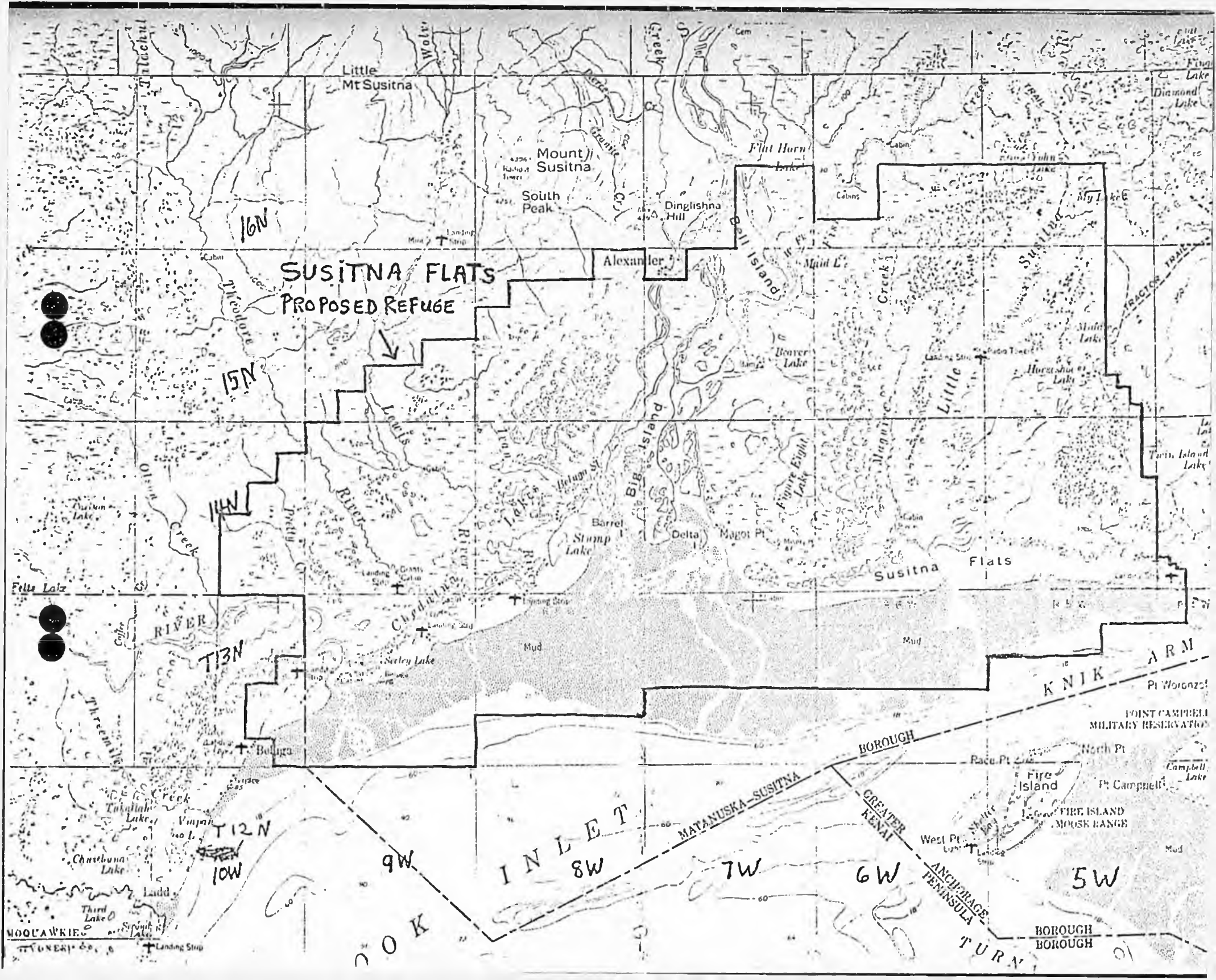


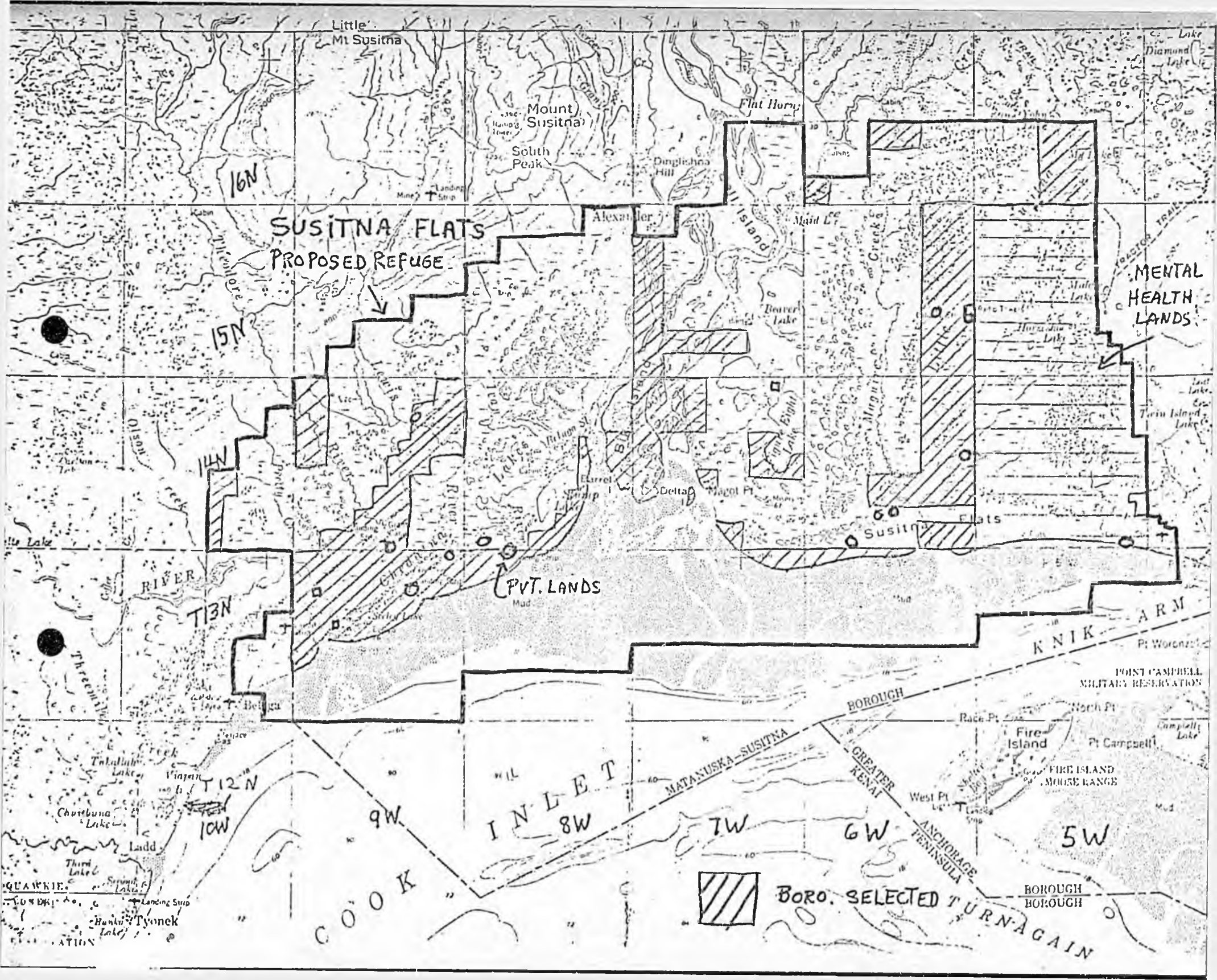
283 HRES MISCELLANEOUS (TESTIMONY, STATEMENTS, MEMOS, ETC)

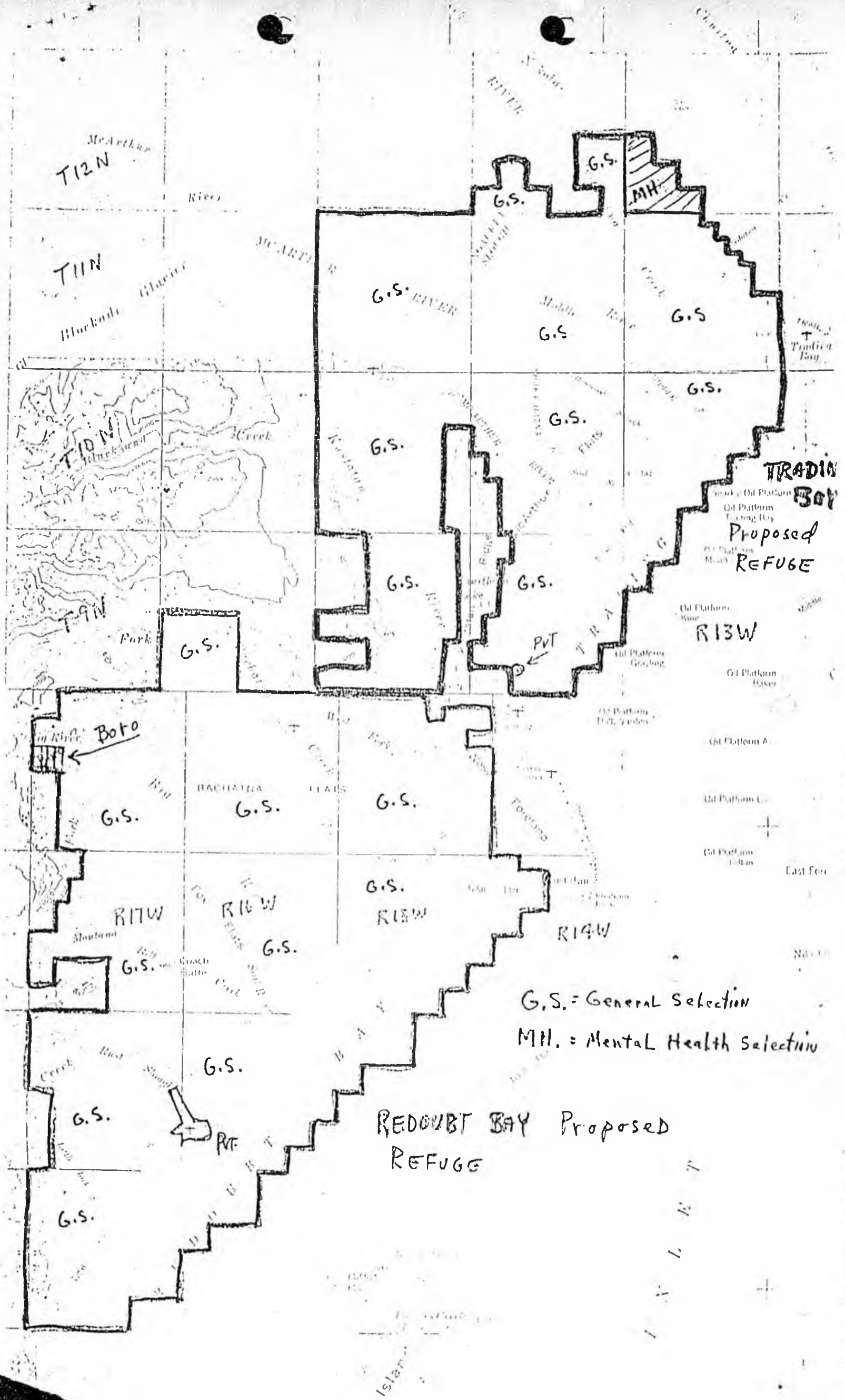
Bay's refuge designation as habitat protection, and providing for the increased public hunting and other user demands associated with future oil development.

Before we draft final refuge management plans our department anticipates holding public meetings for each refuge area to determine what uses Alaskan residents desire. Such a meeting has already been held for the Potter Refuge at Anchorage which resulted in valuable public input for the direction of the areas present and future management.

Mr. Chairman and committee members I would like to thank you again for allowing me this opportunity to bring this information before you today.







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G.S. = General Selection

MH. = Mental Health Selection

REDOUBT BAY Proposed REFUGE

TRADING BOY Proposed REFUGE

River

Blockade Channel

McARTHUR R

G.S. RIVER

Mable Bay

G.S.

TRADING BOY



Oil Platform

Oil Platform

Oil Platform

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MEMORANDUM

March 14, 1975

Re: Advance Sale of Royalty Oil by the State of Alaska

This memorandum and the three agreements attached hereto supplement several brief memoranda dated February 20, 1975, generally describing the structuring of a transaction pursuant to which the State of Alaska could sell its rights to receive a portion of the future production of royalty oil from selected North Slope leases and thereby receive advance payment of the purchase price. The February 20 memoranda are attached hereto for convenient reference; the attached agreements have been prepared in order to further illustrate the transaction described in the memoranda.

As indicated in the February 20 memoranda, the transaction is likely to involve at least three parties:

1. The State of Alaska, which, as seller, would contract to sell a portion of its royalty oil to a buyer for delivery as and when produced.
2. A Buyer which would contractually agree to purchase such royalty oil and to pay the purchase price in advance. The buyer could be an oil company which has use for the oil or some other substantial person or entity; however, there may be relatively few, if any, companies which have funds available to pay the purchase price of the magnitude required by the State or which are willing to incur the debt necessary to pay the purchase price in advance. Therefore, the buyer is likely to be a corporation created for the purpose of serving as the financing vehicle for the transaction. Since the transaction could be structured to provide some financial return to the buyer, that corporation might be owned by a charitable organization or native corporation which could derive some financial benefits from being a party to the transaction without itself

incurring any financial or other obligations which it might be unable to fulfill.

3. A Lender to provide funds to the Buyer in order to pay the purchase price to the State in advance.

Inasmuch as the Buyer is likely to be an entity having neither use for the oil nor the capability of disposing of it, the Buyer would have to make arrangements for disposition of the royalty oil which it is entitled to receive under its agreement with the State. Disposition of the Buyer's share of royalty oil could be accomplished by authorizing an agent to sell the oil on its behalf.

As indicated in the February 20 memoranda, three agreements may be required to effect the transaction discussed therein:

1. An Agreement For the Sale and Purchase of Royalty Oil pursuant to which the State agrees to sell a portion of its royalty oil to the Buyer and the Buyer agrees to pay the purchase price in advance. An example of an agreement illustrating that contractual arrangement is attached hereto as Exhibit I and is hereinafter called the "Purchase Agreement" for convenient reference.
2. A Loan Agreement pursuant to which the Buyer obtains a loan from a lender, presumably a bank or group of banks, to enable it to make the advance payment of the purchase price to the State. A loan agreement so providing is attached hereto as Exhibit II. The loan itself would be evidenced by a note or notes, examples of which are attached to the loan agreement. The Lender would probably require that the notes be secured by a collateral assignment of the Buyer's rights under the Purchase Agreement and the agency agreement pursuant to which the oil would be sold for the Buyer.
3. An Agency Agreement pursuant to which the Buyer would authorize an agent to sell on behalf of the Buyer the royalty oil purchased from the State. Under that agreement, the agent would be required to remit the proceeds of sale to the Buyer which the latter would in turn apply toward liquidation of its loan. The agency agreement would presumably be required if the Buyer did not have the capability or facilities to dispose of the

oil which it is purchasing. The agent could be the State of Alaska or an agency thereof or any private person or corporation, including an oil company. An example of an Agency Agreement is attached hereto as Exhibit III.

There are a number of variables in structuring the transaction which should be considered and merit special comment, particularly insofar as the terms of the Purchase Agreement are concerned. The Purchase Agreement is the keystone to the supporting agreements, i.e., the Loan Agreement and the Agency Agreement.

The Purchase Agreement (Exhibit I) contemplates that the purchase price will be paid in advance to the State in one payment. Alternatively, the agreement could provide for advance payment of the purchase price in installments over a period of time. Installment payments of the purchase price might reduce the total interest costs incurred by the Buyer, but it would probably require payment of commitment fees to the Lender since the Lender would be required to earmark funds for future disbursement of the loan. If the State requires funds in installments, the transaction might be structured to provide for a series of advance sales (by separate purchase agreements) of smaller portions (i.e. smaller percentages or fewer leases) of royalty oil.

Under Section 2 of the Purchase Agreement, only a stated percentage of the royalty oil produced from the lands covered by the leases described therein is sold to the Buyer. Inasmuch as the Alaska Native Claims Settlement Fund is entitled to receive 2% of the gross value of the oil produced from the State's leases, the applicable percentage of the royalty oil sold to the Buyer cannot exceed 98%. The stated percentage of royalty oil sold to the Buyer would presumably be much less and would depend upon the number of leases covered by the Purchase Agreement, the anticipated production schedule, the anticipated field market price of oil and the Lender's requirements for repayment of its

loan to the Buyer.

The Purchase Agreement does not specify the number of barrels of oil purchased by the Buyer. The quantity of oil purchased is to be determined pursuant to the formula provided in Section 4 and is that quantity the proceeds of sale which equal the purchase price plus (i) any taxes paid or other expenses incurred by the Buyer in connection with the transaction and (ii) an interest factor (the so-called "Applicable Computation rate") in order to provide funds for payment of interest on the loan which enabled Buyer to pay the Purchase Price and the taxes and expenses incurred as a result of the transaction. When the proceeds of the royalty oil delivered to the Buyer equal the aggregate of the Purchase Price and the amounts added thereto, the Purchase Agreement and the Buyer's right to oil will terminate. Only at that time will the total quantity of oil purchased and sold be known. Thus, the quantity of oil purchased is a function of, among other things, the cost of the loan, the time when oil is produced and delivered and the market price of oil from time to time during the term of this Agreement. The determination of the quantity of oil to be delivered is made by adjusting the Purchase Price upward by the expense and interest factors and downward by application of the sale proceeds of royalty oil actually produced and delivered to the Buyer until such time as the unapplied balance of the purchase price, as so adjusted, is reduced to zero.

