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PORTFOLIO OF ALASKA CITIZEN ENTERPRISES
DRAFT LEGISLATION

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PACE: Alaska's next plan to spread out the wealth

By ROXINNE ERVASTI
Associated Press Writer

JUNEAU, Alaska (AP) — Alaskans savoring the state's commitment to give them cash from its oil wealth and all but wipe out state income taxes now have an encore to consider — shares in state-owned assets.

It's called PACE — Portfolio of Alaska Citizens Enterprises.

The proposal introduced as legislation Thursday by Gov. Jay Hammond and House Speaker Terry Gardiner would sell stock in some state-owned assets to Alaskans at market value. Fifteen percent of the stock in the assets would be distributed free to all Alaskans.

Chief among the assets are oil, coal and natural gas. But the legislation provides that anything built with state money, be it offices, airports or pipelines, could be turned over to citizens.

The state could even buy shares in private companies, such as airlines, manufacturers or businesses, to sell and give away.

The money for PACE would divert funds from Alaska's burgeoning state treasury — now swelling so quickly from oil revenues that analysts last week upped their three-month-old estimate of its value in mid-1981 by \$319 million — to \$4.5 billion.

"Distributing a portion of Alaska's energy wealth to the people of Alaska in the form of income-producing assets would increase their involvement and awareness of the management of the state's natural resources, the development of its local industries and in the capitalist system overall," Hammond said. "All Alaskans, including the little guy, would have a piece of the action."

This proposal follows a "share-the-state-wealth" plan Hammond signed into law Tuesday that will put \$405 million into the pockets of 400,000 Alaskans this year alone.

Under that law, people who have filed a state income tax return for any three years since statehood in 1959 will be exempt from future taxes and get refunds on 1979 taxes. The state this year will pay residents \$50 in oil wealth "dividends" for each year they have lived in Alaska since 1959.

The "dividends" are to be an annual payment tied to a kind of oil revenues "state savings account" which is building and will give thousands annually to longtime Alaskans in the 1990s.

Under PACE, residents wouldn't get cash. They would get stock.

"Right now, if you want to invest in Alaska's oil, you have to buy shares in Exxon," said Gardiner, 29, a college-educated fisherman born in Ketchikan. "This would give

people a chance to invest directly in Alaska."

Alaskans have a longstanding dislike for "Outsiders" — people who came here years ago and nearly depleted the salmon, those who are absentee owners of fish processing and other facilities and those who came for oil pipeline construction money and left.

"This proposal will enable Alaskans to invest in Alaskan enterprises," says Hammond.

The state also shares its wealth through low-interest business and home loans. But Hammond has sought ways to benefit a broader base of residents, saying the programs give money that belongs to all the people to only a few.

The low-interest loan program in Alaska makes even federal aid pale by contrast.

For example, the Carter administration announced last week it would make \$160 million available to builders for unsold houses and to help low-income buyers. Since January, Alaska has appropriated \$140 million for home mortgage and consumer loans, \$75 million for business loans and \$15 million for fishing and farming loans. Legislators expect to allocate \$300 million more loans this year.

Rep. Russ Meekins, a 30-year-old Democrat and chairman of the House Finance Committee, shrugs his shoulders about the state's wealth and the envy it may bring, saying: "People hate the Rockefellers, too."

About 80 percent of state revenues come from oil through taxes, royalties and other payments from the oil companies to the state.

The oil won't last forever, and backers of the wealth-sharing plans say it makes no sense for the state to spend all the money on public works or other government programs, especially since they expect a mass exodus from Alaska once the oil runs out.

When that will happen is uncertain. But federal estimates indicate the amount of oil available from the state's primary known source — Prudhoe Bay — will decline significantly by the year 2000.

Dr. Arlon Tussing, an economist who worked on the PACE proposal, told legislators that after the oil industry winds down Alaska will be back to a fishing, tourism and timber economy.

"After that, how are the people going to be supported?" he asks.

Tussing estimates Alaska would have to produce 5½ times the United States' total coal production to replace Prudhoe Bay oil revenues, or equal the entire world catch of fish.

"There's little chance the state can fill the gap," he says. "A lot of people are going to have to leave, so you might as well give them a nest egg."

Personal Investing

Trusts That Rake Royalties Off the Top by Aimée L. Morner

Inflation hedgers flocking into natural-resource investments have been eyeing some unusual vehicles known as royalty trusts. These trusts, a few of which have been around since the early 1950's, are unincorporated enterprises that act as conduits for distributing royalty income to investors. Four of the five large publicly traded trusts (see table) derive their income from royalties on sales of oil and gas; the other, Mesabi Trust, gets its royalties from iron ore. Not surprisingly, the oil and gas trusts have risen the most in the last few years, and in mid-March a big new one—Houston Oil Royalty Trust—was about to come to market.

All of the royalty trusts share some common characteristics. None of them owns any real property; instead, they hold interests in royalties from properties owned by, or leased to, one or more operating companies. The royalties, figured as a certain percentage of sales, are paid "off the top"—i.e., before the operator makes any deductions for expenses or taxes. The trusts thus bear none of the risks or costs of drilling or mining. In fact, they are required by the Internal Revenue Service to remain "passive" and, in addition, to pay out virtually all their earnings.

In return, IRS rulings allow the trusts, and investors in their "units of beneficial interest," some tax breaks. The trusts themselves pay no federal income taxes, and the IRS takes the view that investors have a stake in the assets that produce income for the trust. Consequently, part of the cash payout is regarded as depletion, i.e., a return of capital, so shareholders pay no income tax on that portion.

The bookkeeping is tough

The yields on most of the trusts are fairly generous. The highest—11.4 percent for Mesabi Trust—is more than twice the yield on the stock of Cleveland-Cliffs Iron, the nation's largest iron-ore producer. Estimated yields on the other trusts range between 5.6 percent for North European Oil Roy-

alty Trust to 8.1 percent for Mesa Royalty Trust. By comparison, the yield on the S.&P. index of nine domestic oil companies is a slim 3.3 percent.

Figuring the taxes on the trusts' yields is nettlesome, but the bookkeeping is worth the trouble. Investors who have bought into oil and gas trusts in the last few years take "cost depletion," which involves using a depletion rate that is determined annually for each trust by independent engineers. The rates vary—from about 4 percent (an estimate) for Mesa to between 7 and 8 percent for the other three in the table.

The taxpayer applies the depletion rate to the cost of his units. If the rate is 7 percent, for example, and the units have a cost basis of \$40, then \$2.80 is considered a return of capital, and the cost of the units is reduced by that amount. Most of the time the depletion calculation will yield a figure lower than the payout; the rest of the cash distribution is taxed as ordinary income. (The treatment of this excess is dif-

ferent for Mesabi unit-holders. Once its units have been held for a period of time—it varies depending on when they were bought—the excess payout is taxed as a capital gain.)

Even though the underlying assets are being used up, the few analysts who follow the oil and gas trusts expect cash distributions to increase. Frederick A. Lynn, president of F.A.L. Capital Management, has been buying these trusts because he expects oil and gas prices to keep rising, which will not only lift royalties but also cause operators to press harder for more production.

Investors trying to figure out how much production is ultimately possible will be frustrated. While the Securities and Exchange Commission requires most publicly traded companies to report information about the size of their hydrocarbon reserves, some royalty trusts can duck the requirement if the data are either unavailable or too costly to get.

And that's the case with three of the four

THE PAYOUTS KEEP GROWING

	CASH DISTRIBUTION				YIELD	
	1979	1980 estimate	1981 estimate	Rate of growth, compounded 1975-1979	1975	Recent (based on est. 1980 distribution)
North European Oil Royalty Trust	\$4.07	\$5.00	\$7.50	37.2%	6.9%	5.6%
Marine Petroleum Trust	\$2.25	\$2.80	\$3.30	45.7%	8.0%	7.8%
Tidelands Royalty Trust B	\$1.94	\$2.80	\$3.60	N.A.	N.A.	6.7%
Mesa Royalty Trust	N.A.	\$3.05	\$3.30	N.A.	N.A.	8.1%
Mesabi Trust	\$1.39	\$1.65	\$1.80	4.8%	15.9%	11.4%

Two of the four oil and gas royalty trusts shown here—North European and Marine—have boosted cash distributions to investors at a heady pace since 1975. Of the remaining two, Mesa is a newcomer that sprang up last year, and Tidelands, which first began to distribute its royalty income in 1977, has nearly quadrupled its payout in the past two years. The other trust in the group, Mesabi, gets its income from royalties on shipments of iron-

ore pellets, and its performance has been lead-
er. All the estimates for 1980 and 1981 were compiled from forecasts by various analysts and portfolio managers. Though the prices of trust units have risen significantly, the yields, based on the 1980 estimates, have not changed all that radically. A portion of the payouts of all the trusts, with the possible exception of Mesa, can be treated for tax purposes as a return of capital rather than income.

Personal Investing continued

oil and gas trusts. North European Oil derives royalties from properties in West Germany that are leased to Mobil, Royal Dutch, and Exxon, which never whisper a word about the size of those reserves. Gulf Oil is just as tight-lipped about the reserves in fields it operates partly for Marine Petroleum Trust and partly for Tidelands Royalty Trust B.

Investors know a lot more about the reserves associated with Mesa Royalty Trust because of estimates in a prospectus issued last November, when the trust was spun off to shareholders of Mesa Petroleum. Independent petroleum engineers estimated proven oil and gas reserves and calculated their present value, discounting the expected income at an annual rate of 10 percent. This worked out to \$27.75 per unit, but the assumptions about the future price of oil and gas that go into such calculations are considered to be very conservative. Consequently, the units sold for about \$30 once they began trading. They subsequently rose as high as \$42, and were recently selling for about \$35.

Real-world expectations about price increases, particularly for gas, are quite bullish, for good reason. Under the Natural Gas Policy Act of 1978, prices of newly discovered gas—now about \$3 per 1,000 cubic feet (mcf)—may rise 10 percent a year until 1985. At that time controls will be lifted, and some analysts expect new gas to sell at a parity with oil. If they are right, even if oil were to sell at only \$30 a barrel, the price of gas will rise some 65 percent, to \$5 per mcf, in five years, since that quantity of natural gas has one-sixth as much heating power as a barrel of oil.

Life in new leases?

Buyers of Marine Petroleum Trust are betting primarily on the higher gas prices. Marine's royalties—a low 0.75 percent of sales—are derived solely from the trust's interest in 500,000 acres leased to Gulf Oil in the Gulf of Mexico. Half of that acreage now produces oil and gas, much of it coming from "mature" fields. While Gulf could yet find oil or gas in the other half, investors are primarily intrigued that some 70



In the last two years, the standout in this group has been North European, whose units have doubled in price. But over the period shown, Tidelands' shares have gone up even more—from only about \$1 in 1975, to \$42 recently. Shares of Marine (which owns a third of Tidelands' units) have retreated somewhat since reaching a record level last year. With the exception of Mesa and Mesabi, the trusts have relatively few units outstanding, and their prices tend to be quite volatile.

percent of Marine's royalties come from "old" natural gas with an average price of only \$1.20 per mcf. As contracts expire, or if new gas is discovered, that figure will inevitably go a lot higher. And the kicker in Marine is its 32.6 percent equity interest in Tidelands Royalty Trust B.

Tidelands is primarily a speculative bet on an increase in production. The Tidelands trust agreement with Gulf Oil covers 1.3 million acres offshore, and Gulf has so far leased only 40,000 of them. Analysts expect Gulf to seek new leases in the area and to spend freely on wildcat drilling. Tidelands will also benefit, though not as much as Marine, from rising prices: the Tidelands gas sells at an average price of around \$1.80 per mcf.

The price on much of the gas in which Mesa Royalty Trust has an interest is strictly bargain-basement. Close to 80 percent of the gas in its largest field sells under contract at a paltry 25 cents per mcf. The contract won't expire until 1989, but new gas from the same field would, of course, sell for a lot more.

Mesa investors are buying units in the face of an unusual risk: the IRS hasn't yet ruled that it can be treated as a trust. Regardless of how this issue is resolved, a hefty portion of the payout will almost certainly be taxed as ordinary income because Mesa's depletion rate this year is expected to be so low.

The new trust in the wings, an offspring of Houston Oil & Minerals, also lacks an IRS ruling on its tax status. The properties in which Houston Oil Royalty Trust has an interest include a substantial amount of unexplored acreage that would be worth a lot if Houston Oil & Minerals made dis-

coveries there. The company's success in finding new reserves, however, has recently been only fair.

The hottest trust in the market lately has been North European. Unit holders have benefited from the rise in the value of the D-mark because the operating companies involved sell what they produce in West Germany, where the fields are. In the last three years, the trust's royalty income, in dollars, has more than doubled. Carey E. Tharp Jr., an analyst at Stillman, Maynard & Co., is convinced the payout will continue to spurt ahead. He points out that more and more of the gas sold in Germany is coming from a field that produces royalties at a rate 7.5 times higher than the rate on sales from the field that is currently producing much of the trust's income.

A direct link to inflation

The iron trust, Mesabi, hasn't been particularly popular with investors lately. Its royalties come from properties in Minnesota's Mesabi range—the nation's largest iron-ore reserve. They are mined by Reserve Mining, which ships pellets made from the ore to the two steelmakers—Armco and Republic—who jointly own the company. Reserve pays Mesabi a base royalty that depends on the volume of pellets shipped, which means the trust's income is sensitive to the demand for steel. The base is also adjusted by a factor that reflects the annual change in the producer price index. That inflation hedge hasn't swayed investors, who are aware that Reserve's pellet factory could be struck this August when a labor contract expires. After the workers went out three years ago, Mesabi's cash distributions were slashed.

DRAFT: PORTFOLIO OF ALASKA CITIZEN ENTERPRISES (PACE)

A BILL

For an Act entitled: "An Act establishing the Portfolio of Alaska Citizen Enterprises, and providing for an effective date.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

Section 1. AS 43 is amended by adding a new chapter to read:

CHAPTER 17. PORTFOLIO OF ALASKA CITIZEN ENTERPRISES

ARTICLE 1. GENERAL PROVISIONS

§43.17.010 POLICY, PURPOSES, AND FINDINGS

(a) It is the duty and policy of the State with respect to the natural resources belonging to it and the income derived from them to provide for their utilization, development, and conservation for the maximum benefit of its people.

