES BUILDING THE PIPELINE WOULD HAVE USED THEIR CREDIT FOR THE BENEFIT OF OTHERS WITHOUT COMPENSATION, WHICH VIOLATES A CARDINAL RULE OF SOUND FINANCE.

3. REGULATION: THERE HAS BEEN IN THIS COUNTRY MASSIVE FINANCING OF CRUDE OIL AND PRODUCTS PIPELINES SUBJECT TO REGULATION OF THE ICC, AND THE EFFECT OF THIS REGULATION ON THE PIPELINES AND THEIR OWNERS IS WELL UNDERSTOOD BY INSTITUTIONAL INVESTORS. WE NOTE THAT PROVISIONS OF ONE OF THE BILLS APPEAR TO GIVE THE PROPOSED TRANSPORTATION COMMISSION THE AUTHORITY TO ESTABLISH DEPRECIATION RATES AND TARIFFS INDEPENDENTLY OF THE ICC; FURTHER, THE DEPRECIATION RULES APPEAR TO BE AT VARIANCE WITH THOSE PRESCRIBED BY THE ICC.

UNLESS THESE DIFFERENCES ARE ULTIMATELY RESOLVED, WE ARE NOT ABLE TO MEASURE THE IMPACT THEY MAY HAVE ON FINANCING FEASIBILITY, BUT THE IMPACT MAY BE SUBSTANTIAL IF LENDERS CANNOT BE CONVINCED THAT THE OWNERS OF THE PIPELINE WILL BE ABLE TO

EARN A FAIR RETURN ON THEIR INVESTMENTS. AS I SHALL MENTION LATER, UNCERTAINTY WITH REGARD TO SUCH QUESTION, OR TO THE OUTCOME OF COURT TESTS DETERMINING JURISDICTION, CAN CAUSE DELAYS AND INCREASED COSTS IN FINANCING.

4. REDEMPTION PENALTY: THE CONTEMPLATED LEGISLATION CREATES THE POSSIBILITY THAT THE OIL COMPANIES FINANCING THE PIPELINE WILL FIND THEMSELVES IN THE POSITION, VIS-A-VIS THE STATE OF ALASKA, OF "HEADS YOU WIN, TAILS I LOSE." WHEN THEY BORROW TO FINANCE THE LINE, THEY WILL PLEDGE THEIR FULL CREDIT TO REPAY REGARDLESS OF WHETHER THE PIPELINE IS BUILT, OPERATES PROFITABLY, OR IS SHUT DOWN TEMPORARILY OR PERMANENTLY FOR ANY OF A NUMBER OF REASONS. THESE ARE SUBSTANTIAL RISKS. UNDER THE PROPOSED LEGISLATION, HOWEVER, IF THE LINE IS BUILT AND OPERATES SUCCESSFULLY AND PROFITABLY, ALASKA WOULD BE IN POSITION TO TAKE OWNERSHIP AWAY FROM THEM. NOT ONLY WOULD THE COMPANIES LOSE THE ASSET GAINED THROUGH THE INCURRENCE OF RISK, BUT THEY WOULD BE FORCED TO PAY A PENALTY TO THE LENDERS WHEN THEY REDEEMED THE INDEBTEDNESS INCURRED TO BUILD THE LINE.

THERE IS A REASON LENDERS ASK FOR REDEMPTION PREMIUMS. THE TYPES OF LENDERS WHO NORMALLY FURNISH FUNDS FOR THE CONSTRUCTION OF MAJOR PROJECTS, SUCH AS TAPS, HAVE

LONG-TERM LIABILITIES, AND THEY WISH TO INVEST THEIR FUNDS AT WHAT THEY BELIEVE ARE SATISFACTORY RATES FOR LONG PERIODS OF TIME. IF A LOAN IS TO BE PAID OFF PREMATURELY THEY DEMAND COMPENSATION, USUALLY IN THE FORM OF A REDEMPTION PREMIUM. THIS IS TO OFFSET THE POSSIBILITY THAT THE PROCEEDS RECEIVED FROM THE EARLY REPAYMENT OF THE LOAN MAY HAVE TO BE INVESTED AT A LOWER RATE THAN THEY HAVE BEEN RECEIVING. BECAUSE OF THE THREAT THIS LEGISLATION POSES, I BELIEVE THAT THE PREMIUM ASKED FOR REDEMPTION IN THE EARLY YEARS WOULD BE LARGE, IT MIGHT BE AS HIGH AS 10%. AGAINST BORROWINGS OF THE TOTAL PIPE-LINE COSTS, THIS WOULD REPRESENT AN ADDITIONAL $350 MILLION. THIS MIGHT BE MORE THAN THE OIL COMPANIES WILL BE WILLING TO CONTRACT TO PAY, AND THE ALTERNATIVE MIGHT HAVE TO BE TO AGREE TO A HIGHER INTEREST RATE THAN WOULD OTHERWISE BE THE CASE. IN ANY EVENT THERE WOULD BE SUBSTANTIAL (AND UNNECESSARY) ADDITIONAL COST.

