

SCOMM

96:2

COMMITTEE: House Oil & Gas DATE: 2-7-95 TIME: _____

SUBJECT: Dept. of Revenue Oil & Gas Audit Division

MEMBERS: Rep. Rokeberg, Ogan, B. Davis, Cr. Davis, Finklshtein
Brice, Williams. 1

SPEAKER	TAPE#	SIGNIFICANT INFORMATION
Rokeberg	000	Called Committee to order. 10:04/ Members Present.
	0114	Quorum present & Presentation by Dr. Longsdon.
Dr. Longsdon	039	Petroleum Economist w/ Dept. of Revenue. Oil & Gas Taxation systems Presentation.
	062	Executive Update fax - All committee members receive one.
Rokeberg	075	when will they be published.
Longsdon	090	Property Tax: all oil & gas production & hardware is subject to a 20mill tax. (All capital is subject to a property tax.
	120	20 mills is about 2% of appraised value.
	128	Borough property taxes.
	138	Take the appraised value & assess the tax.
	160	Brought in \$61.5 million - total tax assessed \$350 million.
Rokeberg	180	Will you provide that info?
Cr. Davis.	200	What is the history of the tax as far as fluctuations.
Longsdon	210	The investment on the North slope has increased.
	228	The trend is down, \$150 million in 93' it went down to \$66 million.
	245	The Municipalities rely on the Property tax
Rokeberg	250	Appreciation Scales
Longsdon	252	The Pipeline is assessed at a depreciated cost.
Roke	280	The Target is just the Petroleum industry
Longsdon	290	This is a very specific tax.
Roke	295	The borough has taken over much of the responsibility for Auditing

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SPEAKER	TAPE#	SIGNIFICANT INFORMATION
Longsdon	312	Localities in Texas have...
	327	They get a big chunk of the dough - they do not do the appraisals.
Rokeberg.	337	Income streams
Longsdon.	346	The borough state retains the responsibility of Assessing the property.
Longsdon	368	Severance tax - Levied on all capital dealing with oil and Gas production in Alaska.
	375	The rates will vary.
	378	ELF - Try to make the severance tax rate - 2 factors: What's the size of the field & the effici productivity of the wells.
	405	Our tax rate earlier is lower....
		Kaparak - Endikot = 12 1/4 nominal rate.
	410	\$0.4 per barrel If the \$ per barrel floor is
	425	The last page of the handbook has tax rate comparisons.
	435	1994 Prudhugh production statistics.
	460	The key factor in the ELF is production at the economic limit.
		300 barrels a day or less = no tax. (tax free)
	475	2 factors how big is the field, how productive are the wells.
	490	The ELF has been around for awhile.
		History of Severance Tax rate sched: Typically property taxes went to schools. The severance tax however is
	512	it started as a 1% tax.

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SPEAKER	TAPE#	SIGNIFICANT INFORMATION
Longsdon	520	Development on Cook inlet & Fledgling oil industry.
	530	The flat tax could act as a disincentive to several of the oil companies.
	543	Stepwise tax, Every Graduated step schedule of taxation. The tax was on Production.
	558	At one time the ELF had no exponents on it at all.
		When they inserted the first on 1-533-
	570	After 10 yrs. the tax rate @ Prudhoe Bay was supposed to drop.
		The tax Rate at Prudhoe should stay at the 15% rate.
	585	That is a very brief rundown.
Roheberg	595	It may be beneficial to pursue the ELF.
		Could you comment on size & # of Wells & how it relates to the ELF.
Longsdon	606	Typical geology states that if you have a field that produces >30,000 barrels a day...
	620	We found some very productive small pockets of oil &.
	625	below 30,000 barrels a day (per field)
	640	Fields that produce 100,000 barrels, the tax rate is going to be very high. & have a high ELF.
	650	Once you get above 1 billion barrels in the ground, the field size can effect the tax rate.
Roheberg	655	
Longsdon	655 660	Yes, that is an issue.

COMMITTEE TALK LOG

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SPEAKER	TAPE#	SIGNIFICANT INFORMATION
Longsdon	665	
Rokeberg	670	Is it a negative to not drill wells, or fewer wells from an existing wet field.
Longsdon	680	There is a debate as to what a well is.
	700	The price of oil is what really makes the difference. It isn't clear cut.
	707	is the revenue side where the problem is?
H. Davis.	710	Dispute over, overlapping fields.
Longsdon.	719.	They (DOR) try to prepare the correct tax.
	734	This hasn't been a very big problem.
	757	It is difficult to determine what oil came from what field.
	770	Westac.
	773	The ELF is used to tax production not revenue.
Ogan	783	A brief analogy as to the source of the oil disputes.
Longsdon.	800	The value side, the tax base is a very important
		The Price side : is at the wellhead.
	820	On the North Slope the oil comes out, put on Pipe line, then Boats, so what is the "Process" to determine value for the oil.
	847	Is it appropriate to use the wetback.
		The dispute occurred in 1979 & oil prices went way up. so there was no way to establish value.
	880	Wetback approach "
	900	for years there was no agreed upon tariff for the Pipeline.

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SPEAKER	TAPE#	SIGNIFICANT INFORMATION
Longsdon	915	How rapidly should the investors be compensated & what rate of return do we allow.
	945	There is dispute over just what the law meant.
Ogaw	960	Is it a fair assessment that everyone is now doing the same thing
Longsdon	970	Big chunks of dispute have been taken off of the table.
	978	The "Market Paradigm"!
	995	These disputes are much more manageable.
✓ Roke	000	Your group put out the new regs.
Longsdon	012	We want to get rid of the massive paperwork.
	027	6 months & we will find the bugs
Roke	032	Do you need a statutory change.
G. Davis.	036	Tax Returns.
Rep. Green.	045	Is there a process of resolving smaller problems. A procedure to get problems solved quickly.
Longsdon.	061	There are provisions
	078	We'd like to stop short at it.
	085	You may want to talk to the Commissioner, it is fascinating.
Rokeberg.	094	Stipulation as to valuation.
Longsdon	100	We use the SPOT & it depends on the region. The key # is the Spot Price.
	118	We would like to know what we can do to standardize valuation.
	132	We do put a lot of weight on spot prices.

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SPEAKER	TAPE#	SIGNIFICANT INFORMATION
Longsdon	140	Spot prices are being assessed by journalists.
Greon	152	How do you handle the Company & giving oil to their own refinery.
Longsdon	154	The export ban lift will cause some major problems.
Rohberg.	171	
Longsdon	174	We get other wire services. On the Royalty side ...
Rohr	190	state sale of inkind oil.
Longsdon	194	the Royalty value.
	200	spot price is used as Severance tax.
	202	The Royalties, our royalty provision is similar to a standard lease.
	215	some rates on the slope are as high as 20%
	221	Price share leases. like Enclikot.
	336	If you want to think of Royalties at 12 1/2%
	340	The companies will pay a spot tax every month.
	250	Couple of different deals, 6 different crude oils w/4 different weight.
Rohr	258	were these negotiated.
Longsdon.	274	The boiler plate —Graph on chalkboard— Line 63 is a pipeline
	293	Assess weight on the quality. The Gulf coast is similar.
	303	It's a market basket approach using a schematic.