(b) The purposes of this chapter are:

(1) to transfer part of Alaska's petroleum wealth to its people in the form of income-producing assets;

(2) to provide a means for the direct participation of individual Alaskans in the financing of, and profits from, newly organized enterprises of general benefit to the state [such as the Alaska Natural Gas Transportation System (ANGTS)];

(3) to promote greater resident Alaskan control, and to reduce absentee ownership and control, of existing Alaska industries;

(4) to encourage wider citizen participation in and understanding of the capitalist system through wider distribution of ownership in Alaska business enterprise;

(5) to encourage increased awareness and involvement by the people of Alaska in the management of natural resource production and development;

(6) to encourage increased awareness and involvement by the people of Alaska in the state's participation in business enterprise; and

(7) to encourage increased awareness and involvement by the people of Alaska in the development of local industry.

(c) The legislature hereby finds ---

(1) that it is in the public interest and in the furtherance of a public purpose to distribute a portion of Alaska's energy wealth to the people of Alaska in the form of income-producing assets in order to increase their involvement and awareness regarding the management of the state's natural resources, in the development of its local industry, and in the capitalist system;

(2) that a mechanism by which the state distributes a portion of its resource royalties will best promote the state's interest in producing a more personal and direct stake in the impact of decisions involving the state's natural resource production and development; and

(3) that a mechanism by which the state distributes a portion of its ownership interests in business enterprises will best promote the state's interest in providing a more personal and direct stake in the impact of decisions involving state investments, development of local industry, as well as a more personal and direct stake in the capitalist system.

§43.17.020. ESTABLISHMENT OF PORTFOLIO. The Portfolio of Alaska Citizen Enterprises is hereby established in the Department of Revenue as program for citizen wealth ownership and consists of one or more portfolio plans established according to §30 of this chapter.

(d) Except as required or authorized by this Act, or otherwise required by law, the assets distributed under the portfolio shall be the unencumbered private property of its beneficiaries, and the beneficiaries shall not be in any way impaired in their enjoyment of the earnings of those assets, the proceeds of their sale, or any other advantage of their use or disposition.

(e) The portfolio is not intended to create or result in the creation of any new governmental agency, corporation, or enterprise.

(f) Except as provided in this Act, the portfolio is not intended to be part of, duplicate, enlarge or diminish, conflict with, substitute for, or alter in any way ---

(1) any existing service or function of state government;

(2) any state business loan or industrial development program;

(3) any plan for the elimination, refund, or reduction of any state personal or business tax; or

(4) the investment of state revenues in, or the disposition of earnings from, the Permanent Fund.

§ 43.17.030. PORTFOLIO PLANS. (a) A portfolio plan under §20 of this chapter is a plan under which the Commissioner---

(1) contributes, transfers, commits, or dedicates to the Program securities, rights to resource revenues, or other assets, either already owned by the State or acquired expressly for the portfolio; and

(2) distributes those assets to individual Alaskans by grant and/or sale under the terms of this Act.

(b) Each portfolio plan shall provide for the distribution of assets to eligible individuals in the form of certificates that establish their ownership, right, or interest in one (and only one) of the following:

- (1) An Alaska Energy Resource Trust,
- (2) An Alaska Industrial Development Project,
- (3) An Alaska General Stock Ownership Corporation,
- (4) An Alaska Investment Fund,
- (5) An Alaska Real Estate Trust, or
- (6) Shares in one or more existing private enterprises doing business in Alaska.

(c) Each portfolio plan shall provide for a single distribution of such certificates only to persons who were residents on an eligibility date to be specified in the plan.

§ 43.17.040. PORTFOLIO PLANS SUBMITTED TO LEGISLATURE.

(a) The Commissioner shall, on or before the thirtieth legislative day of each Session of the legislature beginning with the First Session of the Twelfth Legislature, submit to the legislature for its consideration and approval, at least one portfolio plan, and not more than three such plans.

(b) Each portfolio plan submitted to the legislature under this section shall be in the form of a report that ---

(1) specifies the assets to be made available for distribution;

(2) authorizes their purchase or other acquisition by the State, if necessary, and their appropriation, transfer, commitment, or dedication to the plan;

(3) specifies the eligibility date for persons receiving benefits under the plan;

(4) specifies the manner in which eligible persons must apply for a grant of assets, or subscribe to purchase assets, distributed under the plan, and the earliest and latest dates on which they may make such an application or subscription;

(5) specifies the type and number of shares, certificates, debentures, warrants, options, or other securities or instruments to be distributed, and the manner in which they are to be distributed;

(6) specifies the terms and manner of payment for any assets to be sold under the plan;

(7) directs and authorizes the disposition of any assets appropriated, transferred, committed, or dedicated to the, and of any authorized or issued certificates that are not actually distributed under the plan;

(8) specifies the restrictions, if any, on the sale, assignment, hypothecation, or other transfers of or encumbrances upon the assets distributed under the portfolio plan, consistent with this chapter; and

(9) authorizes the appropriation and expenditure of such funds as may be necessary to administer the plan.

(c) Each portfolio plan submitted to the legislature under this section shall be accompanied by ---

(1) such draft legislation in the form of a Bill or Bills amending the general laws of Alaska, as may be necessary to implement the plan. [An example might be enactment of an Alaska regulated investment company (mutual fund) law, in order to establish an Alaska Investment Fund]

(2) the proposed articles of incorporation and by-laws of any corporate entity, or the proposed indentures of any trust, whose creation is necessary to implement the plan;

(3) the names of, or a statement of the manner of selecting, the incorporators and initial directors of any such corporate entity, or trustee(s) of any such trust; and

(4) a statement that contains ---

(A) a description of the assets to be distributed under the plan, and an appraisal of their value, with due attention to any uncertainty that may attach to the appraisal;

(B) a tabulation of the initial fiscal cost of the plan to the State, and a projection of probable future fiscal costs, with due attention to any contingent fiscal costs, liabilities, or risks that may attach to the plan;

(C) projections of the probable earnings and appreciation (or decline) in the value of those assets, and of their probable impact on income and wealth of the plan's intended beneficiaries, with due attention to any uncertainty that may attach to those projections;

(D) a statement of any federal or state tax liability that might be incurred by beneficiaries of the plan in connection with the initial distribution of shares, certificates, debentures, warrants, options, or other securities or instruments, earnings derived from them, or their ultimate sale or other disposal, with due attention to any uncertainty that may exist with respect to that tax liability;

(E) an assessment of any other costs, liabilities, or risks that may attach to the receipt or ownership of assets distributed under the plan; and

(F) such other kinds of information as the United States and Alaska securities laws might require to be included in a registration statement or prospectus in an ordinary public offering or sale of the kinds of shares, certificates, debentures, warrants, options, or other securities or instruments to be distributed under the plan.

§43.17.050. LEGISLATIVE APPROVAL. A portfolio plan may not be implemented until it has been enacted by law.

ARTICLE 2. ELIGIBILITY FOR BENEFITS

§43.17.060. ELIGIBILITY FOR BENEFITS. (a) No person other than an individual who was a resident on the eligibility date established for a portfolio plan may receive a free grant under §90 of this chapter, or purchase under §100-110, any asset distributed under that plan.

(b) No person who has been granted, without consideration, any purchase warrant distributed under this chapter, and who has ceased to be a a resident, may exercise any such warrant or portion thereof remaining unexercised on the date on which said person ceased to be a resident, and any said unexercised warrant or option or portion thereof shall become null and void as of that date.

(c) (1) No person who has purchased, for consideration, any purchase warrant distributed under this chapter, and who has ceased to be a resident, may exercise any such warrant or portion thereof that remains unexercised on the date on which said person ceased to be a resident of Alaska, but

(2) any such person may offer any such unexercised and otherwise valid warrant or option or portion thereof for repurchase by the State, and upon such an offer the Commissioner shall repurchase said asset at its issue price, plus interest accrued from the date of issue to the date on which the offeror ceased to be a resident Alaska.

(d) Any installment contract or other loan made or held by the State of Alaska or any agency thereof for the purchase of assets distributed under this chapter, or secured by such assets, shall become due and payable as of the date the beneficiary ceases to be a resident.

§43.17.070. DETERMINATION OF ELIGIBILITY. (a) An individual who claims a distribution of units under §§90-110 of this chapter must file an application and statement of eligibility verified by him or her under penalty of perjury.

(b) In the application and statement of eligibility, the commissioner may require the individual to include one or more of the following:

(1) evidence that he or she was registered to vote in Alaska on that date, and actually voted in the last statewide general election prior to that date;

(2) a copy of the individual's Alaska resident personal income tax return for the tax year which includes that date, or for the previous tax year;

(3) an Alaska driver's license, or resident hunting, fishing, or trapping license, purchased prior to that date, and valid on that date;

(4) evidence that he or she had a telephone or electric utility connection listed in his or her name, or in the name of a spouse, or (in the case of a minor) in the name of a parent or guardian, at a private residence in Alaska on that date; and

(5) a notarized affidavit from two or more Alaska residents who can themselves present at least two of the items listed in paragraphs (1) through (4) of this subsection.

(c) An individual shall be presumed eligible if he or she provides at least two of the items specified in subsection (b) of this section.

(d) Any presumption of residency established under subsection (c) of this section may be rebutted, and a person shall be presumed not to be a resident on a given date if, within thirty days prior to or one year following that date, he or she ---

(1) voted in any election, or stood for election or served in any public office, in another state or nation; or

(2) declared himself or herself to be a resident of any other state or nation for any purpose, or took advantage of any right or privilege reserved to residents of another state or nation.

(e) The department shall prescribe and furnish a form for application and statement of eligibility, which must include a certification of residency in substantially the following form:

Under penalty of perjury, I hereby certify that

(1) I was a resident of the state of Alaska within the meaning of the law (AS 43.17.230(16), which is attached) on [date] , and

(2) I understand that my claim for a distribution of assets is based upon that residency, and that the law (AS 43.17.220, which is attached) provides that I will forfeit those assets and be required to repay any income I have received from them, in addition to any criminal penalties for which I may be liable, if I

should be convicted of perjury or unsworn falsification for making a false claim of residency.

Signature of applicant

§43.17.075 LIST OF PERSONS CLAIMING RESIDENCE. At least sixty days prior to the distribution of any units under any portfolio plan, the commissioner shall make available for public inspection in at least five locations around the state, a list of the names, addresses, and type of residency evidence submitted, of all persons claiming to be residents for the purpose of receiving benefits under the portfolio plan.

ARTICLE 3. DISTRIBUTION OF ASSETS

§43.17.080. BASIC PURCHASE PRICE. (a) The commissioner shall establish a basic purchase price for a unit of any asset to be sold to eligible individuals under §§100-110 of this chapter.

(b) The basic purchase price for units in an Alaska Industrial Development Project, an Alaska General Stock Ownership Corporation, an Alaska Investment Fund, an Alaska Real Estate Trust, or existing private enterprises, shall be equal to the average original cost to the State of Alaska of those units, or of the assets contributed, transferred, committed, or dedicated to the portfolio and represented by those units, plus an amount that, in the judgement of the commissioner, compensates the state for the administrative costs of acquiring, holding, and distributing those units.

(c) The basic purchase price for units in an Alaska Energy Resource Trust, authorized to be distributed to individual Alaskans under any portfolio plan shall be the conservatively appraised value of those units, as defined in subsection (d) of this section.

(d) A conservatively appraised value for units in an Alaska Energy Resource Trust is a value determined by generally accepted appraisal methods, with the following stipulations:

(1) Estimates of resource or production volumes shall have a confidence level of seventy-five percent (75%) or greater --- that is, the appraiser must believe that there is at least a seventy-five percent probability that the actual resource or production volume will equal or exceed the estimated value;

(2) the assumed rate of increase in future world prices for energy commodities (as represented, for example, by the price of Saudi Arabian "marker" crude oil) shall not exceed the general rate of price inflation in the United States; and

(3) the discount rate used to reduce future income and costs to present value shall reflect the judgment of private investors as to the expected pre-tax rate of return required to justify incremental investments in the exploration and development of resources comparable to those from which income has been committed to the portfolio plan.

(e) The assets distributed under any portfolio plan must be divided, or must be subdivisible at the option of the holder, into units whose basic purchase price does not exceed fifty dollars (\$50) per unit.

(f) Prior to sale of any asset under any portfolio plan, the commissioner shall notify prospective purchasers of the basic purchase price determined by him under this section for the units to be sold.

§43.17.090 FREE DISTRIBUTION. Unless otherwise required by law, a fraction to be specified in each portfolio plan, but not less than five percent (5%) nor more than fifteen percent (15%), of the total number of units

to be distributed under each plan shall be granted in equal portions, without consideration, to all eligible individuals Alaskans who apply to receive said assets;

§43.17.100 FIRST RESTRICTED SALE. (a) All units authorized to distributed to eligible individuals under each portfolio plan, other than those distributed as a grant without consideration under §90 of this chapter, shall be offered for sale to eligible individuals in a first restricted sale.

(b) In each sale under this section, each eligible individual shall have the right to subscribe for any number of units of the assets to be distributed, by submitting an application and statement of eligibility under §70 of this chapter together with a deposit equal to ten percent of the basic purchase price of the subscribed units. The deposit shall be in the form of cash, check, money order, or an assignment of any unpaid Alaska income tax refund for a past or current tax year.

(c) The applicant shall indicate on his or her subscription application whether he or she wishes to purchase the assets (1) for cash, or (2), on an extended purchase plan as provided in subsection (f) of this section.

(d) If the first restricted sale is oversubscribed, each eligible applicant shall have the right to complete the purchase of the lesser of ---

(1) the number of units subscribed for,
or

(2) the number of units which, if established as the maximum number of units that any one eligible applicant may purchase, would result in the sale of all the units authorized for sale.

(e) The commissioner shall notify each subscriber who elects to purchase assets for cash as provided in subsection (c) of this section of the total number of units he or she is entitled to purchase in the first restricted sale, and of the cash balance required, after crediting his or her deposit, to complete the purchase of those units. On receipt of cash, check, or money order equal to the balance owing, the commissioner shall, subject to the limitation in §140 of this chapter, convey to such subscriber the shares, certificates, debentures, or other assets so purchased. If the subscriber fails to complete the purchase as provided in paragraph (1) of this subsection within sixty days, the commissioner shall convey to such subscriber, subject to the limitation in §140, the largest number of whole units whose basic purchase price does not exceed the amount of the subscriber's deposit, and refund any balance remaining from the subscriber's deposit.