The Applicable Computation Rate provided for in Section 1(g) of the Purchase Agreement is a fraction (1/16 for illustrative purposes) of 1% above the prime rate charged from time to time by the Lender. This fractional percentage increase above an assumed interest rate on the loan is designed to provide an economic return to the Buyer which, as indicated above, might be owned by a charitable organization or native corporation.

Section 8(d) of the Purchase Agreement provides that so long as

the agreement continues in existence, the State would not require the lessee to pay royalties in the form of money (rather the delivery of royalty oil in kind) at least to the extent of the percentage of the royalty oil purchased by the Buyer under that agreement.

Most of the other provisions of the Purchase Agreement are self-explanatory.

The Loan Agreement is an example of a loan agreement used by a major U.S. bank in a similar transaction and assumes that the interest rate will be the lender's prime rate. If compensating balances are not provided by the borrower, the rate charged by the lender will generally involve an increment of interest in excess of prime.

Sale by the State of Alaska of Rights to  
Receive Future Production of Royalty Oil and Gas

State of Alaska legislation in 1974 provides a procedure with respect to the sale of the State's royalty oil and gas. The Commissioner of Natural Resources of the State can sell royalty oil and gas received in kind at the time of its production. He can also sell the State's rights to receive future royalty oil and gas production and receive payment for all or part of it now in the form of an advance sale.

Such sales must be made with the prior written approval of the Alaskan Royalty Oil and Gas Development Advisory Board and with the prior approval of the Legislature. These sales are not sales of oil or gas in place. The Constitution of Alaska prohibits sales in place.

If the State made a sale of its rights to receive future production of royalty oil or gas, the following questions come up:

1. How would such a deal be structured?
2. Would the State lose any of the increased market value of oil sold in this way between the time of sale and the time of production?
3. What portion of the State's royalty from Prudhoe Bay would have to be committed to the repayment of, say, \$100 million, over a 3½ year period, commencing with the startup of production?

Structure of the Transaction

A transaction of this type would involve at least three parties--seller, buyer and a financial institution. The State of Alaska, as the seller, would contract to sell oil to a Buyer and deliver it as it is produced. The Buyer would contract to buy the oil and would pay for

it in advance. Since it is quite unlikely the Buyer would have money available for such an advance payment, he would very likely borrow it from a group of banks. The Seller and the banks can be readily identified. However, a Buyer cannot be so readily identified.

The Buyer could be an oil company who has use for the oil, however, it is doubtful that there are companies with the money available, or the willingness to incur the debt necessary for such an advance payment. Therefore, the Buyer would likely be a financial vehicle created for this purpose, perhaps a company owned by a charitable organization.

If the Buyer is owned by a charitable organization, the questions arise as to why it would be in such a transaction, and how it would use this oil. It would be in the transaction for the financial gain it would realize. It would probably enter into an agreement with another party, a fourth party in this transaction, to sell the oil as its agent. Such fourth party might well be the working interest owner of the properties from which the oil will be produced. This overall arrangement is outlined on the attached exhibit.

Market Value of Oil

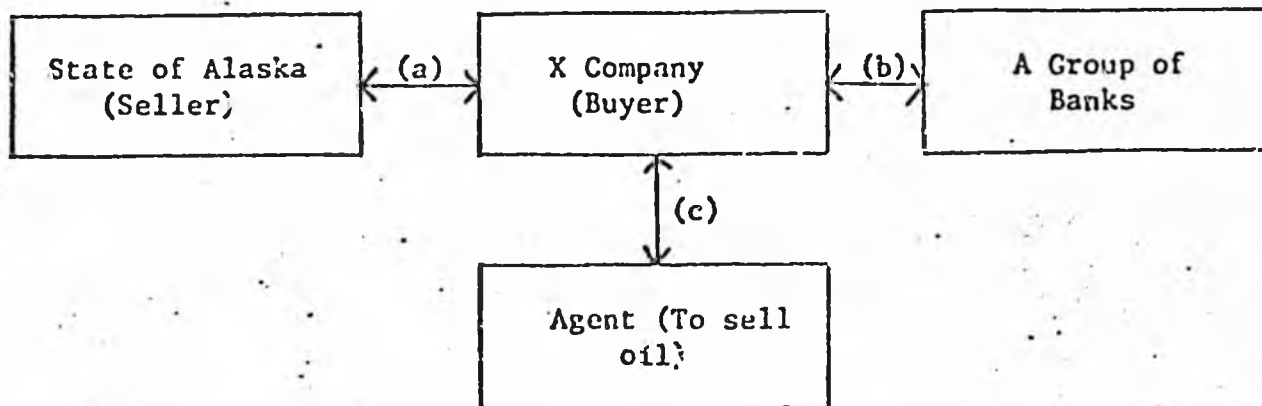
The State should lose nothing in terms of market value by making such a sale. The terms of the agreement would be somewhat as follows: "Seller agrees to sell to the Buyer that quantity of crude oil representing \_\_\_ percent of its royalty interest in leases \_\_\_\_\_, \_\_\_\_\_, and \_\_\_\_\_, until the market value of that oil at the time it is produced is equal to \$\_\_\_\_\_." The quantity of oil to be delivered would include oil to cover interest for the use of the money which the Seller receives in advance and for any profits which the Buyer would make on the transaction. Such profits would be small in terms of the whole transaction.

Portion of Royalty Dedicated to the Sale

If a sale of \$100 million of Prudhoe Bay royalty oil were made on July 1, 1976, and if production commenced at Prudhoe Bay on July 1, 1977, the advance could be paid out of about 15 percent of the State's royalties during the period July 1, 1977 to December 31, 1980-- that is, a period of three and one-half years. The 15 percent applies to the State's royalty after payment of 2 percent into the Native Claims Fund. A wellhead value of the oil of \$5 per barrel and a production rate of 600,000 barrels per day for the first six months and 1.2 million barrels per day thereafter have been assumed. With an assumed interest rate of 8 percent, the State would deliver 25.1 million barrels-- 20 million to repay principal and 5.1 to pay interest. Thus, about 20 percent of the 15 percent dedication (or 3 percent) would go to interest.

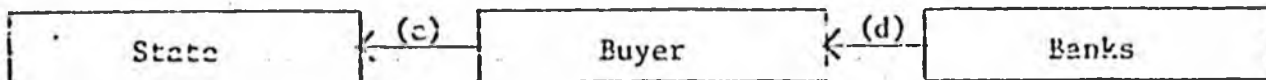
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1. Agreements



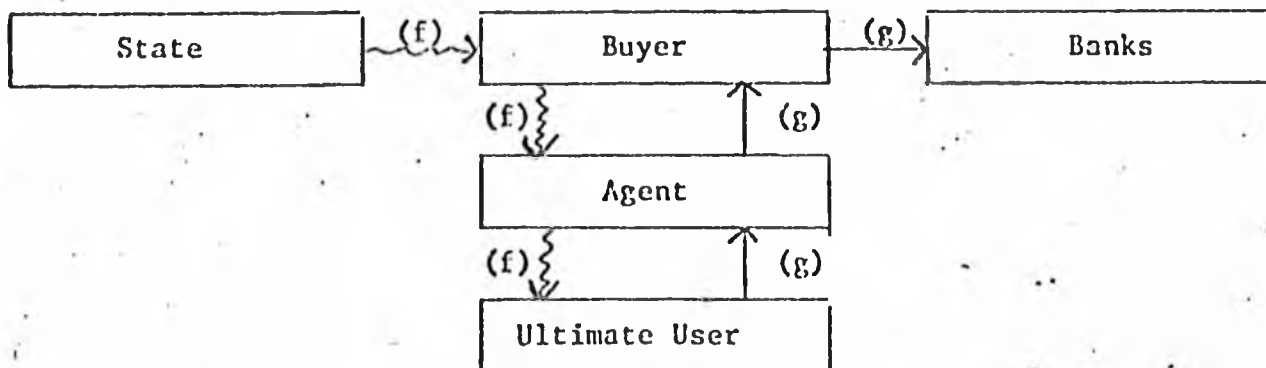
- (a) State agrees to sell oil to Buyer.
- (b) Buyer makes credit agreement with Banks.
- (c) Buyer appoints agent to resell oil to ultimate user.

2. Flow of Money on 7/1/76 (e.g.)



- (d) Banks lend money to Buyer.
- (c) Buyer makes advance payment to State.

3. Delivery of Oil (~~~~~) and Flow of Money (————) --7/1/77 to 12/31/80



- (f) State delivers oil to Buyer who resells and delivers it to the ultimate user, by using an agent to make the sale.
- (g) User pays for the oil and Buyer repays the bank.

PRUDHOE BAY ROYALTY AND SEVERANCE  
 PRODUCTION COMMENCING 7/1/77; 600 M B/D  
 AVERAGE FIRST SIX MONTHS, THEN 1.2 M B/D  
 (Millions)

	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>
1. <u>Production (B/D)</u>	0	0.6	1.2	1.2	1.2	1.2
2. <u>Wellhead Value Per Barrel (a)</u>		\$5	\$5	\$5	\$5	\$5
3. <u>State Income-- No Advance Sale</u>						
Royalty (b)	0	69	274	274	274	274
Severance (8%)	0	38	153	153	153	153
<b>Total</b>	0	107	427	427	427	427
4. <u>Effect of Advance Sale on State's Royalty Income</u>	+100	-10	-39	-39	-38	0
5. <u>State Income-- With Advance Sale</u>						
Royalty (b)	100	59	235	235	236	274
Severance (8%)	0	38	153	153	153	153
<b>Total</b>	100	97	388	388	389	427

(a) Project Independence Blueprint of the Federal Energy Administration makes reference to "Minimum Acceptable Prices" of \$5.16 to \$6.15 per barrel at the wellhead to stimulate development in "special regions," (including the North Slope of Alaska). See Table B-1 in Part 2 of FEA publication dated November 1974 entitled "Task Force Report - Finance."

(b) Includes portion going to Native Claims.

2/20/75

AGREEMENT FOR SALE AND PURCHASE OF ROYALTY OIL

THIS AGREEMENT made as of \_\_\_\_\_, 1975,  
 between THE STATE OF ALASKA, acting by and through its Commissioner of  
 Natural Resources, (hereinafter called the "State"), and \_\_\_\_\_  
 \_\_\_\_\_, a corporation organized and existing under  
 the laws of the State of \_\_\_\_\_ (hereinafter called  
 "Buyer").

W I T N E S S E T H:

The State, as lessor, has executed and delivered the oil and gas leases listed and described in Exhibit A attached hereto and made a part hereof covering certain lands in the Prudhoe Bay Area of the North Slope of Alaska and is entitled to receive royalties on production of oil, gas and associated substances produced and saved from such lands as provided in such leases. The State wishes to sell the percentage hereinafter specified of the Royalty Oil (as hereinafter defined) to which the State is entitled under the leases described in Exhibit A for a limited period of time and Buyer is willing to purchase such Royalty Oil upon the terms and conditions hereinafter set forth.

NOW, THEREFORE, the State and Buyer have agreed and do hereby agree as follows:

1. Certain Definitions. The following terms as used in this Agreement shall have the meanings given below:
  - (a) "Exhibit A" shall mean the schedule or list of Leases attached to this Agreement and marked "Exhibit A".
  - (b) "Lease" shall mean any one of the oil and gas leases listed and described in Exhibit A, and "Leases" shall mean all thereof.
  - (c) "Oil" shall mean crude petroleum oil and other hydro-

carbons regardless of gravity which are produced and saved in liquid form at the well by ordinary production methods.

- (d) "Barrel" shall mean a barrel of 42 standard United States gallons.
- (e) "Commissioner" shall mean the Commissioner of Natural Resources of the State of Alaska.
- (f) "Board" shall mean the Alaska Royalty Oil and Gas Development Advisory Board.
- (g) "Applicable Computation Rate" shall mean, as to any period, a rate per annum equal to 1/16 of 1% above the best rate of interest being charged during such period by \_\_\_\_\_ Bank for new credits of ninety (90) days to responsible and substantial commercial borrowers, any change in such best rate of interest which may be made by said bank from time to time shall be reflected in the Applicable Computation Rate as of the date of the change in such best rate of interest.
- (h) "Effective Date" shall mean \_\_\_\_\_ A.M., Anchorage, Alaska time, on the date first written above.
- (i) "Purchase Price" shall mean the total sum required to be paid by Buyer to the State pursuant to Section 3 hereof concurrently with the execution and delivery of this Agreement and "Adjusted Purchase Price" as of any date shall mean the Purchase Price paid to the State on such date plus all additions to the Purchase Price or Adjusted Purchase Price, as the case may be, required to be made under Section 4 hereof.
- (j) "Royalty Oil" shall mean the Oil which the State is entitled to take as royalty in kind under the Leases.
- (k) "Assigned Royalty Oil" shall mean the percentage of Royalty Oil specified in Section 2 hereof sold to Buyer under this Agreement.

(1) "Market Price of Oil" means the price actually paid or agreed to be paid to the Buyer at the well by the purchaser of the Assigned Royalty Oil if such Assigned Royalty Oil is resold by the Buyer directly or through an agent. If the Assigned Royalty Oil is not resold by the Buyer, "Market Price of Oil" shall be the field market price or value of Royalty Oil as required to be determined under the provisions of the Leases (in most such Leases, the applicable provision is numbered paragraph 16).

(m) "Proceeds" when used herein with reference to the value of Assigned Royalty Oil delivered to or for the account of Buyer hereunder shall mean the number of barrels so delivered in any delivery or during any period multiplied by the appropriate Market Price of Oil.

2. Royalty Oil Sale and Purchase Obligations. Subject to the terms and provisions of this Agreement, the State hereby agrees, during the period of this Agreement, to sell to the Buyer and the Buyer agrees to purchase and pay for in the manner herein provided \_\_\_\_\_ percent (\_\_\_\_%) of all Royalty Oil produced and saved and removed on and after the Effective Date from the lands covered by the Leases until expiration of this Agreement as hereinafter provided in Section 5. Title to the Assigned Royalty Oil delivered to or for the account of Buyer under this Agreement shall pass to Buyer at the time when the Assigned Royalty Oil is delivered to or for the account of Buyer by the lessee pursuant to numbered paragraph 14 of the Leases.

3. Purchase Price. As consideration for the foregoing sale by the State to Buyer of the Assigned Royalty Oil, Buyer shall pay to the State in immediately available U.S. funds at the office of the \_\_\_\_\_ Bank, \_\_\_\_\_, the sum of \_\_\_\_\_ Dollars (\$ \_\_\_\_\_) concurrently with the execution and delivery of

this Agreement.

4. Amount of Assigned Royalty Oil Sold to Buyer. The total barrels of Assigned Royalty Oil purchased by and to be delivered to or for the account of Buyer hereunder, as and when produced from the Leases, shall be that quantity the Proceeds of which determined as hereinbefore provided and which are to be applied under Section 6 hereof equal the aggregate of the following:

- (a) the amount of the Purchase Price; plus
- (b) an amount equal to the aggregate of all amounts paid or payable by or for the account of Buyer from time to time to the United States and to any state or political subdivision thereof on account of ad valorem, gross receipts, gross income, gross revenue, occupation, sales, franchise and other taxes and assessments of any kind whatsoever (but excluding net income, net profits and capital gain taxes of the Buyer) including penalties and interest thereon, imposed or assessed with respect to or measured by or charged against or attributable to payment of the Purchase Price by the Buyer under this Agreement (and/or any additions thereto), the purchase of the Assigned Royalty Oil by the Buyer hereunder, sales by or for the account of the Buyer of such Assigned Royalty Oil or the proceeds thereof, or the acquisition, ownership, sale, assignment, transfer or other disposition by the Buyer in whole or in part of this Agreement or any of its rights hereunder; provided, however, that the State shall have the right at its expense to contest any such taxes or assessments in good faith on behalf of the Buyer; plus

- (c) An amount equal to the aggregate of all reasonable expenses of the Buyer incidental to its purchase, ownership, pledging or transferring of the Assigned Royalty Oil or any part thereof, the obtaining of any loan required to enable Buyer to purchase the Assigned Royalty Oil and the receipt and disbursement of funds (including, without limitation, all fees and expenses of accountants and counsel for the Buyer and of counsel for any lender making any such loan) and all other fees in connection with and all expenses and costs of litigation and the contest, release or discharge of any adverse claim or demand made or proceeding instituted by any person affecting in any manner whatsoever the Buyer's rights to the Assigned Royalty Oil hereunder, which shall have been paid or incurred by the Buyer from time to time until termination of this Agreement; plus
- (d) As to any period amounts computed (on the basis of a 365-day year) from time to time on the aggregate of the amounts referred to and described in the preceding subparagraphs (a), (b) and (c) of this Section 4 outstanding during such period as reduced from time to time during such period by the application (as provided in Section 6 hereof) of the Proceeds of the Assigned Royalty Oil delivered to or for the account of Buyer, such computations to be made as of the first day of each calendar year quarter occurring after the Effective Date at the Applicable Computation Rate and in accordance with the following provisions:

- (i) The first such computation shall be made as of the first day of the calendar year quarter next succeeding the Effective Date for the period commencing with (and including) the Effective Date to (but not including) such first day of such first calendar year quarter.
- (ii) Subsequent computations shall be made quarterly thereafter on the first day of each succeeding calendar year quarter and such computations together shall cover the period commencing on the date of the first computation under the preceding clause (i) and ending with the calendar year quarter in which this Agreement is terminated. Each separate quarterly computation shall cover the calendar year quarter immediately preceding the date as of which each successive computation is required to be made and the first days of such calendar year quarters as of which computations are required to be made are sometimes hereinafter referred to in this section as "Computation Dates".
- (iii) The computations required to be made on the successive Computation Dates under the preceding clauses (i) and (ii) shall take into account the amounts, if any, paid or becoming payable by the Buyer under the provisions of subparagraphs (b) and (c) of this Section 4 and not previously reflected in the totals arrived at under such subparagraphs, and shall also take into account and reflect, as of the date of application by the Buyer under Section 6 hereof, the amount of Proceeds of Assigned Royalty Oil applied or deemed to have been applied pursuant to Section 6 hereof during the period embraced in each such computation.

