cents/barrel taxation upon the company, that is, you had anticipated that a $6.50 wellhead value will obtain for most of the production on the North Slope, in which case the cents per barrel really is not onerous, because the companies were paying on a percent of wellhead value. So if your cents/barrel is geared to hurt a company only if the wellhead value falls below $6.50, and you don't anticipate it falling below $6.50. Oh, this was a kind of compromise, protection against what might go wrong. Well, a lot of things went wrong. Among the things that went wrong were things that were partly beyond control of the company. Namely the adverse economics of disposing of the Prudhoe Bay production beyond California. One of the other things that went wrong, not necessarily wrong but went counter to the expectations of the Legislature, was that the pipeline tariff posted by the companies and now applicable pending adjudication by the Department of Energy, the successor to the ICC, is a very high pipeline tariff. This tends to reduce the wellhead value. So partly the companies have in effect shifted wellhead value down, because of the profit of the pipeline, but partly it has to do with economic circumstances, the ability to market at a good market, the prices in California are not that different than in Gulf Coast, for competitive reasons, but that's a different story. Basically, the price that they have to compete against is not much different in California than in the Gulf of Mexico. The big difference is the difference in transportation costs and there is a difference of $2.50 in transportation costs gross, and probably somewhere between 70 - 80¢ net after taxes out of pocket to the companies to go all the way to the US Gulf Coast.

Q: Sumner: I believe that I heard you say this morning that if we keep foremost in

mind the subject of future investment incentives in Alaska that we're going to have to weigh very carefully, even though we may want to restructure the tax structure here in Alaska, but as it relates to the aggregate of the total taxes that are being paid, I got an impression that you thought maybe we ought to think cautiously of how much we might increase in aggregate the taxes that are paid as it concerns the future investment incentives.

Lipton: I think that's right. I think that no industry can be indifferent and because the industry is important to Alaska, no legislature can be indifferent to the aggregate tax burden. I think that's quite a different thing from simply being overwhelmed by a statistic which says this industry is already paying, given our assumptions, somewhat, 5% more, five percentage points more than we would be paying in California. There's a shadow area between where tax burdens or expected tax burdens suddenly are going to affect industry investment incentives, particularly in the area of exploration. One thing you know, that the exploration dollar does not go automatically where the tax burden is least. The exploration dollar tends to go where the exploration prospects are best. You can surely shift it somewhere in this gray, shadowy area, where the tax burden get so overwhelming, or if there is somewhere the perception, and I think this is one of the things the Legislature surely will want to consider, that if the perception is that changes in the tax structure, as it is applied to the oil and gas industry, are regularly taken, largely with the view to budgetary needs or revenue deficiency, and hardly ever with the long view as to what is a reasonable tax regime for the state, then I think it creates impressions which may be even more important in discouraging investment than the fact of the tax burden per se. And this is why I think in all of our discussions with the legislature, we've

tried to emphasize that a balanced tax structure, in which each of the three elements, which are the income tax, the severence tax, and the ad valorem tax, have to be weighed somehow by a different criteria because they have different effects on the industry, but if it's balanced and if there's a concept of continuity over time, that under those circumstances we have not yet seen this legislature placing such extravagant burdens on the industry that if they had sufficient confidence in, you know, the trend over the future, that this would not discourage investment.

Q: Sumner: What is your guess to the liklihood of depressed oil prices in Alaska to resolve the oil activity throughout the rest of the world. Right now in terms of the efforts to increase or step-up production in many areas of the world and the West Coast surplus to some degree, do you see that as building on itself?

LIPTON: No. I don't think that there's anything in the nature of oil exploration world-wide. One has to have an incentive, and two, has to have a purpose. The incentive is the hoped-for profitability of the relatively high foreign oil prices. The purpose is to try to create the reserves, the expanded reserves that will meet world oil requirements in the future. If I may digress for just a moment, we're living in a strange circumstance. The productive capacity in the world today is considerably larger than world oil requirements. The reserves of the world today are really not very great compared to what future demand is going to be. We're facing a temporary surplus of collective capacity but a long run deficiency in the reserve base for oil, so the exploration is going to go on. I don't think there's any adverse effect on Alaska. I think the long run opportunities for marketing Alaskan oil in North America at prices that are attractive from the standpoint of the profitability

of exploration ventures, from the standpoint of the state's share of the economic value, the prospects down the line are terrific, and if the geologists of the company see the opportunities here, the exploration money will come.

Q: Sumner: I'm trying to determine what period of years might be involved in your projection there and weigh that against what is scheduled to be the peak production years, Prudhoe Bay for instances, which is right now of course one of the largest reserves in the state. You know, if it's ten years down the road, we won't be competitive, or we will have marketed the major part of this oil from that reserve. So does the long term picture look like three years, four years before improved or upturned pricing structure.

LIPTON: I don't think your prospects are all that adverse even at the present time. You're suffering a temporary disadvantage by virtue of several things, one, price control and two, the fact that your production is surplus to the ability or the willingness of California refiners to take that amount of your oil, and this will become aggravated next year when the production goes up substantially and the demand for all crude oil in California refineries is not going to be large, so that a larger portion of your oil is going to move beyond, but there will be in the interim, there'll be improvement in both world and US oil prices, world oil prices because of the level detemined by OPEC and US oil prices under whatever compromise on energy policy evolves.

Q: SUMNER: On the near and the long term?

Q: HUBER: Milton, would you go further into the relationship between cents/barrel in relation to vertically intergrated companies allocation to expenses and profits, sales, processing, production, transportation, such as possibly what would be the difference in situations with BP?SOHIO for instance if they have decided to take not the maximum in the transportation but to take

a minimum from the pipeline transportation and maximize their production profits.

LIPTON: Well, Senator Huber, you pick a difficult example. British Petroleum has a direct participation in the pipeline, so whatever the after-tax profitability of the pipeline operations are, for its undivided share of tax it accrues 100% of the profitability. Now, whatever the effect will be upon the wellhead value at Prudhoe Bay, therefore on the tax liabilities of Prudhoe Bay producers, therefore on the after-tax profits of Prudhoe Bay producers, affect British Petroleum only through it's partial ownership of SOHIO. What the net effect would be, I would assume without doing a great deal of number work, British Petroleum looks at 100% interest on the one hand and less than 100% interest through SOHIO's participation in Prudhoe Bay, would in a sense place greater weight on it's 100% equity which is the pipeline participation than on it's indirect participation in Prudhoe Bay. But you see, neither this company nor any other company has complete flexibility in how they operate. The tariff that British Petroleum set TAPS can set on the same basis as all the other operating companies; that is to say they chose to calculate a tariff based upon the old ICC 8% rate-making modified by the 7% consent decree with Department of Justice, and so they all use the same principles, they've got approximately the same tariffs depending upon their debt proportions and so on. British Petroleum behaved exactly the same way, and obviously, if it did behave the same way as the other companies, it was thinking in terms of what seemed, from their assumptions, to be an appropriate policy. I really don't know that there's so much difference among the companies. The other part of your question is a meaningful one. If you have integrated operations, and if in fact the

tax exposure of profits earned in one place or one function is different, in other words, if you earn the profits here you pay more taxes, therefore you like to have the profit somewhere else. If you earn the profits in production, you pay higher taxes, therefore you like to have the profits in transportation. This is true of any company that has the possibility of shifting through transferring pricing the profitability from production to (IA). But the companies don't have freedom here in terms of the pipeline. . . The issue of the pipeline tariff really I think should be divorced from the taxing policy of the legislature, at least at this moment in time because it's now at issue. First of all in the courts and certain legal respect, and more importantly, it's at issue before the Economic Regulatory Administration, Department of Energy, which is looking into both things, both what the capital base is for the determination of tariffs, and two, what the proper rate of return ought to be. And this is now in adjudiction. And your own Alaska Pipeline Commission is seized with the issue of the tariff between Prudhoe Bay and Fairbanks. It's going through it's own administrative process, and if it turns out that in fact, the administrative decision upheld in the courts is that the pipeline tariff is too high you will get higher wellhead values and (IA) the companies whatever their predilection will be low side of profitibility and tax exposure, are going to have to follow suit.

Q: HUBER: I can recall the arguments when we put in the cents per barrel, and it was to protect the state, if I remember right, through revenues even if the oil would fall to zero wellhead value, and even if the allowed transportation should be extremely high. Coupled with that was the figures given to us many times that most oil pipelines were allowed to 8% maximum but the history of the ICC shows that they weren't, the prices were such that they weren't taking only 5%, 6%, 4.5%

of these figures and many others several times showed that most of ICC-controlled pipelines were not charging that maximum amount. Here we have the situtation that you brought up, SOHIO is paying 12.25% effectively because of the floor

LIPTON: (INTERRUPTS) (16.5)

Q: (continues) you said 16.5% effective, and yet every one of them is change and it seems like they have decided that the Alaska pipeline that the old proportion will be used, they will go for the maximum they can and I'd hate to see what it would be if we didn't have the lid of 8%. It looks like you've got a whole new ball game here.

LIPTON: Senator Huber, I think I do recall your reference to the past.

We have been rather vocal on this subject of ICC tariff regulations and pointed out the history of two things, one, that the 8% rate making rule was a monstrous rate-making rule because it had been adopted in an economic environment which no longer existed and the ICC for unfathomable reasons has never gone back and reviewed the 8% and the rate-making rule, and because of that, we raised the whole question of the effect upon netback values, wellhead values, and we strongly supported the establishment of the Alaska Pipeline Commission, which gives you your own avenue of administrative regulation. But you know, an interesting thing happened. All of a sudden the ICC came alive, and the ICC said that that old 8% rate-making rule is no good. We're going to go to a 10% rule. But you know the 10% rule yields much lower tariffs than the old 8% rule. The 8% rule was 8% after tax and after recovery of interest on total valuation. The 10% rule, and there's nothing magic about it, and I suspect that in the course of time the review of the whole issue will mmodify that too, but the whole point of the 10% rate-making rule is not to give a higher rate of return. What is said in effect was the 10% shall be the total return to capital; that is to say your interest charges,

which are such a fantastically large thing have to be covered by that 10% return of your capital, and this led to ICC-proposed tariffs which were $1.50 or so on the average below what the companies have posted. Now I suspect that the change in attitude of the ICC did not arise of a vaccum. It was a reflection of a long discussion on the implications of the rates that had taken place before your legislature over many years and argumentation over what the appropriate rates of return should be, what the appropriate rate base should be, and what the resulting tariff would be, and I think that at this stage of the game, from the standpoint of Alaska, not from the standpoint of the companies, there is reason to anticipate at least that there will be very very serious review of these pipeline rates. Now if it turns out that after all administrative review and after all judicial review, that the company tariffs stand, where are we left then? What's the judgement then? That everybody's wrong? The companies are wrong? The Department of Energy io wrong? The courts which uphold them are wrong? The Alaska Pipeline Commission hasn't been able to do anything. I doubt that that's the case. But if all of that does transpire, what then is the implication? Maybe the tariffs are not of out line. If it's done through all process, I don't think that's going to be the result. I think the strength of the Alaskan position is in everything which has transpired over the last few years, including the arguments about the rate base, the arguments about the rate of return, and everything else, I think this, I strongly believe that this is a judgment, a personal judgment, that you will have substantially lower tariffs on TAPS than were promulgated by the companies themselves.

Q: HUBER: Just one final follow-up. It is within our responsibility, purvue as legislators for the State of Alaska's people to determine at what point do you say this is what we would do in fairness, or do you say if it isn't economically feasible to produce this oil at this time because of transportation problems, federal rules that are in many cases arbitrary assumptions, maybe we shouldn't get rid of this depletable well at this time. The cents per barrel tends to do that, what I'm talking about, rather than removing it entirely, or move the cents/barrel down to where we could bring more fairness to the companies as you say, what do we do with ...