5. <u>UNCERTAINTY</u>: ANY FINANCING IS DIFFICULT (AND MAY BE IMPOSSIBLE) UNDER CONDITIONS OF UNCERTAINTY. THE PROPOSED LEGISLATION CREATES UNCERTAINTY. NEITHER POTENTIAL BORROWERS NOR POTENTIAL LENDERS KNOW WHETHER LEGISLATION SIMILAR TO THAT IN THE PROPOSED BILLS WILL BE PASSED. PLANS CANNOT BE MADE. TO THE EXTENT THAT THIS UNCERTAINTY HAS THE

EFFECT OF DELAYING THE PROJECT, IT POSSIBLY COULD LEAD TO HIGHER CONSTRUCTION COSTS. A SHORT DELAY COULD EASILY RESULT IN A LOSS OF A WHOLE YEAR BECAUSE OF THE ALASKAN CLIMATE. UNCERTAINTY IS ALREADY HOLDING UP FINANCING BY COMPANIES INVOLVED WITH THE PIPELINE. I AM NOT GOING TO ATTEMPT TO FORECAST THE OUTLOOK FOR INTEREST RATES, BUT I WOULD LIKE TO MENTION PARENTHETICALLY THAT CURRENT RATES ARE WELL BELOW WHAT THEY WERE ONLY A SHORT TIME AGO. IN ADDITION, FUNDS ARE MORE READILY AVAILABLE TO INVESTING INSTITUTIONS FOR LENDING PURPOSES THAN HAS BEEN THE CASE FOR A NUMBER OF YEARS. THIS IS LIKELY TO BE A TEMPORARY SITUATION. MANY BANKERS AND ECONOMISTS BELIEVE THAT AS BUSINESS RECOVERS INTEREST RATES MAY RISE AND, THEREFORE, ANY DELAY IN ARRANGING THE FINANCING COULD WELL RESULT IN THE COMPANIES INCURRING HIGHER INTEREST COSTS. BECAUSE OF THE AMOUNTS INVOLVED, AN INTEREST RATE CHANGE OF 1% RAISES COSTS ANNUALLY BY $35 MILLION.

THEREFORE, I WOULD LIKE TO URGE MOST STRONGLY IN THE INTEREST OF ALL CONCERNED THAT THIS SITUATION OF UNCERTAINTY BE RESOLVED AS PROMPTLY AS POSSIBLE.

ABILITY OF THE STATE TO FINANCE CONSTRUCTION OF THE PIPELINE

FINALLY, WE HAVE GIVEN CONSIDERATION TO THE ABILITY

OF THE STATE TO FINANCE THE CONSTRUCTION OF THE PIPELINE. THIS INVOLVES RAISING THE STAGGERING SUM OF $3.5 BILLION, AND NO STATE HAS EVER SOLD AN ISSUE OF THIS SIZE. I AM CERTAINLY NOT TRYING TO BE NEGATIVE, BUT IT IS IMPORTANT THAT WE BE REALISTIC AND RECOGNIZE THE PROBLEMS INVOLVED IN RAISING THIS AMOUNT OF MONEY, EVEN IF IT WERE TO BE ATTEMPTED OVER THE PERIOD OF CONSTRUCTION RATHER THAN ALL AT ONCE.