5. Termination of Agreement. When Proceeds equal to the full aggregate amounts specified in subparagraphs (a), (b), (c) and (d) of Section 4 of this Agreement have been received by the Buyer, this Agreement and all rights of Buyer to receive Royalty Oil shall immediately terminate. The Buyer agrees that, if so requested by the State at any time or from time to time after the termination of this Agreement, it will execute or cause to be executed such instruments as may be necessary or appropriate to evidence the termination of this Agreement and of Buyer's rights to receive Royalty Oil.

6. Application of Proceeds of Assigned Royalty Oil Received by Buyer. The Proceeds of Assigned Royalty Oil delivered to or for the account of Buyer shall be applied toward liquidation of the Adjusted Purchase Price in accordance with the provisions of this Section 6. The Proceeds of Assigned Royalty Oil used by Buyer or resold by it in any calendar month shall be deemed to have been received by Buyer on the date of actual use thereof or actual receipt from the purchaser or on the last day of the next succeeding calendar month following the month of delivery, whichever is the earlier date, and such Proceeds shall be deemed to have been applied immediately after the opening of business on the next succeeding day. If any date of application specified above shall be a Saturday, Sunday or legal holiday under the law of the jurisdiction in which such Proceeds are actually received or deemed to have been received by the Buyer, such proceeds shall be deemed to have been received and applied as of the close of business on the last business day next preceding such Saturday, Sunday or legal holiday in such jurisdiction. Proceeds remitted to an assignee designated by the Buyer shall be deemed to have been received by the Buyer on the date of receipt by such assignee.

7. No Property Rights in Leases in Favor of the Buyer. Nothing contained in this Agreement shall be construed as granting to or vesting in the Buyer any property rights or interests, legal or equitable, or any economic interests, in any of the Leases or the properties described therein,

or in the crude oil reserves capable of being produced from such properties.

8. Representation by and Certain Agreements of the State. The State hereby makes the following representations to the Buyer and also makes the following agreements, among others, with the Buyer:

- (a) The terms, provisions and conditions set forth herein and the execution and delivery of this Agreement by the Commissioner on behalf of the State have been approved in writing by the Board and have also been approved by the legislature of the State by a concurrent resolution concurred in by a majority of the members of each house in compliance with the provisions of Sections 38.06050 and 38.06055 of the Alaska statutes.
- (b) All of the Leases were validly issued by the State and are in full force and effect on the date hereof.
- (c) Each of the Leases provides for the payment by the lessee to the State of a royalty of twelve and one-half percent (12.5%) in amount or value of Oil produced and saved and removed or sold from the lands covered by the Leases.
- (d) The State has not heretofore exercised the option given to it in Paragraph 15 of each Lease to require the lessee to pay to the State the fair market price or value at the well of all royalty with respect to Oil but has exercised the option given to it in Paragraph 14 of each Lease to take in kind the royalty payable with respect to Oil. The State hereby agrees with the Buyer that such election will not be revoked or changed with respect to the Assigned Royalty Oil without the written consent of the Buyer at any time prior to the termination of this Agreement.

- (e) The State will not, without the prior written consent of Buyer, agree to reduction of its royalty under the Leases at any time prior to termination of this Agreement.

9. No Obligation of State With Respect to Assigned Royalty Oil.

Prior to termination of this Agreement, the Buyer shall be entitled to receive all Assigned Royalty Oil directly from the lessees under the Leases and the State shall have no obligation to the Buyer to receive, store or otherwise deal with the Assigned Royalty Oil.

10. Access to Leases. The State shall permit any one or more representatives designated by the Buyer, but at the Buyer's risk and expense, to inspect the Leases and, to the extent available to the State and/or permissible under the Leases, any logs and test data relating to wells drilled pursuant thereto, any records relating to production and disposition of Royalty Oil produced from the lands covered by the Leases and such other information relating to this Agreement as the Buyer may reasonably request from time to time.

11. Reports to the State. Within twenty (20) days after the close of each calendar month during the period of this Agreement, the Buyer shall furnish or cause to be furnished to the State a written statement showing with respect to such calendar month, the amount of the Purchase Price or Adjusted Purchase Price at the beginning of such month, all additions to the Purchase Price or Adjusted Purchase Price, all applications of Proceeds thereto, and the unliquidated balance of the Adjusted Purchase Price as of the close of such month.

12. Transfers of the Rights of State. Nothing contained in this Agreement shall be construed to limit or restrict in any way the right of the State to sell, transfer or pledge any portion of the Royalty Oil other than the Assigned Royalty Oil sold to Buyer under this Agreement.

13. Transfers of the Rights of Buyer. Nothing contained in this Agreement shall be construed to limit or restrict in any way the right of the Buyer to sell, transfer, assign or pledge its rights under this Agreement,

in whole or in part.

14. Rights of Assignee or Secured Party. If the Buyer shall at any time execute an assignment or security agreement covering all or part of the Buyer's rights under this Agreement as security for any obligation of the Buyer, the assignee or secured party therein named or the holder of any obligation secured thereby shall be entitled, to the extent such assignment or security agreement so provides, to exercise all of the rights, remedies, powers and privileges conferred upon the Buyer by the terms of this Agreement and to give or withhold all consents required to be obtained hereunder by the State, but the provisions of this Section 13 shall in no way be deemed or construed to impose upon the State any obligation or liability undertaken by the Buyer under such assignment or security agreement or under the obligation of Buyer secured thereby.

15. Notices. Any notice, request, demand, report or other instrument which may be required or permitted to be given or furnished to or served upon either party hereto shall be deemed sufficiently given or furnished and served if in writing and delivered to such party or person or to an officer of such party or person or deposited in the United States mail in a sealed envelope, with postage prepaid for certified or registered mail, addressed if to the State in care of \_\_\_\_\_

\_\_\_\_\_ and if to Buyer at \_\_\_\_\_ or to such other address or such other person as the party or person to be addressed shall have designated by written notice to the other party or person.

16. Governing Laws. This Agreement shall be construed and interpreted under and in accordance with the laws of the State of Alaska.

17. Headings. Section headings in this Agreement are for convenience only and shall not affect the construction of this Agreement.

IN WITNESS WHEREOF, the parties have caused this Agreement to be duly executed as of the date first above stated, in several counterparts

(one of which with all property descriptions included in Exhibit A is on file at the office of State), each of which is an original and all of which are identical. Each of the counterparts of this Agreement so executed shall for all purposes be deemed to be an original, and all such counterparts together shall constitute but one and the same Agreement.

STATE OF ALASKA

By: \_\_\_\_\_  
Commissioner of Natural Resources

\_\_\_\_\_  
By: \_\_\_\_\_  
Buyer

EXHIBIT A  
TO  
AGREEMENT FOR SALE AND PURCHASE OF ROYALTY OIL  
SCHEDULE OF LEASES

## LOAN AGREEMENT

LOAN AGREEMENT, dated as of \_\_\_\_\_, 1975, between  
 \_\_\_\_\_, a \_\_\_\_\_ corporation (the "Company"),  
 and \_\_\_\_\_ BANK, a national banking association  
 (the "Bank").

## R E C I T A L S

A. By an Agreement entitled "Agreement For Sale and Purchase of Royalty Oil", dated as of the date of this Agreement (the "Purchase Agreement"), between the State of Alaska (the "State"), as Seller and the Company, as Buyer, a true copy of which has been furnished to the Bank, the State sold to Buyer and the Company purchased from the State a percentage of the Royalty Oil (as defined in the Purchase Agreement) produced and saved from the lands described in the Leases (as defined in the Purchase Agreement) for a limited period of time. The Purchase Agreement requires the Company to pay to the State the sum of \_\_\_\_\_ Dollars (\$ \_\_\_\_\_) for the Royalty Oil purchased and sold thereunder.

B. By an Agreement entitled "Agency Agreement" dated as of the date of this Agreement (the "Agency Agreement") between the Company, as principal, and \_\_\_\_\_, as Agent ("Agent"), a true copy of which has been furnished to the Bank, the Company appointed the Agent to act as its agent for the sale of all Royalty Oil to which the Company shall become entitled under the Purchase Agreement and the Agent accepted such appointment for such purpose.

C. The Company has requested the Bank to make a loan to it to enable it to pay to the State the purchase price of the Royalty Oil purchased and sold under the Purchase Agreement.

NOW, THEREFORE, in consideration of the mutual agreements herein contained, the Company and the Bank have agreed and do hereby agree as follows:

1. Commitment of the Bank. Subject to the terms and conditions of this Agreement the Bank agrees to lend to the Company on the date hereof the sum of \_\_\_\_\_ Dollars (\$ \_\_\_\_\_) in order to pay to the State the purchase price of the Royalty Oil purchased by the Company pursuant to the Purchase Agreement and to pay the other obligations of the Company described in Section 3 below. The advances so to be made by the Bank are herein collectively called the loan.

2. Notes and Interest. The loan shall be evidenced by (i) a promissory note of the Company (the "Loan Note") in the principal amount of \_\_\_\_\_ Dollars (\$ \_\_\_\_\_), and (ii) certain additional notes to be executed and delivered from time to time as provided in Section 3 below (singly called an "Additional Note" and, collectively, "Additional Notes"). The Loan Note shall be dated the date hereof, shall mature and bear interest as provided in, and shall otherwise be in the form of, Exhibit A hereto. Each Additional Note shall be dated the date of its issue as provided in Section 3, shall

mature and bear interest as provided in, and shall otherwise be in the form of, Exhibit B hereto.

3. Advances on Account of Loan. Pending receipt by the Company from time to time of the Proceeds (as defined in the Purchase Agreement) from the sale of the Royalty Oil purchased from the State and to be sold by the Agent pursuant to the Agency Agreement, the Bank will, on the first day of each Accounting month, commencing \_\_\_\_\_, 1975, advance to the Company, against delivery to the Bank of an Additional Note in a principal amount equal to the amount to be advanced, an amount sufficient to enable the Company to pay, to the extent they cannot be paid out of such Proceeds: (i) Interest accrued to said date on the Loan Note, and (ii) Interest accrued to said date on all Additional Notes.

4. Security for the Notes. The Loan Note and the Additional Note (collectively, the "Notes") shall be secured by an Assignment of even date with the Loan Note from the Company to \_\_\_\_\_, as Trustees (the "Assignment"), by which the Company's rights under the Purchase Agreement and under the Agency Agreement are collaterally assigned to the Trustees for the benefit of the Bank and the Proceeds from the sale of Royalty Oil are collaterally assigned to the Bank. The Assignment shall be in substance and form satisfactory to the Bank.

5. Representations and Warranties by the Company. The Company represents and warrants that:

- (a) The Company is a corporation duly organized and existing under the laws of the State of \_\_\_\_\_.
- (b) The Company has the power and authority under its charter and laws of the State of \_\_\_\_\_ to execute the Purchase Agreement, the Agency Agreement, this Agreement, the Loan Note, the Additional Notes and the Assignment, and the performance of its obligations thereunder does not and will not conflict with any provision of law or of its charter or by-laws or of any agreement binding upon it; and
- (c) The Purchase Agreement, Agency Agreement and this Agreement have been duly authorized, executed and delivered by, and constitute legal, valid and binding agreements of, the Company.

All representations and warranties herein shall survive the consummation of the transactions contemplated by this Agreement.

6. Covenant of the Company. The Company agrees with the Bank that from and after the date of this Agreement and until the delivery of the Assignment, the Company will not, without the written consent of the Bank, agree to any material change in the provisions of the Purchase Agreement or the Agency Agreement or give any consents thereunder.

7. Conditions Precedent to Loan Disbursement. The obligation of the

Bank to make the loan is subject, in the discretion of the Bank, to the following conditions precedent:

- (a) No default shall have occurred and be continuing in the performance of any of the Company's covenants or agreements herein set forth, nor shall any representation or warranty made by the Company herein be untrue in any material respect;
- (b) No order, writ or injunction of any court or administrative agency shall be in effect prohibiting the transactions contemplated by the Purchase Agreement, Agency Agreement or this Agreement;
- (c) This Agreement, the Assignment, the Loan Note and the Additional Notes shall have been duly authorized and, with the exception of the Additional Notes, executed and delivered, and the form and substance of each thereof shall be satisfactory to the Bank;
- (d) The Purchase Agreement shall have been executed and delivered by the parties thereto;
- (e) The Agency Agreement shall have been executed and delivered by the parties thereto; and
- (f) The Bank shall have received from Messrs. counsel for the Company, an opinion in scope and substance satisfactory to the Bank and its counsel as to:
  - (1) the matters referred to in 5(a), 5(b) and 5(c);
  - (2) the legality, validity and enforceability of this Agreement, the Assignment, the Loan Note and the Additional Notes (if and when delivered) as against the Company in accordance with their respective terms; and
  - (3) such other matters incidental to the transactions contemplated hereby as the Bank and its counsel may reasonably request.
- (g) The Bank shall have received from counsel for the State and the Agent, an opinion in scope and substance satisfactory to the Bank and its counsel as to the legality, validity and enforceability of the Purchase Agreement and the Agency Agreement against the parties thereto in accordance with the respective terms thereof.

8. Expenses. The Company will pay (i) all expenses incurred in connection with the loan provided for herein, including the fees and disbursements of its counsel, printing or reproducing costs, recording fees, stamp or transfer

taxes, if any, and all other expenses incurred by it in purchasing and selling the Royalty Oil or incurred by it in connection with the transactions contemplated by this Agreement, (ii) the out-of-pocket expenses of counsel for the Bank, and (iii) the out-of-pocket expenses of the Bank incurred in connection with the aforesaid loan.

9. Notices. Any notice or communication required or permitted hereunder shall be given in writing and delivered by hand or sent by United States mail, postage prepaid, or by prepaid telegram, addressed as follows:

To the Company:

To the Bank:

10. Miscellaneous.

- (a) All covenants and provisions of this Agreement by or for the benefit of the parties hereto shall bind and inure to the benefit of their respective successors and assigns.
- (b) This Agreement and the Notes shall be deemed to be contracts entered into under the laws of the State of \_\_\_\_\_ and for all purposes shall be construed in accordance with the laws of that State.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed as of the date hereinabove first written.

By: \_\_\_\_\_

BANK

By: \_\_\_\_\_

EXHIBIT A

LOAN NOTE

\$

1975

On or before \_\_\_\_\_, 19\_\_\_\_, the undersigned, \_\_\_\_\_, a \_\_\_\_\_ corporation, (herein called the "Company") promises to pay to \_\_\_\_\_ BANK (the "Bank"), or its order, at the office of said Bank in \_\_\_\_\_, the principal sum of \_\_\_\_\_ DOLLARS (\$ \_\_\_\_\_), together with interest on the balance of principal remaining from time to time unpaid from the date hereof until maturity at a rate per annum which is equal to the Bank's prime rate (being the best rate of interest the Bank charges for new credits of ninety days to responsible and substantial commercial borrowers at its office in \_\_\_\_\_) in effect from time to time as publicly announced by the Bank.

This Note evidences a Bank loan made to the Company by the Bank under, and is subject to the terms and provisions of, a Loan Agreement, dated as of \_\_\_\_\_, 19\_\_\_\_ (and, if amended, all amendments thereto), between the Company and the Bank and is secured by an Assignment (the "Assignment") of even date herewith from the Company to \_\_\_\_\_, as Trustees, assigning to the Trustees the rights of the Company under the Purchase Agreement and the Agency Agreement (as such terms are defined in the Loan Agreement) and the Proceeds of sale of Oil to be sold by the agent under the Agency Agreement. Reference is made to the Loan Agreement for a statement of its terms and provisions and to the Assignment for a description of the rights assigned, the nature and extent of the security and the rights of the Trustees, the Bank and the Company in respect of such security.

By \_\_\_\_\_  
President



EXHIBIT B

ADDITIONAL NOTE

§

19

On or before December 31, 19 , the undersigned,  
 , a corporation (herein called the  
"Company") promises to pay to BANK  
(the "Bank"), or its order, at the office of said Bank in , the  
principal sum of , together with interest on the  
balance of principal remaining from time to time unpaid from the date hereof  
until maturity at a rate per annum which is equal to the Bank's prime rate  
(being the best rate of interest which the Bank charges for new credits of ninety  
days to responsible and substantial commercial borrowers at its office in )  
in effect from time to time as publicly announced by the Bank.

This Note is one of the Additional Notes referred to in, and is subject  
to the terms and provisions of, a Loan Agreement, dated as of  
19 (and, if amended, all amendments thereto), between the Company and the Bank.  
This Note is also secured by an Assignment (the "Assignment") dated ,  
19 from the Company to , as Trustees,  
assigning to the Trustees the rights of the Company under the Purchase Agreement  
and the Agency Agreement (as such terms are defined in the Loan Agreement) and  
the Proceeds of sale of Oil to be sold by the agent pursuant to the Agency Agree-  
ment. Reference is made to the Loan Agreement for a statement of its terms and  
provisions as they apply to this Note and to the Assignment for a description of  
the rights assigned, the nature and extent of the security and the rights of the  
Trustees, the Bank and the Company in respect of such security.