LIPTON: Senator Huber, if you're talking about revenue per se, it's a persuasive argument. If the function is to provide an underpinning to state revenues, the cents/barrel does it. Now, the other question is what are the implications when you choose to buttress or underpin state revenues by doing this? First of all, what you see is a kind of ad hoc taxing policy, increasingly year after year dedicated to our budgetary needs, revenue deficiencies, or whatever the case may be. There are circumstances which may militate in that direction, if it's necessary, if the state faces a crisis. But you must always ask yourself, is this to be the principle of taxation that you'll follow in every legislative session, or are you willing to say that the state has an economic interest which is represented by, first of all, it's royalty claim in the lease, secondly by principles of taxation which have been evolved over sessions, and only under extreme situations do you start intruding unique revenue problems as the basis for change in the tax liability in one year or the next year or the third year. I have no argument against the necessity of doing so from time to time, when abnormal circumstances intrude. I do think that it

causes, the question is asked of me so many times, including just this session, where do you start adversely affecting corporate investment decisions, and I said thenand I still feel that you could with the burden of taxation do it, but more likely, the kind of changes in the burden of taxation really won't have that much effect, but if there is a perception that tax policy always is detemined with a kind of a unique view toward the budgetary exigencies and the revenue deficiencies of the moment, and there seems to eb no continually over time, that would have a very adverse effect.

Q: HUBER: By possibly reducing the floor, and I do hope that in some cases this might be a viable suggestion. I just can't get it with our responsibility that floor of 62.5 ¢ a barrel, for Alaskan oil now at least that's the floor on severence tax, and I can't see how that could be effective now when this same oil it's competing with throughout the world, other countries like Arabia, are taking $10.00 a barrel, we're taking too much at 62.5¢. I just wonder if we're making our discussions in the right range. We shouldn't be making off somewhere halfway in between somewhere instead of down below the bottom one.

LIPTON: I'll give you a very quick answer to that. Saudi Arabia in effect takes more than $10 a barrel for their oil. But let's assume that you'll be satisfied with a modest $10/barrel taxation on your oil. You take $10/barrel for your oil and the oil has to be sold in L.A in competition with Saudi Arabian oil, or $13/barrel. Now you have left $3/barrel to pay your transportation costs from L.A. to Valdez, never mind the profit on the pipeline, your pipeline costs from Valdez up to PrudhoeBay, the costs of producing the oil. $3 won't do that. That's why you can't get $10 for your oil and Saudi Arabia can

get $10 for it's oil. Furthermore, you are not a Saudi Arabia in Alaska. Let me be presumptious for a moment in addressing the Alaska Legislature. You are not a United States in Alaska either. You're living as part of a nation which also has a tax regime. The United States has all forms of taxation upon oil and gas operations, including your oil and gas operations here in Alaska. The United States has a policy with respect to development of energy resources, the pricing of energy resources, they may be unattractive in Alaska. They are largely tax regimes attractive to the oil companies, the price and policies are attractive to the, but never the less, it is our national policy and it seems to me that the State of Alaska in its perception of how it treats the oil industry, must do so as part of the United States talking about an oil industry which is also part of the United States.

Q: HUBER: It just seems like we've got about a 20 to 1 difference there, and I hate to get working below the one figure in figuring where we should come out when I have a feeling it's somewhere between the 1 and the 20 instead of below the zero line, below the 1 line. And I just can't relate it.

LIPTON: A, Senator here, let me put it this way. There are companies operating here in Alaska who are operating in the Middle East, and earning in the range from .15¢ to .21¢ a barrel for their producing operations. And it's a bonanza to them. A fantastic bonanza, ever so much profitable than any operation in Alaska. If they earn as a margin of after tax profit in Alaska $2 a barrel we couldn't come close to the profit ability of middle east operations. Look at the fantastic difference in investment that's involved. What's of interest is not just how many cents per barrel we take away after cost and taxes, but how much of an investment of that is necessary to do it. There's a tremendous difference. I'm not addressing myself again to the fact the industry could not

stand any increase in taxation here or it's too high now. This is a very difficult thing to arrive at and this is a thing the legislature always has to balance. But I don't think, this is my only point, I don't think that the criterian the legislature should use in deciding whether the taxes are too high, or whether in fact they should raise taxes on the oil industry here. That they should look at the government take or the taxation in foreign producing countries. It's completely irrelevent.

Q: HUBER: Could you tell us better and more direct how should Alaska get it's honest, true, fair share both as a property owner and as a taxing entity if we don't use comparative means. That I think is the level we set up.

LIPTON: You're comparing yourselves with other tax jurisdictions which are also state states in the United States. I mean this is one of the reasonable comparisons. And you look at one form of taxation which is a corporate income tax and try to get what is a, well, you've got a corporate income tax rate. The problem is that that rate is going to apply to too low an estimate income. You can correct that if you choose. You have a severence tax which has evolved over time, I think in a very healthy direction. You have increased the ceiling percent of well head value over time not to any onerous letters compared to other states. You reduced it at the other end. You tried to provide not only for the state's revenue under optimum circumstances, but for protection of larger industry operations under adverse circumstances. You loaded on ad valorem taxes at a very considerable extent, and you did that under the exigencies I think it's quite understandable that, in your judgement revenue needs which anticipated the flow of revenues. You chose an avenue which was to tax before profits were being generated. It happens alot of times. But I think this is the basis upon which you judge. You look first at the total tax burden, then you look at the individual parts, and how are

they in terms of the revenue for the state and what are the economic implications for the companies that have to operate under those taxes. Certainly you've never subscribed here to the opinion that you're aggregate taxation, or that individual aspects of taxation were so onerous that in a sense they are discouraging operations here is Alaska. There's no evidence that operations here in Alaska are discouraged. If there's been a lag in exploratory drilling there certainly hasn't been because of the tax regime. It's because of the problems of leasing, land selection.

Q: REP. MILLER: Just real quick, and I'm curious, name a few states that use separate accounting.

LIPTON: Louisiana and Oklahoma

Q: REP. OSTERBACK: Talking about the oil. Have you done any figuring on the gas? That's the next thing that's going to face us in our Committee, the well-head price on gas. Have you done anything on that.

LIPTON: No. This is a wide open subject, and I have nothing but pity for those individuals who must now wrestle with the problem of not only what, what the well-head price of Prudhoe Bay gas can be. Second, Question, what the well-head price of gas ought to be. Can be, ought to be, and third, is how to get at those things. This is an awesome problem. Just let me say that I think this is one thing which is again to the thinking of the legislature. We always said that your oil is a price taker. That is to say, the price at which your oil can be disposed of in the refining centers of the lower 48 states can never be determined by Alaska, the state of Alaska or Alaskan producers. You're price takers you've got to move into the refineries in competition with other forms of oil. Which is why any increase in real costs that are incurred, for example, the ultimate cost of the pipeline, they come out of the ultimate profitability of Alaskan operations and they come out of the state revenue. There's no way of getting away from that. This

is not quite true in the case of gas. In the case of gas things which happen here in Alaska have influenced what the price of that gas will be when it's delivered to lower 48 markets. For example, severence taxes can be passed on. Increases in cost can be passed on. The reason is that the barrel of oil that reaches the California refinery has to be refined in competition with a barrel of oil from somewhere else. And MCF gas which reaches the Great Lakes area from Alaska doesn't have the market and competition with the MCF of gas which comes up from Texas, or off shore Louisiana, because you've got rolled in pricing which is involved at different stages of the game. Both in the transmission pricing and the distribution gas companies. Now how that's going to be resolved over future years, it has to be resolved before the new gas pipeline is finally going to be brought before us. But it is quite possible that the well-head price of gas on the North Slope will turn out to be higher on the BTU basis than the well-head value of the oil. It's quite possible. In which case the utilization of that gas in Alaska may not be so effective. If that's the way it works out. Although the utilization of the liquids may be very attractive, but that's a different story. I'm sorry but this is kind of a long winded answer, but the answer is basically I don't know what the price is going to be, but there's a difference between the way the price of gas can be determined and the way the price of oil can be determined.

Q: BUTROVICH: At what point in time and has the Prudhoe Bay oil been felt by the National Energy picture?

LIPTON: On sure. I mean there's no two ways about it. You've got 800,000 barrels a day of American oil being produced here which would increase our imports by 800,000 barrels a day if we didn't have.

If you ask how important is that 800,000 barrels a day or 1.2 million barrels a day which hopefully you'll reach next year, or 2 million barrels a day that you may reach by 1980. It's very difficult to judge how important that is from the standpoint of national balances. You would just hate like hell not to have it.

Q: BUTROVICH: I was going to ask you if that is good. The overall effect.

LIPTON: I don't think there's any argument on the part of the producing companies that have to pay your taxes and the part of the State of Alaska that have revenues, and the part of the United States as a whole, which has the benefit of that oil, no question about it.

Q: BUTROVICH: Suppose it hadn't gone on stream until July 1, 1979.

LIPTON: We're importing more oil now. The interim volumes of oil would be available in 1979 and thereafter. I don't think it would be the decisive factor in the national interest. I don't think it would have a very major impact upon the companies, and probably the state of Alaska. The companies' cash flow in the state of Alaska is revenue, you know.

Q: BUTROVICH: Would you elaborate a little about the companies cash flow, I'm not that concerned about the state's revenues.

LIPTON: There's no question that from the standpoint of operating companies the invested proceeds over time there is in the best of circumstances a very considerable lag between the time the investment starts and the time the investment is completed the first production, the first pipeline really begins and then build up your revenues thereafter. The companies have to pay out the money for a long period of years and incur interest costs over the whole interim. The duration between outlay and income, let us say the cash flow, is a very vital consideration, no question about it. Which is one of the reasons

that in almost all instances the companies would look for the most expeditious possible development of a resource the earliest possible production. The cash flow is, you said something interesting about the workers of other companies than the government because the government

Q: BUTROVICH: Pardon me. I didn't mean to say I was more concerned with the companies. I was more concerned with what effect it would have on the companies that's what I wanted to elaborate on. I'm more concerned about the state.

LIPTON: Yes. But your point, I was going to suggest that your comment really is a very meaningful comment in another context. For a profit making company the timing of it's outlays and it's income and it's cash flow, is extremely important to the continuity of it's operations because the dollar that's spent out can't be reemployed until it's returned in so for a company that would like to expand and continue to grandise it's profits. Cash flow is what provides the dynamics of it's operation. But for most governments the cost of waiting for income is really not as terrible as it is for companies. The cost of waiting if you have to put a discount factor or interest factor is bound to be lower for government, because for governments the governments are looking to a continous lead for revenues over the future. Now nobody wants to defer revenue too long, but the dollar of revenue deferred which becomes a dollar of revenue earned is going to play it's role in the budgetary balance wherever it takes place. The viability of government is not dependent upon the timing of cash flow really so much as it is for a profit making organization. That's one of the reasons, again we're talking about taxes. If you built a foreign producing operations, one of the forms that has

recently evolved is a production sharing contract. And you have a company that operates as a producer for a government oil entity and the nature of the production sharing contract is that the company will recover out of early production all of it's operating costs and what barrels of oil recover it's operating costs and relatively will quickly get enough barrels of oil to recover it's whole capital investment. Now after that shares go in increasing proportions say to government. For the company the amount that it's willing in negotiations to give to a foreign government will be the greater. The earlier the foreign government allows that company to get enough barrels of oil to recover it's costs. In other words, they will split more number of the government the earlier they can get back to themselves, because the cash flow is so important to them and the governments which recognize that are willing to do it, because they feel that the cash flow to the government is always going to be valuable in terms of their budgetary balances.

Q: RADAR: Mr. Lipton, the failure of Arthur Andersen to take into consideration the Cook Inlet production, is that considering amount of production. Does that significantly alter their conclusions here.

LIPTON: First of all I was not critical of Arthur Andersen for not doing this. They did what they were asked to do.