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SPEAKER	TAPE#	SIGNIFICANT INFORMATION
Longsdon.	316	On the Royalty side w/BP.
		Exxon \$1.25 per barrel to ship to west coast.
	320	ARCO is more straight forward.
	332	There are specific Accounting Costs.
Rokeberg	338	Wellhead price - transportation.
Longsdon.	341.	FY1991 The Tax tariff now is approx \$3.60, Transport charge about \$1.20.
		The AVG was \$1.47
	356	The AVG = \$6.25 for both indets.
	372	There is a cost that must be recovered.
	381	Pumpability Charge.
	384	Tariffs take oil quality into acct.
	392	in regulatory revision we looked----
	400	on the Royalty side however, for BP.
	411	The Formula Market basket----
	421	Basket price for-----
	431	• Tape ended
		New tape start 000
Longsdon	010	Arco Value Formula.
	020	They use the same Royalty & Severance tax.
Rokeberg.	031	Royalty & Severance....
Longsdon.	040	That's how they negotiated the dispute....
	057	The agreement is subject to reopen every 2 yrs.
Rokeberg	071	Exxon has a formula on the Royalty side.
Longsdon.	085	there may be other factors.
Longsdon.	093.	The splitting factor on the West Coast.

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SPEAKER	TAPE#	SIGNIFICANT INFORMATION
Longsdon	111	Exxon is the same as BP. Except....
	132	The Nature of the agreement on the Royalty side.
	150	Couple other taxes
		<u>Conservation Tax</u> : this tax isn't levied on Public Royalties
	177	Corporate income tax: Not directly sensitive to other influences.
	190	The Percentage of Corporate Sales & Tariffs etc....
	203	Production Tax Surcharge: \$4 Per Barrel
	212	We have hit the cap.
	224	Comparative Systems, how do we stack up to the rest of the U.S.
	240	The Companies marginal take
	248	At the margin, our system isn't that unfair.
	260	Showed Pie Charts.
	280	1994 Corporate income taxes were very small, less than \$100 million.
	288	how much do we produce & how much can we sell it for.
Ogan	300	Is there on the Corporate tax, an investment Credit.
Longsdon	307	Exploration Incentive Credit.
Pokeberg	320	it is at the request of Commissioner.
Longsdon	328	I don't know the \$ amount.
	341	discretionary issue.
Poke	352	Ques: Look at existing statutes.
Longsdon	365	There are a number of things that could be addressed.

COMMITTEE TAPE LOG

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[illegible]

STATE OF ALASKA

DEPARTMENT OF REVENUE

OIL AND GAS AUDIT DIVISION

MAR 10 1995

TONY KNOWLES, GOVERNOR

550 WEST 7TH AVENUE, SUITE 570
ANCHORAGE, ALASKA 99501
PHONE: (907) 276-1363
PHONE: (907) 277-5627
FAX #: (907) 278-5026

March 6, 1995

The Honorable Norman Rokeberg
Alaska State Legislature
State Capitol
Juneau, Alaska 99801-1182

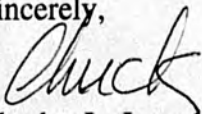
Dear Representative Rokeberg:

The letter I sent to you last week as follow-up to my testimony on the state's oil and gas tax and royalty system misstates the royalty formula for ARCO. The factor used to determine the Valdez netback value of ARCO's royalty production is the factor used in the original royalty settlement and has subsequently been amended as part of the provision in the original settlement allowing periodic renegotiation of the pricing formula. The tanker transportation allowance for ARCO's royalty production is now determined by multiplying \$.91/bbl times the market basket divided by 17.62/bbl. For example, if the market basket in a month were \$15.00/bbl then the tanker transportation allowance in that month would be calculated as follows:

$$$.91/\text{bbl} * \$15.00 / \$17.62 = \$.77469/\text{bbl}$$

I apologize for any inconvenience this may have caused.

Sincerely,



Charles L. Logsdon

95-020



Official Business

Alaska State Legislature

HOUSE OF REPRESENTATIVES

House Special Committee on Oil & GaS

State Capitol
Juneau, AK 99801-1182

MEMORANDUM

TO: Members of Committee

FROM: Representative Norman Rokeberg, Chairman 
House Special Committee on Oil and Gas

DATE: February 6, 1995

SUBJECT: Overview - Dept of Revenue - Oil & Gas Audit Division

The overview will be presented by:

Dr. Charles Logsdon, Chief Petroleum Economist
Dept of Revenue - Oil & Gas Audit Division

The attached information has been provided by the department for the committee.

ALASKA'S OIL and GAS TAXATION SYSTEM--JANUARY 1995

The State of Alaska levies the following specific taxes on the petroleum industry.

1. Property tax (ad valorem). Assessed at the rate of 20 mills (2%) on the appraised value of all oil and gas production and transportation hardware (tangible property).

2. Severance tax. Levied on all production except for public (government) royalty production. The rate varies depending on the vintage of the field and is further subject to the economic limit factor (ELF). The ELF varies depending on field size and well productivity.

The severance tax rate on oil is 12.25% of production value for the first 5 years of production and 15% thereafter for fields coming into production after June 1981, and 15% for fields in production prior to June 1981. There is a minimum tax of \$0.80/bbl. The severance tax rate on gas is 10%. There is a minimum tax of \$.064/mcf.

Both the percent of value and the cents per barrel tax rates are subject to the ELF. The appropriate tax rate is multiplied by the ELF to determine the effective tax rate.

The ELF formula for oil production is as follows:

$$ELF = (1 - (300/PPW))^{((150,000/TP)^{1.5333})}$$

Where PPW = Average oil production per well per day in the field

TP = Average daily production from the field

^ = Exponential

Note: If a field produces 300 bbl/day per well or less the ELF is zero i.e. no severance taxes are assessed.

The two exponents in the formula result in a tax schedule with extremely low tax rates for smaller low productive fields and higher tax rates for larger highly productive fields. The formula is difficult to characterize in a simple way because it is not only non-linear but is three dimensional since there is a unique ELF for every combination of field size and well productivity.

The ELF was originally designed in 1977 to differentiate the tax rate on the new supergiant Prudhoe Bay oilfield and the old declining fields in the Cook Inlet. Subsequent changes in 1981 and 1989 focused on keeping taxes higher on Prudhoe Bay while lowering taxes on the new and undeveloped smaller fields on the North Slope.

The ELF formula for gas production is as follows:

$$ELF = 1 - (3000/PPW)$$

Where PPW = Average gas production per well per day in the field

3. Conservation Tax. Assessed at the rate of 4 mills (\$.004) per barrel of oil production or per 50,000 cubic ft of natural gas. Public (government) royalty production is not subject to this tax.

4. Corporate Income Tax. The income tax base is derived from the corporation worldwide net income apportioned to Alaska under a 3 factor formula comprised of 1. percentage of corporate sales and tariffs from Alaskan operations 2. percentage of production from Alaska and 3. percentage of property represented by Alaska holdings. The maximum marginal rate is 9.4%.