By \_\_\_\_\_  
President

## AGENCY AGREEMENT

THIS AGREEMENT entered into as of the \_\_\_\_\_ day of \_\_\_\_\_, 1975,  
 by and between \_\_\_\_\_, a \_\_\_\_\_  
 corporation (herein called the "Principal"), and \_\_\_\_\_,  
 (herein called the "Agent"):

## W I T N E S S E T H, T H A T

WHEREAS, the State of Alaska as the seller entered into an "Agreement for Sale and Purchase of Royalty Oil" (herein called the "Agreement") with the Principal, therein called the "Buyer" dated as of the date of this Agency Agreement, whereunder the State agreed to sell and deliver certain percentage of the Royalty Oil produced and saved from the Leases (as those terms are defined in the Agreement) in the Prudhoe Bay Area of the North Slope of Alaska during a period commencing on the date of the Agreement and continuing thereafter until the said Agreement by its terms shall have terminated; and

WHEREAS, the Principal desires to have the Agent act as its agent for the sale of all of the Oil to which the Principal shall become entitled under the aforesaid Agreement with the authority, powers, rights and duties hereinafter set forth and the Agent is willing to act for the Principal in such capacity.

NOW, THEREFORE, the parties hereunder have agreed and do by these presents agree as follows:

1. The Principal hereby designates and appoints the Agent as its agent, on its behalf and for its account, to enter into contracts from time to time with a purchaser or purchasers, selected or approved by the Agent, for the sale and delivery of all of the Oil to which the Principal may become entitled under the Agreement. In its capacity as agent the Agent shall have full power and authority to determine and agree upon the terms and conditions to be contained in any such contract or contracts including, but not limited to, the selling price or prices per barrel, the terms of payment and the point of delivery (which may be either in the field where produced or at some other point), to arrange for transportation of the Oil from the Prudhoe Bay Area to the point or points of delivery, to collect the selling price of all of the Principal's Oil so sold and out of such funds to pay for the account of the Principal any taxes of the kind referred to in Paragraph 8 hereof which are required to be paid by the Principal, the gathering charges, if any, for the gathering of the Oil in the field where produced and all transportation charges, if any, for transporting the Oil from the field where produced to the point of delivery.

2. The Agent hereby accepts its appointment as agent of the Principal and agrees to act as Agent for the Principal and to use its best efforts to sell the Oil which the Principal will be entitled to receive under the Agreement at a price or prices per barrel which, after deducting the

transportation costs, if any, incurred in transporting such Oil from the field where produced to the point of delivery, will fairly represent the going field price per barrel in the field where produced at the time of the delivery of such Oil to the purchaser or purchasers in the field or at the time of the delivery of such Oil to a common carrier pipeline in the field for transportation to some other delivery point.

3. In entering into a contract or contracts for the sale of Oil for the account of the Principal the Agent may, but need not, disclose the fact that it is acting as agent for the Principal. Any such contract or contracts may relate solely to the sale of the Principal's Oil. However, the Agent may have, during the period of this Agreement, quantities of Oil of its own to market. Under these circumstances the Agent is hereby authorized, if it shall see fit so to do, to enter into contracts with a purchaser or purchasers for the sale of quantities of Oil produced in the Prudhoe Bay Area, and to fulfill such contract or contracts by delivering to the purchaser or purchasers in part the Principal's Oil and in part the Agent's own Oil. However, in making contracts for the sale of Oil and in making deliveries of Oil to the purchaser or purchasers under such contracts, the Agent shall give no preference or priority to its own Oil as against the Oil sold by the Agent for the account of the Principal.

4. The Agent further agrees to extend credit only to purchasers having acceptable credit ratings, and to make collection for the account of the Principal of the selling price for all of the Principal's Oil sold hereunder. In view of the latitude of the Agent under this Agreement in the selection of a purchaser or purchasers, and in determining credit terms and approving credit ratings, the Agent assumes the risk of collection.

5. The Agent shall, from time to time, remit to the Principal or to a collection agent (which shall be a bank which is a member of the New York Clearing House Association and with which Principal shall maintain an account) designated in writing by the Principal, and to such address as the Principal shall instruct in writing, the Net Proceeds of the Oil sold and delivered by the Agent for the account of the Principal. The term "Net Proceeds" as used herein shall mean the selling price less taxes, if any, of the kind referred to in Paragraph 8 hereof, imposed on the Principal and which the Agent may be obligated to pay under the provisions of said Paragraph 8 for the account of the Principal, and less transportation charges, if any, incurred by the Agent for the Principal.

For accounting purposes under this Agreement and under the Agreement, the Principal shall treat the accrued taxes, which were deducted by the Agent in arriving at the Net Proceeds included in a remittance, as though the Principal had paid such taxes directly to the taxing authority and had been immediately reimbursed therefor.

Remittances by the Agent to the Principal or its collection agent

shall be made on the last day of each calendar month and the Agent shall remit on such day all Net Proceeds applicable to deliveries of the Principal's Oil made during the preceding Accounting Period (as hereinafter defined), whether or not the full sale price of the Principal's Oil shall have actually been collected by the Agent prior to the remittance date and whether or not the taxes and/or transportation charges, if any, payable by the Agent for the account of the Principal have actually been paid by the Agent. If through error or inadvertence the Agent should remit to or for the account of the Principal, for any accounting Period, a sum or sums aggregating more or less than the Net Proceeds which the Principal is entitled to receive for Oil of the Principal delivered in such Accounting Period, the Agent shall make the necessary adjustment on the next remittance date. As used in this Agreement the term "Accounting Period" shall mean the period commencing with and including the first day of the calendar month preceding the month in which applicable remittance date occurs and ending with and including the last day of the calendar month preceding the month in which the applicable remittance date occurs.

6. Notwithstanding any other provisions of this Agreement, if the Agent shall in any Accounting Period sell and deliver to any purchaser Oil belonging to the Principal and also shall sell and deliver to the same purchaser Oil produced from the Leases and belonging to the Agent, the obligation of the Agent hereunder to make remittances of the Net Proceeds of such sales of the Principal's Oil shall be deemed satisfied in all respects if the Agent shall account for and shall remit to the Principal in accordance with Paragraph 5 hereof an amount per barrel equal to the weighted average amount per barrel of the net proceeds accruing to the Agent for the account of the Principal and for its own account from the total quantity of Oil produced from the Leases and delivered to each such purchaser by the Agent in such Accounting Period. If the Agent shall in any Accounting Period sell and deliver to any purchaser Oil of the Principal but shall not sell and deliver to the same purchaser any Oil produced from the Leases and belonging to the Agent, the Agent shall remit to the Principal the actual Net Proceeds per barrel from such sale or sales.

7. From and after the date on which deliveries shall first be made of Oil of the Principal to a purchaser or purchasers, the Agent for and on behalf of the Principal, and if and to the extent that Agent may lawfully do so, shall pay or cause to be paid punctually before the same shall become delinquent (or as to any thereof which are being contested in good faith, promptly after the determination of such contest) to the United States and to any state or political subdivision thereof all ad valorem, gross receipts, gross income, gross revenue, occupation, sales, franchise and other taxes and assessments of any kind whatsoever (but excluding net income, net profits and capital gain taxes of the Principal) including penalties and interest thereon, imposed or assessed with respect to or measured by or chargeable against or attributable to the Purchase Price paid by the Principal to the State under the Agreement (and/or any additions thereto), the purchases of Oil by the Principal, sales by or for the account of the Principal of such Oil or the proceeds thereof, or the acquisition, ownership, sale, assignment, transfer or other disposition by the Principal in whole or in part of the Agreement or any of the Principal's rights thereunder.

8. From and after the commencement date referred to in Paragraph 7 hereof, and continuing until this Agreement shall terminate, the Agent shall promptly after the close of each calendar month furnish to the Principal a statement showing the number of barrels of Principal's Oil delivered to a purchaser or purchasers and the computation of the Net Proceeds available to such barrels.

All monetary computations and reporting required of the Agent under this Agreement shall be in U. S. dollars and all remittances of Net Proceeds made by the Agent to or for the account of the Principal shall be in immediately available funds.

9. This Agreement shall continue in effect so long as the Agreement continues in effect and until such time thereafter as the Agent shall have made all required remittances of proceeds to the Principal and all other undertakings of the Agent hereunder shall have been fulfilled. The Principal may terminate this Agreement at any time by giving written notice of termination to the Agent not less than ninety (90) days prior to a date of termination specified in such notice or if the Agent shall default in the performance of any of its undertakings hereunder and such default shall continue unremedied for a period of thirty (30) days after written notice thereof shall have been given by the Principal to the Agent, or if such default cannot be remedied within such period, the Agent shall not have commenced to remedy such default within such period after receipt of such notice, or having commenced to remedy such default within such period shall not thereafter continuously and diligently pursue the remedying of the same until cured. Written notice of any such termination by the Principal shall be given to the Agent and shall specify therein the effective date of termination, but any such termination shall be subject to all uncompleted contracts for the sale of Principal's Oil entered into by the Agent and existing at the effective date of the termination of this Agreement.

10. The Principal may hereafter assign in whole or in part its rights under the Agreement. If the Principal shall make such an assignment, then the Principal shall assign this Agreement in whole or in part to the same party, and prompt written notice thereof shall be given to the Agent. Such notice shall specify the effective date of the assignment of the rights under the Agreement and under this Agreement, the name and address of the assignee and the portion and extent of the rights assigned by the Principal to such party. If the Principal shall make such an assignment of rights under this Agreement, then by acceptance of such assignment, the assignee shall be deemed to have appointed the Agent as its agent for the purposes of this Agreement and shall be bound by the terms and provisions hereof, and Agent hereby agrees to act as Agent of such assignee. In such case the word "Principal" as used herein shall mean and include such assignee. The Agent shall not assign this Agreement without the prior written consent of the Principal.

11. The Agent shall make no charge for its services in marketing the Principal's Oil or for its services in collecting the proceeds from sales thereof or in accounting for and remitting the Net Proceeds to the Principal. No deductions from the selling price in arriving at Net Proceeds, other than those hereinbefore authorized, shall be made by the Agent.

12. Any notice, request, demand, report or other instrument which may be required or permitted to be given or furnished to or served upon either party hereto shall be deemed sufficiently given or furnished or served if in writing and delivered to such party or person or to an officer of such party or person or deposited in the U. S. Mail in a sealed envelope, registered, with postage prepaid, addressed if to the Principal to

, and if to the Agent to  
, or to such other address as the party or person to be addressed shall have designated by written notice to the party or person giving such notice or furnishing such report or making such request or demand.

All agreements and undertakings of the several parties hereto shall be binding upon, and inure to the benefit of, the respective parties hereto and their respective successors and assigns. No amendment, change or modification of this Agreement shall be binding upon the parties hereto unless made in writing and signed by both parties hereto.

13. The construction and interpretation of this Agreement shall be governed by the laws of the State of Alaska.

IN WITNESS WHEREOF, the parties have caused these presents to be executed as of the day and year first above written.

By \_\_\_\_\_  
President

PRINCIPAL

By \_\_\_\_\_  
President

AGENT

STATEMENT ON AD VALOREM TAXATION OF  
OIL AND GAS PRODUCING PROPERTIES

Robert H. Paschall  
April, 1975

I. DEFINITIONS

- A. "Ad valorem" means "according to value" of the property. In regard to oil and gas properties, "ad valorem" does not mean or imply a given gross income or a given proven reserve of oil or gas. It means the best estimate of the price that might prevail in a sales transaction between two willing and knowledgeable parties. That and nothing more.
- B. An ad valorem tax on oil and gas properties is not a "tax on reserves" or a "tax on oil (or gas) in place." It is, instead, a tax on the value of the leasehold or other mineral interests which properly implies a tax on the value of the right to produce the oil and gas.

II. SOME HISTORY AND COMPARISONS

- A. Oilfields in California have been subject to ad valorem taxation for 60 years. Assessment and tax collection is done locally. In addition, the state levies an income tax that is 50-60 percent as large as the property (ad valorem) tax. The state does not levy a gross production tax.
- B. Oil and gas field values are reviewed and revised annually by professional staffs. The market value of all fields in California in 1974 was about \$4.7 billion, and ad valorem taxes were about \$115 million.

- C. Oil and gas field valuation (which is the assessor's main task relative to these properties) is actually less troublesome than the appraisal of heavy manufacturing plants, e.g., cement plants, steel mills, oil refineries. Put another way, the valuation of any complex property is a challenge, but not a... impossible. In fact--and this is a most important consideration--industry itself regularly makes appraisals. Every major oil company has a properties acquisition department and that department commonly must appraise oil and gas fields in all stages of development.

### III. ELEMENTS OF AN INCOME-TYPE VALUATION

#### A. Definitions

1. The goal sought by the valuation engineer is the present worth of anticipated future net income.
2. Net income is gross income less the out-of-pocket expenses incurred in producing the gross income, that is, in producing the oil and gas.
3. "Present worth" is derived by discounting the future net income at an interest (discount) rate that reflects investors' goal of return on investment.

#### B. Elements Required by the Appraiser

1. Estimate of oil and gas reserves
2. Future rate of production
3. Prices of oil and gas
4. Operating expenses
5. Discount rate

### IV. OBSERVATIONS ON VALUE AND ON AD VALOREM TAXATION

- A. Value is only a fraction of ultimate gross income (which in turn equals the barrels of oil or the MCF of gas multiplied

by their respective prices). My 1973 Prudhoe Bay value estimate was only 14% of ultimate gross income.

- B. Ad valorem taxes are directly tied to the profitability of a producing oil field. Since "profit" and "net income" are essentially synonymous, the higher the future net income, the higher the present value.
- C. The net effect of "B," above, is that a well administered ad valorem tax has the same effect on a producing oil field as a perfectly graduated severance tax. That is, when the field is new and has its highest value, the ad valorem tax might be 10 percent or more of gross income, and would then decline over the life of the field to zero when the field reaches its economic limit.
- D. Ad valorem taxation tends to stimulate development of any type of property, oil or other, not retard it. For example, it is notorious in South America that potentially productive farm land lies idle because it is subject to little or no property taxation.

Actually, economic analysts have criticized an ad valorem tax on oil as an undue stimulus to development and production. So statements that an ad valorem tax might hinder development of an oil discovery are incorrect.

- E. Distant income has little present value. If the discount rate is 15 percent, \$1.00 to be received in 1995 has a present worth of less than 7¢. This means that oil reserves estimates need not be precise if the reserve is to be produced over a relatively long period. For example, I cut off my Prudhoe Bay appraisal at the 20-year mark, although 600 million barrels of oil and 15 trillion cubic feet still remained. But the value shortfall that resulted amounted to

only a fraction of one percent. (A declining rate of production was also influential in this case, as well as the matter of diminishing present worth.)

F. Some Misconceptions on the Part of Senate Witnesses

1. One witness stated his belief that two fields with reserves of 150 million barrels each would both be appraised at the same value, even though one is difficult to produce and will last 30 years, and the other is easy to produce and will last just 15 years. Not so. The net effects of (a) different rates of production, (b) different operating expenses, and (c) different discounting to present worth make it evident that the shorter-life field would have a greater value than the longer-life field--in fact, the value of the one would be about three times that of the value of the other.

2. Another witness was under the impression that gross income and value were the same, so his "estimate of value"--if it can be called that--was 8 to 23 times higher than reality, depending on whether one considered the tax on the total property interest or on only a native corporation's net profits interest in the property.

G. Many precedents exist for the assessment and levying of ad valorem tax on shut-in oil and gas properties. Specifically, a shut-in gas field awaiting pipeline connection is now going into its third year of assessment in California. No one protested its taxability or the \$15 million that went on the assessment roll.

H. A guide exists for the appraisal of oil and gas properties for ad valorem tax purposes. It is the California State

Board of Equalization's 266-page Assessors' Handbook 566, Valuation of Oil and Gas Producing Properties. That volume was subjected to lengthy and critical review by the oil industry ten years ago, and has since been used as an appraisal manual by all state and county valuation engineers.

V. ECONOMICS OF ADMINISTRATION IN CALIFORNIA

1974 Fair Market Value of Oil and Gas Fields	\$4.7 Billion
1974 Taxes	\$115.0 Million

Estimated Cost of Administration

Appraisal Staffs	\$345,000
Enrollment	68,000
Tax Collection	<u>135,000</u>

TOTAL	\$548,000
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Costs as Percent of Taxes	.48 of 1%
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Or Conversely, Net Tax Collection	99.52%
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LA RUE, MOORE & SCHAFER  
PETROLEUM CONSULTANTS  
SUITE 3318 2001 BRYAN TOWER  
DALLAS, TEXAS 75201  
214 / 747-7705  
TELETYPE 73-321

March 19, 1976

Alaska Federation of Natives, Inc.  
670 West Fireweed Lane  
Anchorage, Alaska 99503

Attention: Mr. Sam Kito, Jr.  
President

Gentlemen:

In accordance with your request I have reviewed a report to the Alaska State Legislature entitled "Alaska's Prudhoe Bay Oil, Profitability and Taxation Potential," prepared by Dr. Michael Tanzer of Tanzer Economic Associates and dated January 9, 1976. This study reaches the following basic conclusions:

1. Operators developing the Prudhoe Bay field will reap unearned and undeserved profits because of increased world oil prices and these profits benefit the operators disproportionately and therefore should be taxed at a rate of 50 percent.
2. Profits past 1985 are of little value to the producing company and can be taxed at an even higher rate of 80 percent.
3. Imposition of these taxes would not deter oil exploration in Alaska.
4. The State of Alaska should assume an active participation in oil exploration.