ALTHOUGH CERTAINLY THE TAX-EXEMPT MARKET IS A LARGE ONE, IT IS OUR OPINION THAT IN ORDER FOR ALASKA TO HAVE ANY HOPE OF ACCOMPLISHING SUCH A FINANCING OPERATION, ALL OF THE COUNTRY'S LARGE RESERVOIRS OF CAPITAL WOULD NEED TO BE TAPPED. IN OUR VIEW, THIS WOULD HAVE TO INCLUDE THOSE INSTITUTIONS WHICH ARE NOT NORMALLY BUYERS OF TAX-EXEMPT OBLIGATIONS BECAUSE THEY GET LITTLE OR NO BENEFIT THEREFROM, NAMELY, LIFE INSURANCE COMPANIES AND PENSION FUNDS. THESE INSTITUTIONS ARE THE NORMAL SUPPLIERS OF CAPITAL FOR PIPELINE PROJECTS, AND THEY HAVE REQUIRED THE UNCONDITIONAL BACKSTOPPING BY FINANCIALLY CAPABLE PARTIES THAT I HAVE ALREADY DESCRIBED. FOR TAPS THE OIL COMPANIES ARE ABLE TO PROVIDE THIS, BUT THE STATE DOES NOT PRESENTLY HAVE THE FINANCIAL CAPACITY TO SUBSTITUTE FOR THEM.

WE HAVE HEARD THE THEORY ADVANCED THAT THE STATE CAN

DEDICATE TO THIS PROJECT ITS ANTICIPATED REVENUES FROM OIL ROYALTIES AND SEVERANCE TAXES FROM THE NORTH SLOPE, BUT THOSE REVENUES DEPEND UPON OPERATION OF THE PIPELINE AND ARE NOT "BANKABLE" ASSETS AT THE PRESENT TIME. IN FACT, THEY DO NOT BECOME VALUABLE FOR ADDING SUBSTANCE TO A FINANCIAL UNDERTAKING UNTIL THE PIPELINE IS COMPLETED AND IN OPERATION, BECAUSE THEY ARE COMPLETELY DEPENDENT ON ITS SUCCESS.

THESE CONSIDERATIONS LEAD US TO THE OPINION THAT THE STATE OF ALASKA CANNOT RAISE THE MONEY TO BUILD THE PIPELINE ON THE STRENGTH OF ITS PRESENT CREDIT RESOURCES. IN OUR VIEW, SUCCESSFUL FINANCING OF THE LINE DEPENDS, IN THE FINAL ANALYSIS, ON THE BACKING OF THE OIL COMPANIES' CREDIT.

THE QUESTION HAS ALSO BEEN RAISED OF THE STATE'S ABILITY TO RAISE AN APPROPRIATE AMOUNT OF MONEY TO TAKE OVER THE PIPELINE IN THE FUTURE, AFTER IT HAS BEEN OPERATING SUCCESSFULLY AS A GOING CONCERN. WE DO NOT FEEL THAT ANY EXPERT CAN MAKE AN INTELLIGENT JUDGMENT AT THIS JUNCTURE. THE ANSWER WOULD DEPEND UPON A HOST OF FACTORS - ECONOMICS OF THE SYSTEM AS FINALLY CONSTRUCTED, ECONOMICS OF THE CRUDE AT WEST COAST PORTS, TECHNICAL OPERATING EXPERIENCE, THE LEVEL OF TARIFFS AND DEBT SERVICE BURDENS, ECONOMICS OF ALTERNATIVE FORMS OF TRANSPORTATION THAT MAY BE AVAILABLE AT THE TIME , CONDITIONS

OF MARKETS AND LEVELS OF INTEREST RATES AT THE TIME. AS A CAUTIOUS, BUT EXPERIENCED INVESTMENT BANKER, I HAVE TO SAY THERE WILL BE OTHER FACTORS NONE OF US CAN THINK OF NOW. IF ALL THESE FACTORS TURNED OUT FAVORABLY - AND THAT HAS TO BE A LOT OF IFS - THEN IT IS CONCEIVABLE THAT THE STATE MIGHT, OVER A PERIOD OF TIME, RAISE SUBSTANTIAL SUMS WITH LESS THAN THE UNCONDITIONAL CREDIT BACKING OF THE SHIPPERS.

TO DO SO, HOWEVER, WOULD IN ALL PROBABILITY REQUIRE THAT THE STATE DEDICATE TO THE BORROWING NOT JUST THE PIPELINE EARNINGS, BUT ALL OF THE STATE'S POTENTIAL OIL INCOME IN ORDER TO EFFECT SUCCESSFUL SALES OF BONDS IN THE AMOUNTS NECESSARY TO PAY FOR THE PIPELINE. OBVIOUSLY, SUCH A DEDICATION WOULD SIGNIFICANTLY REDUCE THE STATE'S POTENTIAL ABILITY TO BORROW FOR OTHER PURPOSES, SUCH AS SCHOOLS, HOSPITALS, ROADS AND OTHER WORTHWHILE PROJECTS. IT WOULD ALSO SEEM LIKELY THAT, AT THAT STAGE, THE LARGE INCREASE IN THE AMOUNT OF GENERAL OBLIGATIONS OF THE STATE WHICH WOULD BE OUTSTANDING UNDOUBTEDLY WOULD RAISE THE INTEREST COSTS OF ANY BORROWINGS THAT MIGHT BE UNDERTAKEN FOR REGULAR FINANCING NEEDS.