Q: RADAR: Yes, we are talking about a statewide policy here and ranking. What I'm saying is the failure of their application only to Prudhoe . . . What effect do you think it would have had, had they included Cook Inlet?

LIPTON: Senator, if all you did was to expand Cook Arthur Andersen model to include Cook Inlet as it is today, an extrapolation of the remaining reserves into a production profile for for Cook Inlet and apply the whole thing you'd have very little effect on the sum total. Because we're talking about close to 10 billion barrels of oil in Prudhoe Bay we're talking very

limited reserves, you know production now out of Cook Inlet is around 120,000 barrels a day which is projected with a (IA) overtime. Now I don't, the specific answer to your question is if the model had been designed to include all oil producing operations, all oil reserve discovered and available for development and production as they now exist in Alaska the effect upon the ranking would be very very small.

Q: RADAR: Would it be as much as 1%, maybe bringing 1 from 92 - 93 or something in that range?

LIPTON: I don't know. The answer is two-fold. The effect depends on two things. First of all upon the relative volumes. Now we know what that is. The relative volumes are overwhelmingly in the Prudhoe Bay direction. Plus the pipeline which is so much profitability and taxation involved in the pipeline. However, some of the greatest advantages the state gives under it's tax regime are given to Cook Inlet. I would not think it would make as much as 1 percentage point difference in the ranking producers.

Q: RADAR: In the future when we're in full production instead of limited production because of problems with the pipeline, full production Alaskan wells will move into higher bracket and Alaskan rating or ranking actually as compared to the next closest state would be further apart as the fields grow older and the fields produce less and less. Alaska's ranking would be closer to Louisianias' for example.

LIPTON: I'm not sure that I get the thrust of your question, and that is to say as you increase your production for example, if next year you average 7,000 barrels a day for a Prudhoe Bay well your cents per barrel goes up to 64.8¢. So your cents per barrel tax goes up. The chances are that your

average well-head value if the tariff remains the same will go down. The average well-head will go down, because a larger volume of the Prudhoe Bay production next year is going to have to move to the Gulf Coast and net back even lower. So if you're looking one year ahead then the incidence of taxation in Alaska will look worse than today. If the study were made just for one year, remember Arthur Andersen study is based upon a projection of 25 years. So if you are just doing it for next year as compared to this it will look less favorable. They've already done this for 25 years. That shouldn't have any effect upon their (IA) but let me just say something else. That if your tax regime remains as it is, abstract what may change, you have only to project reasonable increases in the well-head value because of what is happening to world oil prices and what's happening to government prices. Reasonable increases in well-head value and suddenly the tax burden becomes proportionately lower here in Alaska. Because increase in the value of the oil will go to a very considerable extent to the companies themselves. That is to say what's going to be the increase in the tax burden as the value of the oil goes up. Your ad valorem taxation really isn't going to increase very much. Your severence taxation will increase a little bit as you go through cents per barrel into percent of well-head value and by god, your state income tax revenue will hardly increase at all. Because you are under a formula an allocation formula. So as production increases in the future and as the value of Prudhoe oil goes up in the future the burden, the relative burden of Alaska taxation as things now stand becomes less.

Q: RADAR: I'm interested in your observation as to the statement we the federal government is going to expect Alaska to participate in the financing of an Alcan pipeline and the federal government in no circumstance is going to participate. I don't know that, and I understand that some federal people

will be up here in a couple of weeks to talk about that very thing. I'm a little bit uneasy as to what our posture is and what our maneuvering room is against what their maneuvering room is.

LIPTON: I recently returned form Alberta, Edmundton, where we are also consultants. The question of financing the gas line of course has been raised in Alberta as well as in the State of Alaska. I find it of double interest because while the pipelines were competing for authorization the promotors were very hush hush about requiring outside financing and everything. Once the competition was over and the realities begin to emerge and one begins to worry about who's going to do the financing and whether the province of Alberta should take an equity interest or whether the State of Alaska should lend money or whether the State of Alaska should in a sense guarantee the bonds so the rate of interest will be lower. I don't know how many different roles the state of Alaska can be cast. It's already been, with respect to the oil and gas industry, cast in the role of a soverign power. It's already cast in a role of a land owner, and now it's going to be cast in the role of a money lender. I just don't know the answer. This comes down in the end to very pragmatic consideration. What are the realities of financing as they are presented to you? What is the state's interest in pursuing this? How far should the state go?

Q: RADAR: What do you think promoted the Federal government to take the position that it was reasonable for the state to finance or participate in the financing but unreasonable for the federal government to participate.

LIPTON: That's what they said to the city of New York.

Q: RADAR: New York was asking for something, we're not asking for anything.

LIPTON: No. They're saying that these are problems internal to Alaska and we should not take the responsibility for it. That is a bad analogy. But this a subject

one can address themselves to a lot better after one knows what the real circumstances are. I don't know that the Federal government in the end will not play in some kind of a role in the financing of the gas line. An awful lot depends on the extent in which the federal government wants (1) the gasline built by a certain date, (2) is convinced that private financing either is not available, which is unlikely, but is available at onerous interest rates. Therefore what role should the government, any government whether it federal, state or provincial. I think it is a little too early because so far I suspect that what we are hearing are the protestations of the party of the first part. That is to say the people who are involved in the financing.

Q: RADAR: When do you expect when the federal government will reach an agreement on the price, set a price, April - May?

LIPTON: This Spring or early this Summer I would suspect it has to be done. Even if the least optimistic time schedule or authorization, financing, construction, design and construction of the gas line has been met, the pricing policy is basic to almost any other decision that can be made.

Q: RADAR: Well if they expect the state to participate, again I'm thinking about our session and our opportunity to address this problem. Do you think we are likely to have before us the facts that it takes to intelligently address this problem if we were to adjourn in June, what's your best estimate on that?

LIPTON: I would doubt very much if you'll have all the facts, but I think you may have, the first thing I think you have to listen to more than anything else is just what the facts along this line are going to be, what are now the alternatives to the companies involved in the construction line. How do they see their own alternatives. What is the Federal Government realistically thinking about. I don't think the Federal Government is

actually asking the state of Alaska to undertake any of the responsiblity, I'm sure of that at all. The Federal Government may be simply saying to the people building this pipeline, "Look, you go ahead. These are the authorizations - these are the rules of the game. Now you go where can in terms of equity in terms of debt capital and in terms of the government entities that are involved. Really, which is basically the state of Alaska, the Province of Alberta, the Federal government of Canada to a certain extent, even the problems of British Columbia. I doubt if you'll have all the facts, but you'll probably have alot more."

(Answer to question asked by George Silides in Commissioner Gallagher's testimony)

Tom Williams Madame Chairman with your permission I would like to try to address that question and also try to speak a little bit to what Senator Radar was talking about earlier. For the record my name is Tom Williams I'm the Director of Petroleum and Revenue. We have two changes in the severence tax that we are suggesting. One is the economic limit factor and the other is the increase in cents per barrel floor. Right now we have a federal pricing decision to give oil , to Prudhoe Bay oil new oil treatment for both pricing purposes and for entitlements purposes. Entitlement is a transfer of money back and forth among the refiners to equalize their apposition costs to the national average, that is the objective of the entitlement, and new oil in the lower forty eight comes in the refinery less than imported oil consequently there is a fraction of an entitlement that didn't flaw, for the right to run as new oil. Our oil when it gets there, will not be below the cost for import oil it will be right at the cost for import oil. In fact the national policy has been for new oil like high risk North Slope production we got right from our Prudhoe Bay field. National policy is to give that, right now a $10.95 average price, cause of the realities of market, we tried, if we insisted

or if the producers who own that insisted on getting a market price at the refinery that corresponded to a $10.95 well-head price, someone is going to have to pay the transportation cost, and if you have say a total $5.00 transportation cost you would be getting into the market place at $15.95 the Saudi oil which is competitive with ours is selling for $13.50 to $13.75 so somebody would have to, I mean where's the incentive to buy, you'd have to compell people to buy our oil to get $10.95 price or there would have to be a subsidy. This has not been a thing that we have been requesting the federal government to do. We recognize the fact that this is how the market is, we are far away from it in terms of cost. Consequently the well-head value is not that it's realized by a refinery price that's competitive with the Saudi Arabian oil. Our well-head value is going to be lower than the ceiling. The problem is that they are going to, if they treated this new oil, they are going to try to equalize something that is already equalized and it is going to result in a penalty over $3.00 a barrel, this equalization. They will equalize all the rest of new oil for the lower forty eight, it won't hurt them too much, it will cause some problems though, because it will over equalize new oil producers in the lower forty eight. But for us it doesn't, it's completely inappropriate because our oil is already coming in at the level corresponding to imports. There is no need to equalize. Consequently if you make them buy at a fractional entitlement at a cost of $3.00 or $3.35 that means the refiner is going to pay that much less instead of paying $13.50 he will pay $10.50, and that means a Prudhoe Bay producer or the State of Alaska if it takes its royalty in kind and goes out and tries to sell it, when he gets it to the west coast is gonna see only $10.50 coming to him. $3.00 goes into the entitlement,

we never see that. So you start from $10.50 down there in California and then you have that when you get to a $4.00 welling price. Our contention is that if that happens the game is over. There will be no more exploration. There are no more Prudhoe Bays. It is highly unlikely, there is only one Prudhoe Bay in the United States and there may be a second one down in Mexico, in the Tabascoarea in the farmers fields, but a, there pretty darn few and far between to find a field that large and at $4.00 well-head value. If that's the prospect, four dollar well-head with

today's cost, even if you found it out of Prudhoe Bay the chances are nill that it would be developed. And so the game is over because we are not likely to find fields twice and three times the size of Prudhoe Bay. So given that the game would be over, we are not doing any more damage by saying that well, instead of $6.00, $7.10 is the floor and the post which is our present floor with the cents per barrel, we are simply saying, Why should the people of Alaska follow the resource? At the game, it then becomes a question of priorities and where our allegiance lies, with the people of Alaska or the share holders in the larger corporations? Now there is a balance, but given that &7.50 is not a reasonable well head price for North Slope oil in the beginning of a cut, and as production continues and through what builds up, if it, the federal began, assuming the federal government doesn't screw things up and destroy the insantitudes, the increase thuroughfare will lower the pipeline tariff. This will allow the well head value to rise. OPEC countries can be expected to raise their price, that includes Arabia. So if the refinery price for our oil, our refineries will raise the charge for getting our oil from Prudhoe Bay to the refineries will be less. These two things will conbine to raise our well head value and by the early 1980's we won't get by talking about the well head value of $7.50, we will be taldingabout well head values greater than $10.00. In fact extrapulating out by the end of this century, we will be seeing well head values of well, your world market values it sounds obsurd today, but $20.00 well values are certainly not inconceivable at that time, and thats $20.00 in terms of today's dolars, you know, not inflation dolars of the year 2000, that twenty of today's dolars,

thats simply because we have increasing demand, our Latin American neighbors for instance, their energy consumption is growing at a rate ten times ours, their population keeps growing, and world energy demands are far outstripping our own nation's demand and as vast as the OPEC resources are, this is a world wide shortage developing in the next 10-15 years. This shortage is going to cause, ask developers, its going to cause the price to rise in real terms that is to say in addition to the effects of inflation, we will have an additional increase in the real rather than the illusion. Consequently when we turn back, to the point, if the federal government gives us new oil in Tilener's treatment, the question then becomes whether we are willing to sit by and say OK we will take 8% or 10% off for dolars and there it is, its not good, but thats all there is to it. Even though we are paying right now, importing almost 10 mission barrels a day to each, though I don't know what the latest figures are and we are paying our good, loyal allies, Arabs, Iranians, Abu Dhabians, and all those nice people and Indonesians, Nigerians and Algerians, 14-15 somewhere in that range, 14-15 dolars is the average per import acquisition cost.

QUESTION- Tom, I understand what you are saying, I really do, but how, I must have missed somthing, how does that help Cook Inlet today?

