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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 flexibility, 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 administering 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

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

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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 develops 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 visible. 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 apportionment 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 approach 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 record 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.