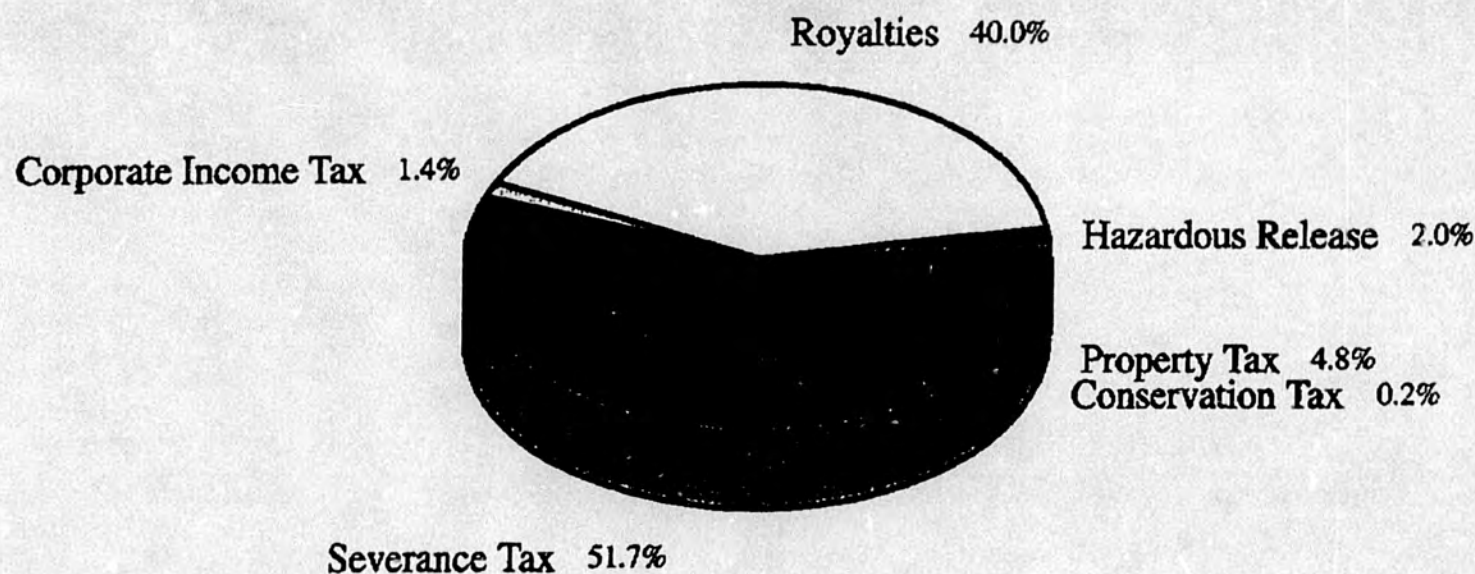
5. Royalties. The State of Alaska receives royalties from the production of oil and gas on State owned lands. Most currently producing leases pay a fixed 12.5% royalty. Some production is subject to a net profit share in addition to a fixed royalty. Some royalty rates are as high as 20%. There is no general differentiation for royalty purposes between onshore and offshore developments.

6. Production Tax Surcharge for Hazardous Spill. Five cents per barrel is charged to each taxable barrel as long as there is less than \$50 million in the Hazardous Release Fund. When the \$50 million cap is reached the surcharge falls to three cents per barrel.

All State taxes and royalties are deductible for Federal Income Tax purposes. The U.S. Federal Corporate Income Tax is assessed at a maximum marginal rate of 35 percent.

State of Alaska Petroleum Taxes & Royalties

FY 1994: Preliminary ACTUAL



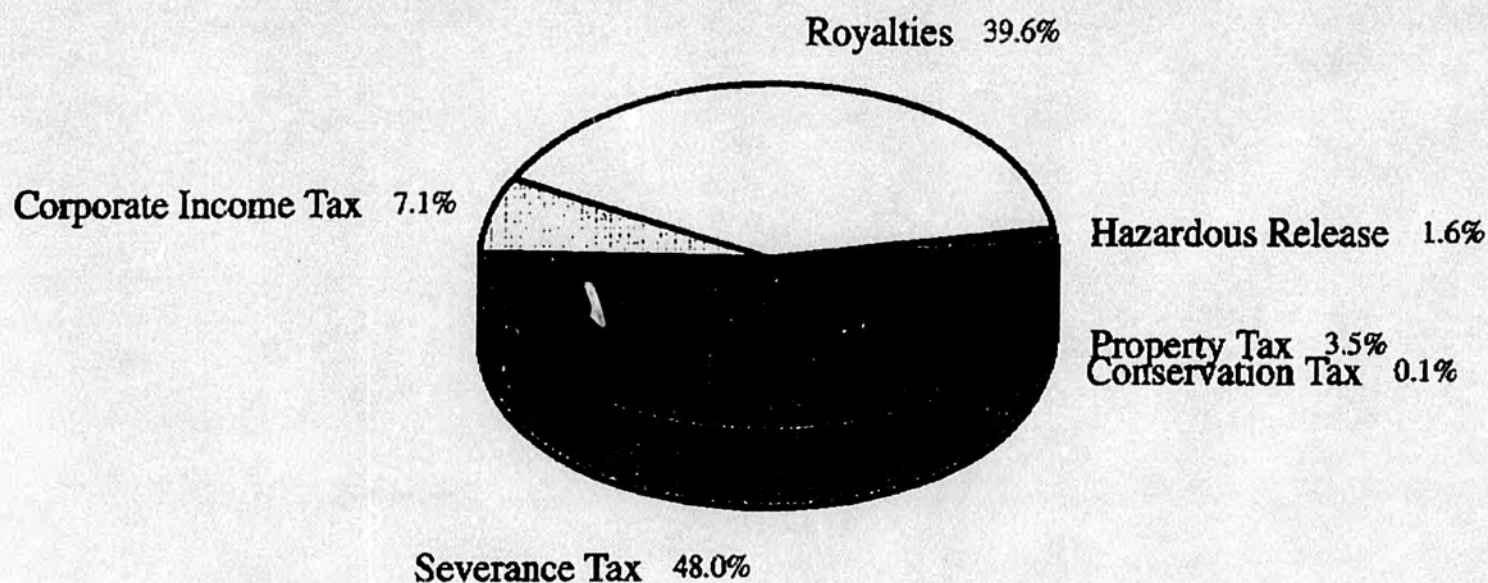
FY94 Production: 1.639 million bbl/day

Petroleum Revenues: \$1.290 billion

Total GF Unrestricted Revenues: \$1.632 billion

State of Alaska Petroleum Taxes & Royalties

FY 1995 Base Case: Projections



FY95 Production: 1.690 million bbl/day

Petroleum Revenues: \$1.655 billion

Total GF Unrestricted Revenues: \$1.953 billion

Alaska Department of Revenue, Oil & Gas Audit Division

Comparison of Tax Rates: Nominal vs. Effective

CY 1994

<u>Lease</u>	(bbls) <u>Taxable Volume</u>	<u>Tax Rate (%)</u>	
		<u>Nominal</u>	<u>Effective</u>
Endicott	28,864,275	15.00	11.26
Kuparuk	97,542,482	15.00	12.96
Lisburne	6,142,197	15.00	0.00
Milne-Kuparuk	3,904,876	15.00	0.08
Milne-Schrader	915,914	15.00	0.00
Niakuk	2,877,581	15.00	0.53
North Prudhoe Bay	737,838	12.25	0.00
Prudhoe	310,397,090	15.00	14.79
Point McIntyre	32,117,146	12.25	11.11
Sag Delta	299,595	12.25	0.00
West Beach	476,195	12.25	0.00
Cook Inlet	18,843,975	15.00	0.00
TOTAL Alaska	503,119,164	14.25	13.00

MEMORANDUM

State of Alaska

Department of Revenue

TO: Bob Baratko
Director Admin. Services

DATE: Jan 26, 1995

FILE NO:

TELEPHONE NO: (907) 277-5627 ext.265

THRU: John Pilkinton
Director Oil and Gas Audit

SUBJECT: ANS EXPORT BAN FISCAL NOTE

FROM: Chuck Logsdon
Petroleum Economist

Apparently there is some confusion over my response to a question about the value of the ANS Export Ban during my testimony before the Senate Finance committee. As I recall I gave a several part response in which I mentioned that one, albeit very rough, way of making the estimate would be to look at the price difference between ANS at the West and ANS at the Gulf. Currently this spread is about \$.50/bbl or using the rule of thumb of \$130 million in general fund unrestricted revenue for every \$1.00/bbl, this would be \$65 million.

The other thing I stated was that even if the price on the West and Gulf were the same, the transportation cost savings alone would account for \$20 million in additional revenues.

The fiscal note I prepared for SJR 3 estimates benefits of \$80 million and uses current prices and transportation costs. The estimate was arrived at as follows:

ANS Price Before Export Ban Lifted
less Tanker Cost

	Gulf	West
	16.90	16.40
	<u>-3.30</u>	<u>-1.20</u>
Net	13.60	15.20

ANS Price After Export Ban Lifted
less Tanker Cost

	Japan	West
	16.65	16.90
	<u>-1.70</u>	<u>-1.20</u>
	14.95	15.70

Weighted Average Net = 14.96
(85% West, 15% Gulf)

Weighted Average Net = 15.59
(85% West, 15% Japan)

Impact on Wellhead = $15.69 - 14.96 = \$0.63/\text{bbl}$ or Revenue = $130 * .63 = \$81.575 \text{ million}$

The analysis on the following page breaks the total of \$81.575 million down into the amount accounted for by transportation cost savings component and the amount accounted for by higher sales price.

