

59 SRES TESTIMONIES BEFORE SRES (NOTEBOOK)

\$2,800 his total expenses at \$5 he's actually receiving for his oil, his real economic limit factor is \$2,800 divided by \$5 or 560 barrels, so that in fact, his limit factor, that is the number of barrels he needs before he's got to shut down, because he doesn't make it out of pocket cost of 560 under this bill it appears to me, he would only get 200. I don't think it really gives you the results that you intend. The result that you intend is to provide relief for marginal wells. It doesn't appear to really serve the intended purpose.

SENATOR HUBER - That's at \$5.61?

RICHARD KILGORE - That's at \$5.00 even.

SENATOR HUBER - But doesn't this other deal work to raise that?

RICHARD KILGORE - Well, the other thing we're talking about is price relief under FEA regulations. I think that's really something different here. I'm addressing.....

SENATOR HUBER - That's not five dollar oil. You know, if we're talking about his economical limit on the well then we assume it to be \$5.00 oil, but he is actually receiving \$10.95 for it because it's below a certain economic limit

already established, then we're dealing with something that doesn't exist, and that's what I'm trying to get into this, and I thought that that was why the State had drafted it.

RICHARD KILGORE - Because it assumes that the Federal government will always bail out people, is what you're saying, other than royalty owners.

SENATOR HUBER - My information was, it didn't only assume, it was based on what was happening. Can you clarify that John?

JOHN MESSENGER - Let me just make a couple comments. I guess it's true that one position that we've taken on this bill that our taxes should not be based on the artificial price set by the Federal government, and the Federal government set a price of \$5.00. Our position is that we shouldn't be content with the tax based on that artificial price, and that's why, one, we've set the cents per barrel floor, likewise when you're figuring the economic limit factor, again, we say the true economic limit is not how many barrel are produced at the artificial price, but the amount of barrels they would produce using the true value of that oil, pre-market oil. We should insure ourselves that so many cents to so many percent of that pre-market oil because that is our resource and we should get at least that percent out of it. Secondly, is that producers are

reaching their break even point which they will stop producing. There is a procedure by which they can make application to the FEA and get price relief and with that higher price they can produce longer, but the FEA has said that they will give price relief only to the producers, and not to royalty owners, so if a company is reaching its economic limit in Cook Inlet, and they go in for price relief, they are given that price relief. They will raise their price, but they will not raise that price in the terms of the amount of royalties which \_\_\_\_\_.

So, it's two things, one is the tax rate and the economic limit factor should be based upon the true value of the oil, and secondly that producers are protected through FEA regulations, but the State is not.

SENATOR HUBER - Then I guess what he's saying is that if someone's going to shut down the production there, by it being below economic limit on \$5.00 oil, the State is advocating that we put the monkey on the fed's back and say you did it, you set an artificial price, we're going to set our tax based on free market price, and if you want to save that resource, save that company, you can turn around and do likewise what's reasonable. I'd say it's what I call putting the monkey on the Fed's back. They caused the problem. I happen to be strongly in agreement with the State's stand on that, and compliment them for it because why should we throw away our royalty share and our

taxing ability because somebody forced an artificial price down our throat, and is forcing that same artificial price down the throat of the oil companies.

RICHARD KILGORE - Look, I'm going to address myself to the question of the artificial price, that's part of what I'm doing here, and I think the Commissioner took issue with earlier testimony I made when I said I thought this was a flaw in the thing, and it certainly was, I thought, a flaw in terms of its purpose of providing relief, and now I do understand why they do this which is another objective, than what appeared to be the intent of the bill, and I'm going to come back to the whole question of the artificial price. It's very clear they did this by design. I'd like to again, as you asked, talk about just very roughly what it does to Prudhoe Bay and then to Cook Inlet, and then discuss the consequences of that. Again, for Prudhoe Bay, looking at 5,000 and 10,000 barrel a day wells at Prudhoe Bay, this bill also raises taxes significantly on those wells as does the other bill, as does HB 321 that we looked at before, excuse me HB 144, that we looked at before, but it does not raise them as sharply as the other tax. If we take a 5,000 barrel a day well, I said that, and I'm not going to run through all the numbers here, I think, but that the other tax for a 5,000 barrel a day well raised the tax about 39% on a 5,000 barrel a day well. This tax would raise it about 29% it appears to us using the presumed hundred

barrel figure. The discrepancy between the two gets larger at very productive wells because of the steep rates near the end of the schedule in the other bill, and for a 10,000 barrel a day well, HB 144 raised it 58%, this would raise it about 27% on the very productive wells, so if it both increased taxes on Prudhoe Bay, clearly the one, HB 144 would increase them significantly.

SENATOR HUBER - That would be effective of what of 5 and 10.

RICHARD KILGORE - Okay, the effective rate would be very close to, on taxable barrels it would be very close to 10%. On 5,000, it would be 9.8% and 9.9% on the 10,000. It approaches 10%.

SENATOR HUBER - Just slightly under ten percent for a total maximum. Or fully 2 and 1/2 percent, a little over 2 and 1/2 percent below Louisiana. Using the Administration's bill.

RICHARD KILGORE - That's correct.

SENATOR HUBER - And it would be right at Louisiana with the other bill.

RICHARD KILGORE - Close to it. That's correct.

Now, let's look at what happens to the Cook Inlet old oil price here. This bill as the other one for a 100 barrel a day well eliminates the tax altogether. It does exactly the same thing, but what we find troublesome is that is you go to 300 barrel a day wells, these are the wells that we're concerned with because of their productivity and the old oil price they have to bare, they get the tax there doesn't go down, but it increases. It goes up from 26.6 cents on gross barrels to 40.6 cents. It goes up by 14 cents a barrel. This tax raises it that much. On a 500 barrel a day well, it raises it by about 13 and 1/2 cents, and on a 1,000 barrel a day well. I'm sorry 14 cents increase on a 300 barrel a day well, 22 cents on a five hundred barrel a day well, and 28 cents on a 1,000 barrel a day well. What I think are particularly disturbing are the increases on the lower productivity wells. A well as low as 300 barrels a day which we already have some concern for because of the effective rate on the old oil thing has actually a fairly substantial increase in its tax burden. As Commissioner Gallagher stated correctly, you get this result because of raising the floor price essentially. You are raising the floor price from \$6.10 to \$7.50 and you have higher tax rates at the same time, and it's deliberately designed to do this. Now, we really feel that this kind of goes against what we feel are good principals of severance taxation. What you're saying is the producer in Cook Inlet he received a relatively low old oil price established by

the Federal government. This in turn restricts his own profitability, but then the State adds to his burden by taxing him as if he received \$7.50, and it seems to us that rather than help his producing situation, this only makes the situation worse. One of the reasons given for doing this is that the Federal government is following an unwise, or I think it was described as a foolish price policy. Now, this may or may not be the case. I'm not willing to pass a judgement on that, but they're, you should know that the Federal government does have reasons for doing this. It's not capricious, they do have reasons. They have concern over the effect. What they're concerned with is this, we've had a fantastic increase in the oil prices outside the United States by the OPEC nations and if one frees the oil, the old oil price, it will go up very, very sharply. It will, perhaps in some cases, close to triple in price and the people are concerned about the consequences of this. Rightly or wrongly, they are concerned about the inflationary impact on consumers. They're concerned about when \_\_\_\_\_ producers, because these are on old oil wells, wells production which is established at old costs and so on and therefore you have to question whether you want to give them huge increases in the price and windfalls. There is concern over that. So there are reasons, and you can argue one way or another, but there are reasons for this.

SENATOR HUBER - Would it be fair to say that those reasons are exactly on a par with the same reasons for having controlled gas prices as would be in inter-state commerce as well as setting a free-market price. It's the same principal in both cases.

RICHARD KILGORE - As deregulation of natural gas prices. Yes.

SENATOR HUBER - Deregulation of natural gas. Deregulation of petroleum would do the same thing, it would increase the price at the burner or the price at the gas tank as it comes in out of the nozzle, but all of the other factors of pro and con are the same.

RICHARD KILGORE - Yes, that's right, and the concern is that if you let it go up to, and I really object to the word free-market price because we're not talking about free-market price, what we're talking about is it goes to a price administered by OPEC. That's what we're talking about going from price administered by the Federal government to a price administered by OPEC. This is by no means a free-market price. It's a market price, but one set by OPEC, and set by political reasons as much as for economic reasons.

SENATOR HUBER - Some of us are referring to free-market price though as to this free-market price that exists that we talk

about what the price would be if OPEC were not controlling it. Some of us are talking about a true free-market price

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RICHARD KILGORE - Senator, I don't know what the price would be if OPEC were not controlling it.

SENATOR HUBER - We don't know. We have projections just like we do on what Prudhoe Bay is going to cost.

RICHARD KILGORE - One the one hand, if OPEC did not exist one would certainly expect over time that the price would rise at some point in time to the level of alternative energy sources which are quite high in the \$20 - \$25 range. On the other hand, in the short run, you do have an overhang of surplus productive capacity in the world, and if there were no OPEC, and it were perfectly free market, there's no reason why the price couldn't drop to less than \$1.00 per barrel, because that's what costs are in their surplus capacity. If there were truly competitive free market, one would have \$1.00 a barrel oil or less because that's what the costs are in the middle east, less than that so but as time went on, and this surplus which overhangs the market now, and which would push it down, gets eaten up and it will, one would then have prices moving off in the other direction. I don't know what the price would be. But anyway, we're talking about not letting the price, the U.S.

government as a matter of policy, not letting it go to a price set outside its own borders by an organization of petroleum exporting companies, and that's what we're talking about. It's the intent apparently of the Congress not to do this because basically the idea is concerned with price impacts, concerned with windfalls, and also that there's no way of assuring that the price that would be set by OPEC is an appropriate price for our internal markets for our own costs and so forth. There's no way of knowing whether they will set a price appropriate to our cost circumstances in the United States or a price that may be very much higher than people think it is now or maybe even a price lower. Not good enough for development of our domestic resources. So this is a matter of national policy and people can quarrel.

SENATOR HUBER - Feable minded or otherwise.....

RICHARD KILGORE - Well, I don't want to characterize it. I'm trying to give you a few of the reasons for doing this, and this is a matter of federal policy. Now, but even if it is a foolish policy, or at least if Alaska views it as one, or the people who did this legislation think it is, I think that you have to ask, if that is the case, still, why do you want to then punish producers for this price policy basically. They already suffer enough from it in terms of the revenues they receive, why do you want to go an

added step and raise their taxes because of this. I don't think it's reasonable to assume that if you do this you will force national policy to change by what you do in the way of taxation here in Alaska. That seems to be reasonable.

GEORGE SILIDES - Madam Chairman, may I ask a question?

In addition to your comment of being unable to force national policy, would you think that this kind of tax is counter-productive?