Dr. Tanzer's report is a near-perfect blueprint for disaster -- both for producers working in the State and for the State itself. There can be no surer way to bring petroleum exploration on State and private lands to a complete stop than to implement Tanzer's proposals. Moreover, great and perhaps irrevocable damage to the State's credibility and the ability to finance Alaskan projects has been done in the eyes of many firms by actually introducing Tanzer-type taxation bills into the legislature.

I very much disagree with Dr. Tanzer's analysis, his economics, his conclusions, and his moral justification of taking property by fiat because some foreign nation has done so. The following is a discussion of the basis for this disagreement and includes a commentary on relationship of the Prudhoe Bay field to

way of comparison, an American Petroleum Institute study on 90-day productive capacity shows that none of the fields in the lower 48 states will support this high a rate on an individual well basis utilizing their present equipment. While a few of the lower 48 fields, if so developed and equipped, could produce at rates required by Alaskan frontier economics, most could not; likewise, a great number of Alaska oil discoveries in frontier areas will prove to be non-commercial because of size and rate.

#### Exploration Objectives, Alaska Frontier

Because of the extremely high cost and risk of exploring on the North Slope and interior areas of Alaska, only the largest prospects are attractive to explorationists. Minimum size field prospect to be of interest at this time is probably between one-half billion and one billion barrels, and must appear capable of producing at rates of around 3,000 barrels per day per well. Probably the minimum rate of return acceptable for an exploration venture of this nature would be 40 to 50 percent. This high rate of return is required by operators in the screening process because the successful ventures must pay for the failures on a company-wide basis regardless of where expenditures are made. If a field is discovered it will hopefully yield this type of return. If not, development will proceed assuming that the lesser rate of return is satisfactory as an investment to company management, but eventually a better field must be found to average out with the failures or the firm must cease exploration.

#### Prudhoe Bay Economics

Capital costs of 3 billion reported in the Tanzer study for development of the Prudhoe Bay field appear low by a factor of at least 2. But even if his numbers were right and discounted future net revenues derived therefrom were correct, the conclusions drawn are fallacious. Taxing the Prudhoe Bay field to the point where the rate of return on that particular venture is minimally satisfactory to the operator would have two very undesirable effects. First, it would provide no margin for exploration failures in the company's ventures because any failure would reduce the overall rate of return to levels below acceptable limits. Second, it would mean that if a field similar in reserves to Prudhoe Bay were found, but with only one-half of the well productivity, this new field could be below minimum economic standards.

What ensues, therefore, from setting Alaska tax policy on the basis of one giant field is that it becomes impossible to look for any field which is not economically superior to the Prudhoe Bay field. By way of example, if the proposed taxation caused the minimum acceptable prospect to move from 1 billion barrels to 2 billion barrels of reserves, and the Alaska field size distribution is similar to the United States or even the world distribution, the chance of finding such a field is diminished by a factor of about 2.

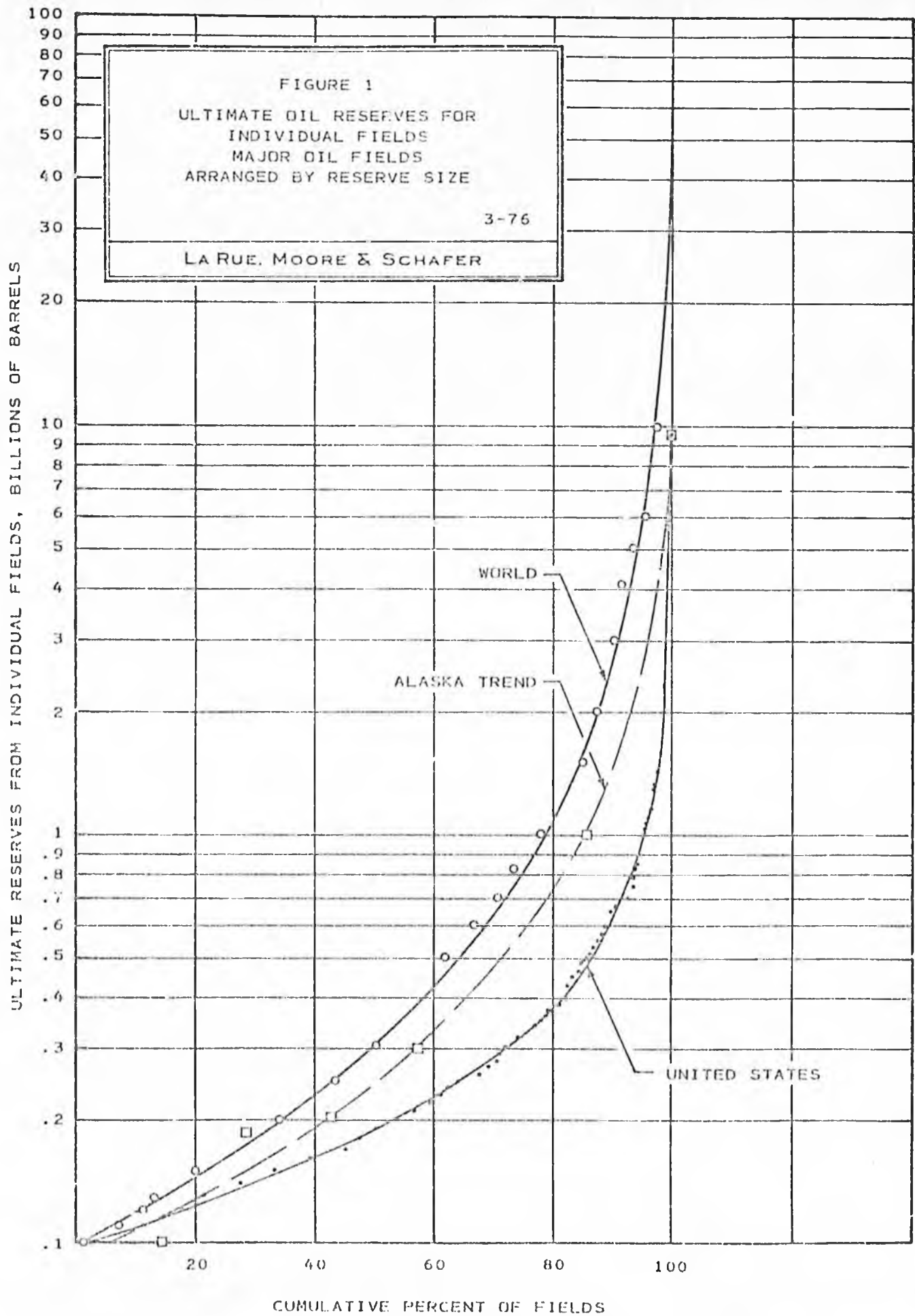
severance and ad valorem taxes required by the state to provide services for all residents, including commercial concerns. Combined severance and ad valorem taxes in oil and gas producing states reaches a maximum of 12 percent and averages about 9 percent. These taxes have not been discriminatory and are at such a level that they do not generally prevent development of oil properties.

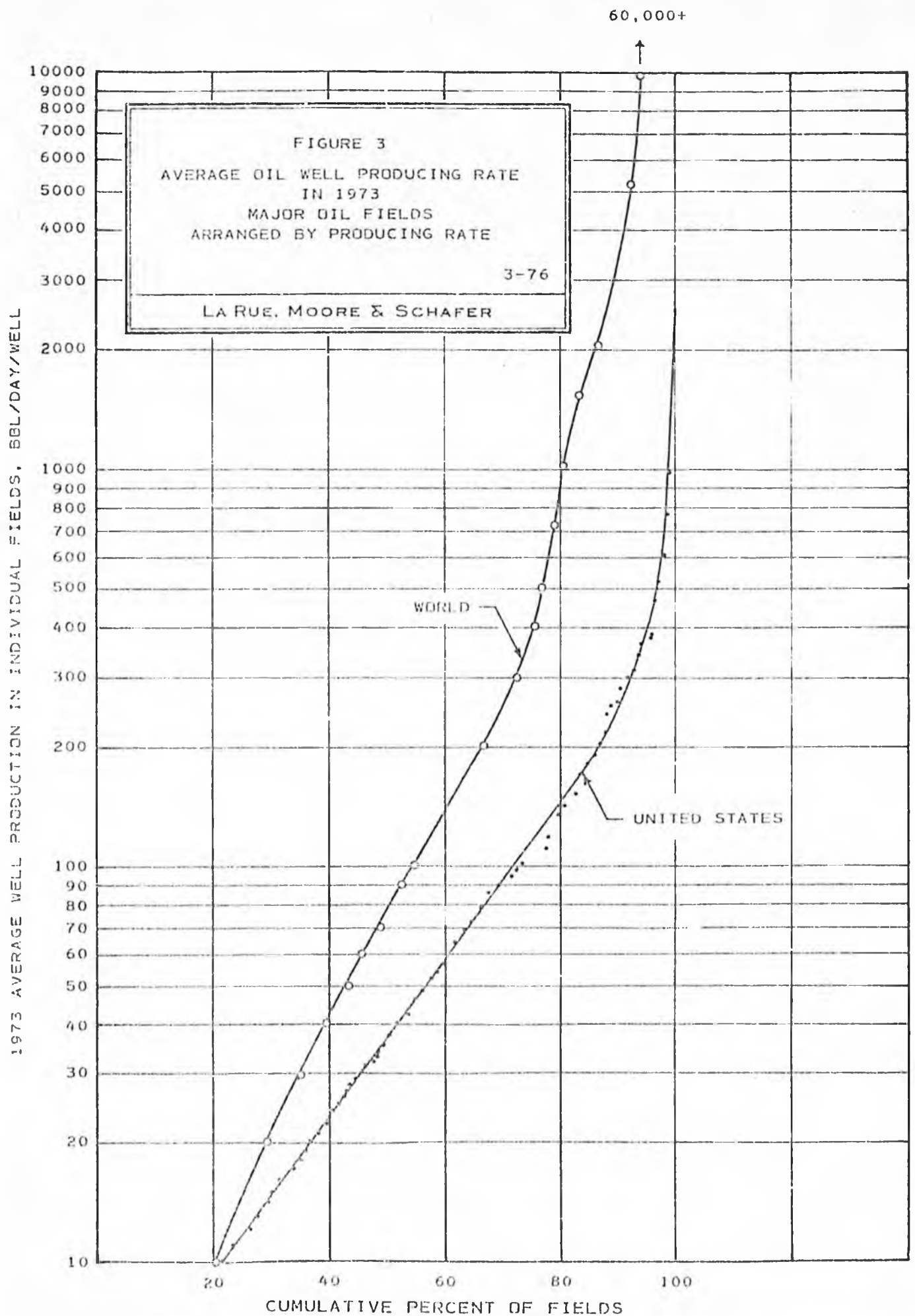
Virtually all the oil producing states, including Alaska, have highly qualified petroleum experts in their state regulatory agencies and most have state lands. The states have found, nevertheless, that it is far better for governments to collect revenues through reasonable taxation and royalties where state lands are involved than to enter into risk ventures. Many of the foreign governments which have plunged into the oil business have found very quickly that it is more economical and efficient to permit private companies to develop properties through leasing arrangements. Others have not come to this conclusion and are still struggling to obtain some measure of success within the constraints imposed by all government bureaucracies. Most observers do not view the nationalization of industry by Great Britain and government management of those industries with Dr. Tanzer's enthusiasm.

#### Effect of New Taxes on Exploration

Clearly, the addition of any new taxes on Alaskan oil production will work to the detriment of exploration activity in the frontier areas in proportion to the burden. Whatever tax policy is followed it must be stable because instability means political risk to the companies engaged in exploration. Both the North Slope and the interior areas of Alaska are just beginning what promises to be a long and successful period of petroleum exploration development. If taxes such as those proposed by Dr. Tanzer were to become effective in these frontier areas the door would simply close on exploration activity.

It would seem more prudent, if the State is desirous of additional petroleum revenues, to encourage the orderly exploration and development of lands within the State's boundaries and levy taxes in a manner consistent with those which have evolved in other states having long term petroleum experience. The revenues to be gained by the State under this procedure, together with royalties, bonuses and rentals from State lands and taxes on private lands, will no doubt outweigh any one time benefit which might be gained by a confiscatory tax on the nation's largest field. If, after some period of time, the revenues accruing to the State from fields as yet undiscovered do not equal those which might be generated by the "Tanzer taxes," the State could always reverse its position and tax the exploring companies out of business.





HOUSE RESOURCE COMMITTEE - Minutes - March 4, 1976

Present were Huntington, Hershberger, Rhode, Osterback, Smith, Brown Swanson, Staff Assistant Van Doren and Chairman Anderson

Subject: HB 769, HB 580

Sponsor Gardiner began. The basic problem is that a two-year time frame imposed on the salvage operations is unworkable. This bill would cut down the time-frame to 30 days with an extension possible. A loss would be recorded by the Department, then after 30 days, if salvage was still desired, but had not begun, an extension would be available. The desire is to make salvage possible of logs the timber industry is not interested in. The Dept. of Natural Resources does not have a policy on the sale of logs from beaches. Permits now are tied up in paperwork--so salvage takes place "illegally". Under HB 769, the state doesn't have to respond to a request for a permit. Automatic approval is granted if no response. Also, the bill would set up a federal-state log agreement. Most salvage logs are above the mean high water--which is federal land. Regarding brands--each business has its own brand.

(2783) According to Gardiner, there would not be any added administrative problem under this proposed legislation.

Chairman Anderson asked whether there was now a problem with permits. Answer: Yes, the process is cumbersome. The timing in the proposed bill is based on the current abandoned log status.

In answer to a question as to what happens to undistinguishable brands on abandoned timber, statement was made that it is now salvageable under permit. Gardiner also stressed that there is no magic in the 30-day timing in the bill. Time is needed to retrieve the logs, but the longer you wait the more "junk" accumulates in the logs. They then become unusable in the mills.

Osterback stated that logs are a hazard to boats. The bill would be an aid to fishermen.

Mr. Smith asked whether there might be another solution to the problem. The proposed bill still presents a cumbersome proposition.

Rep. Gardiner stated that the "sign off" procedure in the bill for the state could speed up the process. Basically the industry is interested only in the larger amounts of logs. They don't bother reporting the smaller amounts. The state does nothing to or with reported losses. It only files them. It is up to the salvager to "do something".

Mr. Miller, co-sponsor of the bill, stated that, as Gardiner had said, the two-year waiting period was the hassel. (Miller referred to letters from Mr. Yates, and Mr. Dutton, copies of which are in committee folders)

Mr. Jim Clark, representing Alaska Lumber and Pulp, presented testimony on HB769. He stated that people will be here Fri., Mar. 5, who could present additional testimony on this bill. Mr. Clark stated that the problem is not when the title passes, although there could be a constitutional problem involved, but the problem is finding people who are willing to salvage the logs.

Mr. Clark elaborated on the title problem. Probably the logs belong to the Forest Service until they are scaled--which is when the actual number of board feet in the contract is known.

Contracting for beach salvage logging is difficult. Tides are a problem--no one has ever "made it" as a beach logger in Southeast. The companies end up getting people from down south to do the salvaging. Industry would "like to have a contract with a beach logger".

Chairman Anderson asked how industry now reflects salvage loss. Mr. Clark stated that it shows up on the books as a loss--the monitoring program shows the loss.

Mr. Clark stated that floating logs are comparatively easy to get. Beached logs are much harder to get. In answer to a question on what the market is for beached logs, Mr. Clark answered that it depends on the condition of the logs. Clark also stated that 30 days was not long enough for industry--people cannot be brought up fast enough to recover the logs in the 30-days.

Chairman Anderson asked whether a 1:30 p.m. meeting Friday would be acceptable with the industry people. The meeting was then set.

Mr. Clark stated additional industry concerns--under the failure to report clause, the term "lost logs" should be used, not "timber property". Also, clarification of "immediate" is needed. Also, there is an unclear relationship between the sections of the proposed Act. Clark made reference to the "Uniform Commercial Code" and its requirements.

Rep. Smith asked that there be clear title passage wording in the Act.

Mr. Anderson asked who owned the logs while they were being pulled down the channel. Mr. Clark answered that the Forest Service says that they own them at that time. However, the question is very real, as to who owns break-away logs. The industry and government have been working under "understandings". Now they are attempting to ascertain "definite" ownership criteria.

Rep. Miller stated that the title problem has nothing to do with the bill.

Clark continued--Industry does bear the risk of loss--they are concerned about the right to get their logs back.

Mr. Huntington asked whether in industry's opinion the present law giving 2 years was o.k. Clark answered "not necessarily, but 30 days is too short".

Rep. Brown referred to the "Uniform Commercial Code", and stated that problems in the proposed legislation could be amended. He stated that others must have had similar problems--and they must have solved them. It would be helpful to have law reference from other jurisdictions.

Mr. Smith asked why the log salvage had become an issue.

Mr. Larry Dutton, State Forester, presented testimony. He said that the state has been attempting to solve the salvage problems since at least 1970. Evidently the bill as presented would preclude sale of salvagable timber. The problem with permits is that the state should be able to recover administrative costs of the program. A fee is needed--either a flat fee or a volume-based fee. Also, the state has to know how much is actually being salvaged. Mr. Dutton felt that the permit system is burdensome. Also, the problem of logs above high water necessitates agreement with the federal people. An estimated value of the logs in question is necessary, with a price.