Bob Baratko
January 26, 1995
Page 2

Transportation Effect

	\$3.30	
less	<u>1.70</u>	
	1.60	gross transport savings /bbl
less	<u>.25</u>	(lower price in Japan than U.S. Gulf since Middle East closer to Japan)
	1.35	net transport savings /bbl
*	<u>.15</u>	
	0.2025	net impact on ANS wellhead (15% shipped to Japan)

Total Transport benefit by the rule of thumb = $130 * .2025 = \$26.325$ million

Price Effect

	\$16.90	after export price
less	<u>16.40</u>	before export price
	0.50	gross increase in sales price
*	<u>.85</u>	
	.425	net impact of higher price on ANS wellhead (85% shipped to West)

Total Price Effect benefit by the rule of thumb = $130 * .425 = \$55.25$ million

Total Price and Transportation Effect = $\$26.325 + \$55.25 = \$81.575$ million

The fiscal note prepared for SJR 3 goes to zero at that point at which our forecast of ANS production declines to the point that there is no longer a surplus of ANS for sale on the West Coast in the second half of FY 1997.

Finally please note that at a minimum, regardless of the price of oil we would achieve a \$26.325 million increase in revenues if the ban were lifted in FY 1996.

FEB 27 1995

STATE OF ALASKA

DEPARTMENT OF REVENUE

OIL AND GAS AUDIT DIVISION

TONY KNOWLES, GOVERNOR

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February 22, 1995

Representative Norman Rokeberg
Alaska State Legislature
State Capitol
Juneau, Alaska 99801-1182

Dear Representative Rokeberg:

I have reviewed the testimony that I gave at the House Special Committee on Oil and Gas February 7, 1995 and would like to provide you with some additional information, comments and corrections to what I stated at that time.

PROPERTY TAX

The state levies a property tax on only that property used to explore for, produce, or transport oil or gas (except for gas distributed for retail use in-state) at 20 mills. The municipalities also may levy property taxes against this same property to the extent to which it is found within their jurisdiction. The tax levied by the municipalities on this property is paid to the municipality by the taxpayers and taken as a credit against their state property tax.

I have spoken with the state assessor and have a better idea about the relationship between the state and the municipalities in which the property is located. First, the boroughs are restricted to 30 mill property tax rate to fund their operating budget (AS 29.45.090(a)). This cap is further subject to a per capita limit based on 225% of the statewide average per capita value of all property in the state (AS 43.56.010(c)). Second, there is no limit on the ability of municipalities to tax to pay their bonds. As a result there is no effective limit on local taxes other than the ability to incur bonded indebtedness.

As a result the boroughs do for example assess other property in the municipality which is not subject to the state property tax. In theory the municipalities, depending on the value of non-oil property and their bonded indebtedness, could receive the entire 20 mill state tax on petroleum production property located within their boundaries.

SEVERANCE TAX

I am enclosing a copy of a paper I presented in 1992 which covers a lot of the issues in oil taxation and particularly the severance tax which you may find interesting.

A review of my testimony indicates that I suggested that the State could raise "oil prices". Unfortunately this is not true. I meant to say we can raise or lower tax rates.

With respect to the ELF, the formula as originally conceived did not have any exponents. The exponents were added as the tax bill evolved in the legislative process.

I also mis-spoke with respect to the way in which the Department handles the issue of wells drilled with multiple completions or those wells which produce from more than one pool of oil. The Department currently holds that a well is a hole in the ground regardless of the number of completions or lateral extensions in that hole. A given hour of a single well's operation may not be counted more than once. That is, in calculating the ELF, such a well must be allocated to the different zones which it is being used to produce. This is based upon a formal hearing decision that is presently under appeal to the Superior Court.

The severance tax is collected monthly, not quarterly as stated in my testimony.

VALUE ISSUES

In my testimony on value I believe I caused a lot of confusion about whether I was talking about the way royalty values are determined or about how severance tax values are determined. I hope that the following outline will help clarify the issue.

Severance Tax Value: Value at the point of production is determined by subtracting from the sales price or prevailing value the actual costs of transporting the oil to the place of sale or transfer to a producer's refinery. The average spot price as reported for the month in *Platt's Oilgram Price Report (Platt's)* for Alaska North Slope (ANS) deliveries to West Coast and Gulf Coast destinations is used when the oil is moved into a producer's own refinery. Prices for ANS crude oil deliveries to markets without a spot quote in *Platt's* or production from Cook Inlet are based on West Coast ANS spot price on a fixed dollar differential. The sales price is used if the oil is sold to a third party unless the sales price is \$.10/bbl less the spot price during the month of delivery, in which case the spot price would be required.

ROYALTIES

Royalty Value: There are a number of formula settlements for oil and gas valuation purposes. The most important ones are for ARCO, EXXON, and BP North Slope oil production. All these formulas share one important feature and that is a market basket of crude oils. There are two market baskets one for the West Coast and one for the Gulf Coast. They are developed monthly since the royalty payment, like the severance tax payment, is due monthly. The market basket is also based on spot prices as reported in *Platt's*.

Representative Rokeberg

February 22, 1995

Page 3

The crude oil in the market basket for the West Coast consists of West Texas Sour (a crude oil produced in Texas similar in quality to ANS), Line 63 (a pipeline blend of crude oil sold in California similar in quality to ANS), THUMS (a heavy California crude oil), Kern River (a heavy California crude oil), ANS for California delivery, Dubai (an Arabian Peninsula crude oil exported by the emirate of Dubai similar in quality to ANS), and Oriente (the export grade oil similar to ANS produced in Ecuador).

The crude oil in the market basket for the Gulf Coast consists of West Texas Sour , ANS Gulf, Dubai, and Oriente.

<u>West Basket</u> <u>Crude Oils</u>	<u>Weights</u>	<u>Gulf Basket</u> <u>Crude Oils</u>	<u>Weights</u>
West Texas Sour	.15	West Texas Sour	.26
Line 63	.30	ANS Gulf	.31
THUMS	.06	Dubai	.09
Kern River	.06	Oriente	<u>.34</u>
ANS Calif.	.18		1.00
Dubai	.05		
Oriente	<u>.20</u>		
	1.00		

ARCO Formula: Basket times 1.03 + or - \$.50/bbl. If ANS Spot price falls within this range then ANS Spot is used otherwise use Basket times 1.03. To determine the price at the wellhead multiply the ANS Spot price (or the Basket times 1.03) by .97554, then subtract the TAPS and other filed Alaska pipeline tariffs.

BP Formula: West Price = Basket West times 1.0164

Gulf Price = Basket Gulf times 1.0021

less actual tanker cost less TAPS and other filed Alaska pipeline tariffs

Mid-Continent Price = Gulf netback + \$.50/bbl

Virgin Islands Price = .5 times West netback + .5 times Gulf netback

EXXON Formula: Price the same as BP

less \$1.25/bbl tanker cost less TAPS and other filed Alaska pipeline tariffs until February 1, 1996 when \$.14/bbl of this amount subject to monthly adjustment based on change in market basket after February 1, 1996. Plus \$.708/bbl portion of charge subject to escalation monthly by the producer price index (PPI).