- OK, with Cook Inlet, we, Sterling and I have gone to the Federal Energy Administration last summer and in fact, the hearings that they had earlier, in April or May, it was in Anchorage regarding the price of new oil and how to compound the upper and lower tears should move through time, and also about this problem

of oil production that reaches its break-even point with the control oil price. Right now, I mean the federal government is not reluctant to price our oil severly below what its actually worth, in the inlet that oil is beginning from $5.00 to $5.15, and for oil of similar quality we are paying, almost, we are probably paying over $15.00 a barrel to get it from Indonesia to the west coast or Pudget Sound. So we don't see a very friendly attitude on the behalf of the federal government toward Alaska production to begin with. We went there and pointed out that there are some properties in the oil that were at that time dangerously close to reaching this break-even point at $5.00 a barrel, we said we know you have shis procedure to allow pricing on this basis, to allow the price to go up, so that they continue to have more revenue than expenditures. Then they, thats indeed true, then they said that of course we are not going to give it to the State of Alaska because thats fixed cost, you are going to be stuck there at $5.00. Well that presents an interesting question about how they rewrite our lease, but they said that they would allow that much pressing relief and return the property to the level of profitability enjoyed in May of 1973 when price controls, that's the reference period they all relate back to, May of '73. But he said, we'll allow to have that same measure of profitability, which to my thinking would include among as profit, you have what's over for tax. So if you raised the severence tax, that's an increase cost, but an oil company can go into the FEA and present the case saying, here are my thoughts, now give me my May 1973 rate of return,

and in fact that should accelerate the movement to a more realistic price to the upper tear which is not still the market price, but at least its, $10.95 is a good site better than $5.00. And consequently, if the Federal Energy Administration is doing what they say they are going to do and if they can do it in a timely fashion, there should be no problem for the oil companies because this is simply an expence, severence taxes are recognised as such.

- that had not been explained before, thank you.

SENATE RESOURCES COMMITTEE

HOUSE RESOURCES COMMITTEE

Testimony of Lawrence L. Wilson

March 25, 1977

My name is Lawrence L. Wilson, Associate Tax Counsel, Union Oil Company of California. I shall be speaking today on a number of bills which cover income taxation, severance taxation and property taxation. Specifically, these will be SB 105 and its companion bill, HB 145 and HB 322, all of which deal with income taxation along with SB 202 which is the "net proceeds" tax. I will also cover SB 103 and HB 321 and its companion bill HB 144, which deal with severance taxation. Finally, there will be remarks covering HB 323 dealing with property taxation and HB 328 dealing with the Reserves Tax. Where appropriate, my remarks will also comment on testimony that has already preceded my testimony. The first bill I wish to comment on is SB 105. No reference is made to HB 145 since it is an identical bill.

SB 105

SB 105 is a bill which purports to determine income to Alaska through the "separate accounting" method. The preficatory language in Section 1 states that the present method of apportioning income under the three-factor formula embodied in the Multistate Tax Compact does not fairly represent the extent of

the business activities in Alaska for corporations engaged in the production and pipeline transportation of crude oil and natural gas. Section 1 goes on to state that the legislature, therefore, intends that section 18 of Article IV of the Compact, which allows separate accounting, shall be adopted for determining income derived from the production and pipeline transportation of oil and gas.

Richard Kilgore of Walter J. Levy and Associates and Professors Jerome Zeifman and Kenneth Ainsworth have commented on "separate accounting" as a method of determining income with Mr. Kilgore defending it and Messrs. Zeifman and Ainsworth attacking it. Even Mr. Kilgore acknowledged that the administrative problems of determining "value" for a product transferred out of the state and of allocating expenses to Alaska were troublesome. Messrs. Zeifman and Ainsworth painted a picture of corporate maneuvering by astute managers to deliberately operate Alaska affiliates at a low profit through such means as selling property to the affiliate at high prices to get high depreciation and by allocating excessive overhead.

However, none of these witnesses have provided this Joint Committee with the really significant reasons why separate accounting is an unsatisfactory method of determining income within a state. First, even if one could overcome the administrative problems of valuing production and allocating overhead, separate accounting simply cannot adequately and properly determine how much profit of a business is derived from within a

state where the overall business has parts which are dependent upon one another and which are located in more than one state. It was for this very reason that the "unitary business" concept was developed along with apportionment formulas to determine how much of the total income of the total multistate business should be apportioned to a state. This is precisely the procedure which Alaska uses today, as well as most taxing jurisdictions, i.e., the total income of the total business of a multistate company is determined and then apportioned.

The other reason why separate accounting should not be adopted is that it exposes the taxpayer to multiple taxation. Income which would be fully taxed in Alaska would also be apportioned to other states using the apportionment method, which looks to the total income of the taxpayer as a taxable apportionment base. Conversely, Alaska's or any other state's adoption of separate accounting could cause it to lose tax from an overall profitable multistate company -- specifically, where the in-state separate accounting calculations produce an in-state loss for such overall profitable company. As Mr. Bonney of EXXON will demonstrate LATER, this would have been his company's case had Alaska been on separate accounting during the development years of the North Slope. Instead, Alaska received income tax by using the current apportionment method, apportioning a part of that company's overall profit into Alaska.

Turning to the provisions of SB 105, it is clear that the bill is not even the form of separate accounting which any of the witnesses were debating. Rather, it is a hybrid form of

separate accounting. It seeks to determine income by simple reference to the wellhead value of oil and gas used for severance tax purposes and then allows only seven deductions while totally ignoring any other legitimate deductions which represent business expenses allowable under established principles of income taxation. Five of the seven allowed deductions relate to costs closely associated with production. Another category is for unsuccessful exploration costs incurred in Alaska. The only out-of-state cost allowed is for interest expense "not capitalized and capitalizable", but this expense would be severely limited for most companies through the use of a ratio of the book value of the fixed assets associated with the field to the total book assets held by the corporation and of its affiliates. All interest expense related to a company's operations within the state should be recognized as a current operating expense, without the limitation described in this bill.

It is clear that SB 105 would introduce new concepts of taxing an oil and gas producer which radically depart from concepts found under the existing Alaska corporate income tax structure. The traditional concepts established over decades of experience and which are contained in that corporate income tax structure would in large part not apply, yet the producer would be taxed at the same 9.4% corporate rate of tax.

One of the seven deductions is for "severance taxes actually paid." This provision may appear to be without problems until one analyzes it in connection with the reserves tax.

Unless the statute is amended, the reserves tax will likely result in nearly $240-250 million dollars paid to the state next June 30th. With the $220 million paid on June 30, 1976, the aggregate of nearly $500 million represents, in essence, prepaid severance taxes because the reserves tax may be used as a credit against future severance taxes payable. Hence, the word "actually" in the clause "severance taxes actually paid" takes on significance, and it appears that the authors' intent is to allow as a deduction only that amount of severance tax "actually" paid over after the credit with the result that some $500 million would be denied as a deduction.

Depreciation is allowable but only on facilities closely associated with production, but the amount of depreciation is simply left to the Department of Revenue to handle by regulation. Depreciation is a vastly complex subject under income tax laws and can be handled in many ways to provide fair and equitable results to a taxpayer. The bill provides little or no guidance on a subject of such importance to a taxpayer.

As noted earlier, SB 105 does not fit within the category of the "separate accounting" method of determining income. What it really seeks to do is draw a ring around successful oil and gas operations and allow as expenses only those that are literally tied to the lease, plus expenses for unsuccessful exploration efforts and a severely limited amount of interest expense. The resulting amount is supposed to be net income, but in fact, would represent a level of income much higher than would occur under regular principles of income taxation.

In addition to the tax received by Alaska based on an inordinately high level of income, the authors of SB 105 would, under Section 43.20.014, still seek to reach, through apportionment, the taxpayer's out-of-state income, including its oil and gas and pipeline income as well as all other income. In short, SB 105 would allow Alaska to fully, or, rather, more than fully, tax directly all of the Alaska income from oil and gas and pipeline transportation and would also require the taxpayer to apportion to Alaska all of its other income except the income already taxed by SB 105. And, of course, the final effect to the taxpayer would be that other states where it does business would also apportion income to themselves under their tax laws and included in that apportionment to them would be the Alaska income already fully taxed by Alaska.

A state may constitutionally tax only that income of a taxpayer which is derived from within its borders. That fundamental rule applies irrespective of the method used to determine income. SB 105 seeks to reach all income from oil and gas and pipeline transportation in Alaska and at the same time, through apportionment, seeks to reach the taxpayer's other income including its non-Alaskan oil and gas and pipeline income, thereby raising the constitutional question of the taxation of extraterritorial value in violation of the Fourteenth Amendment of the U. S. Constitution.

With respect to income from pipeline transportation of oil, Sec. 43.20.013 simply provides that where such a pipeline is regulated by the Interstate Commerce Commission (ICC), the

annual taxable income "shall be eight percent of the valuation." There are no guidelines to determining income under any set of rules, and items of income and expense are not even considered. Obviously, this provision is aimed at the Trans Alaska Pipeline and, in effect, says that the tax shall be valuation times 8% to get around $600 million of "annual income" which, when taxed at 9.4%, produces a tax of about $60 million.

Attempting to tax a business in this manner would be similar to a law which says that an individual shall be deemed to have annual income equal to a certain percentage of the assets he owns. For example, suppose such a law say that a person's annual income is deemed to be 50% of his assets and the person owns an apartment house worth $200,000 but has a $150,000 mortgage against it. His annual income would be $100,000 to be taxed irrespective of his costs. It would not matter that the person may, in fact, show very little profit.

A taxing scheme which deems "income" to be a percent of value of assets without regard to actual income and expenses is, in effect, nothing more than a property tax under the guise of an income tax and raises serious legal and constitutional problems.

The authors, however, have attempted to provide a form of "escape hatch" to the foregoing method of taxation by providing in Section 43.20.013(c) that the corporation operating such an ICC-regulated oil pipeline may elect to have taxable income from the pipeline determined under rules and regulations of the

Alaska Pipeline Commission. Thus, the idea seems to be that if the corporation does not like the percent-of-value method of determining annual income (which would deem annual income to be at a very high and ficticious level), then it can be economically forced to submit to the rules and regulations of the Alaska Pipeline Commission whose rules may or may not be parallel with the ICC rules. In fact, section 6 of the bill contains an amendment to Section 42.06.041 by adding new provisions which require the Alaska Pipeline Commission to give the Department of Revenue a certificate that the pipeline corporation so electing has complied with the Commission's rules and regulations. Subsection (c) of Section 041 provides that the Commission shall by regulations establish an accounting procedure to define net income to "coincide as nearly as possible with the net income definition used by the Commission in establishing rates and measuring rate of return."

What is happening under these provisions seems clear enough. The idea seems to be to put such an onerous tax burden on the ICC-regulated pipeline that it would be forced to elect to comply with all applicable regulations and orders of the Alaska Pipeline Commission concerning accounting methods and reports. In short, the Commission would set the rules for income determination notwithstanding that the pipeline company remains subject to the primary jurisdiction of the ICC. Thus, there would be four parties involved in determining income: the taxpayer, the ICC, the Alaska Pipeline Commission, and the Commissioner of Revenue who is interpreting the Alaska Commission's rules.

Use of the tax laws to achieve the apparent goal of regulation by the Alaska Pipeline Commission is an abuse of the taxing power. Further, the scheme raises obvious legal and constitutional questions and with so many parties that would be involved in the income determination process, the stage would be set for endless controversies.