RICHARD KILGORE - I suppose it's possible, I don't really know the answer to that, but I suppose there are reasons that might want to lead one to that result, and if the FEA has procedures for relief of these kinds of situations, then it sees the State of Alaska in fact imposing higher and higher taxes on such low productivity wells. I don't know. It's not inconceivable that it would enter into their thinking in this matter. Rather than providing relief, it seems that the State of Alaska goes in the other direction in this situation.

SENATOR HUBER - George brought something up here. Isn't this the fact that it effects these 300 barrel wells just because of the total tax maximum that we pay and then how we apply the mechanics of the formula. They could for instance, modify, and the mathematics of it I would have

to find out from somebody else how, so that that point would hit, maybe, more on a five or six hundred barrel a day well and maybe give as much as 10.3% or 10.4% out of Prudhoe Bay instead of an even 10%, and the formula diddled with enough to change that point to where it would be correct. Couldn't that be done?

RICHARD KILGORE - Yes it could be. If you like the basic approach of the continuous formula .....

SENATOR HUBER - Apparently you do, and I do too, and we might consider, and George's question pointed up that we might consider something from being John Messender is here, that they might give us an alternative is that reasonable Madam Chairman?

CHAIRMAN POLAND - Well yes, except today we have Mr. Kilgore with us. He's leaving on a plane and we want to take advantage of this. We can bring this up.

SENATOR HUBER - I have considered this, Madam Chairman, to be a work session with him, and it's more valuable to me, the way we've been conducting it here today, than anything that we've had.

CHAIRMAN POLAND - Well fine. Let's give him a chance to get with it.

RICHARD KILGORE - Okay, we really are concerned with how this aspect works. There are two parts where Alaska is attempting to impose its own view of what the proper price policy should be, that is if they want the OPEC price. It comes on the floor, and it also comes as I said before in this calculation of the economic limit factor again. It enters in two places, and we have serious questions about this and what you really want to do. If the basic intent of the legislation is to provide relief that you don't go off in the other direction simply because you're unhappy with the prices because this throws all the burden on the producer, and then you're going exactly against what you really want to do, and you could have economic consequences to this.

I understand your concern with the prices that you get for your oil, and you'd rather get higher prices than lower prices, and that's fine, but the question is if the price is not set at a level that you think is appropriate then what do you do about it, and I guess, it's just bothersome to us that what you do about it is throw a burden back on a producer here. That's what you're doing about it, and that then goes against what we feel is an appropriate kind of severance tax because then you run into all the kind of economic problems with this gross tax and that's our concern, and we appreciate why you think in terms of floors and why you want to get an adequate value for your oil, and so forth,

and we understand why you do it, it's the consequences.

This tax also raises the tax on natural gas. If you'll recall our testimony before, we were always pointing out to you that if you did this you would have an impact on Alaskan consumers, that would flow through to Alaskan consumers. I noticed that there is another bill which is HB 329, SB 239 which is a residential fuel credit, and I presume that the intent of this is to mitigate to some extent the impact that raising the gas tax would have on Alaska. Consumers - we're not really in a position to know how adequately it does this because this has to do with what fuel bills really are in Anchorage and so on. We really don't have the information to calculate how adequately that does that, but obviously, you are concerned with that aspect to it, and the balance of the increase of course would be assessed against exports. I think that the other thing I should point out is that here you have in this not only an increase in the tax rate from 4% to 10%, but also introduce a floor price here, that is a minimum 6.4% per MCF, which is an effective floor price of 64 cents per MCF, and I think we have the same reservations here about this as you do on the oil side. If you have oil flowing, producers getting less than 64 cents, someone mentioned 42 cents the other day, but less than 64 cents, then you start to raise the effective rate of it, and I think we have the same problems with it here as we would anywhere else, and this

also has a gas flaired feature taxation, but it's only double, not five times, and all my comments on that go for this too.

SENATOR HUBER - That is in the equalization deal?

RICHARD KILGORE - No, it's in the severance tax, itself. There's a provision.

In the end, I'd like to talk a little bit about this whole question of the overall tax burden and how you assess it, the kind of questions that Senator Rader has been talking about, but I would first just like to make a few comments on the property tax bill, unless there are some other questions here on the severance tax.

CHAIRMAN POLAND - No. I was going to suggest that when you are finished on the bill, and before you kind of wrap up, that we take a five minute break.

RICHARD KILGORE - Okay, shall I just say a few things about the property tax. I have relatively limited comments here. HB 323, SB 237, now, this extends the property tax to some other areas as you know to refineries, gas plants, and also to marine transportation, and L & G liquifaction facilities, and so forth. So it extends the kinds of things that you would tax with your property tax. Now, the only real comments

that we have here are that for each of these areas that you're thinking of proposing a property tax on, you think carefully about where that tax will actually be borne. You're talking about taxing properties for crude oil production that largely obviously is borne by producers. They realize prices in the lower '48 that are set for them, and the tax you impose is a tax which they have to bare in terms of their own profitability, but that's not necessarily the case with each of these other areas that you are extending, and what I think you ought to think about what you are doing, because if you're looking at property taxes on refining in Alaska, we would expect that most of the refining capacity in Alaska for some time to come would be basically capacity oriented to supplying low markets so that the tax that you impose on those refineries presumably would over the long run be borne by Alaskan consumers. You're assessing a tax which goes to the treasury, but eventually that tax would have to be borne by consumers if the refineries are to operate properly. So you have to worry about the incidence of the tax. If you're looking at L & G facilities you have to worry again about the consequences of this and what will happen, and who will actually bare this. Will it be a cost that will simply be passed along because the facilities under an FPC jurisdiction will be passed along as probably may be the case. It's not clear that if it's L & G or export to foreign countries whether this would be the case. Who would bare it, it's not entirely clear.

GEORGE SILIDES - Would it not also have an effect on a decision as to whether to locate in Alaska.

RICHARD KILGORE - Yes, it could under certain circumstances. If it's a cost which basically the person thinking of putting in the facility has to bare himself because he hasn't got an automatic pass along or he can't pass along to Alaskan consumers, or he can't through his regulatory process, pass it along, then surely, it would be one of those tax entering into his decision as to whether to locate in Alaska. Noone can say whether this is the thing that would swing it in the balance, but obviously, it's part of the package of doing business, if it's a higher cost, it could have some effect, yes.

The last one is marine transportation, and there, well there's a question of legality, I guess, but we can't address ourselves to those, but it seems to me you might have some concern about this one too, because you already face a problem where you are concerned with the fact that your oil may have to move to quite distant markets, for example the U. S. gulf and the eastcoast, and you're very much rightly concerned about that long haul and those high transportation costs and what it may do to your wellhead value, and if you go this route of taxing marine transportation, you obviously add to the cost of transportation, I don't know how much would be thrown up by this tax, but you are in principal anyway

adding to the cost of transporting your oil which certainly works in the direction of lowering the value of your oil, so I think that you ought to consider this as well, as I say, in each case consider the consequences, but here you're putting an added cost on transportation and it may be small, but it certainly works in the direction of lowering your wellhead value. Basically that concludes my remarks on the specifics of the bill.

I would like to conclude with a few remarks about this old question of the total tax burden in Alaska. What fair share is, and at what point do you destroy incentives, undermine profitability and the like, and of course Senator Rader has been pressing a number of people for answers to this, but as he himself in asking the question admits, there obviously is no easy answer to this question. If there were, somebody would have given it, and I can't give you an easy answer. A number of things have been suggested, all of which make a certain amount of sense. What kind of activity is there in the State has been suggested. A number of people have suggested looking at the total tax burden in Alaska, relative to other states. I have a few comments on that aspect too. It clearly is important what the total tax burden is on the oil and gas industry, there's just no doubt about that and how it compares with other states. It certainly is not just the absolute amount of dollars being paid or dollars per

barrel of production being paid to the State. What really matters for the economics of the industry for their incentives to go in and so forth really are these aggregate dollars or dollars per barrel things put into context of the profitability of the operation in the various states. This is what really counts in the end, not just the amount that one pays. If one is paying a high tax, but in a situation where profitability is very large it's one thing, if they're paying perhaps even a lower level of taxation in a situation where profitability is low can be another thing. So, you really have to put it in the context of profitability. This doesn't make it any easier to answer obviously because profitability is elusive and difficult to measure, but certainly one has to put it in this context, not just in the dollars themselves. And the second thought about it is, I think that although some people have said this, that the mix in which you get your taxes out of this total burden to your state and other states is really not irrelevant. Someone suggested that a dollar is a dollar, but this isn't really quite so it seems to me if you're looking at the burden of those dollars on people. If you have taxes that are relatively based or geared closely to income, that is income taxes in kind of a true income tax in a sense that it is directly trying to measure income, it's one thing if you collect it that way as against certain just gross taxes or property taxes and the like, because if you have taxes based on income, they have a different economic impact than gross taxes.

If you have a severance tax, it's not a matter of indifference how it comes. If you're collecting high severance taxes in Alaska because you have wells that are extremely productive and that's the way your tax is structured that's one thing, if you're just doing it flat out on everything that's another. So, that it's not just the total dollars, these dollars have different effects, and that high taxes in one circumstance where they're thrown up out of a total tax package that's more closely geared to income and costs and so forth may be less of a burden than in another case where you have somewhat lower taxes, but their generated by things that have nothing to do with profitability, and you have a low profitability situation, so that I think it isn't strictly the total, it is the mix and the types of taxes that you have also, that also matters, and to the extent that the closer these are geared to income, the better you really are. The second thought I have on this whole question is the State, I'm thinking in terms of the burden of its taxation also has to remember that it has a role not only as a taxing authority, but you also in this State, and this is different from other states, most other states anyway, you have also a role as a land owner, you have lots of land and you will have leased that land and you will be leasing more, and you have to realize that the higher and higher you put your own taxes, this will have some effect on the kinds of terms that you're going to be able to get for your land. No matter how you lease it.

If you lease it on a bonus basis, the higher your taxes, the lower your bonus. If you go on a royalty bidding basis, the higher your taxes, you'll get lower royalty bids out of all that, or if you have a net carried interest or a net profit interest kind of leasing arrangement which you may turn to. Your profit people are willing to give you also \_\_\_\_\_ part of the taxes.

GEORGE SILIDES - This matter came up before in a different form, and the comment was made by the speaker was that not to be so terribly concerned because the competition in leasing would take care of that matter.

RICHARD KILDGOR - Well what I'm saying is that I think the competition in the leasing is going to reflect your taxation. That is, if you have higher taxes, I would expect in general you will get out of the competitive process when people are bidding for leases on whatever variable they're bidding, whether it be royalty or bonus or whatever, the amount of the tax that they will perceive you will take in the future will effect their bids, and they'll bid competitively and it will be reflected on how much money they're willing to offer you initially, or how much percentage of the thing they're willing to give you and so forth, so that your tax will effect the terms you're able to get on your own land.