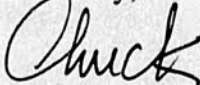
Representative Rokeberg
February 22, 1995
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INCOME TAX

There are two generally applied concepts which distinguish the petroleum corporate income from the general corporate income tax. First, the apportioned income base for the petroleum corporate tax is based on world-wide income rather than the water's edge approach used for the general corporate tax. Second, for most oil companies operating in Alaska, the apportionment factors are property, extraction, and sales, while for regular corporations the factors are property, payroll, and sales. There is a federal tax credit for qualified enhanced oil recovery projects. A portion of these federal tax credits attributable to the corporation's Alaska business activity (as yet undetermined and subject to audit) may be applied against the corporation's state corporate income tax liability.

I hope that this clarifies some of the complex tax issues I testified to at the February 7, 1995 meeting. If you have further questions please feel free to give me a call.

Sincerely,



Charles L. Logsdon
Petroleum Economist

Winter 1992-supplement

**Alaska's relationship with the major
oil companies**

by

Dr Charles L. Logsdon

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Alaska's relationship with the major oil companies

Dr Charles L. Logsdon

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Introduction

OIL WAS DISCOVERED at Swanson River on Alaska's Kenai Peninsula in 1957. The start of commercial production from the Swanson River field in 1958 and Statehood for the territory of Alaska in 1959 marked the beginning of what has become a long and often bitter but mutually profitable relationship between the major oil companies and the State of Alaska.

When Alaska became a State it was allowed to select 108 million acres of Federal land. As part of this entitlement, the State selected land on the Alaska North Slope. These lands proved to contain the largest oil field ever discovered in North America at Prudhoe Bay as well as a host of other smaller oil fields. The ownership of the land containing most of the current oil production in the entire State makes Alaska unique among the producing areas of the US. Not only is the State of Alaska able to tax resources produced within its sovereign boundaries, but it is an owner of a significant amount of the resources produced.

In this short paper I would like to explore the relationship between the major oil producers and the State of Alaska.

Dividing up the rent

Alaska's relationship over time with the oil companies is dominated by the issue of how much of the resource rent goes to the companies, how much goes to the State of Alaska, and how much goes to the Federal government. Alaska has experimented with almost all conceivable methods of extracting some part of the resource rents generated by oil field development that are possible under the US Constitution. The list includes a royalty ownership interest, lease bonuses and rents, production excise taxes, income taxes, property taxes, and reserves taxes. Today, in 1992, Alaska still relies on all but the reserves tax to collect the petroleum rent.

Alaska's recent economic development has been inextricably linked with the oil industry. Major oil production began in the late 1950s and Statehood for Alaska

occurred in 1959. There is even a fairly good argument that, without oil, Alaska would not have had the indigenous income base to support Statehood.

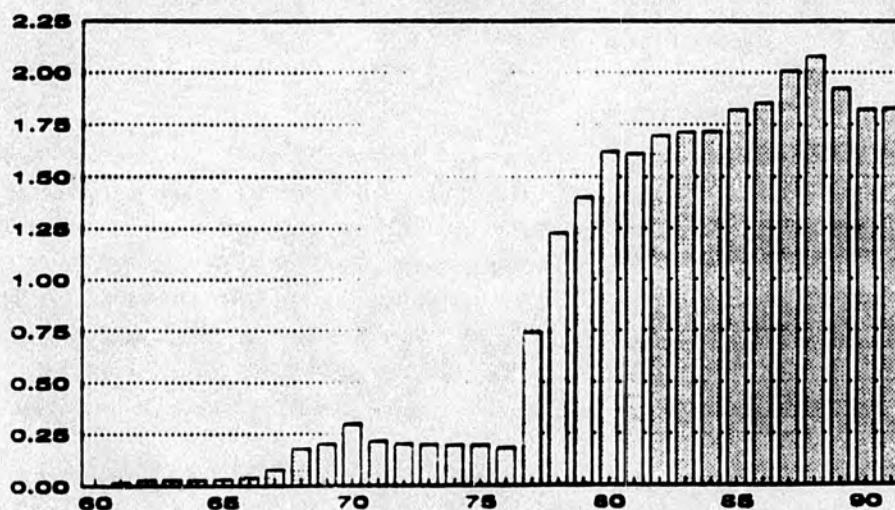
Alaska's approach to determining its share of the rent and its method in achieving this goal has evolved along with the growth in the State's petroleum economy.

The initial discovery of oil in the Cook Inlet led to a burst of oil exploration activity throughout Alaska in the late 1950s and early 1960s. Other oil discoveries were made in Cook Inlet, mainly offshore, so that by the late 1960s Alaskan oil production had reached 200,000 b/d.

The discovery of the largest oil field in North America at Prudhoe Bay in 1968 redefined the parameters of the relationship between Alaska and the oil companies, raising questions about how the oil wealth generated from this field would be taxed and how the field would be developed.

Figure 1 illustrates the tremendous impact the development of the Alaska North Slope oil fields has had on Alaskan oil production and subsequently on the evolving relationship between the State and the oil producers. Alaskan oil production is currently in decline as the huge Prudhoe Bay field is being depleted. This critical factor will usher in a new phase in the relationship between Alaska and the oil companies.

Figure 1
Alaska oil production, 1960-91
mb/d



Alaska North Slope oil profit

The issue of the size of the pie has been the major feature of Alaska's relationship with the oil producers. Obviously, an oil production level over 1.5 million b/d can generate considerable wealth depending on the level of price. Given the distance from market and the high production costs, the issue of petroleum resource value in Alaska has been the focus of lengthy disputes between the State and the oil companies.

Alaska's point of collecting the rent through its severance tax and royalty share is at the petroleum production wellhead. The wellhead value is determined by subtracting the transportation costs incurred in shipping North Slope oil from the sales price at the point of sale. The sales price is determined by third party sales, internal transfer price booked into the producer's refinery, or value at the point of exchange.

The companies producing ANS are highly integrated multinational corporations. Not only do they own the non-royalty production, but they own the pipelines, tankers, refineries, and petroleum product distribution networks. Given this business structure, there is tremendous incentive to shift profit away from the highly taxed wellhead into downstream activities. For this reason, Alaska has spent hundreds of millions of dollars in legally challenging all aspects of how much of the value of the crude oil can be attributed to the resource.

The disputes over sales value have involved conflicting market theories about pricing in a crude oil market muddled by artificial institutional constraints, like the ban on exporting ANS crude oil and the resulting requirement that all ANS crude shipments be made on expensive US flagged tankers to both the US West Coast and distant markets in the Eastern US and Caribbean.

The West Coast market for crude oil has long been the subject of legal controversy. Small producers and royalty owners in California have felt for many years that the major producers have acted so as to depress the wellhead price of California production. At the same time, as ANS production came on line in 1977, a very large surplus of sour crude oil developed on the West Coast.

Three producers, British Petroleum (BP), Atlantic Richfield (ARCO) and EXXON, control roughly 95% of the ANS production. BP, with 50% of the ANS, rapidly established themselves as the price leader in the West Coast market. BP until recently had no downstream business interest on the West Coast and based its marketing and pricing decisions in that market on both its transportation costs to the Gulf Coast and the ability to exchange ANS on the West Coast for crude oil to run through its Mid-America and Gulf Coast refineries.

The net result of all these and other factors was a pricing policy by BP which resulted in a West Coast price which generated a higher realized wellhead value than sales east of Panama.

Table 1
Alaska royalty value market baskets

West Coast royalty basket		Gulf Coast royalty basket	
Crude oil	Weight	Crude oil	Weight
West Texas Sour	.15	West Texas Sour	.26
Line 63	.30	ANS (Gulf)	.31
THUMS	.06	Dubai	.09
Kern River	.06	Oriente (USGC)	.34
ANS (Calif)	.18		
Dubai	.05		
Oriente	.20		

In addition to the value issue, Alaska and the ANS producers continue to dispute the transportation costs deducted from the sales price to arrive at the wellhead value. The largest dispute involved the appropriate charge for shipping oil through the Trans-Alaska Pipeline. This multi-billion dollar dispute was settled in 1986 with the adoption of the TAPS Settlement which established a cost of service methodology for establishing the maximum allowable tariff. The settlement resulted in a front-loaded tariff allowing early capital recovery by the owners in exchange for low tariffs through the 1990s.