The foregoing discussion relates to ICC-regulated oil pipelines. Where an oil pipeline does not yet have a value established by the ICC or where the oil pipeline is strictly an intrastate oil pipeline, the bill provides that such a corporation having one of these pipelines shall have its income determined under the rules and regulations of the Alaska Pipeline Commission. Here again, as would be the case of an ICC-regulated pipeline corporation which was forced to elect to have income determined by the Commission (discussed above), the income determination is left to another agency under rules and regulations as it chooses. In essence, the whole matter of determining income to tax under an income tax law is left to the vague guidelines of another governmental agency. This, in itself, raises questions whether there has been an unconstitutional delegation of legislative authority. But even if one gets over that hurdle, the fact remains that whatever rules would finally apply, those rules would not accord with general principles of income taxation which ought to apply to pipeline operations just as they apply to any other type of operation.

As to gas pipelines regulated by the Federal Power Commission (FPC), SB 105 provides in Section 43.20.013(d) that

taxable income shall be determined in accordance with reporting procedures established by the FPC. Here again, there is a departure from normal application of income tax principles because a gas pipeline, though regulated, is really no different from any other taxpayer insofar as having income tax principles applied to its operations. The regulation and rate-making process of the FPC fully takes into account a gas pipeline's handling of its operations where that pipeline utilizes the provisions of the Internal Revenue Code to achieve tax savings for the benefit of not only its customers but also its shareholders.

Finally, I would like to say a word about Section 43.20.015 which deals with "Public Reporting." Under that provision the Commissioner of Revenue is to compile and transmit to the legislature each year an annual report which shows the tax paid under SB 105 together with the itemized deductions that have been allowed and how much tax revenue was not collected because of the deductions. Further, the report is to provide a summary of the total amount of oil and gas produced by each taxpayer, the taxable income as calculated under Section 12 and 13 relating to oil and gas income and pipeline transportation in Alaska, and the out-of-state income of the taxpayer apportioned to Alaska.

In short, SB 105 would open up for general scrutiny without safeguards of confidentiality the whole operation of the oil and gas producers and pipeline operators in Alaska. I would hope that we haven't progressed to the point in this country where a

taxpayer's returns have become a matter of public record. I doubt if anyone would consent to having their tax return information bundled up by the tax collector to be laid bare for anyone to review. There are strict rules in all states and at the federal level covering disclosure of tax return information, and there are ways whereby certain limited groups of people having a legitimate interest can obtain that information on a strictly confidential basis with criminal sanctions imposed for violations. But under SB 105, the information could be made available to a large number of people where there are no guidelines whatsoever over disclosure. Such a provision is one that simply should not be tolerated no matter who the taxpayer may be.

HB 322

The next bill I wish to discuss is HB 322. This is the Department of Revenue's bill which adopts the recommendations of Professors Zeifman and Ainsworth. Essentially, this bill has the following features:

1. Impose a franchise tax on oil and gas producers operating in Alaska who have gross receipts of $250 million or more.

2. The income base to be taxed would be the higher of (1) pre-tax book income as reported to stockholders before any reduction by reason of taxes on income, or (2) taxable income under the Internal Revenue Code.

3. Apportion the pre-tax book income under item 2 by means of a three-factor formula where the property and payroll factors are the same as now contained in the Multistate Compact but the sales factor in the Compact would be replaced by an extraction factor. Such extraction factor would be the ratio of oil and gas produced in Alaska (expressed in BTU's) to total production of the taxpayer everywhere.

Thus, there are two main themes to HB 322: tax base changes and apportionment factor changes. Such changes are the same changes discussed and recommended by Professors Zeifman and Ainsworth in their testimony earlier this week.

Professors Zeifman and Ainsworth would reject federal taxable income as a tax base because the Federal Internal Revenue Code contains many deductions, credits and exclusions which they allege have diluted revenue-raising potential through subsidization of of some activities while discouraging others.

In their report, though not mentioned except briefly in their testimony, the professors attempted to demonstrate how the revenue raising potential has been eroded and referred to the concept of "tax expenditures" which, in essence, is simply a listing of those items or categories constituting deductions, credits, or exemptions found in the Internal Revenue Code, together with the estimated effect they have on revenue collected. This listing is required to be published each year under the

Congressional Budget Act of 1974. However, instead of discussing and commenting on the more than 75 general categories of items in the published list as they apply to both individual and corporate taxpayers, the professors chose only to extract in their report but six categories, and only one of the six (expensing of exploration and development costs) applies specially to the petroleum and mining industry.

I have here the complete listing of "tax expenditures" for the Fiscal Year 1978 which also shows those "tax expenditures" for years 1976 and 1977. A copy of this listing is attached. There are two columns for each year, one for corporations and one for individuals. A review of both the number of categories listed as well as dollar amounts will reveal that individual taxpayers indeed have fared very well compared with corporate taxpayers. It will also be noted that there are only two items relating specially to the petroleum industry. One deals with the expensing of exploration and development costs, which, from the testimony of the professors as well as Mr. Kilgore, one would think was the major provision in the Internal Revenue Code but which in reality represents a rather small item compared to other items in the listing. In fact, that item has a revenue loss effect about equal to the loss from the credit allowed for buying new homes. The other category deals with the excess of percentage depletion over cost depletion. But this latter item applies to over 100 different minerals which involve percentage depletion--oil and gas being but one category. In any event, percentage depletion has

negligible application to major oil companies because of the severe restriction of percentage depletion for oil and gas resulting from the 1975 Tax Reform Act. The professors' attempt in their paper to show the petroleum industry as a highly favored industry that receives a major share of tax benefits is simply incorrect.

After leveling a finger at corporate taxpayers generally, the professors then recommended that one special group--namely oil companies--be singled out for tax "reform". However, the professors failed to discuss either in their paper or their testimony the inequity or possible legal problems of proposing a "book income" base for major oil companies which would be far different than would apply to any other class of taxpayers. They did not even mention in their report that no state in the country has a law utilizing "pre-tax book income" as a tax base though questioning by the Committee did bring out this information.

Even if one were to agree with the novel approach suggested by Professors Zeifman and Ainsworth and embodied in HB 322, a true advocate of their theory could not logically propose its use with one set of taxpayers and then ignore its applicability to the vast majority of other taxpayers. If such a radical change in tax approach is to be made, then it should apply to all taxpayers under all income tax laws at the same time, with corresponding adjustments of tax rates for all.

An approach which uses the higher of book income before taxes or taxable income can lead to distorted results. Mr. Bonney of EXXON will demonstrate through a simple example how the use of one versus the other could prevent a full recovery of a capital investment and yet tax phantom or non-existent income. Further distortion may result from the inclusion of earnings of non-controlled companies in pre-tax income, as required by generally accepted accounting principles. While the oil companies may be required to report the earnings of their investments in non-controlled companies, they do not determine if or when the earnings of these entities are distributed. Yet HB No. 322 provides for immediate taxation of this income because it would be included within the pre-tax book income reported to stockholders.

Professor Zeifman emphasized the fact that book income is invariably larger than taxable income, thereby showing that big corporations have tax benefits. However, of what real significance is it that a corporation's management chooses to adopt a conservative book accounting method as long as it is consistent in doing so year after year to avoid distortions? Differences between book and tax income due to different treatment has existed for decades under generally accepted accounting principles. For tax purposes the Internal Revenue Service, as well as a company's own auditors, will require a full reconciliation of the taxable income back to the book income and there are extensive schedules in tax returns which do this every year.

The only point Professor Zeifman is making is that under the Internal Revenue Code corporations are permitted certain deductions, or credits, or exclusions which, if taken advantage of, show a lesser "taxable" income than shown on the books if the management chooses to use a consistent method which treats the item differently. But the same thing can be said for all taxpayers, i.e., all taxpayers receive some form of tax treatment which causes their taxes to be less than if the tax law simply taxed the gross dollars received at a specified rate. This can be seen from the "tax expenditures" listing referred to earlier. Pointing the finger at one group of taxpayers as ones who should first go on the chopping block of reform while ignoring others who are not so treated is asking a lot of any legislative body whose duty it is to play fair with its citizens, whether they be corporate citizens or individuals.

Substitution of an "extraction" factor for the "sales" factor

The second main point of HB 322 deals with deleting the sales factor and substituting an extraction factor.

Before plunging into this subject, I believe it would be helpful to give the Committee some background about the traditional three-factor formula utilizing property, payroll and sales, where it came from and why it is used today by most states which tax corporate income. Another reason why this will be helpful is that Professors Zeifman and Ainsworth gave their testimony recommending a change strictly on the basis

that its use will apportion more income and, therefore provide more tax. However, the matter is not quite as simple as the professors have indicated.

When states began taxing corporate income over 50 years ago, there were various formulas used to divide the income. Because there were different formulas, it was not long before disputes arose between states and taxpayers, usually involving the question whether the state was reaching for too much of the taxpayer's income. It is very important to bear in mind all the way through the discussion of this subject that a state can constitutionally tax only that income of the taxpayer which is derived from within the state's borders. Thus, the search has always been to find a formula which gives both the taxpayer and the state fair treatment. But as to the taxpayer who operates in more than one state, the problem has also been to utilize a method of dividing income which does not subject the taxpayer to multiple taxation.

It is not difficult to see how multiple taxation can occur. Suppose X corporation operates in states A, B, and C, each of which has the same standard three-factor formula of property, payroll, and sales and each of which has an 8% income tax rate. In would be rare if X corporation had exactly the same mixture of property, payroll, and sales in each state. However, when each of the three states apply their tax laws and divide the income under their uniform formulas, X's total tax to all three states will be no more than 8% of its total income.

But let's vary the example just slightly and assume that in state A, X corporation has a heavy concentration of property and payroll but not many sales and that state A decides to delete its sales factor and have only a two-factor formula. In such a case state A will apportion to itself a greater amount of X's income but apportionment to States B and C will remain the same. The result will be that an amount greater than X's total income will be apportioned in the aggregate to all three states and X will have been subjected to multiple taxation because State A broke the uniformity.

The foregoing is a simplified example but nevertheless demonstrates how multiple taxation can result. As noted earlier, disputes over income taxation existed for decades and it was not until 1957 when the Commissioners on Uniform Laws in conjunction with the tax section of the American Bar Association and many other interested parties finally wrote a model law known as the "Uniform Division of Income for Tax Purposes Act" (UDITPA) in the hope that states would adopt it and thus put an end to the chaotic condition that existed. The apportionment formula settled upon utilized property, payroll and destination sales. Underlying this three-factor theory of apportionment is the concept that the employment of capital in the form of property, labor as reflected in payrolls and ultimate sales to generate the sustaining revenues for the business are all vital factors to be given equal weight in determining income. Thus, the theory recognizes that in a true economic sense some part of taxable income is earned at every stage of the business process.

To date, about one-half of the states (including Alaska) have adopted UDITPA and all but two states which impose an income tax use the three-factor formula of property payroll and sales.

The UDITPA model law only deals with apportionment of income and does not contain provisions setting forth rules or procedures whereby a state cooperates with other states to administer income taxation on a joint basis. In an effort to promote uniformity of tax rules and cooperation, a number of states formed what is now called the Multistate Tax Compact. However, a state which adopts the Compact also adopts the three-factor division of income formula based on the UDITPA model law. Alaska adopted the Compact in 1970 but followed the UDITPA formula before 1970. Hence, states which have adopted the Compact and states which simply follow the UDITPA rules have compatible laws.

With this brief background let me turn to the proposal to delete the sales factor and impose an extraction factor. The nub of the professors' argument is that the sales factor is low due to destination sales which causes lesser apportionment of income to Alaska and this can be cured by substituting an extraction factor. Thus, the sales factor is dismissed by the professors and the reader of their paper and the audience to their testimony is simply left with a conclusion void of any reasoning except maximizing revenue.