(f) The commissioner shall notify each subscriber who elects to purchase on an extended payment plan as provided in subsection (c) of this section of the total number of units he or she is entitled to purchase in the first restricted sale, and convey to such subscriber:

(1) The largest number of whole units that does not exceed one-tenth of the total number of units the subscriber is entitled to purchase;

(2) A refund of the difference, if any, between the subscriber's deposit and the basic purchase price for the number of units conveyed under paragraph (1) of this subsection; and

(3) Purchase warrants described in §130 of this section, for the balance of the total number of units the subscriber is entitled to purchase.

§43.17.110. SECOND RESTRICTED SALE. (a) If the first restricted sale under any portfolio plan is undersubscribed, and if the plan authorizes a second restricted sale in such an event, the commissioner shall conduct such a sale under this section.

(b) In a sale under this section, each eligible individual may submit one or more sealed bid(s) each of which shall specify the number of units the bidder wishes to purchase at a bid price specified by him or her, which price must be equal to or exceed a minimum bid price specified by the commissioner, but which may otherwise be less than, equal to, or more than the basic purchase price.

(c) The sealed bids described in subsection (b) of this section must be accompanied by an application and statement of eligibility under §70 of this chapter, and a deposit equal to ten percent of the bid price for the number of units subscribed. The deposit may be in the form of cash, check, or money order, or an assignment of any unpaid Alaska personal income tax credit or refund for the past or current tax year not already encumbered in the first restricted sale.

(d) The commissioner shall tally the bids in descending order of bid price, until (1) the total number of units bid for equals the number of units to be sold, or (2) all bids at or above the minimum bid price have been tallied, whichever occurs sooner; and the commissioner shall award to each bidder whose bid has been included in this tally, sale of the number of units for which he or she bid, at an actual sales price equal to his or her bid price for those units [ALTERNATE PROVISION: to the bid price for lowest bid so tallied], until (1) all such bids have been satisfied, or (2) all units have been sold, whichever occurs sooner.

(e) If the number of units for which valid bids are received at a bid price equal to or greater than the actual sales price as described in subsection (d) of this section, exceeds the number of units available for sale, the Commissioner shall award sale of the number of units bid for to each such bidder whose bid price exceeded the actual sales price, and shall award sale of the remaining units to those bidders whose bid price was exactly equal to the actual sales price, in proportion to the number of units for which they bid at that price.

(f) All sales of units shall be cash sales. The commissioner shall notify each successful bidder of the total number of units he or she is entitled to purchase in the second restricted sale, and of the cash balance required, after crediting his or her deposit, to complete the purchase of those units. On receipt of cash, check, or money order equal to the balance owing, the commissioner shall, subject to the limitation in §140 of this chapter, convey to such bidder the units so purchased. If the bidder fails to complete the purchase as provided in this subsection within sixty days, the commissioner shall convey to such bidder, subject to the limitation in §140, the largest number of whole units for which the actual sales price does not exceed the amount of the subscriber's deposit, and refund any balance remaining from the deposit.

§43.17.120. UNRESTRICTED SALE. Except as expressly provided in this Act or the terms of a portfolio plan, or otherwise prohibited by law, the Commissioner is authorized to hold as investments or to sell for maximum revenue, or otherwise for the the benefit of the state, any units authorized to be distributed under a plan, but which (1) remain undistributed after completion of the free distribution under §90 of this chapter, the first restricted sale under §100, and (where authorized) the second restricted sale under §110, and (2) are not reserved for sale under the terms of a purchase warrant.

§43.17.130. PURCHASE WARRANTS. (a) Purchase warrants distributed under §100(f) shall grant an eligible holder the right to purchase, over a period of nine years from their date of issue, the number of units that equals nine-tenths (90%) of the total number of units that the holder was entitled to purchase in a first restricted sale under this chapter, on the following schedule:

(1) The largest number of whole units that does not exceed one-ninth of the total number of units that the holder is entitled to purchase after receipt of the units distributed under §100(f)(1), not later than one year after the issue date;

(2) The largest number of whole units that does not exceed one-eighth of the units that the holder is entitled to purchase after receipt of the units distributed under §100(f)(1), less the number of units he was entitled to purchase under paragraph (1) of this subsection, not later than two years after the issue date;

(3) The largest number of whole units that does not exceed one-seventh of the units that the holder is entitled to purchase after receipt of the units distributed under §100(f)(1), less the number of units he was entitled to purchase under paragraphs (1) and (2) of this subsection, not later than three years after the issue date;

(4) The largest number of whole units that does not exceed one-sixth of the units that the holder was entitled to purchase after receipt of the units distributed under §100(f)(1), less the number of units he or she was entitled to purchase under paragraphs (1) through (3) of this subsection, not later than six years after the issue date;

(5) The largest number of whole units that does not exceed one-fifth of the units that the holder was entitled to purchase after receipt of the units distributed

under §100(f)(1), less the number of units he or she was entitled to purchase under paragraphs (1) through (4) of this subsection, not later than seven years after the issue date;

(6) The largest number of whole units that does not exceed one-fourth of the units that the holder was entitled to purchase after receipt of the units distributed under §100(f)(1), less the number of units he or she was entitled to purchase under paragraphs (1) through (5) of this subsection, not later than six years after the issue date;

(7) The largest number of whole units that does not exceed one-third of the units that the holder was entitled to purchase after receipt of the units distributed under §100(f)(1), less the number of units he or she was entitled to purchase under paragraphs (1) through (6) of this subsection, not later than seven years after the issue date;

(8) The largest number of whole units that does not exceed one-half of the units that the holder was entitled to purchase after receipt of the units distributed under §100(f)(1), less the number of units he or she was entitled to purchase under paragraphs (1) through (7) of this subsection, not later than eight years after the issue date;

(9) The largest number of whole units that does not exceed the number of units that the holder was entitled to purchase after receipt of the units distributed under §100(f)(1), less the number of units he or she was entitled to purchase under paragraphs (1) through (8) of this subsection, not later than nine years after the issue date;

(b) The actual purchase price for any asset purchased by exercising a purchase warrant under this

section shall be the basic purchase price of the unit as defined in §80 of this chapter, as adjusted according to subsection (c) of this section.

(c) The basic purchase price shall be increased by a carrying charge calculated at a rate equal to the weighted average cost of borrowing to the State of Alaska during the fiscal year previous to the date of issue, compounded from the purchase warrant's date of issue to the date of actual purchase of the issue, less any dividends, interest, royalties, or profits received by the State from holding the unit between the stock-purchase warrant's date of issue and the date of actual purchase, but in no event may the actual purchase price be less than one-half the basic purchase price.

(c) Payment for units purchased by exercising a purchase warrant under this chapter may be by cash, check, or money order, or by an assignment of any unpaid Alaska personal income tax credit or refund from the past or current tax year.

(d) All stock-purchase warrants distributed under §80 of this chapter 320(f) shall be non-transferable, except by inheritance, and no purchase right granted by such a warrant shall be exercised except by an individual who is a resident at the time said purchase right is exercised.

§43.17.140. USE OF INCOME TAX REFUNDS. (a) The commissioner may not convey to a purchaser a unit to be distributed under this program, and purchased under §§110-120 of this chapter in whole or in part by means of an assignment of an Alaska personal income tax refund for any year, until the purchaser's personal income tax return for that year has been filed and processed by the Department of Revenue, and the commissioner has determined that the purchaser appears to be entitled to a tax refund sufficient to satisfy the balance owing for his or her purchase of under the portfolio.

(b) If after the purchaser has filed, and the Department has processed, the purchaser's Alaska personal income tax return as provided in subsection (a) of this section, the commissioner determines that the purchaser does not appear to be entitled to a personal income tax credit or refund sufficient to pay the balance owing for his or her purchase, the commissioner shall notify the purchaser of the balance owing after crediting any refund or credit to which the purchaser may be entitled. On receipt of cash, check, or money order equal to the balance owing, the commissioner shall convey to the purchaser the units so purchased. If the purchaser fails to complete the purchase as provided by this subsection within sixty days, the commissioner shall convey to such purchaser the largest number of whole units for which the actual sales price does not exceed the sum of (a) any applicable cash payment and (b) any tax refund or credit which in the judgment of the commissioner may properly be applied to the purchase, and the commissioner shall refund or credit to the purchaser's Alaska tax payments any balance that remains owing to the purchaser.

(c) If a disagreement exists between any purchaser and the commissioner regarding the purchaser's entitlement to apply Alaska personal income tax refunds to the purchase of units under this section, the determination of the commissioner shall, if not amended by him, become final sixty days after the notice provided for in subsection (b) of this section, or if amended by him, sixty days after his notice to the purchaser of such amendment. The purchaser's only remedy against the determination of the commissioner in this section is to pay the balance owing on the purchase of units under the portfolio, and to pursue whatever remedies exist at law to obtain a refund. The purchaser's remedies

do not include any right to compel the commissioner to complete the sale of any units to which the disputed sum would have been applied.

(d) The provisions of subsection (c) of this section shall not in any way alter any person's Alaska personal income tax liability, entitlement to any tax refund or credit, or any remedy he or she may have in respect to any disagreement with the State of Alaska regarding such liability or entitlement.

§43.17.150. DISPOSITION OF PROCEEDS. The commissioner shall deposit all net proceeds from the sale of units under this chapter into the Alaska Permanent Fund established in IX §15 of the Alaska State Constitution and AS 37.13.010.

ARTICLE 4. GENERAL PROVISIONS

§43.17.160. TRANSFER OF ASSETS. Except as expressly provided with respect to purchase warrants in §30 of this chapter, or units in an Alaska Energy Resource Trust or in an Alaska General Stock Ownership Corporation, a recipient or holder of any units distributed under this chapter shall have an unrestricted right to sell, transfer, devise, bequeath, pledge, hypothecate, or otherwise dispose of any such units, or interest in or earnings from those units.

§43.17.170. VOTING RIGHTS. (a) The commissioner may exercise any voting rights owned, held in trust, or reserved for future distribution under the program.

(b) The voting rights attached to ownership of any unit distributed under this chapter shall be conveyed unrestricted to the eligible individual receiving that security, and the commissioner may not reserve, or require as a condition of distribution of any such security that the

recipient waive any such right, grant any proxy, or adhere to any voting trust, unless the security were subject to such a stipulation or covenant at the time it was acquired by the State.

§43.17.180. TAX TREATMENT. (a) The receipt by an eligible individual of units distributed under this chapter is not taxable under AS 43.20.

(b) If the receipt by any eligible individual of units distributed by the State under this program should be treated as income or capital gains under the Internal Revenue Code and, as a result, that individual is required to pay an additional federal income tax, the amount of that additional tax shall be creditable against the individual's Alaska individual income tax for the tax year in which the additional federal income tax is paid.

(c) If the amount of the credit to which an eligible individual is entitled under (a) of this section exceeds his or her net tax liability, if any, under AS 43.20, the individual is entitled to receive a payment for the excess and that payment for the excess shall not be taxable under AS 43.20.

(d) Nothing in this article shall be construed to exempt from state or federal taxes any dividends, interest, profits, or other income received from any units distributed under the program, or the proceeds from their sale.

§47.17.200. AUTHORITY OF COMMISSIONER TO MAKE A MARKET. (a) If the commissioner finds that an efficient public market does not exist for any issue of units distributed under the program, he is authorized to buy, sell, and trade in those units for the purpose of establishing such a market, and to publish regularly the "bid" and "ask" prices for those units.

(b) If the commissioner makes a market in units as authorized in subsection (a) of this section, he shall

as authorized in subsection (a) of this section, he shall maintain an average markup (or spread between bid and ask prices) just sufficient, in his judgment, to compensate the State for the administrative costs of his trading activity.

(c) An efficient public market for purposes of this section means a market in which the units distributed the program have at all times a readily ascertainable market value, and that they may be bought and sold readily and without unnecessary or unreasonable transactions costs.

§43.17.210. WAIVER. The provisions of AS 37.10.085 shall not apply to the acquisition of assets under this chapter.

§43.17.220. REGULATIONS. The department may adopt regulations necessary to administer the program.

§43.17.230. PENALTIES. Any person convicted of perjury or unsworn falsification on the basis of a statement made under §70 of this chapter may never, if that conviction is not reversed, become eligible for the distribution of units under this program, and shall forfeit all units distributed to him or her.

§43.17.240. DEFINITIONS. In this chapter

(1) "Alaska Energy Resource Trust" means a trust established by the commissioner as part of a plan enacted under this chapter, the assets of which trust are a right to receive income equal to a specified portion of the rentals, royalties, net profits, or mineral sale revenues from the production of oil, gas, coal, oil, or other resources from specified leases or properties of the state;

(2) "Alaska Industrial Development Project" means a private enterprise engaged or intending to engage in the business of natural resource extraction or processing, or manufacturing, transportation, or communications, wholly or partly within the state, and to which the State or an

agency or subdivision of the State, contributes capital or assists in financing, thorough an investment of equity or debt capital in the form of money or rights in land or natural resources, or by loan guarantees, having a value exceeding \$100 million;

(3) "Alaska General Stock Ownership Corporation" means a corporation formed in accordance with subchapter U, chapter 1 of the Internal Revenue Code of 1954, as amended (26 U.S.C. 1391-1397);

(4) "Alaska Investment Fund" means a regulated investment company (also known as a mutual fund) organized or caused to be organized by the commissioner in accordance with subchapter M, chapter 1 of the Internal Revenue Code of 1954, as amended (26 U.S.C. 851-855);

(5) "Alaska Real Estate Trust" means a real estate investment trust organized or caused to be organized by the commissioner in accordance with subchapter M, chapter 1 of the Internal Revenue Code of 1954, as amended (26 U.S.C. 856-858);

(6) "assets" means shares of stock, debentures or other debt obligations, royalties or other interests in minerals, or other interests in minerals or other business enterprises or natural resources;

(7) "certificate" means an instrument evidencing ownership of one or more units and includes stock certificates, debentures or other debt instruments and trust certificates;

(8) "commissioner" means the Commissioner of Revenue;

(9) "department" means the Department of Revenue;

(10) "eligible individual" means an individual who is a resident as of an eligibility date set out in a portfolio plan.