So far, Alaska has settled the legal disputes over the value for royalty production although the issue is still in dispute for severance taxes. The settlements establish alternative formula approaches to future value. The ARCO formula uses a market basket of spot crude values (table 1) and an allowance for marine transportation costs equal to 3.7 per cent of the basket value to determine a Valdez net-back. The wellhead value is then calculated by deducting the allowable TAPS tariff. The BP and EXXON royalty value formula uses the same market basket approach although there are additional adjustments for West Coast and Gulf Coast deliveries.

Actual marine transportation costs are allowed as a deduction under the BP formula agreement. The transportation deduction for EXXON West Coast deliveries starts with a basic deduction of \$1.18/b for direct costs and an additional 6% or \$.07/b for indirect costs. 12% of the direct costs are subject to an index based on oil prices relative to the average destination value for the first six months in 1992. Beginning February 1, 1996, the direct costs are adjusted upward by 60%.

Alaska has also instituted an estimated tax procedure which requires that taxpayers adjust severance tax payments to the equivalent of the ANS spot market value for both West Coast and Gulf Coast markets. This is intended to reduce the size of future disputes over value.

Table 2
ANS profitability from the incremental dollar

Royalties	0.125
Severance tax	0.131
State income tax	0.010
State take	0.266
Federal tax	0.249
Aftx profit	0.485

Table 3
Current ANS profitability
S/b

Lower 48 sales price	16.00
less tanker cost	1.50
Valdez netback	14.50
less TAPS	3.45
Field price	11.05
less royalty	1.29
less severance tax	1.46
less property tax	0.53
less operating expense	1.50
less depreciation	1.50
Before tax income	4.77
less State income tax	0.07
less Federal income tax	1.60
ANS production profit	3.10

Current estimates of ANS profitability are developed in the following tables. Table 2 contains estimates of the share of profit from the incremental dollar earned. Table 3 contains estimates of the average per barrel profit using an assumed price and production cost.

As will be seen, a brief review of changes in the State's severance tax structure illustrates the pattern of changes in oil taxes. Initially taxes were increased to generate needed revenues to fund public services associated with a growing economy. With the development of the mammoth Prudhoe Bay field, taxes were

increased to meet some notion of a fair share of the rent from a one-time depletable resource. Finally, recent changes have been made to ensure that the State continues to receive what has come to be perceived as a fair share. The fair share has by default come to be viewed as one-third to Alaska, one-third to the companies, and one-third to the Federal government.

Review of Alaskan oil tax changes

A historical review of the State's share of the economic rent generated by oil extraction is illustrated in figure 1.

The first bulge in Alaska's share shown in figure 2 reflects the implementation of an oil production hardware property tax in 1975 just prior to Prudhoe Bay production. The second Alaska share bulge resulted from the oil price crash of 1986. Since Alaska's production tax includes an \$0.80/b floor and royalty interest is not directly profit sensitive, Alaska's relative share of the economic rent increases as profits shrink.

Severance tax

Alaska has one of the world's most unusual production taxes. An examination of the chronology of how the current method of taxation came to be is a good

Figure 2
Alaska's share of petroleum rent
%

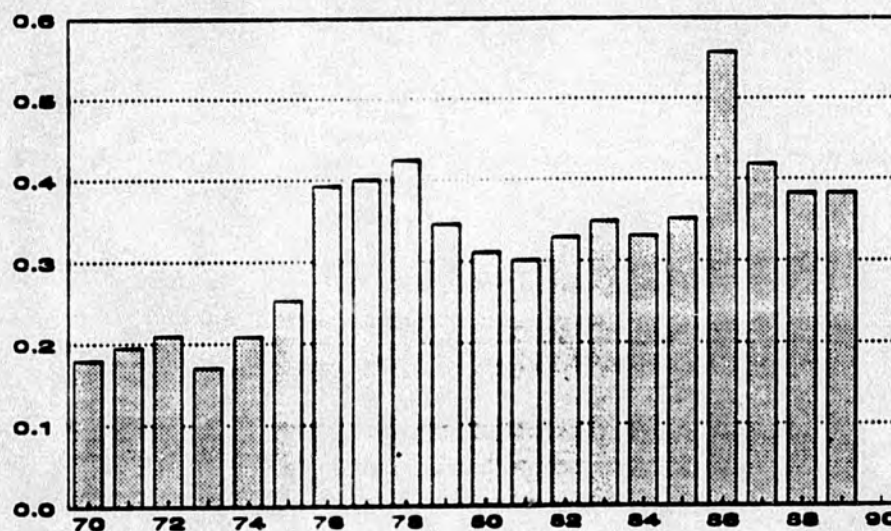


Figure 3
Alaska's average effective severance tax, 1955-91

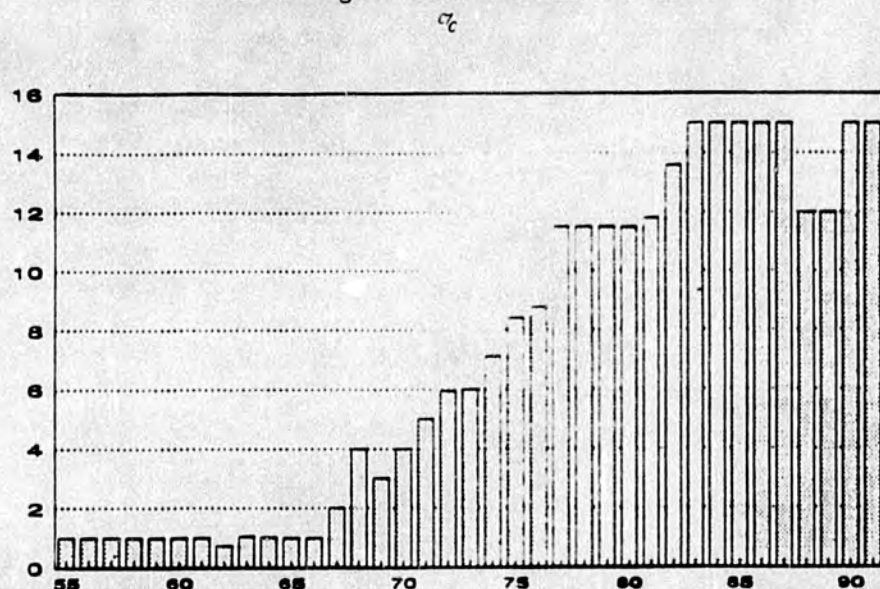


illustration of how the relationship between Alaska and the oil producers developed over time. As can be seen in figure 3, the effective severance tax rate on Alaskan production began to increase as oil and gas production in Alaska began to increase — generally in response to increasing production and revenue needs by the state.

The current oil severance tax structure is the result of a significant number of changes over time made so that an excise tax on production would very roughly mirror the profitability of the oil field being produced.

As shown in Figure 3, the severance tax was originally enacted by the Alaska legislature in 1955 at a rate of 1 per cent of gross value. In 1967 the legislature enacted an additional 1 per cent disaster severance tax to raise money to assist the victims of the Fairbanks flood in that year. In 1968 the rate of the "regular" severance was raised to 3 per cent of the gross value of petroleum production, leaving in place the 1 per cent disaster severance tax. 1968 also was the year in which oil was discovered at Prudhoe Bay.

In 1969 the legislature amended the severance tax structure to a "stair-stepped" rate schedule based on the average daily production per well. The rates started at 3 per cent for the first 300 barrels per day, five per cent on the next 700, 6 per cent on the next 1,500 and 8 per cent on the production exceeding 2,500 barrels per day. The 1 per cent disaster severance tax was repealed.