REPRESENTATIVE OSTERBACK - I would like to ask a question. We listened to all this testimony, but we never came down yet with how much are we getting for our oil. And another question on leasing, it doesn't seem to make any difference, the bids I say that came out from the State or from outside the three mile limit seem to be about the same value they are bidding into the millions for off-shore leasing. What kind of a deal could you answer that on off-shore leasing? And the taxes, what kind of taxes are they paying? Are we going to get a benefit out of the off-shore leasing taxes?

RICHARD KILGORE - Well, on off-shore leases, where they're on Federal waters, you basically will not get the state severance tax from those barrels or MCF's of gas being produced out \_\_\_\_\_ there, and basically the tax that that oil in Federal waters will be subjected to is basically just the Federal income taxation, and you will not get severance or other kinds of tax revenues unless one's able to go through some franchise tax kind of thing. I just don't know whether that's legally possible for you to do that, but unless you can think of something ingenious of that sort, basically it will be just federal taxation on that, and the bids that would be received if you had comparable prospects on shore Alaska, let's say off shore but in Alaska waters similar prospects to something over the line in Federal waters, and you put these up for bonus bidding,

presumably what you would get since you have no severance tax on the offshore, you would presumably get higher bonus bids to the federal government, than you in Alaska would get for your exactly comperable prospects. I don't know if that answers the question or not.

REPRESENTATIVE OSTERBACK - One other thing, somebody brought up the other day that since we get 10%, or we pay 10% of the federal tax, I don't know, I know you know more about, would we be getting a share of the federal tax in the amount of 10%?

RICHARD KILGORE - Yes, to the extent you share in federal revenues and so on, yes you do get some share that way. That is correct, but the other thing is that as you know, there is some move afoot in the Congress to provide some sort of sharing of royalties and other income from offshore productions with the coastal states, and I would think that the State of Alaska should push very hard for this kind of thing, and I would also think that in the past this was probably not the kind of thing that the Congress would pass because there were relatively few states which would benefit from that basically Texas, Louisiana and California that would benefit from that kind of thing, that is sharing the revenues, some portion of the royalties and bonuses in the federal waters off their shores, but the situation seems

to be quite different today because we now are talking about exploration along basically the whole eastcoast of the United States, so there are an awful lot more states which potentially could benefit from this and presumably would support such a measure in Congress. There seems to be a lot more support for that kind of thing than before, and perhaps you will get something like this. I think there's a lot of merit in doing this from a national standpoint too, because as you know on the eastcoast there are all kinds of environmental opposition to this drilling and everything and bringing this oil ashore and everybody is up in arms about the environmental problems, well, I would think that if the states including my own where I live, New Jersey, really thought they had the prospect of getting some direct share of the income from oil and gas in federal waters offshore New Jersey, I think they would view the environmental matters somewhat differently, or at least be willing to look much more realistically at them and have greater support for this activity, so I think that this is something that Alaska should be looking for, and maybe it's another way you would be able to benefit, and if you were able to get some benefit, in that way some share of royalties, bonus income and so on from federal waters offshore Alaska, I think the amounts of money, I don't know what the share would be, I think the amounts of money that you would be getting would be very very much larger than any kind of fooling with apportionment factors

in that franchise bill to try to pick up something. We're talking about much larger potential amounts of money I would think.

REPRESENTATIVE OSTERBACK - Talking about the environmental conservation and everything, you're going to get a lot of static from fishermen, \_\_\_\_\_ coming out that the oil won't take Kachemak Bay for example. Now, Kachemak Bay, only produces about 6 million pounds of shrimp, but you come up towards the chain around Kodiak, what we do, that's just a drop in the bucket, and we're buying that back, so there's going to be a lot of static, say in the Bering Sea, is one of the richest crab, herring, shrimp, and out along the chain, so if there is no revenue for the State, then we're going to kill off our fisheries and there's going to be a lot of static coming from that on the offshore drilling, because you can see what happened in Kachemak Bay, which is just a small little thing, and we're going to pay I don't know how many million dollars to buy that back to save that fishery. And what I'm trying to get across, if we're not going to get no sharing off the offshore, there's going to be a big fight to try to stop it.

RICHARD KILGORE - Absolutely, because then you say what do you need it for, to get nothing whatsoever out of it. I don't want anything I say to be construed that I'm against environmental concerns, they obviously are very real, but

I think what you're saying is correct and this goes for other parts of the country too, if what you're talking about is development of Federal waters, and off your shore with the potential environmental problems from which you will suffer, and you get absolutely no benefit, then what do you need it for. In those circumstances one would take a very extreme, I think, position on viewing the environmental damages. That is, one would say, I don't care if the chances are one in a million, I don't want it because I don't get anything out of it anyway. If there's any chance whatsoever, let's just don't do it, because I don't gain anything anyway, but if you have something to gain from it, I think perhaps people may very well take a more realistic view of what the potential hazards are, what might happen, and with the odds have been happening and so forth, but if people are in the position where they have absolutely nothing to gain, and any possibility of something happening to their environment, that's really going to be against them.

REPRESENTATIVE OSTERBACK - One more, if I may. Take say a barrel of oil is worth what \$12.00, \$11.00, what? A barrel of fish is worth about \$200.00. So what do we want?

RICHARD KILGORE - Sure, if you're going to destroy a valuable industry.....

GEORGE SILIDES - One of the things the administration has put forth through the federal government in my recollection is that, it is just that, and this is why they were hoping to hold off some of the offshore production was to submit a proposition to the Federal government on revenue sharing. I think you are familiar with that, and I think you touched on it. My recollection, and I ask this only for informational purposes as you know, it seems to me that we also suggested a two tier affair. I know you hate everything with two tiers in it, but in that all of the states were able to get a portion of the offshore revenues, so that you gain a broader base of support.

RICHARD KILGORE - Yes, and I think that's a sensible approach to this whole thing too. One can gain broader support where you have some approach as you're saying. Where you have everybody benefits to some extent, but those who are directly effected or so on, get some larger share.

I am saying that you do have this interrelation when you think about how high you put your taxes. There is this interrelation between what your taxing policy will be and how much you are raising taxes, and what you're going to get in terms of economic benefits when you lease lands, and that's very very clear, so to some extent you're taking one area through higher taxes and you give up in another through lower, whatever it is, bonuses and so on. So to some

extent they are offsetting, but of course at the same time you have to appreciate that while this is true on new leases for people under existing lease terms, obviously they can't change their contracts with you if you raise taxes, so if you raise taxes they are hurt. You also through your tax policy, obviously effect the value of lands or the value that one can get out of other landowners in the State, and of course the native corporations are obviously the ones who will be effected to the extent that you raise taxes and they make new arrangements on their lands, they will be effected, and they will get less in the way of.....

SENATOR HUBER - I wanted to just for a moment on that same subject to lead Dick back across the cannon ball range and the mud flats, and back to dry land for a minute on these leasing policies, and you were talking about bonus leasing when we got into this, and isn't it true that the price paid for a bonus lease whether it's offshore or onshore, mud flats or whatever, it is based upon what they're willing to pay for the price to gamble on what may be down there in a huge gamble and if we wanted to minimize what our tax would do on that, the minimum would be no tax, and other than that to have a tax that would have a minimum effect, would be a tax that was a percentage of a net profit, and if you had a percentage of net profit tax, that would be the kind of tax that would provide the minimum for losing money in your bonus, because they would all figure when they were bidding

that there would be no tax on anything that we don't get anything on and it will only be a maximum of this amount of exposure on the net when we do make, and if we don't make, we don't pay.

RICHARD KILGORE - That's correct, but that's assuming of course that the income tax that you have really is taxing what is real kind of income in Alaska. If you are on, as the gentleman from EXXON testified the other day, if you're on an apportionment formula, you may pay income tax anyway.

SENATOR HUBER - I didn't mean to lead you back into the net proceeds tax which you happened to design, but I'm thinking about any fair income tax that would.....

RICHARD KILGORE - The income tax works differently, that's right, in the sense when he factors it in and if it's true income tax, he only pays if he wins, so it does effect what he's willing to pay.

SENATOR HUBER - I just wanted to get it to where we actually, what kind of tax we've heard so much, so many times about how you discourage your front end money in bonus bidding, and in some cases, it's absolute milarkey, you don't do it at all, and there you hardly do any discouragement when you do it on a net profit basis. If you get a portion of that in there in a gross manner, you've got a problem.

RICHARD KILGORE - My only point here was to leave you with the idea that we do have an interrelation between the taxes and what you will get on your lands when you lease them, but you also will effect, of course, the value that other people get from their lands and \_\_\_\_\_ the native corporations.

Well in the end, this whole question of the relative tax burdens and the effects, and when do you have to \_\_\_\_\_ incentives, when do you discourage, obviously there are no easy answers as I said at the outset. There are many things you would obviously have to look at, and many of these have been suggested. One would obviously be an economic study of the industry, some of which have been done. Levels of activity would be another indicator of your total tax package, lease bids and so on, comparisons with other states and all these things are things that one would look to and try to assess how far you have gone in your taxation policy.

I think one of the really best safe courses, so one would really know where one is in this whole thing, even after you look at all these sort of measures, one of the best safeguards is probably to try to design taxes in your state that relate reasonably well to profitability. I think you run less of a risk if you do this. If you are able reasonably, or in some fashion to relate them to profitability, then you're not going to impose a very big tax burden if the industry isn't

very profitable, and if it is very profitable, you tend to throw up higher taxes and you run less of a risk really that you end up imposing on reasonable taxes on people, and this probably in the end is one of your best safeguards to kind of keep those principals in mind which means taxes related either directly related to income or taxes sort of semi-related to income as the step schedule that you have or the continuous schedule as is proposed where you really impose high taxes only in circumstances that seem to indicate high profitability, that is high well productivity which tends to be associated with high profitability, so I think the more that you keep to these kind of principals, the less of a problem you're likely to have in terms of really going too far in your tax burden on the industry.

GEORGE SILIDES - I have questions on two matters which concern most of us. One of them I know particularly concerns Senator Huber also, and if I may I would like to ask them now. One is do you have any comment on wiping out all the industrial incentive taxes in the State.

RICHARD KILGORE - We really don't have a comment on that.

GEORGE SILIDES - And the other one then is something which was discussed back in 1973 when we had a bill before us to own part of the TAAPS line. Now we have some bills in front of us which concern the possibility of again acquiring

an equity interest in gas lines or other lines, and I wonder if you could comment on that, whether your position has changed or what it might be now.

SENATOR HUBER - George, would you \_\_\_\_\_ bills particularly is for an industrial incentive, or for a state sponsor corporation which would operate on its own under the so called industrial incentive type bonding 100% if you could expand your question .....