(11) "eligibility date" means a date established by the commissioner, on which an individual must have been a resident in order to receive units distributed under §90-110 of this chapter;

(12) "existing private enterprise" means an existing private corporation engaged in or intending to engage in natural resource extraction or processing; manufacturing, transportation, communications, trade, or services in Alaska, whose securities the commissioner has purchased under his existing authority, or proposes to purchase under the terms of a portfolio plan for distribution under this chapter;

(13) "extended purchase plan" means the purchase of units over time through the exercise of purchase warrants;

(14) "individual" means a natural person;

(15) "issue date" means the date on which the commissioner issues a purchase warrant or other certificate to an eligible individual;

(16) "oversubscribed" means a sale in which the total number of units subscribed for exceeds the total number of units offered for sale;

(17) "plan" means a portfolio plan as described in §40 of this chapter.

(18) "portfolio" means the Portfolio of Alaska Citizen Enterprises established by this chapter.

(19) "resident" means an individual who maintains a permanent place of abode in the state with the intention of making the state his or her permanent place of residence and who resides in the state continuously except for temporary purposes only and with the intent of returning; a person may not be considered to have gained a residence solely by reason of his or her presence and may not lose it solely by reason of his or her absence while in the

civil or military service of this state or of the United States or by reason of his or her absence because of marriage to a person engaged in the civil or military service of this state or of the United States, or for attendance as a student or visiting scholar at an educational institution, or while in an institution at public expense, while confined in prison, while engaged in the navigation of the waters of the state, the United States, or the high seas, or while residing upon an Indian or military reservation within the state; a minor's residence shall be deemed to be the same as that of his or her parent or guardian; a married person may establish his or her own residence, and does not presumptively lose residency if his or her spouse is not a resident.

(20) "unit" means the smallest fractional interest in an asset distributed under this chapter; and

(21) "warrant" means an instrument authorizing the purchase of units under this chapter.

ARTICLE 5. ALASKA ENERGY RESOURCE TRUSTS.

§43.17.250. DISTRIBUTION OF UNITS. (a) Units in any Alaska Energy Resource Trust established under this chapter shall be distributed to eligible individuals according to the provisions of §90-110 of this chapter, and the basic purchase price for such certificates shall be determined as provided in §80(c) of this chapter.

(b) There shall be no unrestricted sale under §120 of this chapter, of the units of any Alaska Energy Resource Trust; and the commissioner shall hold as an investment for the State any certificates that (1) remain undistributed after completion of the free distribution under §90 of this chapter, the first restricted sale under §100, and (where authorized) the second restricted sale

under \$110, and (2) are not reserved for sale according the terms of a purchase warrant, including those units that were previously so reserved, but for which the outstanding purchase warrants have expired or been invalidated.

§43.17.260. OWNERSHIP AND TRANSFERABILITY. (a) An individual who has received units in an Alaska Energy Resources Trust in a distribution under this chapter shall not be required to return, sell, or otherwise relinquish those certificates as a result of ceasing to be a resident, but no certificates of such a Trust may be sold, given, assigned, transferred, or otherwise conveyed, except by inheritance, to any person who is not a a resident of Alaska; and the trustee may cancel any certificates sold, given, assigned, tranferred, or otherwise conveyed, except by inheritance, to other than a resident, and provide compensation for such shares at no more than the basic purchase price.

(b) No person or affiliated group may obtain or hold, by grant or purchase, whether from the State or otherwise, or by any other means, title to or a beneficial interest in, more than one-twentieth (5%) of the total authorized, issued, or outstanding units (whichever is the least) of any Alaska Energy Resource Trust authorized, issued, or outstanding (whichever is the least), and the trustee of such a Trust may not distribute to any person or affiliated group, and such person or group may not receive, any dividends, royalties, profits, or other payments from the income of such a Trust in excess of those attributable to one-twentieth (5%) of the total shares.

ARTICLE 6. ALASKA INDUSTRIAL DEVELOPMENT PROJECTS

§43.17.270. INTENT. It is the intent of this chapter that, to the extent it is feasible, whenever the State participates in the financing of any enterprise that is an Alaska Industrial Development Project as defined in §240(2) of this chapter,

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(1) the state's direct participation be temporary and limited to the promotional, organizational, design and construction phases (or, in the case of natural resource extractive enterprises, to the promotional, organizational, exploration, and development phases);

(2) any state ownership and management role in such enterprises be relinquished to private parties once those enterprises become established and viable; and

(3) ownership and management roles relinquished by the state in such enterprises be transferred to eligible individuals through the portfolio established by this chapter.

§43.17.280. ALASKA NATURAL GAS TRANSPORTATION SYSTEM. If the commissioner under his existing authority should invest any funds of the state in equity or convertible debentures of the Alaska Natural Gas Transportation System, also known as the Alaska Highway Gas Pipeline (hereinafter ANGTS), or a portion thereof, or in a natural gas conditioning plant or natural gas liquids transportation system associated with ANGTS, or if the governor or any official of the executive branch of the state should submit to the legislature any proposal for state participation in the financing of ANGTS or a portion thereof, or of a natural gas conditioning plant or natural gas liquids pipeline associated with ANGTS, by contribution of equity or purchase of convertible debentures, the commissioner shall, within 30 legislative days of such an investment or the submission of such a proposal, submit a plan for eventual distribution of the state's ownership interest to eligible individuals through the portfolio established by this chapter.

Section 2. The enactment of a version of SB 170 or HB 240 [Eleventh Legislature] relating to general stock ownership corporations and creating an Alaska General Stock

Ownership Corporation shall constitute approval of a portfolio plan under AS 43.17.040. After enactment, the Commissioner of Revenue shall implement the plan in accordance with this Act and a version of SB 170 or HB 240 relating to general stock ownership corporations and creating an Alaska General Stock Ownership Corporation, whichever may be enacted, subject to necessary appropriation. Notwithstanding the approval under this section, the Commissioner of Revenue may submit to the legislature by the thirtieth legislative day of the Twelfth Legislature a revised plan if in his judgment a revised plan is necessary to implement fully the policy, purposes, and findings of this Act and of the version of SB 170 or HB 240 relating to general stock ownership corporations and creating an Alaska General Stock Ownership Corporation, whichever may be enacted, or if in his judgment a revised plan is necessary to provide complete information concerning the plan. A revised plan submitted under this section is subject to legislative approval under AS 43.17.040.

Section 3. This Act takes effect immediately in accordance with AS 01.10.070(c).

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THE PROPOSED ALASKA GENERAL STOCK
OWNERSHIP CORPORATION (AGSOC)

PREPARED BY ARLO R. TUSSING & ASSOCIATES, INC.

For the House Finance Committee

ALASKA STATE LEGISLATURE

February 5, 1980

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PREFACE AND SUMMARY

The geological accident at Prudhoe Bay has given the government of Alaska, and through it the state's four hundred thousand people, a source of income that will far exceed anyone's notions of the funds needed for ordinary public services. The expected cash surplus also surpasses the capital requirements for all but the most far-fetched state economic development schemes.

Most Alaskans give some support to the idea of saving part of this treasure against the day that current oil revenues no longer can provide the citizens with a high level of government services, lavish transfer payments and generous promotional programs for favored industries at practically no cost in personal or business taxes. But savings plans that will benefit mostly strangers ten, twenty, or more years in the future, probably can not match the attraction of programs that will, one way or another, get money into the state's economy now.¹

For many decades, moreover, residents of Alaska have deplored or resented the fact that outside capital dominated its major industries --- mining, fisheries, and now petroleum. In the 1980's, Alaskans have a chance to dilute this outside control, if they wish to use part of the state's oil wealth for such a purpose.

1) As I have commented elsewhere, some proposals that are purportedly aimed at diversifying Alaska's economic base are best understood as disguised programs to "privatize" a part of the oil revenues. [See Arlon R. Tussing, "Investing in Economic Development." Statement at Workshop of Alaska Growth Policy Council, Anchorage, October 20, 1979.]

Thus, it is not surprising that the state's citizens should consider ways in which to turn at least part of the current government windfall directly into private income or wealth. Some current proposals, such as Governor Hammond's energy credit plan and his "people's portfolio" are openly intended to serve this aim.

AGSOC resembles these plans in some respects, and not in others. Like them, it intends to distribute privately-owned wealth broadly among individual Alaskans. But, according to the inventor of the concept, San Francisco financial consultant Louis Kelso, and its most prominent Alaska advocate, Senator Mike Gravel, the Corporation's capital will come from borrowing in private financial markets. Thus, the sponsors assert, any wealth distributed to Alaska residents in the form of AGSOC shares will neither come from, nor depend upon, the state's oil wealth.

Notwithstanding these claims, our report treats AGSOC as one option for managing Alaska's oil and gas wealth, for four reasons: First, until about one year ago, even Mr. Kelso and Senator Gravel presented AGSOC as a wealth-distribution plan. Second, most legislators and concerned members of the public regard it as such a plan. Third, and more important, we can evaluate the General Stock Ownership Corporation (GSOC) as a form of business organization quite separately from the way in which it is originally capitalized. Finally and most significantly, our investigation concludes that there is almost no hope that an Alaska GSOC could be financed entirely with "non-recourse" borrowing --- that is, without a direct state appropriation or loan guarantee.

The Kelso-Gravel program for AGSOC, which is reflected in the variants on H. B. 240 and S. B. 170, has three elements that we can consider separately:

1. The Alaska legislature would charter AGSOC as a private corporation entitled to certain federal tax benefits under Subchapter U of the Internal Revenue Code, and distribute one share in the Corporation free of charge to each Alaska resident.
2. AGSOC would purchase one or more existing profit-making enterprises: AGSOC sponsors have devoted the greatest attention to British Petroleum's interest in the Trans Alaska oil pipeline (TAPS).
3. AGSOC would finance these purchases with borrowed money, using its profits to pay off the debt.

Part I of this report examines the tax treatment of general stock ownership corporations (GSOCs) under Subchapter U and finds that:

1. A GSOC can create significant tax savings for shareholders, compared to an ordinary business corporation, if all of the latter corporation's earnings are exposed to the highest federal tax rates; but
2. Ordinary business corporations can be (and usually are) organized so as to shelter much of their income from the corporate income tax by their scheduling of depreciation, for example, or by converting profits to deferred capital gains and interest;
3. GSOCs are not the only kind of business organization that avoids double taxation of profits: cooperatives, mutual funds, and small businesses (proprietorships, partnerships and Subchapter U corporations), for example, are treated similarly. All other things being equal, the three principal types of small-business organizations are at least equal to, and are usually more efficient than, GSOCs as producers of after-tax earnings;
4. Any tax savings for shareholders that result from organizing a business as a GSOC are greatest in the lowest tax brackets, and may be insignificant for upper-income taxpayers; and that

5. The need to pay dividends every year sufficient to offset the personal tax liability that GSOC ownership creates for individual shareholders severely restricts the kinds of investments that GSOCs may safely make, and the ways in which those investments can be financed.

Thus, the ability to shelter benefits from the federal tax collector is obviously an important consideration in choosing the instruments by which Alaska tries to distribute capital ownership more widely among the state's residents, but it is by no means the only consideration and may not always be the dominant one. And, as we have seen, a GSOC is not even the most effective tax shelter in every instance.

The AGSOC idea may remain an enticing one even if its tax treatment is not an important advantage, because it seems to offer individual Alaskans stock in a profitable business at no cost to them or to state government for the Corporation's initial equity. Any promise of something-for-nothing depends, however, on the success of an unusual financing plan, whereby AGSOC would pay for its plant and equipment entirely by "non-recourse" borrowing. Part II of our report finds that the outlook for any such financing plan is extremely dim.

The only kinds of business that a GSOC would have much hope of financing with even 75 percent non-recourse debt (not to mention 100 percent debt) is one that has a guaranteed market at a guaranteed price. The industries that meet this test are mostly regulated utilities or facilities serving regulated utilities. But utility property as such is not a particularly promising investment for a GSOC, because the ratemaking process does not let tax-exempt businesses retain the benefits of their tax exemption.

The inability to profit from a GSOC's special tax treatment is the most serious of several flaws in the proposal that AGSOC buy an interest in the Trans Alaska

oil pipeline (IAPS). The most appealing investment opportunities are probably non-utility ventures whose product or services can be marketed on long-term cost-of-service contracts. Examples of such enterprises are the North Slope natural gas conditioning plant, a coal mining venture serving out-of-state electric utilities, or specialized ships built for chartering to oil companies or utilities.

As AGSOC is not likely to finance any major acquisition or investment entirely without state government aid, the form which that aid takes is of considerable importance. We conclude that a direct appropriation of equity is a more efficient and less risky way of arranging a GSOC's initial funding than state loans or loan guarantees.

Part III briefly reviews some of the provisions of the AGSOC legislation concerning shareholding and corporate governance. AGSOC is not a something-for-nothing money machine, as Senator Gravel and the AGSOC Educational Committee seem to imply. Nor is it the gateway to a radical reform of capitalism that Louis Kelso proclaims. And despite the fears of some, an Alaska GSOC is not likely to become a parallel government or a powerful political lobby, or otherwise subvert the integrity of democratic government. Even if GSOCs came to hold a significant block of capital assets in Alaska, their impact on the distribution of wealth and political power would be imperceptible.

A GSOC is one rather arcane form of business organization defined in the Internal Revenue Code, nothing more and nothing less. For each of AGSOC's purported objectives --- avoiding or reducing federal tax liabilities, broadening the ownership of corporate capital, redistributing wealth, privatizing a part of Alaska's oil wealth, or whatever --- there are several alternative measures, some of which may be more familiar, less complex, and more efficient.

AGSOC's enthusiasts have their priorities backward. Alaska's citizens, through their elected representatives, first need to decide what existing industries they want to Alaskanize, what new industries they want to promote, whether or not they want a state investment in the gas pipeline or the conditioning plant, and what balance they want between private and governmental management of the state's resource wealth.

It is only in connection with these decisions that it makes sense to choose a kind of business organization or a financing plan. A GSOC may make sense for some investments --- for many others it surely will not. An approach that calls on the state to set up a very specialized corporate organization, and then to let it loose looking for something to do, is simply topsy-turvy.

PART I. THE GENERAL STOCK OWNERSHIP CORPORATION (GSOC):

TAX ADVANTAGES

The General Stock Ownership Corporation (GSOC) is a creature of United States tax law. Its singular advantage, indeed its only advantage, over an ordinary business corporation is the fact that Subchapter U of the Internal Revenue Code exempts the profits of a GSOC from being taxed twice, first as corporate income and once more as dividends to its shareholders.