Looking ahead to Prudhoe Bay production and the potential high transportation costs of a Trans Alaska Pipeline, a severance tax floor based on a cents-per barrel tax with a credit for royalties paid to the State was passed into law in 1972. This was done to prevent the dissipation of resource rent due to unacceptably low wellhead prices resulting from inadequate tariff regulation or construction cost overruns. Although this initial approach to using a floor for the severance tax was soon repealed, a new schedule of three stair stepped rates for value or cents per barrel was introduced and modified in 1973. All of which effectively raised oil taxes.

Finally in 1977, the 3-step schedule was replaced by the Economic Limit Factor (ELF). The ELF was a formula designed to provide a scaled severance tax rate based on average production per well from a producing oil field. The severance tax rate was set at 12.25 per cent subject to the ELF reduction. The formula for the ELF was as follows:

$$ELF = (1 - (pel/tp))^{(460/pel)}$$

where pel = production per well at the economic limit or that level of production per well necessary to cover direct operating costs. The pel was presumed to have a value of 300 b/d unless the tax payer could provide evidence that more was needed.

tp = average daily production per well

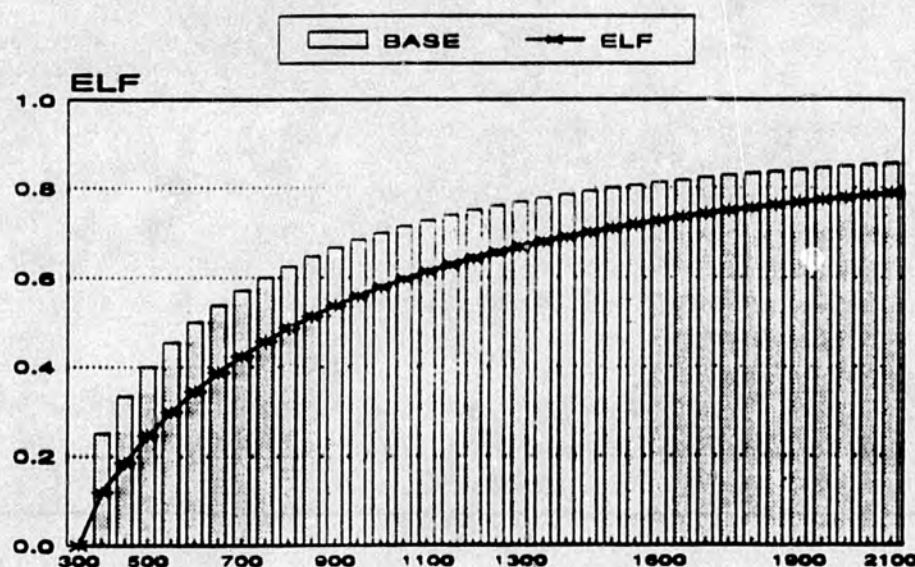
Notice that, in the formula, if average production per well is equal to 300 b/d, the ELF takes a value of zero and no severance tax is due. The exponent $(^{460/300})$ was adopted as a policy variable which reduces the calculated value of the basic ELF fraction for all levels of well productivity (figure 4).

The 1977 change was motivated primarily by the desire to capture a "fair" share of the resource rent from development of the gigantic Prudhoe field while keeping a lid on the taxes paid by the older less prolific Cook Inlet oil fields.

The 1981 change in the severance tax was a direct response to the imposition in 1977 of the oil and gas corporate income tax. The separate accounting oil and gas corporate income tax was part of the tax legislation, mentioned above, which was enacted in anticipation of major production from Prudhoe Bay. The major oil companies filed suit against the tax. State concern over the contingent liability was great enough that the tax was repealed in 1981. The severance tax was modified to make the change "revenue neutral".

The modification defined a new and old field tax rate. The new field rate was set at 12.25 per cent for the first 5 years of production after which the field pays the old field a nominal 15 per cent rate. All fields in production prior to 1981 would pay the 15 per cent rate. Further, a rounding rule was introduced into the

Figure 4
Original economic limit factor
bid per well



ELF calculation. If during the first 10 years of production the calculated value of ELF was 0.7 or greater, the ELF was rounded up to 1.0. After 10 years of production the rounding rule was dropped.

The 1981 oil tax change was clearly designed around the Prudhoe Bay oil field which was at the time expected to begin to decline in 1987, 10 years after production start-up. It raised the effective severance tax on this field from around 10.5 per cent to 15.0 per cent, while leaving the tax on all other fields in the State unchanged.

This key feature in Alaska's oil tax policy i.e. increasing taxes on big oil fields, while decreasing taxes on less prolific fields, was evidenced again in the most recent change in oil tax law in 1989. Prudhoe Bay production continued at high levels through 1988. As a result of the expiration of the rounding rule, the tax rate on Prudhoe Bay dropped and Prudhoe Bay tax revenues fell by roughly \$185 million between 1987 and 1989 (Alaska Revenue Sources, 1990).

Once again concern over protection of what was perceived as the State's fair share of the rent resulted in new tax legislation which modified the ELF to include field size as a component of the formula. Under the new formula, the effective severance tax rates on Prudhoe Bay returned to almost 15 per cent. At the same time

the rate on Kuparuk increased from roughly 8.7 per cent to 12.5 per cent. The effective rate on all other fields decreased or stayed the same.

Tax stability concerns

The changes in the severance tax reviewed above involved very intense political battles. In most cases the higher taxes levied were the result of extremely narrow political victories. Alaskans are very conscious of the high cost environment both consumers and businesses face in the state. Additionally, most people are aware of Alaska's dependence on the oil industry for its economic base. This economic dependency derives from both direct and indirect employment in the industry but also State spending of oil revenues. Oil revenues provide 85 per cent of State revenues which fuel a level of State per capita expenditures many times the national average (Goldsmith *et al*).

As with most tax issues, stability is in the eye of the beholder. Compared with other oil-producing areas of the world, Alaska's tax system is no more unstable than some and significantly more stable than others (Gaffney *et al*). Certainly, however, every major change in petroleum taxes since 1974 has increased the industry tax bill, with the exception of the change in 1981.

Alaska — the owner State

Current Alaskan Governor Walter J. Hickel has promoted the theme of Alaska as the owner State. Through its royalty interest in North America's largest oil field this is a significant feature of the State economy. Alaska's ownership interest in its oil production is based on a contractual relationship with the oil companies in which the State leases the right to explore for and develop petroleum resources from State-owned lands.

Most of the current oil production comes from leases which were issued under a competitive bonus bid system carrying a 12.5 per cent royalty. Under current law, the Alaska Department of Natural Resources (ADNR) is required to conduct a pre-sale analysis prior to each sale to determine not only the petroleum potential of areas to be leased but also the socio-economic and environmental impacts of the sale. The pre-sale analysis serves as the basis for developing lease terms. Although the ADNR has at times offered leases using sliding scale royalties and net profit share terms, most recent sales have been cash bonus bid with a fixed royalty generally set at 12.5 per cent.

Leasing

Most of Alaska's identifiable sedimentary basins have already either been leased or offered for lease. Obviously this means that the decision to explore and drill these lands will depend on the willingness of the lessors to explore their hold-

ings. This willingness is a function of available capital and alternatives for oil exploration. Clearly cost of exploration and development represent a significant hurdle in Alaska, given the extreme climate and relative inaccessibility and distance from markets.

Alaska has also offered additional incentives to encourage the exploration of State lands, such as the exploration incentive credit and the discovery royalty. The exploration incentive credit has in the past been offered as an encouragement to drill geologically attractive leases in which the State has retained a net profit share interest. The exploration incentive credit can be granted by the Commissioner of the Department of Natural Resources and is set at a maximum of 50% of the cost of drilling the first exploration well on a lease. The discovery royalty provision set the royalty rate for the lease with the discovery well at 5 per cent for 10 years following discovery. Only leases issued prior to 1969 are eligible for this royalty reduction.