(Tape 8, Side 1) It is difficult to award a sale without watching out for protection of wildlife habitat. Cooperation with Fish and Game is thus necessary. Also, if 2 or more are applying for the same salvage logs, who gets it? Not enough information is provided. Mr. Dutton stated that large sales are not advertised--they are negotiated. He stated approval of the cooperative agreement that would be forthcoming under the bill between the federal and state governments.

Discussion of salvage problems included: Only 5 to 6 months per year can be used for salvage. Also, only 5 to 6 months per year are covered by insurance on log-towing. Initial recovery period should be for at least 90 days. If industry attempts salvage, it will begin within 30 days. The total time needed would not be more than 90 days.

Mr. Smith asked about research on a state "Log Patrol". The answer was that in 1970 one was tried, but had a lack of support from the timber industry.

According to Mr. Dutton, Alaskan people are in the majority in applying for salvage permits.

Mr. Osterback asked whether if the insurance company has paid for the lost logs, then do they no longer belong to industry? Answer: Maybe.

As to what the insurance company is actually insuring, answer was that this is all or part of the question on when title passes.

Mr. Dutton added that a tremendous amount of money is involved in each log from the minute cutting starts. What the brand means is that that company has an interest in that log, even if the ownership at a given time is not clear.

Mr. Brown elaborated, stating that an example would be the sale of property (land) under contract. Lots can happen before the title

actually passes to the next party.

Mr. John Raynor, U.S.F.S., Div. of Timber Management, testified.  
(Tape 8 Side 1 0474--0595)

Form 421 is used to report the tree count to the Forest Service. When the raft arrives at the scaling point, a recount is made. If there is a significant difference, a check is made. If the check indicates that adverse conditions of weather or raft were present, adjustments might be made on the basis of comparing with the logs shipped.

Mr. Huntington asked why, if the Forest Service has been selling logs for over 20 years, how come no solution has been reached yet. Also, if the logs are on your beach, why wouldn't they be your logs. Answer was made that ownership of the brands goes for two years, with a 1 year extension possible. That's why this bill is necessary. After a three-year period, the logs are worthless.

A problem was stated as to combining state and federal logs in any one sale.

Mr. Anderson asked how come the problem hasn't been solved (saivage) yet, at least on federal lands. He also asked whether the federal government could charge industry a rental fee for space the logs take up. There was no concrete answer.

A question regarding navigation problems, ascertained that if the logs are not on National Forest lands, they are not the responsibility of the Forest Service.

Mr. Brown stated that the Federal Government has control of the navigable areas through the Coast Guard.

In answer to a question from Mr. Huntington as to what other states do about this situation, reply was made that the magnitude of the problems other states face is not as great as ours.

It was stated that there is support for the state and federal governments working together on this problem. As to progress on a proposed state-federal agreement alluded to, Mr. Raynor answered that only the concept has been discussed, with no agreement proposed yet. The bill would accelerate the process of getting agreement finalized. Probably three years would be necessary to complete the agreement.

Chairman Anderson stated that we definitely need to move on the waste problem.

Mr. Dutton quoted a memorandum to Roger Lewis re: a governor's log salvage bill. Evidently it is not going to be available. If HB 769 is passed, and if sale is involved, wording from the memorandum needs to be included.

Mr. Clark added information on timing. The logs go from the U.S.F.S. to the insurance company (if lost) and possibly a "reasonable" time needs to be specified for each step of the process. Chairman Anderson felt that this problem could be solved by regulations. Clark stated that regulations might be better than law for timing.

Mr. Brown asked whether the bill could refer not to the owner of the logs, but the owner of interest in the logs? Clark answered--"Probably".

Action on HB769 was recessed until 1:30 p.m. Friday, Mar. 5, 1976.

Announcement was made that status plats are to be sent on SB444 from Anchorage.

Mr. Smith moved that HB580 be passed with No Recommendation to Finance. Motion passed.

Present were Eliason, Huntington, Rhode, Smith, Osterback and Brown, with Staff Assistant Van Doren and Chairman Anderson.

Subject: HB 769

Mr. Smith began continuation of the hearing on HB 769 by asking whether a tidelands lease was really necessary to salvage logs.

Mr. Jim Clark, of Alaska Lumber and Pulp Co. (counsel) stated affirmatively. The state still has some requests for permits from a year ago. In order to salvage the logs, a rafting area must be established. The "killer" is that the Corps of Engineers require a permit for a rafting area. This problem could use up the entire 30 days plus an extension proposed in HB 769.

Mr. Smith stated that short term permits only are necessary for such as rafting procedures. That wouldn't take as much time.

Rep. Mike Miller stated that an entire raft breakup would not be usual. Small breakups are the common occurrence.

Mr. Walt Begalka, of Ketchikan Pulp Co., stated that he has worked with permits at least since 1958. Originally much leeway was allowed. Now permits are required for everything. If a change of as little as one-half mile is incurred from the original permit, a new permit must be obtained.

Question: What is the feasibility of logging salvage?

Answer: If "everything" was picked up, it could be profitable.

Question: How soon do you have to get wood for it to be saleable?

Answer: The biggest problem is iron and rocks in the wood.

Mr. Jim Rynearson, of Ketchikan Pulp, stated that salvageability depends upon when the logs were lost. If the logs are originally washed up high on the beach, they may be good for at least 3 years. However, if they are washed up at low tide, they probably will be battered.

Question: How can salvage operations be improved?

Answer: There are many problems--legal problems. So far, private ownership situations are no problem, but when the native ownership takes over additional problems will occur.

Also, the Corps of Engineers permits take up large amounts of time. Temporary permits used to be offered, but now only permanent permits are available.

British Columbia operations have been observed for several years, and many ways have been tried to solve the salvage problem. No profitable solution has yet been found.

Question: Why are there no Alaskan salvage operators?

Answer: Possibly because of the ownership problem (ownership of the logs). But basically, because of the cumbersome salvage permit system.

Mr. Begalka stated that many ways have been tried. Many losses are incurred at this time of year when it is impossible to retrieve lost logs.

Mr. Huntington asked for a suggestion of a proper time frame for the bill. The answer was maybe a year, but some agencies don't move very fast. A year after the permit was awarded would be plenty of time.

In answer to a question as to how long a salvage permit lasts, answer was one year. It can be renewed, but a new fee is necessary. Also, total areas are not necessarily covered. There may be large open spaces between areas covered by the permit.

Discussion:

Rewrite the bill to fit time constraints. That would be a positive advance.

Eighty percent of logs are left above mean high tide.

Certain types of logs simply can't be used--no metal, no holes, no cedar, no rocks.

Logs used to be moved in flat rafts--logs left the rafts. It was/is difficult to bundle the logs.

The only real way to log after their being stranded on a beach is to load them with an A-frame or a loading machine. They must be bundled.

Regarding title: Title stays with the U.S.F.S. until the logs are scaled. Once rafts are paid for under loss, insurance company would own the logs. (right of subrogation)

The industry's loss on an annual basis is possibly 2,000,000 feet a year. or \$300,000.00. (Bogalka)

Mr. Dutton stated that the Administration wouldn't object to a one-year limit if the subject company notified the state if at any time it actually abandoned the logs.

Discussion of the time involved to deliver logs from their source to their mill elicited that a possible 4 knots could be attained with rafts in good conditions. But the total situation is unpredictable. Logs are started in the South, transferred to northern tugs, then wait for a favorable tide at Sitka.

Mr. Dutton stated that the proposed bill requires an immediate report of log loss, whereas industry doesn't know a loss has been sustained until the scaling of the logs at the destination.

Mr. Bogalka stated that any logs not accounted for at the destination must be paid for to the Forest Service.

Mr. Miller stated that the two-year period is generally agreed to be too long, both by government and by industry. But he expressed concern as to the "smoke screens" being raised on the issue. The problem is not title--it's time. Possible 45 days could be allowed for reporting, with no absolute outside limit for recovery. (3485) "If you are going to recover them, we don't care how long it takes".

Miller (cont.) Originally industry was not behind the bill because too much money was involved with little return. Now the main problem may be a need for legal counsel overview to clear up any problems that have been incurred.

Chairman Anderson: There is a problem--If industry is required to retrieve logs, then the profitability decreases--is that correct? Mr. Begalka answered that at least 10% of wood on beaches is Douglas fir. Also on beaches is cottonwood and pine. The Forest Service won't allow any logs to be taken unless all are taken. (180). A concerted effort by industry and government is needed to recover the wood.

\_\_\_\_\_, representing the U.S.F.S., stated that the salvage problem has been recognized for many years--at least since 1957. Many of the stranded logs are not of Alaskan origin. (He will have more facts on this by next week). Probably only 2% to 3% are uprooted trees. The rest were once logs. Brands are unrecognizable in 96% of the logs beached. Cedar comprises 21% of the useable lumber--and cedar is unuseable in pulp. There is lots of hemlock on the beaches, also. The longer the logs are on the beaches, the more the brands will disappear. There is also a trespass problem in recovering the logs. This problem will also be researched for the committee.

Chairman Anderson asked what was done with the logs no one wanted? Answer: There is no good solution at this time.

The representative of the Forest Service stated that at the time of an adjustment for lost logs, title passes. In effect, scaling is then accomplished.

Anderson--It doesn't appear to hurt industry if a few logs are lost. What is industry losing? The federal government should be able to go ahead and say to a salvager in such a situation "Get rid of it".

Mr. Al Anderson, of Alaska Wood Products, stated that just because the logs are insured doesn't mean that industry doesn't care what happens. Insurance rates go up. In answer to a question as to whether an insurance company will go out and gather up logs it has paid for, answer was "Maybe".

Mr. Miller asked how often there was a major spill. Mr. Begalka answered that Ketchikan Pulp has had two major breakups in 20 years. Al Anderson stated that an insurance company had recovered 900,000 out of 1,400,000 b/f in their most recent spill.

Mr. Begalka stated that the problem of lost logs is compounded by count inaccuracies.

Roger Allington, of Sealaska Corporation, testified to future problems foreseen by the native corporations. The corporations will be industry, but will also own the land. There is a problem with what the government

can do, versus what a private land owner can do. For instance, a private land owner cannot condemn property. Also trespass is a problem--there is a need for clarification on when a private owner can handle log property--in other words, who owns and for how long?

Mr. Miller stated that he sees it as a good deal for the private owner. If 30 days goes by they are already your logs by right of possession.

Chairman Anderson informed the committee that the bill will be addressed again after the information is in from Dutton.-- with a tentative date of March 19 for the rehearing. Staff was advised to get in touch with insurance companies for the timber industry.

Meeting adjourned.

HOUSE RESOURCE COMMITTEE - Minutes - March 18, 1976

Present were Huntington, Swanson, Hershberger, Rhode, Smith and Brown; :  
Staff Assistant Van Doren and Chairman Anderson.

Subject: CS SCR 83 am  
CS HB 769  
HB 863

Motion was made to Pass CS SCR 83 am out of committee. Swanson made objection. General discussion cleared up the objection by Swanson. Motion carried to recommend Do Pass on CS SCR 83 am.

RE: HB 769. Joel Bennett gave a general resume of the changes in the committee substitute from the original bill. 1) there is now a 90-day salvage clause. 2) there is addition of good faith wording as applied to salvage attempts. 3) there is addition of "rightful transporter" wording.

Mr. Brown asked whether there might be a need for a definition of "rightful transporter".

Mr. Bennett answered that "rightful transporter" is to help clarify responsibility. Bennett also mentioned that the criminal provision of the original bill has been removed at request of the sponsor. Guidelines for the "good faith effort" will be in draft regulations.

Brown stated that regulations wouldn't be needed--"good faith" is familiar in the law. Brown presented a possible definition of "rightful transporter", (approx.) a person having an executory contract or interest in the logs, or his designee, or one who in normal process of trade transports or causes to be transported the logs. (0955)

Swanson expressed concern with regulations--they might present the catch in the bill.

Huntington stated the problem of logs the state owns that are under salvage contract, but the salvagers haven't done the job.

Brown suggested that there might be a need for another phrase covering "good faith" in the salvage operation.

Swanson mentioned situations in which it was impossible to retrieve logs because of adverse tides. There is "alot to salvage besides "floating" the log".

Mr. Smith presented a possible "good faith" wording--"good faith effort includes the fact that effects of weather, tide, etc., might preclude salvage operations" (approx.)

Motion was made to include Mr. Smith's "good faith" wording and Mr. Browns "rightful transporter" wording in the Committee Substitute. Motion passed.

Motion for Do Pass recommendation of CS for HB 769 carried unanimously.

Mr. Brown suggested that a bill be presented by the Resources Committee addressing the salvage owner problem. Chairman Anderson requested the staff to handle this as expeditiously as possible.

It was requested that HB 863, scheduled for Monday morning, be brought before the committee for consideration. Committee agreed.

Pending receipt of a fiscal note, the Committee moved a Do Pass recommendation on HB863. Motion carried. If there is an adverse impact reflected in the note, the committee will reconsider the bill.

Meeting adjourned.

day, it's the average rate of return on the net assets of the stockholders, it can be an internal rate of return, it can be the marginal efficiency. These are technical things about which economists will argue endlessly. The point is that it is the prospective profitability which the State may want to look at but the tax system should be such that it is not triggered in any case until the potential profitability is realized. One doesn't tax on the basis of projections of profitability.

Therefore, if you are looking at the taxation system of Alaska, which encompasses already a severance tax, a normal corporate income tax, which we find faulty for reasons I will not discuss again but which I think should be fixed up in any case, and the proposals for some form of supplementary tax. How high the supplementary tax should be, how you determine what income is subject to supplementary tax -- we will discuss all of these things a little later. But, if you took at the entire tax system of Alaska and possible amendments to it, I'd say there are several things you must keep in mind which are absolutely basic if the tax system is to serve the interests of Alaska. First of all, it should not discourage exploration. There should be nothing in your tax system which discourages continuing exploration. You, yourself, will determine what kind of exploration and how it should be done by your leasing policy itself, but you should not use a tax system to discourage exploration and you wouldn't want anything in your tax system which does discourage exploration. That is to say, don't push back the margin of exploration. If there are prospects that industry would be well to explore, the tax system should encourage them, not discourage them from the exploration. Secondly, that the tax system should not impinge unduly on the prospects for profits and profitability of successful fields. On the prospects for profit and profitability of successful fields! Don't confront the industry in advance with a full knowledge that the tax system works in that way. Third, and this follows from what I said before, that the tax system, particularly if there is to be some form of surtax, or surcharge, that it should not be based on the assumption of superior profits, but it may well come into effect and apply when the fact, the evidence and the knowledge, the reality of superior profitability becomes evident. This is what I mean by not misinterpreting my remarks about DCF calculations, about Prudhoe Bay. I don't think the State has to close its eyes to the potential profitability of Prudhoe Bay, but if the potential profitability is established and a fact, then I think it is perfectly reasonable within certain guidelines, for the State to say that this is a proper avenue for taxation amongst all of the other decisions by the Legislature as to what the spending and disbursement policy of the State is, what the total revenue policy of the State is, but, certainly one cannot say \_\_\_\_\_ that one can ignore this as a potential avenue for revenue.

So the critical question then becomes, "Should there be, in Alaska, such a thing as a surtax." In other words, if in addition to your normal income tax, which is paid by every corporation based upon its taxable income within the State of Alaska, should there be for

the oil industry, first of all and I'd like to get this in as often as I could, a restructuring of your income tax of the oil industry at least pays the same nine plus percent tax on its producing profits as it would if it were any other type of industry in the state. But beyond that, should there be a surtax? This absolutely must fall within the discretion of the Legislature. No one can say, from the standpoint of economic policy, from the standpoint of the pros and cons of the industry's position, you must do it, or you dare not do it. It depends upon the whole structure of the Legislature's own thinking about the needs for revenue, about the alternative sources of revenue and is this something which ranks as a high priority rank in the minds of the Legislators as a source of revenue. Let me assume for a moment, for purposes of our discussion, that the answer is yes, that the Legislature is inclined to look upon the income from oil producing operations in the State of Alaska, separate and apart from the income of other economic activity in Alaska. It may chose not to do so, but if you do, what are the guidelines to the kind of tax that might then appropriately be levied?

First, I think the most important thing, such a surtax should not be effected before the company that is producing in Alaska and the income of that company from oil producing operations in Alaska is clearly beyond the average profitability. That is to say, the profitability is not estimated, is not imputed, is not guessed at, but it has been clearly established. Secondly, that the surtax should, under no circumstances, become effective for anything which is close to marginal exploration. That is to say, anyone who is looking at an exploration prospect here, and says, in the State of Alaska there is a surtax on certain types of oil producing income, must know that if what he finds is a marginal field, if it is barely worth developing, or if it is going to give him modest profit as well, that he is not discouraged either from looking at the prospect in advance and taking a lease, or having taken a lease because he thinks its going to be a real good prospect and finding out that it is very very marginal -- is the candle worth the burning -- should we develop that field or shouldn't we -- there should be nothing in the tax structure that discourages that.

This means, in effect, that the price which the United States Government is holding out to the State of Alaska and which determines the value of oil produced in Alaska, this price that the U.S. government is setting, the upper tier price, the price for new oil, which is designed as an incentive thrust to encourage people to go in and explore farther, explore harder, that there is nothing in the Alaska tax system which cuts away any of the incentives under that price. The full price is basically available as the incentive to exploration in Alaska as much as it is to exploration in any other state in the union, as much as it is to exploration in the Outer Continental Shelf or on federal lands.