With a top rate of 46 percent, the federal corporate tax can leave as little as 54 cents out of each profit dollar earned by an ordinary corporation to be reinvested or distributed as dividends. (State corporate and personal income taxes will of course reduce the shareholder's after-tax benefits even further.) A shareholder who is subject to a 30 percent marginal tax rate on his personal income could thus end with after-tax benefits of only about 38 cents per dollar of earnings:

$$\begin{array}{lcl} & - \text{\$.46 corporate tax (46\%)} & \\ \text{\$1.00 profits} < & = \text{\$.54 after-tax profit (54\%)} < & - \text{\$.162 personal income tax (30\%)} \\ & & & = \text{\$.378 net personal income (70\%)} \end{array}$$

The ability to avoid double taxation under federal law can give AGSOC shareholders a real advantage over shareholders of other corporations that do not qualify under Subchapter U. The earnings of a GSOC, in contrast to ordinary corporate profits, are taxed only once at the federal level --- as personal income to the shareholder. Thus, a GSOC shareholder in the 30 percent federal income tax bracket might be able to benefit from as much as 70 percent of his GSOC profit dollar:

$$\begin{array}{lcl} \text{\$1.00 GSOC profits} & \text{-----} & \text{\$1.00 dividend (100\%)} < & - \text{\$.30 personal income tax (30\%)} \\ & & & = \text{\$.70 net personal income (70\%)} \end{array}$$

The GSOC is not the only form of business organization that can avoid having its earnings taxed twice. This ability is shared by proprietorships (single-owner businesses), partnerships, small business corporations under Subchapter S of the Internal Revenue Code, regulated investment companies (mutual funds), cooperatives, and thrift institutions.² The previous comparison, moreover, tends to exaggerate the tax advantage of GSOCs over ordinary business corporations, because:

1. Most corporations can arrange their affairs so that they do not in fact pay the maximum rate of the corporate income tax;

2. The larger part of shareholders' earnings on common stock is not made up of dividends but of capital gains that are taxed only when the stock is sold, and even then at rates that are (at most) one-half of the rates that apply to ordinary income; and

3. Subchapter U creates tax disadvantages as well as advantages:

- a) GSOC dividends do not receive the \$100 exclusion that applies to ordinary dividend income:

- b) A GSOC may not benefit from the investment tax credit (IIC) --- IIC benefits, if any, have to be claimed by shareholders on their personal income tax returns;

2) In this context, we cannot ignore the alternative of state- or municipally-owned enterprises, whose earnings are tax free, and which can, in addition, borrow in the tax-exempt bond market. Some government enterprises (like the Alaska Marine Highway and the Alaska Power Authority) exist to provide services to the citizens at a low cost, and others (like the Anchorage Telephone Utility or the Washington State Liquor Board), are operated primarily as sources of revenue. New forms of state enterprise conceivably could be designed to channel income and wealth directly to individual citizens.

c) GSOC shareholders are liable for personal income taxes on their share of GSOC earnings, whether or not the GSOC distributes sufficient dividends to cover this added tax liability;

d) While GSOC shareholders are liable for taxes on their share of its earnings, they may not claim GSOC losses as deductions on their personal income tax returns; and

e) A GSOC that distributes less than 90 percent of its taxable income in any year is subject to an additional 20 percent tax penalty.

One way to consider all these factors together may be to look at the total tax burden on the profits from an identical investment under various forms of business organization. The actual burden in any real-world instance depends upon a large number of factors, and the reader should realize that the figures in this report are only illustrations, and not predictions about the performance of any particular enterprise.

The chief assumptions of the calculations of tables 1 through 7 are that:

1. A company is formed with a net investment of \$1,000 per shareholder;
2. The company is capable of earning 25 percent before taxes on that investment, and also on any funds that it may reinvest;
3. Each year's depreciation is 10 percent of the previous year's cumulative net investment, and all depreciation allowances are reinvested; and
4. The company or its shareholders earn a 10 percent investment tax credit (ITC) on its initial investment and on all reinvested funds.

The tax rate on corporate profits is assumed to be 45 percent, and after-tax benefits to shareholders are calculated for taxpayers at 20 and 50 percent marginal tax rate brackets, with capital gains taxed at half the rate on ordinary income.

Dividend and total earnings after taxes: GSOC vs. an ordinary business corporation. Our first comparison is between a GSOC and an ordinary business corporation, both of which distribute 90 percent of their net earnings as dividends. I have chosen this assumption because the tax law penalizes a GSOC that distributes less than 90 percent of its earnings directly to shareholders.

Table 1 shows the after-tax benefits to a taxpayer in the 20 percent income tax bracket. In year 5, the GSOC pays dividends worth \$207 after taxes, while the ordinary corporation's dividends are worth only \$140 --- a difference of 48 percent. This difference is due to the GSOC's shareholder's avoidance of double taxation.

Table 1. Dividend Earnings After Taxes--
20 Percent Tax Bracket

<u>year</u>	<u>GSOC</u>	<u>ordinary corporation</u>	<u>ratio</u>
5	\$207	\$140	148%
20	\$297	\$197	151%

The total benefits of share ownership reflect total company earnings, which include appreciation in the value of the shares, as well as dividend payments. Again, the GSOC shareholder enjoys a substantial advantage. In the fifth year, GSOC dividends plus book value appreciation are worth \$232, while the corresponding total for the ordinary corporation is only \$168, a difference of 38 percent.

Table 2. Total Earnings After Taxes--
20 Percent Marginal Tax Bracket

<u>year</u>	<u>GSOC</u>	<u>ordinary corporation</u>	<u>ratio</u>
5	\$232	\$168	138%
20	\$336	\$238	141%

As we go up the income scale, however, the picture changes. To a taxpayer in the 50 percent marginal income tax bracket, the advantage of a GSOC over an ordinary corporation is much weaker. Until about the eighth year, after-tax performance favors the ordinary corporation. Even in the twentieth year, GSOC after-tax dividends are only 15 percent higher than those of the ordinary company, and total earnings are 1 percent less.

Table 3. Dividend Earnings After Taxes--
50 Percent Tax Bracket

<u>year</u>	<u>GSOC</u>	<u>ordinary corporation</u>	<u>ratio</u>
5	\$124	\$125	99%
20	\$184	\$160	115%

Table 4. Total Earnings After Taxes

<u>year</u>	<u>GSOC</u>	<u>ordinary corporation</u>	<u>ratio</u>
5	\$145	\$160	91%
20	\$210	\$212	101%

The main reason the ordinary corporation is relatively more attractive to higher-bracket taxpayers is that the personal income tax is a greater part of their total tax burden. Here, the exclusion of the first \$100 of ordinary corporate income (an exclusion not available for GSOC dividends) makes a noticeable difference, as does the fact that capital gains are taxed at a much lower rate than ordinary income.

GSOCs vs. tax shelters for ordinary corporate earnings.

The comparisons above probably overstate the tax advantage of GSOCs over ordinary corporations, because the framework of corporate accounting and the tax laws offer many ways to

reduce the burden of double taxation. Thus the previous cases tend to be "worst-case" examples --- cases of companies without clever managers or tax advisors. The following illustrates the effect of just one simple corporate tax-avoidance device --- but it is one that might well be used by an Alaska state-sponsored enterprise taking a conventional corporate form.

One way to shelter corporate earnings from double taxation is to treat them as interest rather than profits. In the case of the "leveraged" business corporation whose performance we summarize below, the shareholder's original \$1000 in common shares is replaced by \$100 in common shares, plus \$900 in "junior debt" --- in effect a second mortgage on the corporation's assets. This debt is more risky than the company's regular bonds, because it would be the last to be serviced if earnings were insufficient to meet all the firm's obligations. Hence it is reasonable that this junior debt earn a higher rate of return than ordinary corporate bonds --- say 20 percent. In place of dividends alone, the shareholder now receives a combination of dividends and interest.

Interest, like the profits of a GSOC, is not subject to the corporate profits tax, but is taxed only as income to the ultimate recipient. Thus, under our "leveraging" plan, the same corporate revenues suffer a substantially lower tax burden before they reach the investor.

Compare the after-tax dividends plus interest, and the total earnings, of the leveraged corporation with those of the GSOC. In the lowest tax bracket, according to Table 5, the GSOC retains some dividend advantage, but its edge is very much diminished: In the fifth year, GSOC payments are worth \$207 after taxes, while the leveraged corporation produces 97 percent of that figure, or \$200.

Table 5. Dividends and Interest After Taxes--
20 Percent Tax Bracket

<u>year</u>	<u>GSOC</u>	<u>leveraged corporation</u>	<u>ratio</u>
5	\$207	\$200	104%
20	\$297	\$244	122%

Total earnings including the increase in book value are \$232 and \$217 respectively, a difference of only 6 percent between the GSOC and the leveraged corporation. The GSOC's advantage increases somewhat over the years, but is still substantially less than it was in our earlier comparison with a conventional business corporation.

Table 6. Total Earnings After Taxes--
20 Percent Tax Bracket

<u>year</u>	<u>GSOC</u>	<u>leveraged corporation</u>	<u>ratio</u>
5	\$232	\$217	107%
20	\$336	\$270	124%

At higher incomes, the GSOC's advantage in after-tax earnings disappears, and a taxpayer in the 50 percent bracket may receive more dividends after taxes by holding an interest in a leveraged corporation than by owning GSOC shares.

Table 7. Dividends and Interest After Taxes--
50 Percent Tax Bracket

<u>year</u>	<u>GSOC</u>	<u>leveraged corporation</u>	<u>ratio</u>
5	\$124	\$146	85%
20	\$184	\$190	97%

The increase in after-tax total earnings shows a similar picture:

Table 8. Total Earnings After Taxes--
50 Percent Tax Bracket

<u>year</u>	<u>GSOC</u>	<u>leveraged corporation</u>	<u>ratio</u>
5	\$145	\$160	91%
20	\$210	\$212	99%

GSOC's versus small business organization. As noted earlier, a GSOC is not the only kind of business organization that can avoid double-taxation of its earnings. Proprietorships, partnerships, and Subchapter S small business corporations (which are taxed essentially as if they were partnerships), are also permitted to flow their profits through to their owners untaxed.

The Internal Revenue Code provides similar treatment for these three kinds of business organizations, and here we can lump them all together under the heading small business. One essential difference in accounting and tax treatment between GSOCs and small businesses does concern us here: Subchapter U does not permit a GSOC to benefit from investment tax credits (IIC); any tax credits generated by the GSOC investment must be claimed by the GSOC shareholders on their individual income tax returns.

While the owners of small businesses may (and often do) use the IIC as a tax-shelter for income from other sources, there is nothing in the tax code that prevents them from plowing it back into their businesses; and this is by far their most common use for the IIC. The tables assume therefore that small businesses reinvest any IIC they

earn, (together with their depreciation allowances and 10 percent of their taxable income). Any IIC the GSOC earned, however, is treated as an offset to shareholder tax liability --- that is, as part of shareholder after-tax earnings.

As a result, tables 9 through 12 show that a given investment in a small business will yield at least as much current after-tax income and at least as much after-tax total earnings from a given investment as will a GSOC, in all tax brackets. In most cases, the small business form of organization is substantially more effective in sheltering earnings from the federal tax collector.

The fifth-year figures in table 9 show, for example, that a small business can give a low-income taxpayer 9 percent more current after-tax income than a GSOC; the advantage is 29 percent in the 20th year. (In this case, the heading "current income" may cover proprietor's income or partnership income.) The small business has a 16 percent edge in total after-tax earnings in year 5, and a 38 percent edge in year 20.

Table 9. Current Income After Taxes-- 20 Percent Marginal Tax Bracket

<u>year</u>	<u>GSOC</u>	<u>small business</u>	<u>ratio</u>
5	\$207	\$226	92%
20	\$297	\$384	77%

Tables 10 through 12 show similar patterns for after-tax current income in the 50 percent tax bracket, and for total income in both the 20 and 50 percent brackets.

Table 10. Current Income After Taxes--50 Percent Marginal
Tax Bracket

<u>year</u>	<u>GSOC</u>	<u>small business</u>	<u>ratio</u>
5	\$145	\$166	87%
20	\$210	\$276	76%

Table 11. Total Income After Taxes--20 Percent Marginal
Tax Bracket

<u>year</u>	<u>GSOC</u>	<u>small business</u>	<u>ratio</u>
5	\$207	\$226	92%
20	\$297	\$384	77%

Table 12. Total Income After Taxes--50 Percent Marginal
Tax Bracket

<u>year</u>	<u>GSOC</u>	<u>small business</u>	<u>ratio</u>
5	\$124	\$124	100%
20	\$145	\$166	87%

REINVESTMENT OF GSOC EARNINGS

A business corporation normally does not distribute the bulk of its net earnings as dividends, but keeps them inside the firm to finance new investment. This arrangement is in the interest of both the company and its shareholders: On the one hand, internally-generated funds are usually the cheapest source of new equity capital for the firm. On the other hand, the shareholders are able to take most of their profits in the form of long-term capital gains, which are taxed at lower rates than dividend income --- if at all.

Many highly profitable corporations pay at most token dividends. Indeed, the more profitable the company and, especially, the greater its opportunities for growth, the more its shareholders tend to benefit from a policy of keeping dividend payments to a minimum.

Congress, when it enacted Subchapter U, clearly intended that GSOCs not reinvest the bulk of their earnings. Indeed the chief rationale for exempting GSOCs from corporate income taxes was the idea that they would be direct conduits for earnings like mutual funds, and not accumulators of capital.

Despite this explicit intent, the penalty in tax code on a GSOC that accumulates internal capital is remarkably mild: a 20 percent tax on undistributed earnings exceeding 10 percent of taxable income in any one year. This penalty is still less than half the top tax rate --- 46 percent --- on the income of ordinary corporations, whether that income is distributed or retained. Thus, the frequent assertion that Subsection U prohibits GSOCs from reinvesting their earnings is inaccurate, and we shall see in the following tables what happens to the after-tax dividends and total after-tax earnings of a GSOC that reinvests a substantial part of its profits.

Tables 13 through 16 compare the after-tax earnings on a \$1000 net investment by (1) a GSOC; (2) an ordinary business corporation, all of whose income is exposed to the top rates of the corporate tax; (3) an ordinary business corporation in which the owners each contribute \$100 as common equity and \$900 as junior debt at an interest rate of 20 percent in lieu of \$1000 equity; and (4) a small business taxed as a proprietorship, a partnership, or a Subchapter S corporation. In each case, a firm reinvests 50 percent of its net earnings, in addition to its depreciation allowances and (except for the GSOC) its IIC.