There was a sound reason for the UDITPA and Compact treatment of sales on a destination basis for purposes of the "sales" factor. A destination sale is one which occurs in a state if goods are

delivered in that state or services are performed in that state. Suppose a manufacturer has its plant in Illinois and has a large payroll at that plant. From this plant the manufacturer ships most all of his products to purchasers in other states. If this is the only plant, the property and the payroll factor to Illinois

will be high and if the sales are attributed to the Illinois plant as the origination point of the sale, then Illinois would apportion nearly all the income for taxation in Illinois. As can be seen from this simplified example, the major manufacturing states would receive an unreasonably high proportion of apportioned income to the detriment of non-manufacturing states. Hence, the "destination" sales concept is one which not only affords protection to less populated, non-manufacturing states, such as Alaska, but also gives legitimate recognition to sales activity in consumer states by deeming the sale to "occur" where the purchase takes delivery.

What the professors have proposed as a factor change is no different from what they might propose in any state based upon simple reasoning to get more revenue, the only difference being that in such other states it might be a different factor which provides the key. For example, they might shift their proposal to Illinois or Pennsylvania to point out that its sales factor also is destination-oriented and because most products are shipped out-of-state, the ratio of sales in either of those states will be lower. The professors could then recommend that the "destination" sales factor be changed to an "origin" sales factor or that the sales factor be deleted in favor of one based on manufactured units (e.g., television sets) in the state to total units manufactured everywhere. By such changes, those states could then command most of the apportioned revenue since, being manufacturing states, they already have the bulk of property and payroll and, through the sales factor change, they could prevent

dilution of the total factor to be used by the taxpayer.

But suppose it was some state which did not have heavy manufacturing (i.e., low property and payroll in the state)? Under the professors' reasoning this might call for use of only a sales factor -- i.e., destination sales and not origin sales because only the former would help the state (in contract to what was said above as being in the "best interests" of Illinois or Pennsylvania). By so limiting the formula to a single factor, the non-manufacturing state maximizes apportionment of income to the state.*

The foregoing are only two examples out of many one could establish to tailor apportionment formulas for various states if the only objective is simply maximizing revenue without concern for inequitable or unconstitutional consequences. However, the problems with the examples are parallel to the same problems that are contained in the professors' proposal for an extraction factor. In each instance there is a break in the uniformity of treatment by a state which inevitably results in the taxpayer being subjected to multiple taxation. The state breaking uniformity will tax a larger part of the income by use of its advan-

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* Recently the Iowa courts struck down as unconstitutional that state's use of a single factor of sales because it was not an adequate measure of the taxpayer's income derived from within Iowa. (Moorman Mfg. Co., Polk Cty. Dist. Ct. No. CE 3-1595 (12-17-76)). Similarly, in General Motors Corporation vs. Dist. of Columbia, 380 U.S. 512 (1965), the United States Supreme Court struck down use of a single sales factor by the District of Columbia.

tageous apportionment factors. Unfortunately, part of that same income will also be apportioned to and taxed by the other states having the uniform apportionment formula.

As noted, the professors have given no reason for use of the extraction factor except that it will raise revenue. Missing is the reasoning why the present factors are not a proper measure of a taxpayer's income within Alaska or, conversely, why use of the extraction factor will give a more accurate measure of that income. Merely saying that oil goes out of the state and does not count as a "sale" in Alaska to its detriment is not good enough because, as shown earlier, any state could analyze its economic position and make the same argument when it observes a resource material or manufactured item being shipped out of the state. If that happened, then clearly the states and taxpayers would be back to the same chaotic situation that existed before the uniform rules of UDITPA and the Multistate Tax Compact were formulated and adopted.

To satisfy constitutional requirements, an apportionment formula must fairly and reasonably measure a taxpayer's net income in the particular state since a state has jurisdiction to tax only that income derived within its borders. The professors and some Alaskan critics of the present three-factor formula have simply looked at the oil production aspects of the business of a multistate oil company operating in Alaska but apparently wish to ignore the other part of the business where that oil has to be transported, refined into products, distributed and sold.

In fact, the bulk of such a company's employees and a large portion of its investment lie in these phases of the business. Moreover, the revenue which pays for the expenses of company operations is generated mainly out of the sales of refined products.

The concept of income taxation is the taxation of the overall profits of an enterprise which may have many parts in many states but all of which contribute to the ultimate profit or loss. In devising a formula to measure income for apportionment, the drafters of the UDITPA model law were not being arbitrary when they settled upon use of property, payroll and "destination-oriented" sales. They were looking for a formula which not only contained elements reflecting as many aspects or segments of the business as possible but also for a formula which could be easily and uniformly administered and which provided equitable treatment to states as well as taxpayers. Using these guidelines, the drafters found that property, payroll and sales provided a balance of factors reaching and reflecting the essential elements of any manufacturing or mercantile business.

There can be no doubt that the author's solution fails to protect the taxpayer from multiple taxation but, rather, actually creates it. While this is reason enough to reject use of the extraction factor, it also is clear that use of this form of factor in place of a sales factor reduces the segments or sectors contained within a business whose operations are reflected in the formula. Sales from all phases of the integrated business are the sustaining element of the business without which the business fails, and such sales reflected in the sales factor

are drawn from the total business. Units of petroleum extracted are important to the business too but represent operations pertaining to only one segment or phase of an integrated petroleum company's total business.

While crude oil extracted may have a value at the point of production, that value exists only because of consumer demand for products produced within other equally important phases of the business consisting of refining, product transportation and marketing distribution. In this regard, oil production in the case of the oil industry is not unique and the same reasoning can be applied for iron ore in connection with steel making, for raw timber in connection with finished wood products, or even for grapes grown for winemaking since in each of these cases the raw product can be viewed as having been "extracted". In all these cases, as well as with the oil industry, the "extracted" material undergoes a complex transformation into products resulting in sales revenues only after having been acted upon by other necessary phases of the business containing most of the taxpayer's employees and containing facilities representing a substantial part of the taxpayer's invested capital, both of which are distinct from the "extraction" phase yet still a part of the overall operation of the enterprise.

By using an extraction factor in place of a sales factor the whole element of sales which sustain the business for its survival are disregarded. Units of oil and gas produced is simply not a proper measuring factor and, as will be pointed

out in an example by Mr. Bonney of EXXON, the substitution of an extraction factor can result in a distorted attribution of "downstream" income from transportation, refining, marketing, etc. to Alaska which can result in the taxpayer having income taxed twice.

From the foregoing it can be seen that substituting an "extraction" factor for the "sales" factor actually distorts rather than improves the measurement of net income of the total enterprise attributable to or derived from within a particular state. What it does is provide a change to "maximize" revenue which is not a goal of formula apportionment when done at the expense of sacrificing the other principles which lie behind the concept of apportionment

I would like to say a word about the provision in HB 322 which the professors recommend as being a basis for Alaska including OCS property, payroll and extracted oil and gas as its own factors when the OCS property is dependent upon on-shore Alaska operations. The professors were certainly correct in saying that there may be problems. However, they failed to point out that section 1333 of Title 43, which deals in part with state laws applicable to the OCS area, contains rather troublesome language for a state attempting to extend its tax laws to the OCS area. Section 1333(a)(2) contains the following sentence:

> "State taxation laws shall not apply to the Outer Continental Shelf."

At least one state, California, has looked deeply into this matter of whether California, could consider the OCS developed area as providing property, payroll and sales factors for use by California, i.e., the same consideration being recommended by Professor Ainsworth. The California Franchise Tax Board in Legal Ruling No. 366 has held that California cannot claim property, payroll and sales in the OCS area for California's benefit, i.e., California cannot put these factors in the numerator for California. There is attached to my testimony copies of the pertinent federal statute referred to above, along with a copy of Legal Ruling No. 366 of the California Franchise Tax Board.

SB 202

SB 202 is basically the same bill which was considered in the 1976 session as SSSB 620. The main difference between the bills is that under SSSB 620 the net proceeds tax was a credit against regular corporation income tax insofar as that corporation income tax would represent tax on income from oil production taxed under SSSB 620; under SB 202, the taxpayer also remains subject to the Alaska corporation income tax but is deemed to be exempt only to the extent of income earned from production of oil in the state. In short, under SSSB 620 there was an actual credit against the Alaska corporation income tax but the net proceeds tax credit was only applicable against that part of the corporation income tax which was applicable to income from Alaska oil operations. Under SB 202 there is no credit as such but the taxpayer who apportions income to Alaska is simply not

taxed on income deemed to come from Alaska oil production.

As some of the members of this Committee know, I testified on SSSB 620 last year and pointed out what I believed to be the deficiencies in that bill. That testimony is no doubt still available in the Committee files and I do not propose to go into all the details of the bill again. Rather, I shall have some general comments on the bill and point out how this bill impacts on the taxpayer, as well as point out some of the legal problems with its operation.

The "net proceeds tax" contemplated by its proponents has features of an income tax in that it attempts to reach a level of "income" or "profitability" from successful oil and gas production operations with a tax rate applied which is equal to (or higher than) the regular Alaska corporation income tax rate (i.e., 9.4%). Essentially, the tax would be determined by subtracting from the wellhead value of oil and gas production certain limited costs and expenses directly associated with production and multiplying the difference by the corporation income tax rate of 9.4%.

Proponents of the "net proceeds" tax have chosen to label it as an "ad valorem" tax rather than an "income" tax. However, in substance and operation the tax is unquestionably a form of income tax and merely calling it by another name cannot change that fact.

Because the "net proceeds" tax approach is itself a form of separate accounting, taxpayers will be exposed to multiple

taxation under that approach for the same reasons as discussed in connection with SB 105. In fact, the economic effect to a taxpayer would be even more adverse since the goal of the "net proceeds" tax is simply to isolate successful Alaskan oil and gas producing operations, allow a very limited amount of deductions closely and directly associated with production, and tax the resulting "net proceeds" at the corporation income tax rate (9.4%) as though those "net proceeds" constituted net income of the taxpayers.

Proponents of the "net proceeds" tax in the past have admitted that the "net proceeds" to be taxed would represent a tax base which is higher than would occur under regular principles of income taxation applicable to other taxpayers. Hence, the economic effect is that Alaska would place a tax (at the 9.4% corporate income tax rate) on a level of income (but called "net proceeds" instead of "income") which is much higher than would result under regular income tax principles, and that same income (or at least a certain level of that income) would be included in the base subject to apportionment to other states and taxed by them because they use the standard three-factor apportionment formula.

But the adverse effect of the "net proceeds" tax approach would not stop there because under that approach the same taxpayer would still be subject to the regular Alaska corporation income tax. SB 202 would still require the taxpayer to apportion to Alaska under the three-factor formula all of the tax-

payer's income from outside Alaska, including its non-Alaska oil and gas income. Thus, SB 202 would provide Alaska with the best of all worlds: it would receive a tax at the 9.4% corporate income tax rate on Alaska "net proceeds" which would constitute a tax base much higher than under regular income tax principles and, through apportionment, it would also seek to reach all of the taxpayer's income from outside Alaska as well as any non-oil and gas income from within Alaska.

The concept of the "net proceeds" tax which would operate in substance like an income tax raises a legal question whether the method would permit the state to tax a greater amount of net income than reasonably could be attributed to Alaska.

Proponents of the "net proceeds" tax have claimed that a "precedent" exists for such form of tax and have cited the states of Nevada, Utah, Colorado, Idaho, Montana, and New Mexico as examples. However, a review of the statutes in those states reveals that the "net proceeds" tax has nothing whatsoever to do with a scheme to tax income such as that being advanced by the proponents of the "net proceeds" tax. Rather, the "net proceeds" involved in the states referred to are simply convenient and simplified means of arriving at a value on mining or oil properties for purposes of applying property tax rates by local county assessors in order to provide property tax revenue in the local counties. Such a method is essentially a substitution for the rather sophisticated and complex valuation procedure that would otherwise occur each year, such as the complex

valuation of the Prudhoe Bay field for purposes of applying the reserves tax in Alaska.

It is safe to say that no state in the country imposes a "net proceeds" tax of the type the proponents in Alaska have in mind.

I would now like to direct my comments to the Legislative Council's proposed production tax changes incorporated in the identical bills, SB 103 and HB 144.