It seems to me that the criticism which we may have of the bills that are now before the Legislature, which in one form or another involves surtax, the excess value surtax which is House Bill 703 and Senate Bill 621 and the oil production income tax which is House Bill 803, at least in the version that we have seen, and I am not sure we have seen all of the sponsor's amendments to them, but at least in the version that we have them, our criticism of these bills would be that to expose profits on production to a surtax before this superior profitability has really been established. In other words, they are anticipating that. One can object to them in principle also, there should or shouldn't be a surtax. I think I have covered that -- I suppose I should repeat it every once in a while because it gets lost. On the assumption that there is willingness on the part of the Legislature to consider at least the principle of the surtax. Our basic criticism of these bills is that they trigger the exposure of producing profitability to a surtax at a time when we feel is previous, unnecessary and possibly introduces all kinds of disincentives towards the exploration operation.

I suggested in my testimony yesterday morning, that there might be an alternative. I'm sure there are many alternatives. But there is one that we threw out and we put it out on the floor of the Joint Committee -- I will mention it here also because I think it is worth something as a basis for discussion by staffs and by legislators too. And this was the idea that if there is to be a surtax that what determines the breaking point between the time when a producing company pays no more than the regular state corporate income tax on his profits and when he is exposed to some surtax or some surcharge on his continuing profits from the producing operation in Alaska, should be the principle of capital recovery. That is to say, for purposes of the state income tax he continues as is normal under your state law and under your revenue department's regulations, he takes depreciation as it is allowed, expenses as it is allowed and so on. But for purposes for determining whether or not there is any producing income liable to surtax and if so, how much income there is liable to surtax, he shall be able to charge against his producing income as fast as he has revenues to do so, all of his capital costs necessary to achieve that production. Which means the lease acquisition costs, exploration costs, development costs and so on, and capital costs plus. That is to say, some markup of those capital costs, charged against his producing revenue. This means that for some length of time, even the most prolific field will probably not be susceptible or liable to any surtax. How long depends upon how much production is coming out of the field and what the costs were. But for a while there is no exposure to the surtax. For marginal fields, where it may take the life of the entire operation to recover all of the capital costs, there would never be any surtax so that it has no effect upon the marginal whatsoever. For the fields of modest profitability, not by guesswork, I am talking about at the end of the day, at the end of the life, there may or may not be exposure to surtax, depending upon what the capital cost ratios are. Now, capital recovery plus how much? I don't want to offer

a number at the present time. I might suggest for example that where there is such a tax system in practice, which is in the U.K. North Sea, they allow 1.75 times the capital recovery. I am not proposing the State of Alaska consider the U.K. tax regime, far from it. In our Bicentennial Year, I am not going to suggest that the United States look at a British tax system 200 years after they fought against the Stamp Act and got our independence. But there are some features which are similar and I think this is worthy of discussion because it meets one very important criterion, and that criterion is that it does not or should not have any affect upon the incentive for exploration and it really doesn't become effective until superior profitability is established.

Whether or not this would yield any revenues from Prudhoe Bay depends upon many circumstances. Nevermind the DCF calculations about Prudhoe Bay. What is the margin of profit? That is to say, the cents per barrel that would be made. This depends upon an awful lot of factors. None of us really know what the price is going to be and so on. But it all falls into place so that over time there is very substantial profitability in Prudhoe Bay, I would say, yes, it probably will be \_\_\_\_\_. If things go wrong in Prudhoe Bay, incidentally, -- if things so right it works well. Suppose things go wrong. What can go wrong? The \_\_\_\_\_ for example -- in the timing of the start of the production -- or the ability to move from 600,000 barrels per day to 1.2 million barrels per day -- experience in the first few years of producing operations. Nothing else should go wrong in Prudhoe Bay, enough has gone wrong already. But there has been no real experience with the affect of producing operations upon reservoir pressures but the industry has tremendous confidence and so on. But the economics of Prudhoe Bay, probably at this stage of the game, depend more than anything else upon well producability and the ability of wells with an average producability of four or five, six thousand barrels a day, but this has to carry forward. If it turns out that it is going to take a tremendous amount of additional drilling of producing wells after several years of operation in order to sustain the producability of Prudhoe Bay, then something else has gone wrong and that begins very seriously to interfere with the flow of the barrel profits and the ultimate profitability. So you see, what this principle of capital recovery costs does is it says to the oil company, "Up to the day you produce the first barrel, you've taken all of the risks. You took risks when you first took a lease from us and paid bonuses." They weren't so large in '64, '65 and '66, but they were pretty big in '69. "You took exploration expenses and they could have been dry holes. You started to develop" -- and development costs in Alaska typically must run tremendously high -- "You've taken all of the risks and now the first barrel is being produced. We the State, will pick up some of the risk now. That is to say, if there is to be a surtax, that surtax is not going to touch you for some period of time. You are now going to recover your capital which you have invested and for taking all these risks. After that period, your risks have become very little. You have recovered your capital. The State feels that if a superior profitability" -- now that doesn't mean that the industry shouldn't be compensated several times over for the

risks that they took. This has to do with the rates of return and what you expect if you are taking all these risks. The State says at least, "We are not going to even touch you with any kind of a surtax until -- we are taking the risk here and if things go wrong in a producing field so that you incur greater expenses, okay, then we are going to allow you the recovery of that also before a surtax comes into effect." In the producing operation which may be very profitable for a while but in order to sustain production it is going to require reworking of wells, a secondary recovery, these become capital outlays and the State says, "Fine. If you do this to sustain production, our surtax becomes abated until you recover that as well." But it does say that "If at some point in time you have very superior successes in Alaska, the State will not ignore that this is something vital, this industry is vital to Alaska, we do everything to sustain it but at that point in time we do not close our eyes to the fact that there can be superior profitability and this is the way in which we propose to tax."

Secondly. If the State is considering a surtax -- I think this is tremendously important -- what is the rate of the surtax? If you move from the state income tax at a little over 9% which you must strengthen so you make sure you get that 9.3% severance tax. But if you move to a surtax, the surtax rates cannot be oppressive. If the surtax rate is oppressive I think it does violence to three tremendously important features of a state tax policy.

First of all, an oppressive surtax cuts into, it cuts too deeply into the superior profit which the most successful are expected to earn and have to earn if they are going to pay for the marginal fields and for all of the losses. In other words, the tax system should not imply that suddenly all of this added profitability is surplus profits, windfall profit, or in the language of the economist, all economic rent, and therefore you can tax all of it away. That is to say, do not leave one unnecessary dollar with an oil company. I don't think this should be the policy of state taxation. You can't have excess profitability until you recognize that there are sufficient losses. You can't have windfall profits until you recognize that there are windfall losses. And there is no such thing as an economic rent on an oil field. There is only an economic rent in an entire oil producing product. You simply cannot measure economic rent on an individual oil field. You have to have a margin of superior profitability. This is what brings people into the exploration game. Nobody really looks to find a marginal oil field. Nobody really looks to drill dry holes -- of course not. Nobody looks to discover a marginal oil field -- the real incentive to exploration is the attraction of the bonanza, of the great discovery. And a certain amount of that must always be the expectation, and it must always be the realization. So the rate of surtax has to attune itself to the fact that there is going to be superior profitability which remains with the most successful company.

Secondly, I think you must be very, very concerned, careful, as to how deeply the State's rate of taxation cuts into the federal tax \_\_\_\_\_ . I would hate to suggest to the Alaskans that they take their taxes after the federal government. You obviously have first claim. I don't think it is in the interest of Alaska completely to ignore the fact that when they are taxing with a surtax, the profits of companies, they are also taxing the income of the federal government. The federal government picks up a part. You take that into account when you reckon what the net cost is to an oil producing company to pay taxes to Alaska. I don't think you can really ignore how much you are taxing the federal government, when you establish a tax system in Alaska. You may weigh this how you will but the fact is that Alaskan oil producing operations are very much a part of the U. S. oil producing area. They are in many different ways. The most particular one and of relevance to you is that under our present energy act, the value of oil in Alaska is determined by the federal government. The producers at Prudhoe Bay suffered as many of the \_\_\_\_\_ and misfortunes as any successful explore could have been confronted with. Between the time of the discovery well and their first barrel of production there have been delays, there have been run up of costs, there has been misadventure after misadventure. All the risks that a private company should take, and have taken all of those risks, the profitability of Prudhoe Bay may have been driven down to an infinitesimal figure if they hadn't been bailed out. What happened in the interim was the tremendous run up of world oil prices by OPEC. This did not bail out the producers of Prudhoe Bay because the world congress which authorized the construction of the Alyeska system forbid, without special approval, the export of a single barrel of North Slope oil. You may be able to get \$15 a barrel in world markets but you are not allowed to do it. What has bailed out Prudhoe Bay has been the policy of the federal government, which has said, even under conditions of price control that we are establishing price incentives for new exploration ventures. Whereas before, at the time of the discovery well, the average price of crude oil to the United States was about \$3.40 a barrel, under normal circumstances it might have gone up five percent a year -- seven percent a year. \$5.00 oil in the lower 48 states would have left Prudhoe Bay a poor venture indeed. But the federal government said that, "despite the fact that we maintain price control, we are allowing an upper tier price for new oil." Prices today as high \$11.28 and they are going to go higher. But this is all pursuant to federal policy. And the purpose of this federal policy is to \_\_\_\_\_ exploration. And I don't think the state of Alaska would want to do anything which says in effect that the pricing policy of the federal government was designed to achieve certain purposes, shall not be fully appreciated here in Alaska, and we will ignore this by an undue level of taxation.

I have been quoted to the effect that, "If Alaska isn't careful, the FEA, the Federal Energy Administration, is going to lower the price of North Slope oil." I never said that. I think that is nonsense. I don't think the difficulty that may emerge between Alaska and the Federal government if you go to an exaggerated tax

system is going to depress the price of your oil. I think that is silly. That would be cutting their nose to spite their face. There is uncertainty as to what the price of North Slope oil is going to be for a lot of different reasons. But the problem has to do less with whether there is going to be specific retaliation, but more in the nature of how does Alaska as a state fit into the whole concept of our federal system and where does one draw the line between what the state takes first and what is left thereafter.

Third, it has to do with the implications of your surtax rate for the export of capital. Let me explain what I mean by that .... And if you don't allow the expensing of dry holes in Texas, you should allow the export of capital as well. That is to say, Alaska has benefited from the willingness of companies to come in and explore in Alaska on the basis of the superior earnings of their exploration efforts elsewhere. When you look at your rate of surcharge, what that tax rate is, you must be perfectly willing to allow that there are superior profits. You've given them an incentive to invest superior profits in Alaska. But they should not be denied superior profits even if they want to export the capital out of the State. In other words, you admit that you are part of the United States and you are not trying to tax away every dollar of superior profitability unless it stays in the State of Alaska. The principle then that I am addressing myself to is that if there is to be any such thing as a surtax, called by whatever name it is, if there is to be, (1) It should hold marginal and modest exploration efforts harmless against any surtax; (2) it should not come into effect in any case until superior profitability has been well established - one to one criterion is the recovery plus of capital; and (3) when it is applied, the tax rate shall not become onerous, it shall be a tax rate which is reasonable in terms of the presumed profitability so it does not attempt to simply siphon off all of that profitability, but it remains cognizant, aware of, and sensitive to the fact that a superior exploration effort must continue to earn superior profitability, even though it becomes subject to and liable for some surtax in Alaska.

SENATOR JOE ORSINI: If we had a regular corporation profit tax of 9 percent, which would actually tax them, as you pointed out numerous times in past years, that you are actually taxing at nine percent. Would we then also have the severance tax or should we drop the severance tax if we had sufficient regular corporation tax?

MILTON LIPTON: I think that a corporate income tax at the level that you have it, coupled with a severance tax is absolutely appropriate. I see no reason why the State of Alaska, if it subjects the oil industry to nothing more than normal corporate income, should give up principles of taxation which have been adopted in every other state -- either a combination

of severance tax, gross production tax, advalorem taxes and so on. I think that your attention of the severance tax is absolutely appropriate. It is not unreasonable for you to consider possible increases or restructuring of your severance tax rates in light of what has happened. I wouldn't want you to go ahead and decide on a whole new set of severance tax rates before you've made a decision on so many of the other tax bills that are before the legislature.

SENATOR JOE ORSINI: Then you recommend against then, to have the advalorem tax?

MILTON LIPTON: You are quite right. I should have said yes and dropped it. But I want to draw an analogy. Our criticism of the advalorem reserve tax was in effect, that it was a tax on profits before the first profit was being had. What we are trying to suggest to you is that if you go the surtax route, that again, you don't assume that there are superior profits until the evidence of superior profits is in hand. Of course the evidence is in hand after there has been this degree of capital recovery. And after the risks have been largely removed and you are saying to the company, "You have taken all the risks up to now, we will take the risk now." The criticism of the advalorem tax was that you tax normal profits before they began. If you are going to have a surtax, I don't think you would want to tax superior profits until the fact of superior profitability is clearly evidenced and not because somebody has computed, no matter how correctly, a DCF rate of return.

SENATOR JOE ORSINI: If we are going to change our regular corporation tax structure to adequately get the oil company, do we have the mechanisms now to allow the various costs involved to be amortized over a period of time?

MILTON LIPTON: I think that if you go ahead with a revision of the corporate income tax. For example, the net proceeds tax proposal is essentially, as I understand it, an attempt to transform the companies' options under the tax law, to a new method of calculating what the profit is on oil production per se, and subject them to the same rate of taxation as they would have if the present income tax could reach out and identify producing profits, which we don't think it can. The net proceeds tax would involve a certain form of revenue accounting to your Revenue Department. But so would it today if the companies filed on the basis of income -- that

is direct accounting under your present law would require them to show gross proceeds from sales in Alaska, allocation of costs, proper allocation of depreciation according to the nature of the property and so on. All of that would have to be done. The reason it really isn't done is because the companies don't fill out more than the first line - gross revenue from sales in Alaska - None. Nothing else is necessary and you can't touch oil producing profits in the State of Alaska. You could go to the allocation \_\_\_\_\_, we think that is sufficient. Now, whether you go the net proceeds bill -- I think your Revenue Department will comment on that net proceeds bill -- if you want us to we can also. Or the Revenue Department may come up with its own way of doing direct accounting. But if once you have that kind of accounting for purposes of the regular corporate income tax, there is not a lot more of accounting which is going to be necessary to determine whether a company is liable to surtax or if so to what extent it is liable to surtax. But I don't think this involves a bureaucratic nightmare.

SENATOR JOE ORSINI: You haven't then, looked at the net proceeds tax proposal? As I understood, you weren't prepared to comment on the specifics.

MILTON LIPTON: Yes, I have looked at the net proceeds tax. Yes, we would be glad to comment on the specifics if you like us to. I don't know if you are at that point.

(QUESTION INDISCERNIBLE)

MILTON LIPTON: Our major objection to the net proceeds bill as it is written, is that it makes the determination of gross value, which is the starting point of everything else, we think unduly cumbersome. It says, "FOB price at the Alaska border or other convenient point or as determined by the Department" and so on. The idea here is to separate out a company's income tax liability on account of profits from oil operations from all other forms of income because the feeling is that this is the one thing that gets most badly hidden in your present tax regime. If that were the case, it seems to us the most convenient and the most representative place to calculate the value before everything else is computed is at the wellhead. It has to be calculated at the wellhead in any case for reasons of severance tax and for reasons of royalty payments. And there would be as much or as little dispute about wellhead value for these purposes as it would be for income purposes. Indeed, if you could, under your present tax laws,

say, "Line 1 of direct accounting for income in Alaska." If you could legally say, "Gross revenues from sales in Alaska or in the case of oil producing operations, wellhead value of oil produced in Alaska", then you could go with your present tax law, you wouldn't have any problems. I think that for that purpose, it would make an awful lot of sense to start with a wellhead value since the purpose is to separate the income from oil producing operations from everything else so that it becomes identified and susceptible to the normal income tax rate.

There are some problems about the deduction of drilling costs and capital expenditures. It is not clear what this definition of property is, whether these allowances are by lease or what provision is made for dry hole expenditures. I think there are technical things in here that one has to look at very carefully. There may be easier ways to go about it but this is the sort of thing that the Revenue Department can probably speak to quite quickly.

SENATOR CHANCY CROFT: With the changes that you've suggested with regard to the net proceeds tax, do you think it is a reasonable approach?

MILTON LIPTON: The net proceeds tax? Yes. If we understand the intent and purpose of the net proceeds tax -- is to say that there shall be in effect a direct accounting of income from oil producing operations in Alaska. We are going to \_\_\_\_\_ at it this way, it's by indirection, but we are going to get it out this way and we are going to subject it to the same rate of taxation as if it fell under the purview of the regular corporate income tax law. This is not literally true. The minute you segregate out one piece of income from another piece of income, the two taxes don't work exactly the same. I have no real criticism of this approach. If this is the way in which you insure that oil producing profits in Alaska are subject to the normal state income tax rate, all well and good. Certain things happen. For example, you cannot reduce your liability for corporate income tax on the profits of Prudhoe Bay by money you lose in a gasoline station. On the other hand you can't reduce your tax liability for profits you make on gasoline by a dry hole somewhere else. You are separating it out. I don't think that is an abomination. I think the most important thing is that the oil producing income is reasonably subject to a corporate income tax. This is whether or not you have a surtax. If there is an easier way of doing it, I would like to to be done an easier way.

SENATOR CHANCY CROFT: Do you know of an easier way of doing it?