GEORGE SILIDES - Senator, yes, I was going to make it into two parts, one is just to get a general statement on the State being an equity owner, and secondly of course we have SB 251 which is Senator Huber's bill actually.

RICHARD KILGORE - I haven't seen the bill itself.

SENATOR HUBER - It establishes an authority Dick, and with all of the powers, 100% of the authority to build the gas line.

RICHARD KILGORE - Well, frankly I would prefer, if you don't mind kind of deferring an answer to this question, and give it a little more thought. I know we have in the past, I guess, generally kind of questioned states being involved in things of this sort, and I don't want to give a general answer.

SENATOR HUBER - I don't want to force it either, but the reason that you might give it some consideration when you go back home is that the bill is not this one that is just an idea of whether we do it next year. This particular bill is an either now or never type of thing because it is designed, the whole purpose of it is to supply the North Slope gas to the lower '48 at an economically feasible price to make the project feasible, so it don't have to be subsidized either by users or the government, and if with the FEA setup and everything is set up with the President's approval and everything, it's an either pass it, so it's a method or else it will not be a factor. It's kind of a forced thing but it's now or never. It's timely.

RICHARD KILGORE - Senator, there are a lot of ramifications and a lot of things to think through on this particular kind of thing. I would prefer rather than just giving it off the top of my head, if we did especially take a look at the bill in itself, think it through carefully, and either come back to you with a written response or on the occasion of our next visit be prepared to respond.

MEETING ADJOURNED.

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LEONARD E. KUST is a partner in the New York law firm of Cadwalader, Wickersham & Taft. He was formerly Vice President and General Tax Counsel of Westinghouse Electric Corporation with which he was associated from 1955 to 1970.

A native of Wisconsin, Mr. Kust is a graduate of the University of Wisconsin and the Harvard Law School. He is a member of the New York and Pennsylvania bars.

He is a past president of the Tax Institute of America, and of the Tax Executives Institute. Mr. Kust has served as Chairman of Governor Scranton's Committee on Tax Administration, Chairman of Task Forces for Governor Shafer's Tax Study and Revision Commission, and was a member of the Advisory Committee of the Commissioner of Internal Revenue. He has served on the Executive Committee of the National Tax Association, as a Director of the Chamber of Commerce of the United States, and as a member of the Taxation Committee. He is a member of the Tax Section of the American Bar Association, a member of the Council of the U.S.A. Branch of the International Fiscal Association, a member of the Advisory Board of Tax Management, and a member of the Advisory Board of the Tax Foundation.

Mr. Kust has written on a wide variety of tax issues, including "State Taxation of Income from Interstate Commerce: New Dimensions of an Old Problem", S.W. L.J. 1 (1960); "State Taxation of Interstate Sales", 46 Va. L. Rev. 1290 (1960); "Federal Tax Reform", the Tax Executive, Vol XIV, April, 1962; "Standards of Conduct for Tax Executives", the Tax Executive, Vol. XIV, July 1962; "A Re-appraisal of Taxation of International Business Income", National Tax Association Proceedings, Annual Conference, 1966, p.154; "Alternatives for New Federal Revenues", Tax Review, Tax Foundation, Vol. XXXIV, No. 7, July, 1973.

TESTIMONY BEFORE THE  
SENATE RESOURCES COMMITTEE  
OF THE  
ALASKA STATE LEGISLATURE

By

LEONARD E. KUST

February 10, 1978

Madame Chairman and members of the Committee:

I am LEONARD KUST, partner in the New York City law firm of Cadwalader, Wickersham & Taft. I have been retained by the Alaska Oil and Gas Association (AOGA) to study the present Alaska corporate income tax and the various proposals to change that tax pending before the Alaska Legislature. On December 9, 1977 I presented a 45 page paper to AOGA setting forth my views on these issues. This paper has, I understand, been made available to you and I offer a copy for inclusion in the record of these hearings.

Before I proceed further I think you are entitled to ask whether I have the credentials to presume to give you views which it is worth your time to listen to and consider. I have for this purpose prepared a resume of my past involvement in issues of state taxation of the income of multistate and multinational business. I would like to offer this

resume for the record and hand copies to members of the committee for their perusal, if they wish.

I understand that your major concern and the concern which the various bills under consideration are intended to address is that the current Alaska income tax fails to reach and effectively tax income derived from oil and gas production and transportation activity in Alaska and your concern that oil and gas corporations operating in Alaska are paying to Alaska significantly less than the statutory 9.4% tax rate on their income.

Let me remind you at the outset of what I am sure you are all aware. Under the United States Constitution Alaska cannot impose its tax of 9.4% on the entire income of corporations engaged in business in Alaska and elsewhere. Such a tax would insure multiple taxation by the states in which the corporation does business and be an unconstitutional burden on interstate commerce.

This constitutional limitation conforms with internationally recognized fundamental principles of tax jurisprudence. Where the activities of a business extend over two or more countries or states, all of the income from such business cannot be taxed by each of the countries or states.

Accordingly Alaska can impose a tax only on Alaska source income of corporations which operate in Alaska and elsewhere. Any tax which applies to income earned outside Alaska will not only result in multiple taxation but will also violate both the United States Constitution and the generally accepted principles of tax jurisprudence.

The problem, of course, is in determining the source of income. This is not a new problem. It is a problem which scholars, legislators, and tax administrators have struggled with over the years. In this modern era as corporations have expanded their interests throughout the country and in many cases the world the problem has become more acute. The states from the outset upon enacting corporation net income taxes beginning in 1911 strove to avoid imposing an unconstitutional burden on interstate commerce by taxing only a portion of the income of the interstate business. The development over the years has been in devising and refining the method by which to determine the portion of the total income of a multistate business which should be taxed by each state and the attainment of uniformity in the methods used by different states so as to subject to tax all, but not more than all, of the total income of multistate business.

The system which has developed has two elements:

(i) a tax base measured by a company's worldwide income determined by reference to Federal taxable income and (ii) a method of dividing this base through use of an apportionment formula.

Why a formula approach? Well, the states initially sought to determine the source of income by means of "separate accounting", that is, by constructing an income or loss statement for the activities of the business in the state as if it constituted an independent business dealing at arm's-length with the remainder of the business and the outside world. It was soon evident, however, that separate accounting was not reasonably feasible within the limits of administrative practicability. As a consequence, the so-called "Massachusetts formula" gained early and general acceptance, commencing in the 1920's, among tax administrators and business taxpayers as a reasonable alternative to separate accounting for determining the portion of the total income of multistate business which is taxable in each of the states in which it has activities. The Massachusetts three-factor formula apportions the income of a business to the taxing state on the basis of the average of three fractions:

- (1) property within the state over total property,
- (2) payroll within the state over total payroll,

and

(3) sales within the state over total sales.

It was recognized at the outset that multiple taxation of multistate business income arises not merely from failure to apportion reasonably but from disparity in methods of apportionment as well, even though each method by itself and applied universally might be reasonable. The National Tax Association began advocating uniformity in the method of apportionment as early as 1919. Ultimately, these and other efforts culminated in the Uniform Division of Income for Tax Purposes Act (UDITPA) adopted by the National Commissioners on Uniform State Laws in 1957. UDITPA incorporated the three-factor formula and, most notably, defined the numerator of the sales fraction, with respect to which the greatest divergence from uniformity had developed, as being sales having their destination, that is, delivered to customers, in the state.

The Multistate Tax Compact, of which Alaska is a member, inaugurated in 1966 to promote uniformity and thereby avert Federal legislation then under consideration to impose uniformity on the states, incorporates UDITPA.

The UDITPA formula is not without its flaws; clearly it is not perfect. Whether, in theory, a better formula can

be developed, I do not know. This particular formula rests on common sense which has survived years of practical application. Most importantly, this formula has been accepted by both taxpayers and state tax administrators.

I want to emphasize the general acceptance of the three factor UDITPA formula. Out of my experience serving as co-chairman in 1969-71 of a committee of state administrators and business representatives seeking to formalize a country-wide uniform system for division of income of multistate and multinational business by a combination of the Multistate Tax Compact and Federal legislation, I can report that there was at no time any disagreement among the state tax administrators and business representatives as to the validity of the three factor formula. It was accepted by all as the bedrock on which any system of uniform division of income must rest.

Out of a total of 44 states and the District of Columbia which impose a corporate net income tax, 40 provide for the three-factor formula, 25 by adoption of UDITPA or the Multistate Tax Compact and 15 by incorporation in their own tax statutes, four of the latter giving greater weight to the sales factor than to the property and payroll factors. Differences in the economies of the states as to whether primarily industrial, or commercial, or agricultural or extractive have not affected the general acceptance of the three-

factor formula as essentially fair and reasonable.

The major concern raised by the proposals under consideration by this Committee , and I will discuss the proposals more specifically in a few moments, is that they would seriously disrupt the uniformity which over the years the states and business have labored to achieve, and which, I believe, is essential to fair and effective taxation by the states of the income of multistate businesses. A few other states have begun to tinker with the formula for their own parochial interests. I deplore such action. If you really believe that the UDITPA formula is not reasonable with respect to the oil and gas industry as a whole, the solution is to proceed under Section 18 of UDITPA on a case by case basis or to approach other states and seek a new uniform method for division of the income of the industry. Unilateral action by Alaska or by any other state would generate multiple taxation and would threaten the framework that has developed for division of income among the states.

But beyond the question of uniformity, I believe that both HB 322 and SCS CS HB 322 and the impetus behind them are based on a fundamental fallacy. They are based on the assumption--and I stress assumption--that the "fair" share of income to be taxed by Alaska is

to be determined by changing the apportionment formula or by statutory "separate accounting" so as to approximate the income based on barrels of production in Alaska times the well-head price less costs and expenses incurred solely in Alaska. This is demonstrably not the "fair" share of income attributable to Alaska. Income is not merely the result of production. The creation of income requires both production and consumption. It is the demand created by the economies of the consumption states that converts the production into income. The consumption states have an undeniably legitimate claim to tax part of the income which is based on this price created by their demand. Would Alaska agree that only the states in which the goods are produced which are sold by Sears in Alaska can tax the income and Alaska cannot? Of course not. As the consumer state in this case it wants to and is entitled to and it does tax a portion of the income from production outside Alaska.

Thus, having read some of the prior testimony, I would take sharp issue with the confident assertion that Alaska's fair share of the income of the oil and gas industry is the well-head price less costs and expenses incurred in Alaska.

I would like to challenge Mr. Lipton and Professor Zeifman to present their arguments to the Multistate Tax Commission or to a meeting of the National Association of Tax Administrators in support of their proposals as appropriate uniform methods to be accepted by all states for division of the income of the oil and gas industry. I think it is reasonable to predict that neither of the proposals would be judged to be a fair and reasonable basis for uniform division of income among the states.