In most respects the results are just what we would expect from Tables 1 through 10. In general, GSOCs produce more after-tax income and grow faster on the same initial investment than ordinary business corporations, and small businesses earn more and grow faster than GSOCs. The contrasts between the figures in Tables 11 through 14 and those of Tables 1 through 10 reflect the general principle that reinvesting means sacrificing current income for future income or capital gains. Comparing Table 11 with Table 1, for example, it is not surprising that reinvesting 50 percent of earnings yields a lower after-tax dividend in year 5 than reinvesting only 10 percent, except in the case of the "leveraged" corporation.

Table 13. Current Income After Taxes, Fifth Year--
20 Percent Marginal Tax Bracket

<u>Reinvestment of percent earnings</u>	<u>GSOC</u>	<u>ordinary business corporation</u>	<u>"leveraged" corporation</u>	<u>small business</u>
10%	\$207	\$140	\$200	\$226
50%	\$119	\$103	\$200	\$139

The contrast in year 20 dividends per share between a corporation which always reinvests half of its income and one that invests only 10 percent is a dramatic illustration of the power of compounding. The reason the leveraged corporation shows its best dividend performance relative to a GSOC in its early years and the poorest comparison in the later years is its large fixed payout (\$180 per share) in the form of interest, and thus the relatively lower proportion of the leveraged corporation's total earnings (profit plus interest) that is reinvested.

Table 14. Current Income After Taxes, Twentieth Year--
20 Percent Marginal Tax Bracket

<u>reinvestment</u> <u>(percentage of</u> <u>taxable income)</u>	<u>GSOC</u>	<u>ordinary</u> <u>business</u> <u>corporation</u>	<u>"leveraged"</u> <u>corporation</u>	<u>small</u> <u>business</u>
10%	\$297	\$197	\$244	\$ 384
50%	\$698	\$306	\$247	\$1,083

The impact on after-tax total earnings of a high reinvestment rate is even greater than its effect on after-tax dividends. In the 20 percent tax bracket the difference is notable even in year 5.

Table 15. Total Earnings After Taxes, Fifth Year--
20 Percent Marginal Tax Bracket

<u>reinvestment</u> <u>(percentage of</u> <u>taxable income)</u>	<u>GSOC</u>	<u>ordinary</u> <u>business</u> <u>corporation</u>	<u>"leveraged"</u> <u>corporation</u>	<u>small</u> <u>business</u>
10%	\$238	\$168	\$217	\$270
50%	\$299	\$220	\$250	\$383

The higher reinvestment rate of course has an even more dramatic impact on total earnings in the 20th year.

Table 16. Total Earnings After Taxes, Twentieth Year--
20 Percent Marginal Tax Bracket

<u>reinvestment</u> <u>(percentage of</u> <u>taxable income)</u>	<u>GSOC</u>	<u>ordinary</u> <u>business</u> <u>corporation</u>	<u>"leveraged"</u> <u>corporation</u>	<u>small</u> <u>business</u>
10%	\$ 336	\$238	\$270	\$ 462
50%	\$1,658	\$708	\$466	\$2,990

THE DANGER OF CASH DEFICIENCIES

Table 17 shows one especially striking implication of choosing to operate a company under Subchapter U of the tax code. A GSOC or a small business that invests 50 percent of its earnings generates no after-tax income at all for a shareholder in the 50 percent tax bracket. In a sense this situation is equivalent to that of an ordinary corporation that retains and reinvests 100 percent of its net income.

In contrast to owners of ordinary common stock, however, GSOC shareholders are liable for personal income taxes on their share of the GSOC's earnings whether or not the GSOC distributes dividends, and totally without respect to any dividends that the GSOC does distribute.

Table 17. Current Income After Taxes, 50 Percent Reinvestment--
50 Percent Marginal Tax Bracket

<u>year</u>	<u>GSOC</u>	<u>ordinary</u> <u>corporation</u>	<u>"leveraged"</u> <u>corporation</u>	<u>small</u> <u>business</u>
5	-1	79	102	0
20	-3	288	212	0

In table 17, therefore, we see a major danger to shareholders arising from the very aspect of the GSOC that makes it an attractive form of business organization --- "tax integration" --- together with a serious limitation on the GSOC's management and investment flexibility.

In at least one plausible combination of circumstances, therefore, the sum of GSOC dividends and ITC are barely enough --- or not quite enough --- to cover the additional personal tax liability that the GSOC's earnings have created for its shareholders. This situation can be expected to arise, under the assumptions used in this analysis, any time reinvestment of earnings approaches 50 percent.

Actually, Table 17 understates the seriousness of this potential problem because:

1. The table assumes that the GSOC passes on to its shareholders substantial ITC benefits every year, which can be used to offset additional tax liabilities. It is quite probable, however, that a large part of GSOC investment will be in assets such as land, existing plant and equipment, and working capital which do not generate any ITC.

2. The table assumes there are no claims against GSOC earnings other than reinvestment and payment of dividends --- specifically that depreciation allowances will always generate enough cash to amortize any outstanding debt.

3. There is nothing in the GSOC scheme that rules out a situation in which the corporation earns a taxable income --- and thus creates a tax liability for its shareholders --- and yet is unable to pay them sufficient dividends to offset that tax liability.

It will be intolerable if any group of shareholders is put into a negative cash position as a result of owning GSOC stock. Such a situation clearly can come about, however,

with reinvestment rates considerably less than 50 percent, and there are plausible circumstances in which it might arise even if there were no reinvestment at all.

Consider, for example, a GSOC that had to pay off initial borrowings of \$1,000 per share out of its earnings over a period of ten years. Assume that it earns only 15 percent, or \$150 per share, instead of the 25 percent projected by its organizers (which would have permitted the GSOC to pay sufficient dividends to cover the additional tax liabilities for all classes of shareholders). Only \$50 per share thus remains for distribution as dividends --- and to pay the 20 percent added tax Subsection U imposes on undistributed earnings in excess of 10 percent of taxable income. The maximum dividend payment would therefore be \$28.75 per share.

Table 18. GSOC Income Available for Distribution (per share)

Taxable income	\$150.00
(Less) amortization	100.00
(Less) penalty tax	<u>21.15*</u>
<u>Available for Distribution</u>	\$ 28.75

*[20% x (90% x \$150.00 - \$28.75)]

The shareholders' tax liability does not depend upon the dividends they actually receive, however, but upon their portion of the corporation's taxable income, which is \$150 per share. Thus, owning a GSOC share will increase each shareholder's tax bill. A taxpayer in the 20 percent bracket will have to pay an additional \$30.00 per share in personal income taxes, while a taxpayer in the 50 percent bracket will have to pay \$75.00. Both of these figures exceed cash flow available to the GSOC for payment of dividends.

Table 19. GSOC Dividends and Shareholder Tax Liability

<u>marginal tax bracket</u>	<u>dividends</u>	<u>increased tax liability</u>	<u>income deficiency</u>
20%	\$28.75	\$30.00	\$ (1.25)
50%	28.75	75.00	(46.25)

In this quite plausible instance, therefore, ownership of GSOC shares has put taxpayers of every bracket into a negative cash position. This scenario is not the worst possible one; the reader can surely conceive of even more troublesome situations.

There is little doubt that a GSOC can theoretically capitalized and operated so as to avoid any danger that the personal tax liabilities of any shareholder group would ever exceed its dividend distributions. To be quite safe, however, such a GSOC probably must ---

1. Limit its borrowing, both for its initial capitalization and for expansion, to levels at which the GSOC can meet its debt service obligations out of depreciation allowances alone in all events, without ever having to rely on taxable income;
2. Begin with and keep a substantial equity cushion in the form of initial paid-in capital and surplus, or retained depreciation allowances and profits; the GSOC will have to maintain such a reserve in order to cover any short-term losses and to pay sufficient dividends in every year to cover each shareholder's tax liabilities if, for any reason whatsoever, there is not sufficient cash flow from current operations; and
3. Give up any notion of financing its expansion out of retained earnings.

A GSOC's tax advantages, in brief, comes at a high price to the corporation in flexibility regarding the kind of business it can operate, in the range of prudent capital-

ization plans available to it, and in the ability to respond to new investment opportunities. In many instances, surely, these costs will more than offset the benefits of operating under the provisions of Subchapter U. Indeed, we cannot be certain that there is any kind of investment in Alaska, or any strategy for distributing private wealth more broadly among individual Alaskans, for which a GSOC is clearly the most suitable form of business organization.

PART II. AGSOC FINANCING AND INVESTMENT STRATEGY

HOW IS AGSOC TO BE FINANCED?

AGSOC's advocates intend that individual Alaskans will each receive at least one share of stock at no charge to them. Whether the AGSOC financing plan requires the use of state government revenues is not so easy to determine.

Until recently, state loan guarantees were clearly a crucial part of the AGSOC concept. For example, Senator Gravel's press release of March 29, 1978 stated:

What [Mr. Kelso] has proposed, basically, is this: the people of Alaska could, through the offices of the state, form a corporation which would finance and own a portion of the new pipeline. The state would assist in securing the money which would establish the corporation, and the money would be paid back to the lenders out of the profits generated by the pipeline. [emphasis added]

Senator Gravel, in his April 10, 1978, Response to Several Questions Concerning the Alaska General Stock Ownership Plan, answered one question as follows:

Up front cash, a question also raised, need not be required. The only State appropriation required would be for the study, so that the Alaskan GSOP could be properly launched. Any operating or investment monies that it needs could be borrowed. The loans in question, at the beginning, would have to have a State government guarantee, but not an appropriation. In fact, the Alaskan GSOP could even repay the moneys expended by the State in setting it up. The guarantee, if the investment is sound, need pose little risk . . . [emphasis added]

Louis Kelso, et al., in a February 1979 report, Design of an Alaskan General Stock Ownership Plan, included a proposed "Act Establishing Alaska General Stock Ownership

Corporation." Section 11 of the draft provided for special sessions of the legislature and special elections to approve state treasury backing for AGSOC projects:

Section 11. SPECIAL SESSION TO APPROVE FINANCING. It is the intent of the legislature that at such time as AGSOC comes forward with a request for project financing that the Governor shall call a special session of the legislature to consider such request. . . In the event that the legislature shall determine that financing or the guaranty of financing for an AGSOC project is necessary or desirable, the legislature shall at the earliest convenient time call a special election . . . for voting on the approval of the extension of credit to AGSOC by the State of Alaska, or the guarantying [sic] by the State of Alaska or by any agency or instrumentality thereof of the credit of AGSOC.

In support of the bill, the Kelso report offered the following "Analysis Recommended for Inclusion in the Legislative Financial Committee Report to Accompany the AGSOC Bill:"

The average citizen does not have effective access to credit for capital formation because he does not have existing wealth to guarantee the lender's risk. However, joined together with his fellow citizens through his State government he has tremendous borrowing power. The security of a State guarantee can perform the same guarantee function for the average citizen which existing capital does for the wealthy. Through the power of State government the typical citizen can leverage himself into a capital asset which will pay for itself and throw off income to him and his neighbors and his children. [emphasis added]

Recently, however, publicity efforts in favor of AGSOC have begun to downplay or disavow any notion that a GSOC would require state financial support (other than for its initial organizing expenses). At a hearing of the House Finance Committee on November 2, 1979, for example, Senator Gravel argued at length that AGSOC had nothing in common with Governor Hammond's proposed energy credits or Alaska, Inc., because AGSOC was not a plan to distribute benefits of

the state's oil wealth among private citizens. AGSOC, Senator Gravel insisted, did not depend on state revenues in any way, and he specifically objected to the assumption that AGSOC would require state loan guarantees for its initial capitalization: "It is a concept just as valid for Chad as for Alaska."

The AGSOC Educational Committee's recent campaign brochure, "It's Time to Take Stock in Alaska", is categorical on this point:

Once AGSOC was formed, it would operate independently of the state.

AGSOC would borrow money from banks, insurance companies and other large institutional investors. These lenders would loan their money on the strength of investments proposed by AGSOC and eventually on the financial strength of AGSOC itself.

If any AGSOC investment should fail, the lenders would not be able to recover any money from the shareholders. They could only look to the AGSOC itself for AGSOC debts. [emphasis in original]

Senator Gravel's current campaign for AGSOC and the propaganda of the AGSOC Educational Committee thus clearly reject the notion that the Corporation's financing will depend upon a state equity contribution or state loan guarantees. But the question is not thereby laid to rest. In the following pages, we shall examine whether or not 100 percent non-recourse debt financing is a realistic hope for AGSOC under any circumstance, and if so, for what kinds of investments. To the extent that AGSOC can not be capitalized without a direct appropriation or guarantees from the state, however, we shall consider the implications of such assistance, both for the state budget and for AGSOC's shareholders.

PRINCIPLES OF FINANCING

All investments are risky, and some are riskier than others. Business risks include market setbacks that can be unique to a particular firm or reflect general economic conditions; increased costs for labor, materials or services; accidents, strikes, and disasters; management mistakes, incompetence or dishonesty; unpleasant surprises from new technologies or unfamiliar environments; cost overruns or delays in plant construction or in delivery of equipment; and changes in laws, regulations, or taxes.

The first principle of debt financing is that lenders do not voluntarily assume any of these risks. Of course, some borrowers do become delinquent or default on loans; the spread in interest rates charged to different borrowers reflects this experience. In order to minimize risk, however, business lenders invariably require one, and usually both, of the following assurances:

1. The venture's projected cash flow from current operations must be sufficient to make all scheduled payments of principal and interest on time --- even under the worst plausible circumstances, and with some margin to spare; and

2. The borrower or a creditworthy third party must pledge sufficient collateral in the form of saleable assets or unrelated income to pay off the entire loan plus accumulated interest, even if the venture in question fails totally, i.e., generates no cash flow.

These requirements are normally met by the borrower's equity in the venture. Investors expect the return of and on equity to provide the business with a substantial margin of cash flow in excess of its fixed costs, which include repayment of principal and interest on debt. Hence, profits

may fall drastically, or the business may even run considerable losses for a long time, before it can no longer cover its debt service obligations out of current revenues. The shareholders' equity itself provides collateral that lenders can attach and liquidate if necessary, should the business fail to generate enough cash to meet its obligations.