Petroleum ownership issues

Over 90 per cent of oil production in Alaska is controlled by three companies — British Petroleum (46 per cent), ARCO (27 per cent), and EXXON (20 per cent). One issue which has often been overlooked by policy makers is the relative concentration of ownership of not only producing leases but also, as a result, most of the surface facilities and transportation network which enables oil production to be marketed off the Alaska North Slope.

It is not clear how much this concentration of ownership impacts the ability of the State to attract new exploration capital or the extent to which it effects the rate of development of known petroleum deposits. If potential bidders on State leases believe that they will face disadvantageous costs imposed by current owners to move their production off the North Slope and out of Alaska, they will be effectively excluded from the area.

The Trans-Alaska oil pipeline is a regulated common carrier and as such operates to insure that all shippers have equal access at published tariffs. The pipeline has an ownership structure called a divided interest. This means that each pipeline owner has a separate tariff for the portion of the pipeline that it owns. As a result, the capacity of the pipeline is pro-rated among the shippers so that all shippers face essentially the same overall average tariff. This should insure that access and charge for using the TAPS are not a barrier to new entrants.

The issue of marine transportation does, however, raise some additional interesting issues. Dramatic increases in insurance requirements for ships loading oil at the Valdez terminal in the wake of the EXXON Valdez oil spill have served to increase the cost of shipping barrels of ANS, both by raising the average cost of operating tankers loading at Valdez and by reducing the number of tankers avail-

able to move crude oil. Unless a tanker can be used to move a significant number of cargos, the large fixed insurance cost acts as a barrier to entering this market.

So far the effect of this change in market condition has been to leave small producers of ANS with three alternatives: 1. to sell to the big producers; 2. to pay very high marine transportation charges; or 3. to try to sell to the Alaska in-State refiners. It appears that they are probably doing all of the above. In fact sales to in-State refiners have gone up enough that MAPCO, the refinery in Fairbanks, has reduced the amount of Alaska royalty oil it buys. Because MAPCO pays a price for Alaska royalty oil very close to the average wellhead value reported by the biggest producers, this implies that some producers are selling at a discount reflecting their marketing disadvantage.

Environmental costs

Environmental costs have long been an issue in Alaska resource development. Legislation clearing the way for the construction of TAPS itself was only narrowly approved and then only in response to the Arab oil embargo. Alaskan residents have generally elected officials who have sided with the oil companies in seeking to overcome environmental opposition to oil field development. A case in point is the unanimous bi-partisan support in both executive and legislative branches to open up the Arctic National Wildlife Refuge for exploration.

Attitudes in the State towards protecting the environment may be "greening up" in the aftermath of Exxon Valdez oil spill. However, it is probably safe to say that Alaska has a track record of willingness to compromise on environment versus development issues, in order to earn additional oil revenues.

The resource rent generated from the development of high value petroleum resources makes it possible to invest in environmental impact mitigation while still earning an attractive rate of return. The issue becomes difficult when the marginal increment in environmental mitigation comes at a very high cost. Certainly environmental regulation has contributed to delays in the development of the Niakuk oil field.

Alaska's North Slope oil development provides a number of examples of so called green solutions which benefit the environment and actually lower development total costs. These include small footprint development and the increased use of directional and horizontal well drilling techniques minimizing surface disruption as well as downhole disposal of drilling fluids.

Tax costs

Alaska's method of collecting the resource rent from petroleum production is clearly not economically efficient since it relies on levies against gross resource value rather than net resource value. It can very easily be demonstrated in theory

that, if the economic rent or net resource value were taxed, Alaska would not only be a more attractive place for petroleum exploration and development but also would generate as a result more resource rent. The theory underlines the trend in most other parts of the world to make the petroleum taxation systems focus on rent taxes rather than excise or production taxes.

Interestingly, with hindsight, Alaska's separate accounting oil and gas corporate income tax was a rent tax. The producers apparently were more willing at the time to get rid of that tax as long as the excise tax rate could be kept down. In practice, even with the fixed royalty and production tax system, Alaska's oil taxes compare favorably with other oil-producing regions of the world in terms of providing oil producers with a sufficient rate of return for the super giant Prudhoe Bay field (Gaffney *et al*). A rent-based tax system would definitely enhance the commercial viability of a number of currently uneconomic discoveries in the Alaskan Arctic.

Active management of Alaska's royalty oil

Alaska has sold large amounts of its royalty oil to in-State refiners for many years. These sales have a multiple purpose including providing value enhancement and creation of jobs, insuring the availability of petroleum products to citizens, and earning public revenue. The maximization of royalty value has not been a goal. Alaska has specifically attempted to remain a passive rent collector and has not strived to enhance the value of its royalty production. In those few cases in which royalty oil was sold to the highest bidder, the State ended up with a number of deals which were defaulted upon. As a result, royalty value enhancement has not been seriously considered as a viable royalty oil management option.

It has been suggested several times that Alaska could become more active in managing royalty oil for additional return. Alaska could negotiate a sale of its oil for delivery to a lower 48 refinery obtaining valuable information and experience as to the actual costs associated with the business of shipping and selling oil. The State could also do processing deals with lower 48 refiners or other potentially profitable downstream activities enhancing the value of its oil production.

Theoretically there is no reason that the State of Alaska could not establish a quasi-public agency to explore, develop, and market its petroleum resources. In fact most of the oil produced in the world today is produced in countries with national oil companies. Certainly this is the case for OPEC, but also many non-OPEC countries as well. Norway, for example, not only has a national oil company Stat-oil, but is a shareholder in Norsk Hydro. Net importing countries like the French and Italians also have successful national oil companies.

Alaska does have some additional regulatory power over the rate of production which could theoretically be exercised to enhance royalty values. If the power to regulate oil production to prevent waste were defined to include an economic

dimension, then Alaska would have the power to require oil producers to underlift or produce at something less than physical capacity. This is the power which the Texas Railroad Commission used in the 1930s and 1940s to pro rate oil production in Texas to support oil prices. If Alaska had exercised this right in 1986, when oil prices were below \$10/b (near \$0/b at the wellhead), oil left in the ground could have been sold for \$20/b 12 months later.

Alaska, as part of the US, faces very real institutional barriers to this kind of active involvement in the oil business beyond the wellhead. I have attempted to identify some of these barriers as follows:

1. This kind of activity is most often thought to be the purview of the private sector.
2. The disposition of the State royalty oil involves the public right to know the how and what of this disposition. This makes a commercial agreement difficult for negotiating parties, particularly in an environment as competitive as petroleum marketing.
3. The US political system is not well suited to allowing public officials to take market risks with public money.

Facing these kinds of institutional barriers, it seems unlikely that Alaska will ever follow in the steps of other oil-exporting regions of the world by moving beyond the role of rent collector. This suggests that Alaska will continue to maintain its love/hate symbiotic relationship with the oil industry.

Summary

Alaska has had a long and mutually profitable association with the oil industry. Generally speaking, Alaska's claim on petroleum resource rent initially increased in line with revenue needs. Later, with the discovery and development of the mammoth Prudhoe Bay field, this claim became an issue of fair share. This fair share has informally been defined as one-third of the resource rent.

Because of the generally recognized dependence of much of the Alaskan economy on oil revenues, issues of industry taxation have always been approached in a serious matter by policy-makers. No one in the State wishes to kill the goose that lays the golden egg.

At the same time, however, comparison of how Alaska manages the production of its oil resource with other exporting regions of the world shows that Alaska has the potential for enhancing the value of its oil resources which it is not willing or able to undertake. Alaska has opted to be something less than either a full partner or even a competitor with the oil industry. Alaska has instead opted to be a passive rent collector and regulator.

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