DESCRIPTION OF THE BILL

As discussed yesterday, the proposal would:

a. Change the point where the taxable value of oil is determined from the "well" to the point where "oil is first metered or measured in a condition of pipeline quality".

b. Realign the stepped tax rates, lowering the tax on the first 1,000 bbls per well per day and substantially raise the tax on all production over the first 1,000 bbls with a high rate of 14% on all production exceeding 3,500 bbls per day.

c. Use lease or property averaging in determining each well's daily production.

d. Tax flared gas at 5 times the normal rate.

e. Advance the monthly tax due date to the 20th day of the month following production.

COMMENTS

1. Adoption of lease or property averaging of daily bbl. per well production is a step in the right direction in properly ascertaining the stepped tax rates applicable to a field. The change, of course, will aid both the taxpayer and the state administratively.

2. The resultant increase in the overall industry tax burden (estimated by the Legislative Affairs Agency to be about $180 million per year by 1980) is completely unwarranted, considering the question of need which others have already addressed and considering the fact that Alaska oil is already being taxed at virtually the highest level in the nation. The limited benefit given to the lower producing fields in Cook Inlet in no way should be considered as justification (or a basis of consistency) for placing such a harsh extra tax burden on high producing wells in the North Slope or any other location. This approach portrays the concept of taxing the taxpayer at a high level, not on the basis of state governmentel need, which we believe to be grossly unfair.

3. Retention of the alternate cents-per-barrel rate floor with its wholesale price index adjustments more than counteracts any true benefit out of reduced rates given low Cook Inlet producing wells through percentage rate reduction. As Levy Associates has maintained, this minimum price-setting device has created an artificially high value on the old Cook Inlet oil for tax purposes, resulting in an effective tax rate well in excess of what we believe was intended by the legislature on such oil. The last time I reviewed the situation--which was about a year ago--the cents-per-barrel feature of the severance tax had caused Union and other companies for which it reports severance tax to pay about

$5 million more than would have been paid under the percent-of-value method. We view this amount as simply an unintended windfall benefit to the State since January 1, 1974, the date the current cents-per-barrel tax took effect.

4. We do not see any justification for imposing a penalty rate (5 times normal rate) for flared gas, considering the fact that such flaring controls are best placed with regulatory agencies, not taxing agencies. If proper regulatory authority exists to flare gas, such as for safety pruposes, there is no justification for adding tax at a confiscatory rate to a product that the producer loses through flaring where that flaring is done for reasons of safety.

5. Moving the point of measurement of production value downstream to the point of metering in a condition of pipeline quality could unjustly place a substantial tax on transportation costs on some fields which for a variety of reasons require movement of oil significant distances before measurement. Since the Alaska Production Tax is an occupation tax on the privilege of severing oil and gas, it would be more appropriate to continue measuring it by its value at the point of severance, i.e., the wellhead, instead of adding on to it incremental values of gathering, transportation and field treatment.

6. Advancing the delinquent date for payment from the first of the month following the month of production to the 20th day of the month following the month of production would place

an undue administrative strain on the reporting groups within the various producing companies. In most cases, the production data to calculate tax liability and prepare returns must be transmitted to offices outside Alaska. Advancing the delinquent date by 10 days will simply make worse an already short time open to comply with the law. By advancing the reporting time 10 days, the State, overall, only gains a total of 10 days for revenue collection which seems inconsequential compared with the added administrative burden on producers.

My next comments pertain to HB 321 and SB 238, identical bills, which contain the Administration's recommended changes to the oil and gas production tax.

Briefly, the bills would replace the present stair-stepped tax rates on oil production per well with a single rate of 10% on value or one alternative minimum cents-per-barrel rate of 75 cents (adjusted for gravity and for changes in the "Gross National Product Deflator").

Also, the 4% rate on gas would increase to 10% with a new alternative minimum tax of 6.4 cents per MCF. The new percentage rate and cents-per-unit rates would be adjusted by an "economic limit factor (ELF) discussed later.

The proposal also makes other changes, including changing the point of measurement from the wellhead to the point of measurement of pipeline quality. The proposal also imposes a double rate of tax on flared gas.

We strongly oppose perpetuation of cents-per-barrel floor prices and expansion of it to gas production, as well as increasing the minimum price to which it relates, that is, $7.50 per barrel. As Milton Lipton has advised, the current floor as escalated by the National Wholesale Crude Price Index has worked in unintended ways on Cook Inlet Crude, creating an artificial taxing value well in excess of the value permitted by the FEA on old oil. Now the Administration not only recommends continuance of the minimum price concept but also proposes to increase the minimum price to $7.50 per barrel.

The Administration supports this course with the argument that the FEA price is artificially low. But the oil companies producing such "old" oil nevertheless suffer the economic realities of federal pricing. Accordingly, we believe it is unfair that in addition to bearing such economic loss in price, the Cook Inlet producer must also bear an increase in production tax because of an arbitrary floor of $7.50 per barrel used as the measure of tax. This, of course, would be equally true on the North Slope if the FEA placed a value below $7.50 on that production. We fail to see any justification for the State to arbitrarily burden the production with such a heavy production tax through an artificially set value because of the possibility that FEA pricing decisions may not be favorable.

As mentioned above, HB 321 introduces the concept of an Economic Limit Factor (ELF) as an adjustment to the percentage rate of tax applied to both oil and gas. According to the Department of Revenue's February 1977 study, the Department believes that the present "stair step" rate schedule does not adequately take into account differences in the economic conditions existing from field to field, e.g., a well producing 1,000 bbl/day at one location may be marginal while such a producing rate at another location may be profitable. In short, the stair-step approach is deemed defective because it does not adequately protect against excessive taxation as a well approaches its economic limit.

To correct this, the Department proposes an ELF, the calculation of which begins by determining a fraction the numerator of

which is the "monthly production rate at the economic limit" and the denominator of which is the production during the month for which the tax is to be paid. Under HB 321, the numerator is by statute deemed to be 100 barrels times the number of well-days. Well-days are by definition the number of days a well is operating. Thus, if there were 10 wells on a lease operating for 28 days each, the numerator would be 100 X 10 X 28 = 28,000 bbls. If the total monthly production on the lease was 280,000 bbls, the ratio would be 10%, or expressed as a decimal, .10. The next step in determining the ELF is to reduce "unity", i.e., 1.00, by the ratio expressed as a decimal. Thus, 1.00 less .10 = .90 = ELF.

The best way to explain how the HB 321 mechanism works is through a simplified example, a copy of which is attached. The example uses Cook Inlet production of 35° oil at a $4.85 per barrel controlled price. Under the bill, one of the adjustments is a half-cent for each degree above 27°, so 4 cents is added to the 75 cents. The GNP Deflator adjustment is ignored. The statutory presumption of 100 barrels is the numerator and 1,600 barrels is the denominator which gives a decimal of .0625, and when subtracted from 1.00 gives an ELF of .9375. Both the cents per barrel of 79 cents and the 10% rate are multiplied by .9375 to find the adjusted cents-per-barrel and percent-of-value rates. Next, the royalty of 200 barrels is subtracted to find 1,400 non-royalty barrels. Finally, the 1,400 barrels are multiplied by the value of $4.85 and then by 9.375% to find the tax under the percent-of-value method, and are multiplied by $.7406 to find the tax under

the cents-per-barrel method. Since the tax of $1,036.84 is the higher (i.e., under the cents-per-barrel), that tax is the one that would be payable.

At the bottom of the example the tax under HB 321 is compared with the tax produced on the same production if it occurred this month (March 1977) under current law. As shown, the increase is about 60%. Also at the bottom of the example it is shown that the effective rate of the production tax under current law would be 9.5% but 15.3% under HB 321. While not shown if the production rate had been 800 bbls/day instead of 1,600, the increase in tax over the current tax would have been around 75% instead of 60%.

As mentioned earlier and used in the example, the monthly production rate at the economic limit is, by statute, presumed to be 100 barrels times well-days unless the producer in a formal hearing proves by "clear and convincing evidence" that it is otherwise. However, in proving this, HB 321 contains some rather curious and questionable ground rules which do not track with reality. These provisions are found in subsections (b), (c), and (d) of Section 43.55.013. In essence, the "average monthly direct operating cost" (based on at least 4 consecutive months) is divided by the value at the point of production of oil which is produced from the lease, but this "value" is not the value the producer actually gets but, rather, that value which is deemed to be the value of comparable crude at West Coast refineries for imported oil which is then "backed out" to the wellhead.

Translated, the "value" used to divide into the monthly operating costs is, for Cook Inlet, Indonesian Crude laid into Los Angeles at about $14.50 per barrel. When the $14.50 is "backed out" to the wellhead, the value at the wellhead is about $13.50. Thus, it is not the $4.85 real price used to calculate "monthly production rate at the economic limit" but, rather, $13.50.

While that is bad enough, with regard to the "direct operating expenses allowed", the bill only allows four: drilling supplies, fuel, routine maintenance and wages and benefits of employees working on production operations. Specifically excluded are capital expenditures, tangible or intangible drilling expenses, costs of well workovers, costs for repairs or replacements (other than routine maintenance), depreciation or amortization, taxes, insurance, overhead, or monies paid or set aside to cover the cost of terminating operations, i.e., abandonment costs.

Allowing only four listed costs is not realistic because there are cash operating costs not allowed but which are tied to operations versus no operations. Any cash cost which would be affected by a decision to operate or not operate is the realistic approach and more in line with the way it would actually be approached by a producer in a true situation. HB 321 would even deny severance taxes on the production itself and property taxes on the equipment. In short, "economic limit" is that point at which actual revenue and actual costs are equal.

I requested Union Oil's oil and gas division engineers to run some calculations using real data as a test. Doing it in the

normal way, our people used the realistic value of about $4.85/bbl for value and the real operating costs to get an ELF of about .67. But by using $13.50 per barrel as a value and limiting the costs to the four categories the ELF was around .92. We also made a rough comparison of the taxes under HB 321 compared with taxes paid in 1976 and found that the tax on oil production would have been increased by about 50% if HB 321 had been in effect in 1976.

HB 321 also contains an ELF for gas production though it is not totally clear under the bill language how this is computed. In any event, the principle is the same and the same four direct operating costs are used but the value used for gas is the highest price in the field or within 100 miles.

With respect to gas production, the minimum of 6.4 cents per MCF is especially onerous, since gas is customarily sold under long term contracts and those contracts may not permit the seller to receive a value which happens to be the highest price on the lease on "within 100 miles". The 6.4 cents minimum tax is equal to 64 cents gas at a 10% rate, but there are contracts of sale for gas where the price is much less than 64 cents. Hence, the effective rate of tax on gas is much higher. For example, if gas were sold at 42 cents, the tax would nevertheless be the minimum of 6.4 cents (assuming no ELF applied) which would equate to an effective rate of tax of 15.2%.

With respect to the proposed gas rate increase--while admittedly the gas tax rate might warrant some degree of increase, the severity of this proposal is overreaching. We would suggest that any value tax on gas be based on actual sales price at the

sales meter. We would discourage taxation governed by an artificial floor price or by what some other producer may be receiving for his gas in some other field.

For flared gas, the rate is doubled, i.e., 12.8 cents. Even gas used for safety flaring necessary to safe operations would be taxed, which cannot be justified by any standard. We oppose this double tax for the same reasons as stated in the discussion under SB 103.

In summary, while there is merit to the concept of an economic limit factor, the manner in which it is determined under this bill is unrealistic and virtually meaningless. It seems to me a lot more thought has got to go into it before it can be a worthwile mechanism. The way it is set up now--with questionable use of phantom values and restricted costs--an ELF so determined could have other consequences beyond just severance tax because the concept of economic life of a field is one used in valuation for property tax too. If economic lives of oil or gas properties as used for property valuations are to be determined using the methods for the ELF for severance tax purposes, then the stage is further set for endless arguments and disputes over property values as well as in connection with the ELF itself.