MILTON LIPTON: The easier way depends upon legality. My feeling is that if you could simply have all companies report either gross value of sales in Alaska or in the case of any product -- I hate to get involved in things which may involve other industries -- but if you're willing to say that in the case of oil producing operations, if you can simply either the value of sales in Alaska or the value at the wellhead. The value at the wellhead presumably represents a net \_\_\_\_\_ from \_\_\_\_\_ value of the sale wherever it took place. If you can do that legally, I think that is the easiest and simplest way. If not, then you have to go the round about way and if it involves this kind of segregation, which means that you are separating out the profits in oil production from the profits elsewhere, you are separating out the losses in oil production from losses elsewhere, then you've done that kind of artificial division. I don't think there is anything terribly wrong about that.

SENATOR CHANCY CROFT: Just so that I understand it, its one thing to say there's nothing terribly wrong about it, but its another to say that....

MILTON LIPTON: I will be much more positive. I think that if this is the way that you can insure that Alaska collects its normal rate of corporate taxation of oil producing profits, then I think it is a good piece of legislation. I cannot say that there may not be a simpler way. But, per se, I think it is certainly an appropriate way of going about this.

SENATOR CHANCY CROFT: I know that you \_\_\_\_\_ money, but I think that you have had a chance to see, to at least talk to, some of the people on the staff and it seems to me that it was their opinion that the reason for taking this approach was that legally you had substantial problems with any other method. I think it was because of the legal concerns that you discussed that this method was proposed.

What about the question of severance tax? Do you think we should consider changes in the severance tax rate at this time?

MILTON LIPTON: Yes, but I don't think that you should do it independently of your decision as to how to dispose of the other tax legislation. I think it is perfectly appropriate to consider revisions in your severance tax from a lot of different standpoints. You may want to consider what the effect of higher rates

may be, you may want to change the steps schedule, you may want to continue or abandon the cents per barrel feature which I think has worked in a rather uncertain way, sometimes to the detriment of the industry sometimes to the detriment of the state. I well remember the reason for it having been put in. The merits of the reasons at that time are no longer merits today. I think an awful lot has happened since those severance tax rates were established. You will remember that when this aspect of severance taxation was introduced and was being discussed, we talked about them excessively for keeping severance taxation in Alaska reasonably in line with severance taxation elsewhere taking into account also, where there is or is not advalorem property tax. Alaska has found a range of advalorem property taxes in the interim which they have added to it. When we say, reasonably in line, it doesn't necessarily mean that a barrel of oil produced in Alaska shall pay no more in severance tax and advalorem tax than a barrel of oil produced somewhere else. What it means is that if a severance tax in Alaska were adopted by all 48 states, would it make sense or would it                     . Now the feature of the severance tax which we feel is most progressive is the step schedule, which says in effect that the State of Alaska is prepared to tax, as a percent of the gross value of oil at the wellhead, certain producing operations, less than virtually any other state in the union. It is prepared to tax as a percent of wellhead value for certain operations more than many states in the union but not more than some. To consider, at this stage of the game, with a vast change in the circumstances of costs, prices, values and everything else, to reconsider these severance taxes -- I think it is appropriate. My only suggestion at this moment for the committee is that the decision on the severance tax not be the first decision taken but it be taken in the context of how the other tax legislation is disposed of.

SENATOR CHANCY CROFT: Just so that we might have it in perspective. You mentioned that the problems and the risks that the owners of the Prudhoe Bay fields have taken, and it is true that from their original estimate of some 900 million dollars to build the pipeline, they are now talking close to 10 billion dollars at this point -- a tenfold increase in that item of cost alone. But shouldn't we also keep in prospective the increase in the value of Prudhoe Bay. At the time they were talking about \$900 million, they were talking about \$3 00 a barrel oil?

MILTON LIPTON: The expectation is that by the time it is produced it might be on the order of \$5.00 a barrel.

SENATOR CHANCY CROFT: And now we are talking about over \$10.00 a barrel.

MILTON LIPTON: The net effect of everything that has happened in the interim upon Prudhoe Bay, per se, is certain or uncertain depending upon how you measure the net effect. If you measure it in terms of the rate of return on their investment -- it depends upon what calculation you use. By our basis of calculation, and we are not prepared to utilize the industry's arguments that all capital investments including the pipeline and tankers will all have to be paid out of the profits of Prudhoe Bay. But by our calculations, it would appear that -- and again, say that the assumptions about the future, and you are right about those assumptions, that the rate of return on Prudhoe is probably lower today than what? This is the important thing. That might have been estimated in 1970 on the basis of what then were reasonable assumptions about the future. And people made different kinds of estimates then. We think that the rate of return may well be lower. Especially if you use the DCF calculation. But the aggregate profitability is going to be ever so much higher. The dollars per barrel that will be earned on production should be much greater today than one might have assumed before, dollars per barrel. Which means that if your profitability on one -- if your rate of return on one Prudhoe Bay has gone down, if you now have a lower rate of return on several Prudhoe Bays, because the rate of return is now being calculated on a multiplied capital investment. In a sense, the rate of return on Prudhoe Bay has gone down but because of the acceleration in prices and so on -- it is not as though the rate of return on Prudhoe Bay has gone down, but it is as though the companies have now found oil field A, oil field B, and oil field C, all of which have somewhat \_\_\_\_\_ rates in tax. I don't know what you make of this as a principle of taxation. I don't think it is really relevant for formulating what kind of tax policy the state should follow.

If you take into account what has happened to costs and to prices, then in general it would seem, that because of the tremendous inflation would -- When the costs that were inflated are capital costs, it takes a hell of a lot of earning to maintain a rate of return. But you may still have a very, very large increase margin of profit per barrel. This

is the net effect of what has happened in between. I would guess that the oil industry could probably demonstrate to you that the rate of return has gone down to very much lower than what has been assumed. And they argue that the margin per barrel has not increased as much. This is a matter of judgement. The profitability rate of return is probably lower, the total profit per barrel, and multiplied by all the barrels at Prudhoe Bay are very considerably larger.

QUESTION: Larger? Is it fair to say that the rate of return on Prudhoe Bay has gone down and other fields have gone up, since 1974 of world ....

MILTON LIPTON: Yes. The rate of return on most existing oil producing operations will have been improved because the capital base remains unchanged. Operating costs have gone up somewhat owing to inflation but it is relatively unimportant. But if the price under which the oil is sold is very much higher, and this is true even for a large number of established oil fields that are operating under the old price ceiling, these can be very, very profitable. When the price which you get goes from \$3.40 to \$5.25, and even taking into account the loss of the depletion allowance in the interim, it looks as though, on the average, the profitability of oil fields has improved.

I'm not sure the net effect would have been in the Cook Inlet because while their capital base has remained the same, it's an old established thing, and the prices have gone up somewhat, the State of Alaska has really subjected them to a high rate of severance taxation. Quite independent of the increase in their own wellhead price. In Cook Inlet they are paying on the basis of cents per barrel and the cents per barrel has gone up under your severance tax escalation clause not only because the price of old oil has gone up but it's based upon the wholesale price index of crude oil and that raised the combination of new oil prices and old oil prices. And when the new oil price started going up, as it did last month up to about \$13.00 a barrel, that pulled the wholesale price index up. The wholesale price index escalated your cents per barrel severance tax and for over a year their own wellhead price is under old oil price control. This stuff stayed here, the cents per barrel tax came up and you were collecting windfall profits which the state had never anticipated. The state thought the cents per barrel would go up as the posting at Cook Inlet would go up. "Don't let the oil companies fool around too much with their posting, we are going to make sure they're honest. To get back to your question, I would guess that for -- Your question really needs two

different answers. What the effect of a relationship between higher prices and higher costs will be on an exploration venture in Alaska today. I would guess that it is favorable for the exploration venture and for profitability. Although costs have multiplied several fold, there has really been quite a rapid run-up in the new oil price, the upper tier price, and it is still going higher. I think it should be very favorable for exploration incentives and for the profitability of successful ventures. The second part of my answer deals with something I discussed on Tuesday morning and I think it is very well worth bearing in mind. In any aspect of your consideration of taxation, if in fact there has been a favorable impact on the profitability of exploration ventures, this is absolutely essential. It is essential because this higher price which gives you the higher profitability on successful exploration ventures was intended to bring the industry in to more exploration than they otherwise would have done. And more exploration means taking leases where they otherwise would not have. Taking leases on inferior prospects. Drilling more dry holes. Abandoning more leases. Doing seismic work and then saying, "No we are not going to drill." It means that the high price is an inducement to the industry to lose more money. "We give you this high price with the complete expectation that you will lose more money in unsuccessful ventures." If the industry doesn't, then the whole U.S. policy falls apart. But how do you induce industries to lose more money? Because the high price says that when you are successful you will make more profit than you would have if you were successful with a five dollar price or a four dollar price. In other words, although the new price cost relationship should be favorable for profitability, they very well better be, if the industry is going to do the kind of exploration and suffer the kind of risks which the high price is designed to encourage. So there are two balanced aspects of it. I think this is part and parcel of the intention of our oil policy and the idea of giving out a higher price will support the objectives of policy only in so far as it works that way. Only in so far as the industry is prepared to take on greater risks than they otherwise would have before, when they are successful to earn somewhat higher prices to pay for the greater number of losses. This is one of the things I said that the State should take into account when they say, "Well, where is the measure of superior profitability. What rate would we, if we do at all impose a surtax on them."

SENATOR CHANCY CROFT: I am also curious with regard to the question of the profitability of Prudhoe Bay and that analysis. There is some indication that the oil industry is again moving the point at which it plans to maximize its profit from its integrated operations. It has moved it historically through several different stages of the process and there is an indication again, with the loss of the depletion allowance that industry is moving their profits from the production stage to the refining and marketing stage. I wonder if you might care to comment on that?

MILTON LIPTON: It is pretty difficult to generalize about what the industry is doing when each company strikes its own \_\_\_\_\_ and it does it only within the limits of what it is permitted to do by tax laws. The profitability of the producing venture is supported by prices. Prices have gone up even though your depletion allowance has been eliminated. Profitability, historically had been very low in refined marketing. One of the reasons of course is that the competition is very intense. Competition is intense because of the structure of operation. Not only the structure of the industry, there are more firms in refining marketing, but it is the structure of the operation too. The fact that if you have capital invested in a refinery and the refinery operates at 80% of capacity, you've got 20% of refining capacity, you utilize it. Then the marginal processing is very much lower than the \_\_\_\_\_. When you can measure capacity in the refinery -- you can't measure capacity. You certainly can't measure unutilized capacity in distribution plants and gasoline stations. Historically, you've got so much unutilized capacity in that feature of the industry -- you put investment in gasoline stations, you want to get volume, turnover, and so the oil company operates a gasoline station, like a department store, you want to get as many people walking through, you want to sell as many units of your product as you can. And historically the companies could survive if there was intense competition at that end, provided they had some form of superior profitability in the producing end. Whether it was because of the depletion allowance on U. S. operations, or high unit profitability on foreign operations. That is pretty much out of the window now. Now the industry is faced with the need to obtain competitive profitability in virtually every function of their operation. There really isn't one thing that is going to support the other. A great deal of the profitability in foreign operations has been very much reduced. So that you find a tendency, a trend towards the strengthening of product prices out of the sheer necessity to make them profitable

so that you can support them, insofar as competition permits it. It is not happening in Europe yet, that is for sure. In the United States, of course, there has been a reduction in product prices but this is part of the \_\_\_\_\_ . I would say over the next few years, I would expect that refining and marketing profits will improve here. I don't think it is a matter of shifting so much. I think in Alaska we have always been very much concerned about the \_\_\_\_\_ of integrated profitability as between the producing function and the transportation function. Because the profits on the pipeline is virtually assured so long as operations continue and they are protected against the rate of taxation in that, so in effect, if the profit goes into the pipeline, which reduces the wellhead value, they are protected against any higher rate of taxation on a dollar of producing profit than it would have on a dollar of transportation profit. This is one of the things that the state would presume to maintain surveillance over, is Alaska Pipe Company.

SENATOR CHANCY CROFT: You were very critical yesterday of the discounted cash flow method of analysis that has been utilized in attempting to analyze profitability. Several of us in the legislature have been told that is the method by which the industry itself often evaluates a venture before they commit themselves to it, is the discounted cash flow. It also seems to me that you're suggestion with regard to a capital recovery mechanism in the surtax proposal is somewhat similar to a discounted cash flow method of analysis, that what you are ensuring is that there is a rate of return based on a level of expenditures.

MILTON LIPTON: I am not critical of DCF calculation. I am critical of some of the ways in which DCF calculations have been used or interpreted in connection with analyses of Prudhoe Bay. How can you criticize a DCF calculation? It is a piece of arithmetic, that's all it is. Does the industry use DCF calculations? The industry must speak for itself, company by company must speak for itself. Let me tell you what our experience has been with oil companies, insofar as we are consultants with oil companies. The DCF calculation is used typically, to array alternative investments. If you have a DCF rate of return of 35 that goes here, if it is 30 it goes here, if it is 15 it goes down here. It permits you to array. Secondly, when you say that this is higher in the array and this is lower in the array, you've got to look at what your nature of the investment is. DCF calculations become reasonably comparable and are useful for purposes of array if two things hold true. If the intensity of capital



MILTON LIPTON: I would like to suggest that perhaps you would like on Friday, to at least devote a little time to the question of leasing policy. This has been an old issue and I know that the native corporations have raised the whole subject of leasing policy as something which is vital to how the state reviews both tax policy and leasing policy. There is a bill that is before the legislature on leasing policy and I think it might be worth spending at least a few minutes if it is of interest to you now.

SENATE RESOURCES COMMITTEE  
TESTIMONY OF MILTON LIPTON  
LEGISLATIVE CONSULTANT ON OIL & GAS

March 26, 1976

Members in attendance were Senator Kay Poland, Chairman, Senator Joseph Orsini, Senator John Butrovich, Senator Chancy Croft and Senator Pete Meland.

SENATOR KAY POLAND: We have Mr. Lipton with us again today. And although Senator Croft will be along in five minutes, I think we will go ahead and start. Mr. Lipton?

MILTON LIPTON:

I don't propose to repeat our discussion of Wednesday. I would like to pick up approximately where we left off, but in the context of a great deal of the testimony that has been presented to the two resource committees in the intervening days. I suspect that there has been more discussion here this week on the subject of capital risks, profits, and tax policy than has probably taken place anywhere else outside of the University classroom. There has been a lot of divergence as to attitudes, \_\_\_\_\_. I wish I could select the few pippy words and resolve all of the controversy. There is just no way of doing it. But I am struck by the fact that the evidence that has been put on the record in the last few days, by the companies, indicates that the rates of return to date in Cook Inlet are not nearly as fullsome as some of the previous studies have indicated. It is difficult really, to judge even historical data without access to the specific numbers. I found extremely striking the ARCO representation that the operating costs per barrel in Cook Inlet were on the order of \$1.35 per barrel. If this is the case, and definitions of operating costs are elusive until one sees exactly what goes into it, but if this is the case, and considering the very high capital investment per barrel in Cook Inlet where you have very heavy platform costs and only a few hundred barrels per day in production, this would indicate that perhaps the returns in Cook Inlet, at least thus far, are not all that exuberant. Looking ahead, of course, it depends upon what is going to happen in the future to the prices that they will be able to get for Cook Inlet oil.

Prudhoe Bay is much of the same story. The evidence as put down before you that quite apart from some of the very high rates of return which earlier studies had indicated, at least individual

companies estimate that at best, their rates of return now after the run-up in prices, but having to compensate for the increase in costs, at best are only as good as they were in 1969 when they first looked at Prudhoe. And since the rates of return now, they suggest, are going to be fairly low -- on the order of 16% -- they suggest that these companies are really quite heroic in having entered into the fantastic cost of development and pipeline construction and everything else. In 1969, with the expectations of no more than a 16% rate of return. Everything remains for the future. I don't believe that any government can really devise a tax policy or even a schedule of tax rates on the basis of anticipation. The principle of taxation can be laid down well in advance. It may or may not raise the revenue for the government or for the state, depending upon what future results are in terms of production and profitability of the field. For example, if you go back to Prudhoe. If in fact, it should take, at Prudhoe, five, six, seven years to recover all of their capital costs, to obtain the leases, to explore, to develop and to establish the production capacity -- if it should take five, six, seven years to recover their costs and thereafter their per barrel costs, the margin between the price, the value of the oil at the wellhead and their royalties, severance taxes, operating costs and state income tax -- if that margin is slim and it takes five to six to seven years to recover costs, then, in fact, Prudhoe Bay will not be anything like the bonanza that they or the world or we might have anticipated.

On the other hand, if it turns out that the capital costs associated with Prudhoe Bay development can be recovered in two to three years and thereafter there is a relatively large margin between the value of the oil at the wellhead and all the continuing costs of production, royalties, severance tax, operating costs and so on, then I would say that the superior profitability of Prudhoe Bay will have been established. The industry's position throughout has been that any proposed changes in taxation look to take more than the industry would like to surrender to the state. There are others who believe that under the existing forms of taxation, the state may get less than is probably fair to the state. This is really more a theological debate than anything else. What is fair cannot be defined. What is right or what is wrong cannot be defined except in theological terms, which I am disinclined, under any circumstances to argue. But certainly with respect to the oil industry where theology was very much thrown into the balance in the middle east, the industry argued the Christian ethic in terms of sanctity of contract, and lost the theological argument very, very quickly because the answer was "If Allah wanted you to have the oil he would have given it to you. He gave it to us." You cannot argue theology when the islamic world has the reserves.

But what is interesting is whether or not the state can devise a tax structure which is not necessarily destructive of incentives for exploration or for marginal development. This brings us back to the discussion that we had on Wednesday as to what are the effects and implications of the tax. Not what is fair. Not what is right or what is wrong. But if the state is willing to consider