It follows, therefore, that the more equity there is in a company's capital structure, the less likely it is that revenues will fail to cover operating expenses and debt service. Conversely, the more leveraged a firm's capital structure, that is, the higher the percentage of debt, the greater the danger that, for some reason, revenues will not be adequate.

For this reason, the financing of business ventures with anything approaching 100 percent debt (as Senator Gravel now proposes for AGSOC acquisitions) is extremely rare. Most firms have a capital structure about evenly divided between equity and debt. The 1978 debt of the top 50 manufacturing companies in the Fortune 500, for example, was 51 percent of their total assets; only 7 of the 50 had debt ratios greater than 60 percent. Even for the 50 top utility companies, debt was only 62 percent of total assets, and among them there were just two that had debt ratios exceeding 75 percent.

In support of their claim that AGSOC could finance its acquisition of business plant and equipment entirely with non-recourse borrowing, Senator Gravel and other AGSOC advocates have cited examples of several kinds of financing that seem to contradict the principles we have outlined, but it is important to look carefully at such examples. The following cases illustrate most of the circumstances in

which individuals, firms, or governmental entities are able to make highly leveraged investments. In very few of the examples is the borrower truly exempt both from contributing substantial equity to the venture, and from pledging some other kind of security in place of equity.

PROJECT FINANCING: ELEVEN CASES

Case 1: Commercial real estate. An Anchorage businessman buys an office building for \$1 million --- and a friendly local banker assigns the property a value of \$1.4 million in order to lend the buyer \$1.15 million. The building is fully leased, so that its cash flow can easily cover payments on a mortgage of this amount. Our businessman not only acquires an income-generating asset with no down payment, but walks away from the closing with \$150,000 in cash!

Can the buyer truly finance such a purchase without any equity investment? Is the bank really assuming the risk that the building may be half-empty next year and thus fail to bring in enough cash to cover the mortgage payments? Not really, because the buyer, who has a net worth of \$3.5 million, personally signed the note. The bank's security for its \$1.15 million is, therefore, not a building worth \$1 million, but \$4.5 million --- the value of the building plus the owner's net interest in other properties.

Case 2: Commercial real estate. A Texas oil billionaire buys and finances an Anchorage commercial building on the same terms as the local businessman in Case 1, but in this instance the Texan does not personally sign the note.

Is this a case of 100 (or 115) percent debt financing? Not quite, because the oilman's total income and assets are implicit security for the loan, at least as good as the borrower's signature in Case 1. The bank has no reason to doubt the borrower's ability or his motivation to pay, even if the investment in question turned out to be a bad one: For him to renege on this relatively small loan would be a near scandal, and would cost the oilman more in damage to his business reputation and credit standing than he would save by defaulting on the debt.

Case 3: Oil pipeline. The oil companies that built the IAPS oil pipeline each financed its own share of the project with 90 to 100 percent borrowed funds.

Are the owner companies' equity contributions really less than 10 percent of the pipeline's total cost? This case is just like Case 1: Each of the companies put its entire worldwide assets at stake, so the 40 to 60 percent debt ratios of the parent companies are the real capital structure, not the apparent 90 to 100 percent debt covered on the books of their pipeline subsidiaries.

Case 4: Electrical generating plant. An electric utility builds a new generating plant, and sells bonds that pay the entire cost of the facility.

Is this a 100 percent debt financing? Once more, not really, because the debt is secured by the utility's other assets and its total income. The willingness of lenders to fund the new plant will not depend on the income from that facility alone, but rather on the projected coverage ratio for the utility's entire operations. Each future year's cash flow available for debt service must be some multiple of --- usually at least twice --- its anticipated debt service requirement.

Case 5: Electrical generating plant. A consortium of electric utilities has formed a joint venture to build a new generating plant. The plant is project-financed: The utilities establish a new corporate entity financially independent of all the sponsoring companies. The new corporation then borrows 100 percent of its long-term capital needs on a non-recourse basis, meaning that the parent companies do not guarantee the debt.

Surely this is a true 100 percent debt financing? Yes and no. Lenders have no direct recourse against the sponsoring utilities' other assets in event of default, but project financing is possible only because the utilities have signed all-events, minimum-bill contracts to buy the project's electrical output.

In some instances, lenders prefer this form of project financing to conventional balance-sheet financing, because regulatory commissions and bankruptcy courts will allow the parent utility to continue paying its operating costs which include current costs for the purchase of electricity even if the parent utility's own bonds are in default. This arrangement in effect makes the cash outlay serving the project's bonds senior to all debt instruments previously issued by the sponsoring utilities.

An absolute prerequisite for this form of non-recourse project financing of gas or electric utility investments is perfect tracking --- arrangements guaranteeing that no regulatory commission will ever prevent the utilities who sign all-events, minimum-bill service agreements from passing these charges on to final consumers, no matter how many separate transactions and regulatory jurisdictions may be involved.

Case 6: LNG terminal. A group of gas utilities are jointly building a terminal to receive liquefied natural gas (LNG) by tanker and to regasify it for delivery into their gas distribution networks. Long-term financing will be 25 percent equity and 75 percent non-recourse debt, secured by full-cost-of-service-contracts signed by the sponsoring utilities and approved by the state and federal regulatory commissions that have jurisdiction over the utilities.

The commissions have turned down sponsors' requests to begin customer billing for servicing debt during the construction phase. Instead of putting construction work in progress (CWIP) into their present rate base the companies must capitalize the allowance for funds used during construction (AFUDC) --- the return to debt and equity accrued during the construction period --- and begin billing consumers only after the plant goes into service. Thus the lenders can be expected to insist upon external loan guarantees during the construction phase, though they may be willing to accept non-recourse financing terms once operations begin.

Case 7: Ship construction. A group of investors has formed a limited partnership to build and charter an oil-industry service vessel (a heavy-duty ocean-going tug for moving and servicing offshore drilling rigs). Financing for the \$2 million vessel will consist of a conventional 12 year bank loan for 65 percent of the cost and a 5 year second mortgage from a finance company for 25 percent. Taking the 10 percent investment tax credit (IIC) into account, the investors will not have to make any long-term equity contribution, and they might even recover all of their organizational and promotional expenses out of the loan proceeds.

How can these investors manage without equity? Collateral for a 65 percent conventional loan is the value of the vessel itself. Since the ship's value is insufficient to serve as collateral on the second mortgage as well, a boat charter to a major oil company assures the necessary cash flow for a period of three years to cover payments on both loans. The holder of the second mortgage insists, however, on some security for the fourth and fifth year payments on his loan; to accomplish this, he requires the owners (during the three year charter period) to set aside a certain part of their profits in a sinking fund which can meet the fourth and fifth year payments if necessary.

Case 8: Ship construction. A transportation company built a \$50 million U.S. flag tanker with an equity contribution of only \$2.5 million, without a charter and indeed without any clear idea of where the tanker will be used.

How? Seventy-five percent of the total price was borrowed from financial institutions on the strength of a U.S. Maritime Administration (Marad) loan guarantee under Title XI of the Merchant Marine Act. Another 10 percent was a direct loan by another federal agency that was trying to preserve shipyard jobs in a community with high unemployment rates. Addition of the 10 percent Investment Tax Credit left the owners with a need to supply only five percent of the project cost from their own resources.

Case 9: Public works. A school district plans to sell bonds for a construction program and to finance the construction entirely out of the bond proceeds.

Is this 100 percent debt financing? Once more, yes and no. Because the bonds are "general obligation" bonds, they are backed by the school district's taxing authority. The marketability of the bonds depends upon the lenders' assess-

ment of the district's tax base, its other debt service obligations, and its legal and political capacity to levy whatever taxes are necessary to service the debt.

Case 10: Public works. A state toll road authority sells bonds to finance turnpike construction, and pays for that construction entirely out of loan proceeds.

Is this 100 percent debt financing? Maybe. The bonds are revenue bonds, secured completely by tolls without recourse to the state's general fund. The ability of the authority to sell these bonds, however, depends upon convincing lenders that tolls from the project will be sufficient to cover all debt service obligations with some margin of safety and that the authority is legally and politically capable of increasing tolls on this project or on others in order to make up any deficit.

Case 11: Housing.

(a) In the late 1960's and early 1970's some prominent banks formed real estate investment trusts (REITs) to develop rental housing and condominiums. The REITs were 80 to 100 percent capitalized by loans from a variety of financial institutions and individuals. In the mid-1970's, however, cost overruns, construction delays, and high vacancy rates caused a number of REITs to fail, costing the lenders hundreds of millions of dollars.

(b) The government of an eastern state formed a public corporation to build middle-income housing. Construction was funded entirely by sale of bonds that were to be serviced from rent receipts. Here again, cost overruns, construction delays, high vacancy rates, and tenant resistance caused the housing corporation to become delinquent in its debt service payments, creating substantial losses for the bondholders.

Why did the lenders make such poorly-secured loans? In each case, they thought that the debt carried an implicit guarantee from a creditworthy sponsor as in Case 2. In the first instance, the association of prominent banks with the REITs led lenders into assuming these banks would take responsibility for REIT debts. In the case of the state housing corporation, the governor (who was himself a financier of sorts) had styled the corporation's debt as "moral obligation bonds," despite the fact that the bonds themselves provided no explicit recourse against the "full faith and credit" of the state. Ironically, some of the same banks that walked away from the debts incurred by their REITs were fooled into believing that the state government would stand behind its own housing subsidiary.

. . . AND THEIR IMPLICATIONS

The preceding examples show that it is indeed possible to borrow all or almost all the funds needed for a business venture, but only if:

(1) The debt is secured by recourse against other assets or income of the borrower, either express (cases 1 and 3) or implied (cases 2 and 11), or by a guarantee from a creditworthy third party (such as the federal government in case 8);

(2) The debt service is assured by a contract that commits creditworthy purchasers to pay the venture's full cost of service, or at least to pay a minimum bill that covers its fixed costs "in all events," or "come hell or high water" (cases 5 and 6); or

(3) The borrower is (a) a regulated utility, fully assured that the regulatory authorities will allow it whatever rates may be necessary to service its debt (case 4), or (b) an unregulated monopoly or a governmental body with the power to set its prices or levy taxes, at whatever level may be necessary to service its debt (cases 9 and 10).

While these three conditions do not absolutely rule out any possibility of financing AGSOC ventures without either a state appropriation or a state loan guarantee, they do stringently narrow the investment options for any state-sponsored enterprise that starts without equity and without the ability to pledge the state's credit.

Our cases illustrate at least two more principles relevant to the outlook for financing AGSOC investments:

(1) With a governmental loan guarantee, it is possible to borrow even on a patently unsound business enterprise, like the shipbuilding venture in case 8 (or the Chrysler Corporation's 1981 model year). The state's credit is thus capable of making almost any AGSOC enterprise financible, but it does not thereby make it a sound venture.

2) It is sometimes possible to persuade lenders that an implicit loan guarantee from government exists for bonds that are really only revenue bonds, or that an implicit guarantee from a creditworthy entity attaches to loans that on their face are non-recourse debt.

Conceivably, therefore, AGSOC could borrow more money for one of its business ventures than would normally be prudent for either AGSOC or the lenders, but only on the condition the loan were guaranteed by the state treasury, or where the lenders believed that AGSOC's political influence (or the state government's fear of damage to its own credit standing) would force the state to cover AGSOC's debts even in the absence of a legal obligation to do so.

Notwithstanding the possibility that AGSOC's initial investments could be financed with 100 percent non-recourse debt on the strength of the state's "moral obligation" alone, the probability is very small --- because of recent experiences like those of case 11, because of the capital market's unfamiliarity with GSOCs as a form of business

enterprise, and because of the political controversy in which an Alaska GSOC would likely be born, and the controversy that would certainly surround it if it got into financial trouble.

PUBLIC UTILITY INVESTMENTS

The preceding discussion leads toward one strong conclusion about AGSOC financing: The only kind of business that a GSOC has much hope of financing with a capital structure containing even 75 percent (not to mention 100 percent) non-recourse debt, is one with a guaranteed market at a guaranteed price. This probably means either regulated utility property, or facilities serving regulated utilities through long-term, cost-of-service contracts.

The fact that almost every urban transit company and most of the major railroads in the United States have gone into bankruptcy at one time or another is ample evidence that regulated industries are not necessarily riskless enterprises. Electric, gas, and telephone utilities have tended to be relatively safe investments, however, because (until recently) they have enjoyed the lucky combination of rapidly expanding demand and falling real costs. Nevertheless, risks do exist even in these industries. While new project-financed gas or electric ventures secured by all-events, minimum bill service agreements have managed to obtain financing based on only 25 percent equity, the typical utility company has had to maintain about 40 percent equity in its overall capital structure. The various segments of the Alaska Highway gas transportation system, all to be owned by newly-created entities of utilities and others, plan ratios in the vicinity of 75/25.

Where a project's revenues are effectively guaranteed by regulation or by a long-term contract with a regulated utility, lenders are much less concerned about the project's capital structure. Instead, they scrutinize its coverage ratio --- the cash flow available for debt service as a multiple of the total debt service obligation. Here, a GSOC might appear to have a distinct advantage over a conventional firm; the following discussion will show why.

Implications of GSOC's tax exemptions. As we noted in Part I of this report, the singular advantage of a GSOC over an ordinary business corporation is the fact that Subchapter U of the Internal Revenue Code exempts the GSOC's profits from being taxed twice, first as corporate income and once more as dividends to shareholders. To the extent AGSOC does not pay federal income taxes, more cash should be available out of a given stream of revenues to service debt than would be the case for a fully taxable company.

Consider, for example, a project-financed investment with a cost of \$1 billion undertaken by a conventional corporation and a GSOC respectively. Assume that:

- (1) Either venture would produce a contractually-guaranteed net operating income (revenues less operating costs) of \$250 million;
- (2) Interest is 10 percent annually, and debt is amortized on a straight-line 20 year schedule; and
- (3) The GSOC pays no corporate income taxes, while the ordinary corporation's earnings are taxed at 45 percent.

Suppose that lenders demand a coverage ratio (a ratio of current cash flow to debt service requirements) of 1.9 or higher on this kind of project. The table below shows that

an ordinary corporation would be able to borrow about 75 percent of its capital requirements and a GSOC about 85 percent, without bringing their respective coverage ratios below 1.9.