This committee and the Alaska legislature will ultimately decide what course to follow. It is your responsibility and your prerogative but I would like to suggest that your decision should be made against the broader framework which I have presented rather than the narrow perspective urged upon you in support of the proposals under consideration.

#### THE ZEIFMAN-AINSWORTH PROPOSALS

The proposals of Professors Zeifman and Ainsworth which are incorporated in H.B. 322 are based on these two premises: (i) that Alaska's tax base has been eroded through Federal tax subsidies and incentives which are unrelated to the definition of net income, and (ii) that the UDITPA apportionment formula unfairly reduces the amount of taxable income attributable to Alaska by corporations which export non-renewable petroleum resources from the state. Zeifman and Ainsworth recommend:

1. Adoption of a tax base measured by the greater of book income or Federal taxable income, and
2. Replacement of the destination-oriented sales factor with an "extraction factor".

Furthermore, they propose that these changes apply only to corporations with ordinary gross receipts in excess of \$250,000,000, more than 50% of which is derived from production, transportation, refining, manufacturing, processing, distribution or retail sale of oil or gas or products derived from oil and gas.

I believe that Professors Zeifman and Ainsworth are mistaken both as to their premises and their recommended solutions.

The current Alaska income tax base is a corporation's Federal taxable income. That base includes the worldwide income of the corporation - not just United States source income. In determining Federal taxable income, Congress has allowed certain deductions which are not taken into account in determining the corporation's book income. These "tax subsidies", however, are for the most part available to all corporations, including corporations engaged in business solely in Alaska and multinational corporations engaged in various business activities in Alaska. It is unfair to single out the oil industry. If "tax subsidies" are to be eliminated they should be eliminated for all corporations.

Furthermore, with respect to the one Federal "tax subsidy" available solely to the oil and gas industry, a current deduction for intangible drilling costs, it is erroneous to charge that because drilling costs reduce Federal taxable income Alaska in using such income provides an incentive to drilling wells outside Alaska. Federal taxable income reflects not only deductions for the cost of wells drilled outside Alaska but also the income from such wells. It is not a one-way street. Alaska is no more providing an incentive for drilling outside Alaska than other states are providing an incentive for drilling in Alaska.

The Department of Revenue has cited Congressional studies by Congressman Vanik of Ohio to support the Department's claim that adoption of the Federal tax base by Alaska results in an effective tax rate significantly less than 9.4%. Vanik's study measures Federal income tax due as a percentage of worldwide income. Obviously this comparison will result in an effective U.S. tax rate of less than 48% for companies engaged in foreign operations because the United States provides a credit against its tax on worldwide income for taxes paid to other countries. This is the necessary alternative to taxing only the income earned in the United States. Similarly, measuring taxes due to Alaska as a percentage of a corporation's total worldwide income will result in an effective tax rate of less than 9.4%. Both comparisons are meaningless, since neither the United States nor the State of Alaska intends or reasonably can impose its tax on the worldwide income of taxpayers without a foreign tax credit or without apportionment. It is primarily because of the division of income (by means of a foreign tax credit at the Federal level and formula apportionment at the state level), not determination of the tax base, that the effective rate on worldwide income is significantly less than the statutory rate. If 25% of the worldwide income of a company is earned in Alaska, obviously the effective rate of Alaska tax on worldwide income will be 2.35%.

The suggestion of Professors Zeifman and Ainsworth, which is incorporated in H.B. 322, that book income be used as

a tax base is unique. I am aware of no state with a tax base measured by book income, even as an alternative basis. Book income is an inappropriate tax base. Adoption of such a tax base would in effect delegate determination of income to the company's management and the accounting profession. If Alaska is not prepared to accept management's and their accountants' determination, it will have to develop an audit staff sufficient in size and skill to conduct its own audits. It will not be able to rely on the audit skills and extensive examinations of the Federal government or the Multistate Tax Compact.

Furthermore, book income not only reflects taxable income before tax subsidies but also many accounting and timing differences unrelated to Congressional tax policies, many of which reduce book income in comparison to taxable income. As an example, corporations are often entitled and even required for financial accounting purposes to set up reserves for certain estimated expenses or losses which are not deductible in determining Federal taxable income.

Finally, use of the higher of Federal taxable income or pre-tax book net income as a tax base, as is proposed in H.B. 322, will tax income without reduction for those expenses which are deducted in different years in determining book net income and Federal taxable income. For example, if book income

exceeds Federal taxable income because of current deduction for intangible drilling costs which are deferred for book purposes, and then Federal taxable income in a succeeding year exceeds book income because the deferred intangible drilling costs are then expensed for book purposes, the tax base will be determined without deduction for such costs at any time.

As to substitution of the extraction factor for the sales factor in the apportionment formula, it is my view that the UDITPA formula provides for fair and equitable division of income of oil and gas corporations between Alaska and the rest of the world and fairly reflects the extent of their activity in Alaska as compared to the rest of the world.

The destination sales factor cannot be regarded as allocating Alaska's share of income to other states but more properly as assuring to the market states a fair share of the taxable income base. Without the purchasing power and demand provided by the market states, there would be little if any income of oil and gas companies for Alaska to tax. The sales factor quite properly gives recognition to the contribution by the market states to the creation of the income tax base. Substitution of the extraction factor for the sales factor would ignore the contribution of the market state to the creation of income, just as would an origin-oriented sales factor

which was used for years by heavy manufacturing states for their parochial interest. Use of this factor was so short sighted that it drove business out of these states. States such as New York and Massachusetts have had to retreat so far that they have adopted double-weighted destination sales factors to attempt to convince businesses to stay or to return to their states.

Alaska may dismiss this experience as irrelevant since the oil is in Alaska and the oil business cannot go elsewhere. Only within limits is this so, but in any event Alaska cannot ignore applicable principles of fairness and of cooperative action among the states to avoid multiple taxation. Use of an extraction factor in Alaska when other states use a destination sales factor would obviously result in multiple taxation. Is it proper for Alaska to take deviant action and expect all the other states to conform their apportionment formulas to Alaska's in order to avoid multiple taxation? Is it appropriate for Alaska unilaterally to disrupt the progress the states have cooperatively been making toward uniformity in their apportionment formulas?

Professors Zeifman's and Ainsworth's proposal to replace the destination sales factor of the UDITPA formula with an origin-oriented extraction factor is based primarily on

ADDRESS TO SENATE RESOURCE COMMITTEE

SCSCSHB 322

(AN ACT RELATING TO THE ALASKA NET INCOME TAX)

MADAME CHAIRMAN, MEMBERS OF THE COMMITTEE, MY NAME IS OLIVER LEAVITT. I AM A RESIDENT OF BARROW AND SERVE AS DIRECTOR AND TREASURER OF THE ARCTIC SLOPE REGIONAL CORPORATION. I ALSO AM PRIVILEGED TO SERVE ON THE BOARD OF THE ALASKA FEDERATION OF NATIVES.

TWO YEARS AGO I HAD THE PLEASURE TO APPEAR BEFORE THIS COMMITTEE AND GIVE TESTIMONY CONCERNING A PACKAGE OF BILLS THAT COLLECTIVELY DEALT WITH INCREASES IN EXISTING TAXES OR IMPOSED NEW TAXES ON OIL AND GAS PRODUCTION IN THE STATE. AT THAT TIME WE ARGUED AGAINST THE IMPOSITION OF NEW OR ADDITIONAL TAXES AS UNNECESSARY AND COUNTER-PRODUCTIVE FOR THE STATE AND VERY HARMFUL TO THE ECONOMIC CONDITION OF THE NATIVE REGIONAL CORPORATIONS WHO HAD NOT SUFFICIENT TIME TO GENERATE A POSITIVE CASH FLOW IN CONNECTION WITH NATURAL RESOURCE DEVELOPMENT.

WHILE SOME MAY HAVE HEEDED OUR TESTIMONY IN 1976 SINCE THE PROPOSALS TO ENACT NEW TAXES WERE NOT ADOPTED THAT SESSION; A MAJOR INCREASE IN THE SEVERANCE TAX PASSED AND BECAME LAW IN THE SECOND SESSION OF THE 9TH LEGISLATURE OR LAST YEAR IN 1977.

WE ARE THANKFUL THAT SOME OF THE MORE REVOLUTIONARY AND

POTENTIALLY DAMAGING TAX PROPOSALS WERE NOT ACTED UPON.

SINCE PASSAGE OF THE SEVERANCE TAX INCREASE LAST YEAR SEVERAL VERY IMPORTANT FACTORS HAVE SURFACED THAT AFFECT THE VALUE OF PRESENT AND PROBABLY FUTURE OIL PRODUCTION FROM THE NORTH SLOPE.

MOST SERIOUS IS THE CURRENT AND PROPOSED PERMANENT TAPS AND TANKER TARIFFS WHICH ARE ALMOST 4.00/BBL GREATER THAN WE ANTICIPATED IN 1976. OF COURSE, THE FINAL TARIFF IS NOT SETTLED BUT IT MOST CERTAINLY WILL BE GREATER THAN WE BELIEVED POSSIBLE AT THE TIME WE CALCULATED THE THEN WELLHEAD VALUE OF CRUDE.

THE OUTCOME OF A PENDING LAWSUIT - STATE OF ALASKA VS. AMARADA HESS CORPORATION, ET. AL. - COULD HAVE VERY SERIOUS ADVERSE AFFECTS ON THE FUTURE OF OIL AND GAS REVENUES THAT MAY BE GENERATED FROM ASRC LANDS - IF THE STATE WERE TO LOSE IN ITS ARGUMENT AGAINST DEDUCTIONS FOR FIELD GATHERING CHARGES.

IF THE TARIFFS AS PROPOSED BY OWNER COMPANIES OF ALYESKA PIPELINE SERVICE COMPANY ARE SUSTAINED AND IF ADDITIONAL CHARGES ARE ALLOWED TO MOVE OIL FROM THE WELLHEAD TO THE CUSTODY TRANSFER POINT, AND AN ADDITIONAL TARIFF TO BRING THE LIKELY SOURCE AREAS FOR ASRC CRUDE TO MARKET VIA TAPS OR SOME OTHER ALTERNATIVE MEANS IS ASSUMED - THE HIGHEST OPEC PRICE TODAY WOULD PROBABLY NET BACK CLOSE TO NOTHING AT THE WELLHEAD. AS YOU ARE AWARE BOTH ROYALTY AND NET PROFITS ARE

CALCULATED FROM WELLHEAD PRICE.

OF COURSE THESE ARE EXTREMES BUT THERE ARE NO ASSURANCES AT THIS TIME THAT CRUDE OIL PRODUCED FROM ASRC LANDS WILL COMMAND A PRICE THAT WILL ADEQUATELY COMPENSATE ASRC FOR EXTRACTION OF ITS RESOURCES,

ONE OF THE MOST SIGNIFICANT AREAS OF POTENTIAL REVENUE FOR ASRC AND HENCE THE OTHER REGIONS THAT WILL SHARE UNDER 7(I) OF ANSCA IS THE NET PROFITS PROVISIONS OF THE VARIOUS AGREEMENTS WE HAVE WITH SEVERAL MAJOR OIL COMPANIES.