Concluding Note

To sum up, the proposed legislation puts a number of clouds over the financing of this pipeline.

If it is passed as it presently stands, there would be considerable doubt in the eyes of the investing public whether the oil companies could maintain control of the operation and earn an adequate return on their investment. When doubts of this kind exist, they are severe impediments to financing and would result in having to pay higher interest costs.

We are all painfully aware how the cost of TAPS has already escalated while its construction has been delayed in Washington. I would therefore urge in the interest of both Alaska and the producers that they avoid delay and an additional increase in cost by resolving their differences so that the project can go ahead.

INSERT PAGE 13

SUPPLEMENT

THE FIRST CONCERNS THE VOLUME OF OIL THAT CAN BE EXPECTED TO BE MOVED THROUGH TAPS. IT HAS BEEN INDICATED THAT AN AVERAGE THROUGHPUT OF 2,000,000 BBLS./DAY CAN BE MOVED THROUGH THE PIPELINE FOR ALL BUT THE FIRST TWO OR THREE YEARS OF A 25-YEAR PERIOD. I DO NOT THINK THAT SUCH AN ASSUMPTION IS A SOUND BASIS FOR PROJECTING INCOME. IT IS TRUE THAT THE LINE IS BEING DESIGNED FOR AN ULTIMATE CAPACITY OF TWO MILLION BARRELS PER DAY, BUT A THROUGHPUT OF THIS MAGNITUDE IS NOT YET IN SIGHT. OUR OWN ESTIMATES OF PROVEN RECOVERABLE RESERVES IN THE PRUDHOE BAY AREA ARE APPROXIMATELY THE SAME AS THE 9.8 BILLION BARRELS THAT I UNDERSTAND COMMISSIONER HERBERT SPOKE OF ON MONDAY, MARCH 6. IF 9.8 BILLION BARRELS WERE PRODUCED AT AN AVERAGE RATE OVER 25 YEARS, THE AVERAGE RATE WOULD BE ABOUT 1,000,000 BBLS/DAY -- NOT 2. (THE ACTUAL RATE WOULD BE SLIGHTLY MORE THAN 1.07 MILLION BARRELS PER DAY) OUR OWN ENGINEERS' CALCULATIONS INDICATE THAT THE MAXIMUM EFFICIENT OIL PRODUCTION RATE IS 1.5 MILLION BARRELS PER DAY AND THAT SUCH A RATE CANNOT BE MAINTAINED MORE THAN 13 TO 15 YEARS, AFTER WHICH A DECLINE WILL BEGIN AND CONTINUE. CONSEQUENTLY, IT SEEMS TO ME THAT ECONOMIC PROJECTIONS BASED ON AN AVERAGE OIL FLOW OF 2,000,000 B/D AFTER THE INITIAL 2-3 YEARS OF OPERATION ARE HIGHLY SPECULATIVE, DEPENDENT UPON DISCOVERIES YET TO BE MADE AS A CONSEQUENCE OF EXPLORATION NOT YET IN PROGRESS.

INSERT PAGE 13

ON THE OTHER HAND, I BELIEVE THAT IT IS UNDULY PESSIMISTIC TO ASSUME THAT THE PIPELINE WILL NOT BE IN OPERATION BEFORE MID-1977. I BELIEVE THAT IT IS POSSIBLE TO BE DELIVERING OIL TO MARKET IN MID-1976. A SUBSTANTIAL NUMBER OF MY ASSOCIATES BELIEVE THAT EARLY 1976 IS A REASONABLE POSSIBILITY.

INSERT PAGE 13

IT HAS BEEN STATED THAT THERE CAN BE NO PROFIT IN NORTH SLOPE OIL IN THE 70'S IF THE PIPELINE REMAINS IN PRIVATE HANDS. THIS COMES AS A SURPRISE TO ME. WE ARE DOING EVERYTHING POSSIBLE TO REALIZE PRODUCTION BEGINNING IN 1976, AND I ASSURE YOU THAT WE WOULD NOT BE DOING SO WITH THE EXPECTATION OF PRODUCING OIL OF NO VALUE.

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