I would next like to comment on the Administration Sponsored Bill, HB 323.

This bill proposes several amendments to the so-called "20-Mill Hardware Tax", and certain provisions of Title 29, governing municipal taxing limitations.

Section 1 would add to the statute a highly controversial amendment to regulation 15 AAC 05.840 which was issued by the Department of Revenue in June 1976. This provides that any municipal tax levy, say for bonded debt, which is in excess of the $1,500 per capita limitation is not creditable against the 20-mill tax.

We take direct exception to this provision in that AS 43.010(a) quite clearly provides for a maximum tax of 20 mills on our state-assessed properties. This issue is presently being litigated in a case involving the 1976 tax levy of the North Slope Borough. It would seem appropriate to let the court rule on this important issue rather than to amend the statute at this time.

Heretofore, the state 20-mill tax has applied to exploration, production, and pipeline transportation properties. HB 323 would extend this tax to refineries, liquefaction or processing plants, plants manufacturing oil or gas products and also to tankers and other marine equipment used in the transportation of oil and gas.

We believe it inadvisable to enact any further extension of this special state property tax imposed upon oil and gas producers.

The taxable basis on the marine equipment is specified as replacement cost less depreciation based on useful life multiplied by a fraction of days in Alaska ports over days in port both within and without the state. This proposal raises serious questions in

that it is believed that only the home port, under long standing case law and practice, has taxing jurisdiction over ocean-going vessels.

Aside from the "home port" doctrine, and assuming that Alaska could legally assess these properties, we would suggest a more equitable formula. One possibility would be use of days in Alaska ports versus days in the year.

Due to the controversial nature of this issue, however, we would respectfully urge that this section of the bill be stricken, irrespective of what action is taken on the remainder.

HB 323 additionally would delete the existing provision for using straight line depreciation of historical cost on pipeline assessable values in those instances where the physical life of the pipeline materially exceeds the economic life of reserves committed thereto. As a consequence, pipelines would be assessed with regard to "economic" value based on the economic life of committed reserves.

This issue is being litigated in the Cook Inlet Pipeline Co. case and it would seem appropriate to let the court rule on the issue rather than amending the statute. It is further believed that the existing law and Regulation 15 AAC 05.890 pertaining thereto are sufficiently workable to develop assessments for operating pipelines which will be fair and reasonable, both for the state and the taxpayer.

Section 8 of the bill provides that the municipal taxing limitation of $1,500 per capita shall be adjusted each year in accordance with changes in the Consumer Price Index for Anchorage.

Assuming that the $1,500 per capita levy is reasonable, it would likewise be reasonable to key it to an inflation index.

Section 12 makes the provisions of HB 323 retroactive to January 1, 1977, except for tanker assessments which begin January 1, 1978. This retroactive provision seems peculiarly unreasonable in view of the fact that the 1977 tax returns have been filed and assessment notices have been issued by the Department.

I will now turn to House Bill Number 328, the Administration's proposal on the Oil and Gas Reserves Tax.

The Reserves Tax was enacted for a two year period, 1976 and 1977, for the purpose of meeting anticipated revenue shortfalls for Fiscal Years 1976 and 1977. The statutory tax rate for 1976 was 20 mills (2%) and the 1977 tax rate was set by the 1976 legislature at the same rate -- 20 mills. Reserves Taxes paid in 1976 were $223 Million and in 1977 are expected to total approximately $270 Million.

In Fiscal Year 1976, because of the Reserves Tax revenues and increases in other revenue sources, unrestricted general fund revenues exceeded expenditures by approximately $125 Million, leaving a surplus of $505 Million, of which $338 Million was available for appropriation at 6/30/76. Revenues in FY 1977 are also expected to exceed expenditures, thereby increasing the surplus.

HB No. 328 proposes to reduce the 1977 tax rate from 20 mills to 12 mills, reducing the revenue from this tax from $270 Million to about $170 Million, but subject to the following:

(1) If on October 1, 1977, TAPS thru-put is less than 600,000 bbls/day, an additional 8 mills would be levied, payable November 30. 1977.

(2) If on December 15, 1977, TAPS thru-put is less than 1.2 Million bbls/day, the Reserves Tax would be extended another year.

While the prospect of a reduced tax rate is always welcomed, we question the propriety of the limitations mentioned, which limitations are so specific and restrictive.

Present indications are that the Prudhoe Bay Field will start delivering oil to TAPS reasonably close to schedule at mid-1977. It seems unreasonable that some minor variance from the restrictive provisions of this bill could cause the tax rate to be increased and possibly for the Reserves Tax to be extended another year.

Accordingly, we believe that the Reserves Tax should expire, as scheduled in the existing statute, at the end of 1977. However, we certainly agree that the 1977 tax rate can be reduced to 12 mills, since the 1978 budget can be met with no difficulty and the 1979 budget as well unless there were some serious, prolonged delay in TAPS startup. This reduction would certainly be consistent with the original intent of the reserves tax which was to help the state over a potential period of deficit in the General Fund.

ATTACHMENTS TO TESTIMONY

OF

LAWRENCE L. WILSON

SPECIAL ANALYSES BUDGET OF THE UNITED STATES GOVERNMENT

FISCAL YEAR

1978

repeal of all itemized deductions resulting in tax expenditures. This hypothetical revenue gain would be $21.2 billion in 1978, whereas the simple sum of the tax expenditures for each separate item is $31.3 billion. The estimate for the combined effect of all such deductions was derived from a model of the tax system that accounts for the interaction between tax expenditure provisions and the provisions of the normal structure. In particular the model provides that individuals would take the standard deduction if itemized deductions were repealed. No comparable estimate can reasonably be made for the combined effect of a hypothetical repeal of all exclusion provisions.

A few aggregations of related tax expenditure items are presented and discussed in the next section. These aggregates have been specially estimated so as to account for the interactions referred to above but do not consider the effect of changes in behavior. Where tax expenditures for both individuals and corporations result from the same tax code provision, such as the investment tax credit, the two estimates may appropriately be added together.

Tax Expenditures by Function

Estimates of tax expenditures are grouped together by functional category and presented in table F–1. The estimates are shown separately for individuals and corporations. Wherever possible, particular tax expenditures have been classified according to the functional categories used for budget outlays. Many tax expenditures do not, however, fit into these categories and for this reason three special functional categories have been added: business investment; personal investment; and other tax expenditures.

A brief description of each of the special tax provisions for which a tax expenditure estimate is shown in table F–1 follows.

National defense.—The supplements to salaries of military personnel, including provision of quarters and meals on military bases and quarters allowances for military families, and virtually all salary payments and reenlistment bonuses to military personnel serving in combat zones, are excluded from tax. Disability-related military pensions received by current retirees are largely excluded from taxable income. The Tax Reform Act of 1976 terminated the exclusion of noncombat related disability pensions for those who entered the armed services after September 24, 1975.

International affairs.—Prior to 1976, a U.S. citizen was generally able to exclude up to $20,000 a year of foreign earnings if the taxpayer were a bona fide resident of a foreign country. After 3 years of foreign residence a taxpayer could exclude up to $25,000 a tax year of foreign earnings. The Tax Reform Act of 1976 modified these provisions, limiting the exclusion to $20,000 only for employees of U.S. charitable organizations and reducing it to $15,000 for all others, denying tax credits for foreign taxes paid on excluded income, and taxing income beyond the amount eligible for exclusion at the higher bracket rates which would apply if the excluded income were also subject to tax. The estimates also reflect the tax-exempt status of certain allowances received by Federal employees working abroad.

Table F-1. TAX EXPENDITURE ESTIMATES BY FUNCTION[1]

(In millions of dollars)

Description	Corporations			Individuals		
	1976	1977	1978	1976	1977	1978
National defense:						
Exclusion of benefits and allowances to Armed Forces personnel	-----	-----	-----	1,020	1,095	1,260
Exclusion of military disability pensions	-----	-----	-----	90	105	115
International affairs:						
Exclusion of gross-up on dividends of LDC corporations	40	-----	-----	-----	-----	-----
Exclusion of income earned abroad by U.S. citizens	-----	-----	-----	145	120	135
Deferral of income of domestic international sales corporations (DISC)	1,220	1,030	1,190	-----	-----	-----
Special rate for Western Hemisphere trade corporations	50	35	25	-----	-----	-----
Agriculture:						
Expensing of certain capital outlays	85	80	70	455	370	440
Capital gain treatment of certain income	10	10	15	315	350	350
Natural resources, environment, and energy:						
Exclusion of interest on State and local government pollution control bonds	110	170	220	50	75	100
Exclusion of payments in aid of construction: Water and sewage utilities	-----	15	10	-----	-----	-----
Expensing of exploration and development costs	640	610	600	160	105	150
Excess of percentage over cost depletion	1,010	1,035	1,060	285	275	300
Pollution control: 5-year amortization	10	−80	−130	-----	-----	-----
Capital gain treatment of royalties on coal and iron ore	15	20	20	40	45	50
Capital gain treatment of certain timber income	290	300	325	95	95	100
Commerce and transportation:						
Exemption of credit unions	145	165	185	-----	-----	-----
Exclusion of certain income of cooperatives	410	455	490	−155	−165	−170
Corporate surtax exemption	4,170	4,630	4,250	-----	-----	-----
Deferral of tax on shipping companies	110	90	70	-----	-----	-----
Railroad rolling stock: 5-year amortization	−25	−35	−40	-----	-----	-----
Financial institutions: Excess bad debt reserves	485	560	645	-----	-----	-----
Deductibility of nonbusiness State gasoline taxes	-----	-----	-----	710	795	880
Community and regional development:						
Housing rehabilitation: 5-year amortization	15	10	5	25	20	10
Education, training, employment, and social services:						
Exclusion of scholarships and fellowships	-----	-----	-----	195	250	285
Personal personal exemptions for students, ages 19 and over	-----	-----	-----	720	750	770
Deductibility of contributions to educational institutions	190	215	240	510	540	565
Deductibility of and credit for child and dependent care expenses	-----	-----	-----	770	840	870
Credit for employing AFDC and public assistance recipients	10	15	15	-----	-----	-----
Health:						
Exclusion of employer contributions to medical insurance premiums and medical care	-----	-----	-----	4,440	5,195	5,840
Expensing of removal of architectural barriers to the handicapped	-----	5	10	-----	-----	-----
Deductibility of medical expenses	-----	-----	-----	2,315	2,585	2,870
Income security:						
Exclusion of social security benefits:						
Disability insurance benefits	-----	-----	-----	330	380	430
OASI benefits for aged	-----	-----	-----	2,725	3,135	3,600
Benefits for dependents and survivors	-----	-----	-----	615	730	795

See footnote at end of table.

Table F-1. TAX EXPE

Descrip
Income security—Continued
Exclusion of railroad reti
Exclusion of sick pay
Exclusion of unemployme
Exclusion of workmen's c
Exclusion of public assist
Exclusion of special be miners
Net exclusion of pension ings:
Employer plans
Plans for self-employe
Exclusion of other emplo
Premiums on group-t
Premiums of acciden insurance
Income of trusts to fina ployment benefits
Meals and lodging (ot
Employer contributio plans
Employee stock owner through investment
Exclusion of capital ga
Excess of percentage sta income allowance
Additional exemption fo
Additional exemption fo
Retireme t income credi
Earned income credit
Veterans benefits and ser
Exclusion of veterans d
Exclusion of veterans p
Exclusion of GI bill ben
General government: Cas litical contributions
Revenue sharing and ge ance:
Exclusion of interest o local debt
Credit for corporation
Deductibility of nonbu (other than on owne line)
Interest: Deferral of inte
Business investment:
Exclusion of interest o development bonds
Excess first-year depre
Depreciation on build
Rental housing
Other
Expensing of research tures
Expensing of constru taxes
Capital gain: Corpora timber)
Investment credit

See footnote at end of