THE NET PROFITS INTEREST IS CALCULATED ON THE COMPANY'S PROFIT PER BARREL BEFORE FEDERAL INCOME TAXES BUT AFTER DEDUCTIONS OF ALL OTHER COSTS INCLUDING STATE TAXES. THE LOWER THE PRE TAX (FEDERAL) PROFIT THE LESS THAT ASRC AND THE OTHER REGIONS WILL RECEIVE.

ANOTHER IMPORTANT MATTER WE THINK THE COMMITTEE SHOULD WEIGH IN CONSIDERING THE DIRECT AND INDIRECT IMPACT OF INCREASED TAXES IS THE AFFECT IT WILL HAVE ON FUTURE LAND TRANSACTIONS THAT MAY INVOLVE ASRC LANDS NOT SUBJECT TO ANY PRESENT AGREEMENT.

OF APPROXIMATELY 5 MILLION ACRES TO BE CONVEYED TO ASRC LESS THAN HALF IS SUBJECT TO EXISTING CONTRACTS.

WHILE WE BELIEVE THAT SOME OF THE LANDS UNDER LEASE ARE HIGHLY PROSPECTIVE FOR OIL AND GAS, WE HAVE FOUND NONE YET

AND UNTIL WE DO THERE REMAINS THE CONCERN THAT MAYBE NONE OF THE LANDS BEING EXPLORED HAVE ANY SUBSURFACE VALUE.

THE NECESSITY FOR THE SUBSURFACE RESOURCES TO PAY OFF IN FAVOR OF THE NATIVE REGIONAL CORPORATIONS IS SO OBVIOUS THAT I NEED NOT EVEN BRING IT UP.

WE ARE VERY CONCERNED THAT AN UNSTABLE TAX POLICY THAT CHANGES EACH YEAR WILL BE AN OBSTACLE IN MAKING NEW EXPLORATION CONTRACTS ON THE 50 PERCENT OF ASRC LANDS THAT ARE AVAILABLE FOR NEW DEALS.

IN SUMMARY WE THINK THAT THE UNCERTAINTY OF THE IMPACT OF PERMANENT TARIFFS AND OTHER DEDUCTIONS TO THE WELLHEAD VALUE OF CRUDE OIL AND GAS SHOULD BE ENOUGH OF A CAUTION SIGN TO THE LEGISLATURE TO GET ALL THE FACTS AND SEE WHERE THE STATE AND ALL OF ITS PEOPLE STAND BEFORE HASTILY ADOPTING ADDITIONAL TAXES ON INDUSTRY WHICH GO FAR BEYOND A COMPANY'S POCKET BOOK - THEY WILL AFFECT AN AWFUL LOT OF THE PERMANENT CITIZENS OF THIS STATE.

THANK YOU

MILTON LIPTON TESTIMONY  
BEFORE THE JOINT RESOURCES COMMITTEES  
January 25, 1978

MILTON LIPTON ::

The comments that I would like to offer and then open up to your questions are based upon the draft for a bill that amends the leasing policy of the state. To begin with, I call your attention to a rather unique and I think a very progressive statement of the preamble which says that among the purposes of this is to maximize the state's share from profitable oil and gas production while minimizing revenue from unsuccessful exploration wells and from marginal economic oil and gas production. It is a most unusual approach for a state or a government that is leasing property to take....that is...what you are saying in effect is that you are not trying to maximize your revenues come oil or high water, but that you'll take your revenues from successful oil and gas exploration and you are prepared to forego under certain circumstances optimum revenues that you might have gotten from bonuses paid to the state where the venture was unsuccessful. I would think that the industry would look with great favor upon this as a principle of leasing, and as I said before, it's a most unusual thing to see a government proposing this itself.

A major change which is now being proposed in your leasing policy has to do with bidding methods and on page 4 of the proposed draft bill there are actually eight (8) different bidding methods itemized which would be available to the commissioner and from which he could select in any particular lease sale. The eight different bidding methods break down really into four different bid variables. The first is the very familiar front end bonus bid, and there are three (3) different ways this can be done.

The second is royalty bidding and there are two different ways the commissioner can do that. The third is bidding for a net profit interest to the state out of the proceeds of successful oil and gas exploration development and production. The fourth is bidding on the basis of work obligations, how much a company will commit itself to work obligations. As I said, the bonus bidding is the familiar one which has been used most commonly, I think, almost exclusively here in Alaska in which the blocks which are up for competitive bidding will go to that company that offers to the state the highest bonus, and then the terms of the lease specify certain fixed commitments on the part of the leasing company, in the past, it has been almost universally 12 1/2% royalty. Under this proposed legislation, if the commissioner can solicit competitive bidding on the basis of a front-end bonus but with one of three alternative sets of fixed commitments written into the lease. One is a straight royalty which shall not be less than 12 1/2%. Second is a sliding scale royalty, that is beginning initial production at one level and then moving upward. And the third is a combination of a fixed royalty and a net profit interest to the state where the fixed royalty shall not be less than 12 1/2% of the fixed profit, interest shall not be set by the commissioner at less than 30%. So in effect this deviates from your present practice only insofar as it gives the commissioner a choice of three different elements which he can write into the leases when he opens them up for competitive bidding on the basis of the bonus. The royalty bidding is quite different. Here the two alternatives are that the companies would bid competitively; offering, competing on the basis of a sliding scale royalty which cannot begin at less than 12 1/2% and which carries thereafter a fixed bonus. The bonus is fixed by the commissioner, the companies bid on what kind of a sliding scale royalty they are prepared to offer the state or alternatively there's a fixed bonus and they offer a

fixed royalty. They bid competitively on royalty not a sliding scale royalty, but one says I'll offer 12 1/2%, another one says I'll offer 15%, yet another one says I'll offer 18%..... A few words about royalty, competitive royalty bidding, in previous discussions with committees of this legislature we have argued that royalty bidding is not a preferred form of bidding, except under very exceptional circumstances. If, for example, you have semi-proven acreage where the volume of the oil to be found is reasonably calculable, and the risks are not that great, location of the oil in terms of distance from ports or whatever else is pretty well known because other production is close by, under those circumstances you might have royalty bidding. But under most circumstances we would feel that royalty bidding is not a preferred form of bidding. You remember from our discussion of severance tax that the nature of the royalty or of the severance tax is that it becomes a percentage of gross value. Taken off the top of the gross value without regard to what the profitability of the venture is and when companies don't have to pay a very large bonus, the bonus is fixed at a modest rate, everybody pays the same bonus bids, but competitively on the basis of the royalty there may be a tendency for companies in their exuberance to obtain the lease to push the royalty which they offer the state progressively higher, they don't know what their competitors are going to offer, so they stretch their bid in order to win the lease. And then subsequently it may turn out that this royalty to which they commit themselves and which must be paid on every barrel of production over the entire duration of the lease becomes a very burdensome one; it could lead to earlier abandonment. But this is particularly relevant, what I'm saying now in the context of paragraph "D" at the bottom of page 4, which says regulation shall be established for all bidding methods to allow reduction of royalty to compensate for these increasing costs in the later stages of production decline, to prolong the

economic life of the field. And then it goes on, it says that the commissioner cannot really abate the royalty before at least two years of production have transpired. But, I put it to you, that although discretion on the part of the commissioner to abate royalties is something which you had in your lease a long, long time ago in your leasing bill; although this may be good legislative practice and good administrative practice when fields are beginning to reach the end of their natural life and you would like to encourage the maintenance of production even if it means taking a lesser royalty; to have this in the statute at the time when companies are bidding competitively on the royalty and then there is a temptation to say, well, if we bid too high a royalty, we come running back to the commissioner and we ask for abatement of the royalty. So, you put the state, you put the commissioner in a very bad hole and and you have perhaps without intending to, you encouraged the companies to bid not the highest royalty that they think they can afford to pay in light of their exploration expectations, but to over bid because when worse comes to worse they will go running back for abatement of royalty. So I would think that if you are going to maintain this feature in the leasing law which says that in order to encourage the continuation of marginal production there will be the possibility of abating royalty then you certainly, I think, want to consider very, very carefully whether you want to have among the options, under which the commissioner can lease, bidding competitively on royalty. The third alternative or the third form of competitive bidding is bidding a percentage of net profit to the state. What this means in effect is that the companies who are bidding competitively to obtain a lease will say to the state, well, your lease requires us to pay a fixed bonus so we all have to do that and in another version your lease requires us to pay a fixed bonus, plus no less than 12 1/2% royalty whatever the commissioner specifies. Now, each company

bids competitively by saying to the state that after we have paid the bonus and after we pay a royalty of 12 1/2% of gross well head value on every dollar of production, thereafter, each year we convey to the state a percentage of our net profits and the companies bid competitively; the company that commits itself to turning back to the state the largest percentage of net profits is the company that wins the lease. Net profits can be defined, they are not defined in the statute, and I think correctly not so. The commissioner before any lease sale where the bidding component or the bidding variable is net profit, tells all companies who are entering the bidding precisely how net profit will be computed. It does not have to be and, hopefully, will not be the same way net profit is computed for income tax purposes. It is a notional concept of net profit which says you start with this gross value or whatever it is and you subtract certain specified costs everyone knows precisely without too great argument or debate how the accounting will be done in the course of the year and relatively simple accounting can be mandated by the commissioner before the lease sale. We have felt for a long time that the net profit bidding variable is a particularly attractive one, both in the standpoint of industry and for the standpoint of whatever government it is that's putting up acreage for lease. Not necessarily to the exclusion to other possibilities, but under certain circumstances a very attractive approach. What it does is, it removes a great deal of the capital available for exploration from the front-end bonuses so that the money that's available goes to productive work instead of just to front-end bonus. Where there is highly successful exploration the lessor, State of Alaska in this case, can expect to have very, very substantial revenues from the lease quite apart from taxation or anything else. Revenue from the