Table 20. Cash Flow: GSOC Versus An Ordinary Corporation
(millions of dollars)

			<u>ordinary corporation</u>	<u>GSOC</u>
a	Equity		\$250	\$150
b	Debt		\$750	\$850
c	Net operating income	\$250	\$250	\$250
d	(Less) depreciation	\$100	100	100
e	(Less) interest	10% of debt	75	85
f	Taxable income	(c - d - e)	\$ 75	\$ 65
g	(Less) corporate tax	45% of f	33.75	0
h	Net income	(f - g)	\$ 41.75	\$ 65
i	Debt amortization	5% of debt	\$ 37.50	\$ 42.50
e	Plus interest	10% of debt	75.	85.
j	Total debt service	(i + e)	\$112.50	\$127.50
d	Depreciation	\$100	\$100	\$100
e	Plus interest	10% of debt	75.	85
h	Plus net income	(f - g)	41.75	65
k	Available cash flow	(d + e + h)	\$216.75	\$250
l	Coverage ratio	(k/j)	1.92	1.96
m	Return on equity	(h/a)	16.5%	43.3%

Note that the GSOC's preferential corporate tax treatment results in an after-tax rate of return to shareholder equity almost three times that of the conventional corporation, but that the GSOC is still unable to get by completely without equity of its own. In the real world, a GSOC's advantage would probably be much less than the illustration above suggests, because:

1) As noted in Part I, few conventional corporations are actually taxed at the maximum rates of the corporate income tax.

2) A conventional corporation can benefit directly from the investment tax credit (ITC), while a GSOC can not. (Any ITC earned by a GSOC must be claimed by its shareholders on their personal tax returns.) This feature alone may completely negate the apparent advantage the GSOC's corporate tax exemption gives it in financing!

3) The GSOC's apparent advantages in Table 20 both in financing and in return to equity, depend entirely upon the questionable assumption that the state or federal regulatory commission having jurisdiction over a GSOC-owned utility project would permit it to retain its tax savings rather than requiring them to "flow-through" for the ratepayers' benefit.

Considering only the role of the ITC, the effective sources of investment funds for the two firms described previously will be changed to the following:

Table 21. Financial Requirements, GSOC Versus Ordinary Corporation

	<u>ordinary corporation</u>	<u>GSOC</u>
a Equity	\$150 Mil.	\$150 Mil.
a' Investment tax credit	100	0
b Debt	750	850

All other figures on the two income statements would remain the same except the bottom line. The GSOC's financial advantage has disappeared, but it still has an edge in rate of return to shareholder equity (though considerably reduced):

h Net income	(f-g)	\$ 41.75	\$ 65
m Return to equity	(h/a)	27.8%	43.3%

Allowed earnings of regulated utilities. The reasoning and behavior of regulatory commissions are neither wholly uniform nor wholly predictable, and the various state and federal regulatory commissions differ greatly in their treatment of tax issues, for example accelerated depreciation. But it is quite unlikely that any commission having authority over a utility investment in Alaska would leave AGSOC's federal tax savings intact.

Most commissions (including the Federal Energy Regulatory Commission [FERC] in its jurisdiction over wholesale electricity transactions and the interstate transportation of natural gas, and the Alaska Public Utilities Commission [APUC], in its jurisdiction over the distribution of locally-produced gas and electricity in Alaska) treat income tax liabilities as a specific component of the utility's cost of service. Thus, if the utility's tax liability is reduced or eliminated, its rates will be reduced by exactly the same amount.

Suppose, for example, AGSOC were to own a major hydroelectric or coal-fired generating plant in Alaska. The Alaska Power Administration (federal), the Alaska Power Authority (state), the Anchorage and Fairbanks municipal utilities, or the Golden Valley and Chugach Electric Associations (cooperatives) are also tax-exempt. None of these utilities charges its ratepayers for non-existent corporate taxes. None of them computes the interest on its tax-exempt bonds or low interest loans from the United States Treasury at the rates they would have had to pay private lenders in the taxable corporate bond market. How then, could APUC justify allowing an AGSOC-owned utility project to add taxes that it does not pay to the bills it sends Alaska consumers?

Consider, alternatively, a project whose ultimate ratepayers are mainly consumers outside Alaska, as would

be the case with an AGSOC investment in IAPS or the Alaska Highway gas pipeline. Once again, FERC builds up a regulated firm's allowable rates out of specific cost elements, including corporate income taxes.

Treatment of IIC. While regulatory commissions normally require a flow-through of any tax exemption to the ratepayers, the Internal Revenue Code virtually prohibits a flow-through of the investment tax credit. The law denies IIC to any utility if the regulators reduce either the size of its rate base or the rate of return to that rate base on account of the IIC. In the incentive rate of return (IROR) proceeding for the Alaska natural gas transportation system, for example, FERC interpreted the tax law as compelling it to ignore the IIC totally in setting the pipeline tariff. Thus, the joint effect of utilities law (flow-through of tax exemptions) and the tax code (no flow-through of IIC) may be fatal to AGSOC as a vehicle for investment in regulated industries.

Assume, for example, that FERC or APUC allowed an AGSOC-owned project to collect the only same 16.5 percent rate of return to equity it found fair and reasonable for the conventional private utility whose accounts are summarized in Table 20 and repeated in the first column of Table 22 below. The second column shows that the GSOC could not actually borrow 85 percent of its capital requirement as we assumed in Table 20, because its resulting debt service coverage ratio would be only 1.65. Thus, the GSOC's borrowing capacity would be only 75 percent of its total investment, just like that of the ordinary corporation.

But, as we can see in the third column below, the GSOC's effective loss of the corporate tax advantage with respect to utility investment would leave it with an earnings capability even less than that of an ordinary corporation.

TABLE 22. Effect of Flow-Through and Investment Tax Credit on GSOC and Ordinary Utility Cash Flow

(millions of dollars)			GSOC	
		ordinary corporation	85% debt	75% debt
a	Equity	\$150	\$150	\$250
a'	Investment tax credit	100	0	0
b	Debt	750	850	750
c	Net operating income	\$250	\$209.75	\$216.75
d	(Less) depreciation	\$100	100	100
e	(Less) interest	10% of debt	85	75
f	Taxable income	(c - d - e)	\$ 24.75	41.75
g	(Less) corporate tax	45% of f	0	0
h	Net income	(f - g)	\$ 24.75	\$ 41.75
i	Debt amortization	5% of debt	\$ 37.50	\$ 37.50
e	Plus interest	10% of debt	75	75
j	Total debt service	(i + e)	\$127.50	\$112.50
d	Depreciation	\$100	\$100	\$100
e	Plus interest	10% of debt	85	75
h	Plus net income	(f - g)	24.75	41.75
k	Available cash flow	(d + e + h)	\$209.75	\$216.75
l	Coverage ratio	(k/j)	1.65	1.93
m	Return on equity	(h/a)	16.5%	16.5%

To summarize the preceding pages, it appears that:

- 1) The chance of AGSOC financing major investments with 100 percent non-recourse debt is virtually non-existent.
- 2) The only investments AGSOC is likely to finance with a high proportion (75 percent or more) of non-recourse debt are projects with a contractually-guaranteed market and price over the life of the debt;

3) Non-recourse financing will be available even under these circumstances only for completed projects, projects that have virtually no risk of prolonged delay, non-completion or premature abandonment, or projects in which the customers accept these risks; and

4) A GSOC's special tax treatment does not give it any advantage, and may in fact be a handicap, in financing regulated utility projects.

The preceding pages examined the opportunities and limitations for a GSOC with respect to general classes of investments and financing schemes. Now we shall look at the prospects for making specific investments, including those that have been proposed by the most prominent sponsors of the AGSOC concept.

BRITISH PETROLEUM'S INTEREST IN TAPS

The investment most often suggested by Senator Gravel and other advocates of AGSOC is the British Petroleum (BP) interest in the Trans Alaska pipeline system (TAPS). BP retains a 15.84 percent undivided interest in the pipeline, despite the fact that it has transferred its operating interest in the Prudhoe Bay field, and a 33.34 percent interest in TAPS to its affiliate, Sohio. BP officers have hinted that the company would be willing to sell its interest if the terms were right, and have held preliminary discussions with Senator Gravel, Alaska state officials, members of the legislature, and investment advisors regarding possible terms.

TAPS is an undivided interest pipeline, which is (curiously) the term for a joint-venture pipeline in which each of the several owners arranges its own financing, keeps

separate books, files its own tariffs, and accepts separate "tenders" (proposals to ship oil) from shippers, as if it owned and operated a physically separate pipeline. Alyeska Pipeline Service Company does not own IAPS, but is only a non-profit service corporation that schedules shipments, operates and maintains the system, and sends monthly bills to each of the eight IAPS owners for its proportion of the pipeline's operating costs.

If IAPS were a single corporate entity in which each oil company was a shareholder, rather than an undivided-interest venture, there would be no reason even to consider an AGSOC purchase of the BP share, as Subchapter U denies its special tax exemption to any dividends a GSOC might receive from another corporation. (It also forbids a GSOC to own more than 20 percent of any other corporation, but this provision is not at issue here, as BP's interest in IAPS is less than 20 percent.)

Financing the purchase. Senator Gravel and Louis Kelso [in Kelso & Co.'s December 7, 1978, memorandum to the state] assume that AGSOC's purchase of the pipeline share would be 100 percent debt-financed. AGSOC could either (1) buy the property for cash and arrange its own bond issue, or (2) assume BP's debt and issue new debt in AGSOC's name only to pay for BP's equity interest in the pipeline.

Either course would require the state to guarantee AGSOC's bonds: BP's present creditors would surely refuse to exchange the liens they now hold against the worldwide interests of British Petroleum for a practically worthless claim on AGSOC assets. The bondholders might be willing to accept the state of Alaska as a substitute guarantor in place of BP, but it would be unreasonable to expect BP to maintain its existing billion-dollar-plus guarantee on a pipeline that it no longer owned --- unless the state were willing to backstop this liability.

Assuming, however, that AGSOC could somehow refinance the pipeline, the proposed AGSOC purchase invokes some more fundamental problems:

Purchase price. What will the purchase price be? Kelso & Co. seem to assume that the price will be the pipeline's book value at the time of sale. This assumption, however, begs the question of what "book value" really means in this context. Is it the ICC valuation (which was used in fixing the initial tariffs), or BP's net pipeline assets according to generally accepted accounting practices (GAAP)? There is no reason, in fact, to assume that BP would be willing to sell at either price, or at any price that is even remotely related to either of them.

Tariff conditions. Moreover, until FERC decides what ratemaking methodology it will require oil pipelines to use in the future, it is impossible to estimate the pipeline's real worth to either party with much confidence. The Commission may retain the old ICC concept of valuation, under which pipeline rates can be expected to increase with inflation, as FERC's Chairman, Charles Curtis, has repeatedly suggested.

Under the latter method (whose advocates in the ICC and FERC proceedings included the U.S. Justice Department, FERC staff, and the state of Alaska), a 100 percent debt-financed pipeline would not be entitled to any profit at all, because it would have no equity in its rate base on which to earn a profit. Until FERC finally defines its oil pipeline ratemaking methodology, therefore, any estimate of the value of a share in IAPS is quite conjectural and, further, poses the danger that a highly-leveraged investment might all but destroy its profitability.

Only after this proceeding is completed can one even begin to calculate the pipeline property's value to AGSOC or any prospective purchaser. This value is, of course, based upon the stream of net income the owner would expect to receive, discounted to the present. But, as we explained previously, it is extremely unlikely that FERC would allow a GSOC-owned pipeline to add non-existent corporate income taxes to its rates, regardless of which of the two basic ratemaking principles it finally adopts. Thus, in the most probable circumstance, there would be no real advantage to a GSOC investment in the line, and further inquiries into its worth from the buyer's standpoint would be futile.

If by chance, FERC did permit AGSOC to extract a larger net income from the pipeline tariff each year than BP, because of the Subchapter U tax exemption, the property would be worth more to AGSOC than to BP. Both companies could, therefore, benefit from the sale of the TAPS interest at any price less than its worth to AGSOC and more than its worth to BP. (That price must of course compensate BP for any capital gains taxes it has to pay as a result of the sale, as well as for the present value of future pipeline earnings.)

But where, within this range of prices will the deal be cut? There is no confident way to answer such a question: it is a matter for bargaining. BP, however, would tend to have the stronger hand because it has no compelling need to sell its interest in the pipeline, while AGSOC's management would be under pressure to buy something if only in order to justify its own existence. In any case, the final price is likely to be substantially higher than the pipeline's current worth as seen by BP: the bargaining process will surely enable BP to extract from AGSOC some part of whatever added worth the latter's tax-exempt status might convey to the pipeline property.

Risk. Thus, the BP pipeline purchase is at best a wild gamble for AGSOC. Granted, deals are in fact made in the face of great uncertainty --- oil and gas lease sales, for example --- but for this one, every omen is unfavorable. Kelso & Co.'s own cash flow scenarios [loc. cit.] make unreasonably optimistic assumptions regarding the purchase price and FERC's treatment of AGSOC's tax exemption, plus an additional unsupportable assumption that pipeline throughput will remain steady for 20 years at either 1.2 or 1.6 million barrels per day.³ Despite these biases, many of Kelso's own scenarios show only trivial payouts to AGSOC shareholders, and others even show losses.

The purely financial risks to AGSOC in such a purchase are monumental, particularly if a large fixed debt-service obligation caused by 100 percent debt financing reduces the margin for error to the barest minimum. Senator Gravel has himself identified another notable risk, yet dismisses it with a most unusual argument:

The guarantee, if the investment is sound, need pose little risk particularly so for the purchase of an interest in the TAPS line, since we are already dependent upon the oil line for our prosperity and for substantial State revenues. Whatever is at risk in the guarantee of the purchase of an interest in the TAPS line is very little risk indeed, since we are already at risk as a State on the economic success of that line. In the unlikely event that the TAPS line should fail, the State will suffer severe economic dislocation because of the loss of jobs and our inability to transport royalty oil. An Alaskan GSOP ownership interest in the line would not substantially compound the economic crisis resulting from a failure. ["Response to Several Questions Concerning the Alaska General Stock Ownership Plan," April 10, 1978.]

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- 3) Our projections show a probability of only 50 percent that total Arctic Slope oil production --- including production from new fields --- will exceed 1 million barrels per day in 1995, or 600 thousand barrels per day in 2000. See Arlon R. Tussing & Associates, Inc., Alaska North Slope Production Forecasts, 1980-2000 [October 8, 1979].