lease as the percentage of net profits. You might even think of net profit as a royalty based upon net value instead of a royalty based upon gross value. Sometime it's referred to as a net royalty or a net profit carried interest. What it means in effect is that the State of Alaska takes on a very considerable proportion of the risks in the exploration game. It does get a bonus but the bonus is a small bonus fixed by the commissioner as being appropriate to this bidding variable. And it may get, say, a fixed royalty but after that the larger proportion of the income which the state might expect to receive it would receive only if the lease proves to be a productive lease and how much the state gets depends upon how much oil or gas is found, what the value the oil or gas is, and how profitable the operation. So the state in a sense becomes a partner with the explorer in both the failures and the successes of the venture. But the state does not become a working partner, the state does not become an active partner, the state is not in the oil and gas business. The decision as to whether or not the exploration should take place, the competitive bidding on what the net profit conveyed to the state is... all of these are private decisions by private industry in a competitive environment. Then the final variable, and it is the eighth item among the alternatives available to the commissioner, is bidding on the basis of work commitments. And there in a sense, the commissioner says when the sale is being advertised, that there is going to be a fixed bonus, and there is going to be a stipulated royalty. Now the winner of this lease who is entitled to do the exploration is the company who commits the largest amount of money to exploration process. This kind of bidding, perhaps, would be utilized in very, very difficult environment areas where the state wants to be sure that all potentials of the acreage are really explored, where the costs of exploration may be very, very high and where in the absence of work commitments the companies may be inclined to back out too quickly in terms of the results of one

unsuccessful well or whatever the case might be and the state would like to get the best possible exploration of the prospects within the area put up for lease and therefore says to the companies, we will reduce your bonus commitments, we won't have a bidding on the basis of royalty, but we will allow you to bid on how much you are prepared to commit to the exploration of this acreage which the state is putting up for lease. Well, just a few comments, I've already indicated that I think, that we think, that gross royalty bidding except in rare circumstances, is not the most attractive form of competitive bidding, and particularly not if you are going to allow abatement of royalty under certain circumstances. Bonus bidding, net profit bidding, work bidding, each one a reasonable approach to competitive bidding depending upon the nature of the area which is up for lease; how the state, the commissioner, and his technical staff regard the potentials. So I think that by providing these alternatives, the state is in effect creating a reasonable basis for a leasing policy within Alaska. I wonder, however, whether it is necessary in legislation to itemize all eight possibilities, that is to say, a bonus bid with not less than a 12 1/2% royalty, or a bonus bid with a sliding scale royalty, or a bonus bid with not less than 12 1/2% royalty and not less than 30% net profit. There are many variations which are itemized here, and for example, a bonus bid with not less than 12 1/2% royalty, and not less than 30% net profit is hardly, I would suspect in most areas, is hardly going to get much competition in terms of the bonus. Why not less than 30% net profit? It seems to me that if you lay out in gross terms what the permissible bid variables are, bonus under certain circumstances royalty, perhaps net profit, work commitments, and then leave it to the commissioner as to the combination of variables and the minima for the fixed items he wants to put in there, how far can one anticipate in legislation itself, what combination of fixed commitments

should underlie the selection of a bid variable, like a bonus variable and I would think that perhaps it might be advisable for the legislature to consider presenting to the commissioner a greater option of more bidding variables and perhaps set certain minima, but not itemize them in the details which appear here. Now there is one other aspect of the bidding that I would like to refer to and it is an item that appears on page 9. It says lands which have been offered for lease within the previous five years, but which received no bids at public auction may at the discretion of the commissioner be immediately offered for lease under regulations promulgated in advance upon terms most advantageous to the state including leasing non-competitively. The commissioner shall utilize a sliding scale of royalty based upon such formulae as he determines to be equitable, but need not adhere to the rental schedule in subsection (k) of this act nor to the 57 (indesc.) acres per lease and so on. What I am calling your attention to is the option here available to the commissioner where a lease that is offered for bidding has not been taken up very quickly, to put it back for lease including under noncompetitive circumstances. I think that this could open up some dangerous precedents. Particularly if it's offered too quickly. I mean that the fact that a lease is not taken up in competitive bidding does not mean that there is no oil and gas there, it does not mean that the prospects are not good for oil or gas, it means that given the state of the knowledge at that moment of time, given the way the industry perceives the attractiveness at the moment of time they have'nt been interested in bidding on it.. They had other things that were more attractive, whatever the case might be. But let some time go by before opening this up for leasing again and particularly under competitive conditions again, what may have been learned about the geology of the state in the interim period. The way in which

company perspectives may have changed for a lot different reasons, I don't know what the case may be, I think may lead to the ability to lease under more favorable terms rather than for the state to conclude that nobody wanted our lease, well, we would like to have it explored anyway, lets get it on the market as quickly as possible, even if under noncompetitive circumstances. I would strongly suggest that you hear from the department, as well as from me, and others about why there is a sense of urgency about leasing noncompetitively just because the lease has not been taken up. I pass to other aspects than the terms of bidding and leasing. On page 5, there is a very pregnant one line clause which says the commissioner is authorized to withhold acreage from leasing in a particular lease sale. Now again, for those of you who remember one of the first reports we made for the legislature on leasing policy many, many years ago, one of the things that was discussed was the advisability, under appropriate circumstances, of the state leasing less than the full acreage in which there might be industry interest. Now enough acreage has to be put up for lease so that the companies that win the leases have a reasonable aggregation of acreage to provide for viable production of oil or gas or whatever is discovered. It doesn't necessarily mean that everything within a particular area of prospective interest has to be put up for lease simultaneously, there is good reason particularly if the purpose is to maximize the states share from profitable oil and gas production and minimize revenue from unsuccessful exploration wells and from marginal production for the state to withhold a certain amount of acreage. Now the acreage which was withheld may be condemned as absolutely sterile if the exploration around it finds nothing, (indesc.) the state may have withheld may turn out to be condemned by the industry you will never be able to lease it in which case you will not have gotten any bonus revenue

or whatever the case may be. But on the other hand, if it is successful you may come up with a subsequent lease sale with a net profit bidding for example, which makes it very attractive to the state in terms of the income that they will receive. So I would think that this thing is that the commissioner is not only authorized, but subject only to circumstances which make it undesirable which in case the commissioner has to exercise his judgement, that he should in fact withhold acreage it should be a more positive thing. I wouldn't want to make it binding under all circumstances. discretion must lie (indesc.) some areas where it may not be feasible where whatever acreage is put up really has to encompass the most of the structure which is in interest. If it can be done, I think it would be advisable to do so. The next feature that I would like to touch on briefly has to do with the period of exploration and on page 6 the appropriate paragraph says that an oil and gas lease shall cover a reasonably compact area and be for a period of five years. And there is no provision here for extension of the exploration period except under specific circumstances if production is eminent or a well has to be completed or the property goes into unitization. What under normal circumstances is a 5 year exploration period. I would suggest that there should be provision for at least some reasonable extension of the exploration period particularly in a country as difficult to operate in as the State of Alaska, where the geology, the environment, the climate, the circumstances all make it impossible to conclude an ongoing exploration period precisely within the five years. A whole exploration season may be lost because of a combination of circumstances; because drilling equipment couldn't get out there, or at the end of one season the

seismic work never got completed and one has to wait for the proper time of the year to go back and finish it and one loses a year of exploration. I would think it would be advisable to allow an extension of the exploration period. If in the view of the commissioner, good faith has been exercised by the leasing company in the previous 5 years. I think it does no violence to the interest of the state. But there is another very interest feature that's introduced here at the bottom of page 9, paragraph v, the state shall have the right to purchase not to exceed  $16 \frac{2}{3}\%$  by volume of the oil and gas produced pursuant to a lease, and it goes on. That is to say, the state is assuring itself that if it chooses, it can have as much as  $1/6$ th of the oil or gas produced on the lease. Now included within that would be the state's royalty oil and gas and the volume metric equivalent of whatever the state may get on a net profit share. But if those fall short of  $2/3$ rds of the oil and gas the state has the right to buy at the market value at the field price enough to make up  $2/3$ rds. There is no obligation on the state to do it, the state has the right to do it. I see a tremendous advantage of the state in this, I see no great disadvantage to the industry in this if exercised judiciously. It could be unattractive to the industry if it is arbitrarily applied and particularly out of small production where the lease holder really needs a substantial volume of oil to provide the economics for his export out of the state for example, and taking away  $1/6$ th of the volume of oil starts cutting things too narrow for him, then I would say that this could be a burden to any company who is undertaking the exploration and who successfully is doing the development. So I would think there ought to be at least some proviso where by the lease holder is protected against simply a determination to take  $16 \frac{2}{3}$ rd

no matter what, and in particularly small areas where the increment of the state gets may matter very little to the state but may matter very much to the producing company. I think some kind of clause should be put in to provide the protection.

That's the sum of the remarks that I think I could make about the special features of this proposed bill and if there are any aspects of it that I touched on or things that I have not chosen to talk to that you would like to address yourself to, I'm at your mercy.

SENATOR POLAND I will ask you one question Mr. Lipton, and that is, have you felt for sometime that our leasing policy needed to be updated or overhauled?

MILTON LIPTON Well, I think that if only to broaden increase, the number of options available for leasing, yes, I think so. I think the traditional front end bonus bidding and there is a lot to be said for it under the proper circumstances, and, but for this to be the sole basis of competitive bidding, I think it places a burden in rank wildcat areas upon the industry which is unnecessary, that you have to put so much money that ought to be used constructively, pay out as a bonus and it puts the state in a position where in many rank wildcat areas what the state gets is miniscule in terms of bonuses compared to what may be the profitability. If you add up the sum total of bonuses received by the state from the producing areas of Prudhoe Bay, it is miniscule bonus income because the companies were bidding on rank wildcat areas at a time when even if they were

successful no one ever knew if it could be developed, tremendous volumes of oil had to be found and if prices had ever stayed at \$3.00 per barrel it never would have been produced you see, under those circumstances obviously the bonuses are very very little. Now, I think there is no great virtue in the state having competition on the basis of front end bonuses when the total amount of bonus income you may get, particularly in the less attractive areas of the state. What seemed to be the less attractive areas of the state will be very very little and may prove to be the most attractive producing areas after they are developed. So that if you minimize the front end bonus under certain circumstances and go to a net profit interest then you have a chance of sharing much more considerably in the profitability of successful ventures and without doing great violence to the incentives of the industry. Because no company is going to bid away such a large share of the net profits that it leaves them without the incentive of very very profitable operations on the remaining shares. Now it is something which I think can be equitable both to the state and to the company. So yes, I do think that the leasing warranted amendment if for no other reason than to introduce a greater variety of bidding variables without going mad with you know giving the commissioner so many options that the poor man will never know on what basis he can make a selection. But I think to introduce several other options is a major step forward.

Q: Senator Huber - Milt, can you tell me from industries viewpoint if we would do any harm to this bill, in particular, or good or otherwise, your comments in regards to us putting an Alaska hire clause into the leasing requiring Alaska hire based not upon our regulatory rights but upon our proprietary contract rights?

Lipton: Senator Huber, you know, you ask me from the standpoint of the industry you really should ask that of the industry, not of me, but I would give you a very quick impression and if you put an Alaska hire clause, in, what it

means to the industry depends really on what you intend by Alaska hire. I mean there, if the industry doesn't have sufficient flexibility to obtain competent people, whatever their origin, then I think it does harm to the industry. But if the way in which it is applied is sufficiently flexible then I suspect not only wouldn't the industry object, but the industry would be delighted. You know, I think the industry would like to make the maximum possible contribution to Alaska hire. But it must be a very difficult thing to administer, I suppose.

Q: Senator Huber - I apologize for asking the industry viewpoint. I was asking basically for the economics of the industries viewpoint.

Lipton - Well, as I said the economics are affected depending upon how this either contributes to, or intereferes with the efficiency of the industries exploration and producing operations.

Q: Senator Huber - I was referring to a particularity in the difference between our regulatory powers as a government and our proprietary rights as a contract maker in this particular case.

Lipton - Well Senator Huber, this suggests to me that if you are doing this as part of a contract rather than by regulation, does that mean it's going to be less flexible, because it is in the contract?

Q: Senator Huber - Madame Chairman, Mr. Lipton, the intention is to make it less flexible because we are presently finding that our leases do not contain this and that hiring is not being done from the North Slope from Alaska where it could be done when there is qualified people sitting on the benches. And we want something to get a handle on this, so that it is not going to be struck down by the Supreme Court saying that you cannot make

such a law we want to work on our proprietary rights being that is our oil that we are selling.

Lipton - Senator Huber, I find it very difficult to give you a responsive answer because if you say that there are qualified people sitting up there who are not being hired, now obviously that is bad and if you had it in the lease they would be hired. On the other hand, if the industry may interpret qualified people differently. I don't know it's very very, it's difficult to say. But if the whole idea is to make it a firmer obligation through the lease that is one thing. But if you make it a firmer obligation and there is no flexibility then I think it could be very difficult.

Q: Senator Huber - Well Madame Chairman, I won't dwell on it but just one more short thing, so that you understand what I am talking about. When the industry on the North Slope makes a deal, with for instance, a Hawaiian corporation to supply them with the personnel and to do the hiring for them and then the hiring is done in Houston Texas we become concerned when there is qualified Alaskans sitting on the bench. But if we have a handle, a way that we can get a handle on this, using our proprietary rights we should be doing it, or trying to find a way to do it when we know that we can't do it with our regulatory rights and that is why I wanted to get your expertise on this.

Senator Meland - Madame Chairman, I, has Mr. Lipton spoken to any type of questions about all the legislature or are we just talking about (inaudible). Because I did have some questions that were left over from Wednesday, but we can certainly wait on that and talk about this legislation before us.

Senator Poland - Well what we had though we would do is talk about this and when there are no more questions on this we will go to the royalty oil proposals and then throw it open for all types of questions.

Q: Senator Radar - There are many question Madame Chairman. I had two items that I would like to have Dr. Lipton comment on. One of them is the concept of limiting from 500,000 acres to 200,000 acres the amount that any one entity can hold in leased lands and that concept actually appears in several faces in the bill. I assume it is to prevent or to insure a competitive market here so that we don't end up with one company dominating the field. Comment on this and give us your observations on that and what problems and benefits might flow from that.

Lipton - I think there is great virute in limiting acerage holding by an individual company. On the other hand, I have no feel really, for whether 200,000 acres as an amendment to the 500,000 alternative is too little or not. I would strongly urge that in order to acheive the same purpose, that is, I think that two things are of value. Acerage limitation I think could go in there. I don't think it does violence, providing that it is not so narrow that in a sense very soon you start reducing the number of competitors and a company that is successful in a couple of lease sales and then suddenly finds itself barred from further competitive bidding for acerage. You defeat your own purpose if you do that. But I sense that the purpose of the legislature and certainly the interest of the state is that acerage shall not be held. The purpose of winning acerage under a lease is to get on with the business of exploration. And therefore I would suggest that whether there is competitive bidding on work obligations is one of the options or not. I think there should be work obligations in every lease. The commissioner should in every lease stipulate minimum, not maximum work obligations. We are not trying to tell the companies how to conduct their exploration activities. But there should be certain minimum work commitments which the companies have to perform in order to hold that lease. Let them get on with the business of exploration. It does no violence to the purpose of the companies, unless they want to get in that bidding and then sit back and wait for

somebody else to do some work or they wanted to be sure they were represented in the area but they had other fish to fry elsewhere in the state or somewhere else. I think you have a five year duration of the lease and I have already suggested that you might be willing to extend it, if the companies really need it and they have been going about their business. On the other hand, there should be minimum work obligations in every lease there. I think also there is a certain virtue in putting a ceiling on the amount of acreage which a given corporate or individual can hold as a result of leasing from the State of Alaska. I certainly would not want you to cut that down so small that you lose the competitive bidding and the third, fourth and the fifth lease sale because one company has already not exhausted it's interest, not even exhausted it's dollars but has exhausted it's ability to hold acreage in the state.

Q: Senator Radar - Would you comment on the provision as to the lessee or permittee conducting any exploration for development or production of oil and gas, the state shall provide the commissioner access to all data obtained from such activities and shall provide copies of such specific data as the commissioner may request. I don't know whether that is intended to change the public disclosure of that information or whether there is still proprietary interests or not but what is your understanding of that provision and your comment? It is on the top of page ten. It starts on the second line.

Lipton - I assume that your statutes prevent public disclosure of this for some minimum period. What is it two years in Alaska. Two years, I think I believe. Two years by statute.

Q: Senator Radar - Cause I take it that the proposal here does not suggest that we alter that proprietary -

Lipton - I would hope not. I would hope not. I think the right to proprietary information for at least two years. For any company operating here considering the amount of money which goes into

exploration. I think that should be protected.

Q: Senator Radar - Well let me ask you this. Would that be true. I assume the reason for your statement is that a company therefore gets the value of it's own work product. But what if the state, for example, should for reasons unknown, at the time of exploration, should withhold in the leasing for a period of three years. Then under those circumstances we would have deprived the company of the value of it's own work product. I don't know how to avoid that but I can see a problem here and perhaps discretion should be available here. Although I am not certain as to the purpose of this particular section or what the discretion or the thrust of the discretion should be. Whether the purpose here basically is to give the state the right to deprive them of the work product, within two years or what?

Lipton - Well I don't know how you can set the period of confidentiality so that it conforms with the amount of, the lapse of time between one lease sale and another lease sale. I mean that is a pretty difficult thing to do. I don't think, see the point is the state has access to this information. It is just that the competitors don't have access to this information. And in that respect there is a certain value in extending the period of confidentiality to a reasonable period of time because the value of the information is not just for another lease sale in exactly the same area. There is an awful lot of information. It becomes valuable because one correlates it with what one knows from other wells elsewhere. One builds up ones geologic and geophysical knowledge as this stuff becomes public. So there is virtue in keeping it confidential for a reasonable length of time. But I don't know, one can't do it for too long a time or you deprive the industry as a whole of what is really basic knowledge necessary for it to advance. So there is some kind of a compromise has to be struck between the virtue of the confidentiality to the company doing the work and how important it is for the whole industry to know more and more about the State of Alaska.

Q: Senator Radar - Well let me ask you. You have suggested in a number of instances descretion in the commissioner. Do you think that in this particular instance that we should provide administrative descretion in perhaps, write in a minimum or maximum or something of that nature. Or do you think the two year -

Lipton - Senator Radar I don't think this is an area where the commissioner ought to have descretion. This is a protection which the legislature is going to give to an exploring company as they are taking the risks in putting it's money in. It depends upon the legislature to know exactly what it's protection is.

Q: Senator Radar - Well what if you wrote in a minimum of two years, an extension of that period of time before it was made public?

Lipton - Senator Radar, I don't know of any place where that exists. That of course doesn't mean that it's a bad idea. I don't know that it exists anywhere else. I am not familiar with it. I think normally two years is pretty ample time. Again I would certainly defer to the judgement of people in the administration you know they have alot more experience with what the circumstances up here in Alaska have been.

Q: Senator Huber - Madame Chairman, I would like to just ask Milton just one thing, one question that was raised here by Senator Radar and I would hope he would concur with me. Milton will you take a look into the matter that Senator Radar brought out to determine in your opinion how our laws stack up on this at this time and give us some kind of a report on it. I think I know and the question I would like to ask you would be if you thought that two years was the best period of time and compare this with our current law and give us another report.

Lipton - Yes. I would be pleased to.

Q: Senator Radar - Madame Chairman, perhaps if I might ask Dr. Lipton, he said he had no particular feel to the 200,000 acre limitation for single holdings. I might ask him if it is possible for you to develop a feel for that. At least give us your best judgement as to whether or not -

Lipton - Yes.

## MILTON LIPTON'S COMMENTS ON ROYALTY OIL

Lipton - Obviously you are waiting to see whether and if so what kind of a royalty contract is going to emerge from the Royalty Board itself. In the absence of any specific proposal and certainly, there is very little purpose to comment on the versions of the proposals that were presented early on. They were in preliminary form and a great deal of negotiation has been taking place during the last several months. So all I can talk about is something which has to do with the way in which you would look at a royalty contract if it is presented to you. I think it is germain but not all that direct. First of all just let me say and I guess virtually all those studies that have been done come to pretty much the same conclusion. That if you consider a given facility to process petroleum feedstocks from Alaska, if the facility could be built in Alaska or were to be built closer to the markets, say in the lower 48 states, the identical facility in Alaska will cost more to build.

There is very little question about that for a lot of reasons. The facility will cost more if it is built here than if it is built there. Secondly, that if you look at the transportation costs, if the facility were in the lower 48 say a refinery, and the crude oil is transported from Alaska to the refining facility below, the transportation cost of moving that crude oil will be substantially less than the transportation costs of moving the output of the facility in Alaska to the markets. Whether it is petroleum products or whether it is petrochemical fractions. Transportation costs will be very very considerably higher. So that when you contemplate the development of a refining petrochemical complex in Alaska based upon Alaskan feedstocks, one faces immediately this advantageous cost, both in construction and transportation. The basic question which anyone has to address himself to, whether it is someone who wants to contract for the use of the royalty oil or whether it's the legislature looking at his proposal, the basic question is, how do you offset this competitive disadvantage. How do you do it. And I put it to you, there are three ways in which it can be done. One if there

is something unique about the project. That is to say, the people have conjured up, have imagined, have created a concept which somehow is more favorable because it is in Alaska than it would be elsewhere. That is to say, partial use of products here, products going to various destinations elsewhere or a different combination of products, somewhere out of the product mix or out of the technology which creates that product mix you might be able to get an offset. Second of course is if the state gives a subsidy. That is to say there is a cost disadvantage here. Does the state want the other benefits of this kind of industrialization, whether it is employment or whether it is a creation of a tax base or the value of the products have been increased, or whatever the reason. Is this a sufficient reason for the state to give a subsidy. The State could offset the competitive disadvantage. The third possibility is that everybody expects that the competitive disadvantage has been taken care of and there is no subsidy required. But in fact it has not been taken care of. That is to say after five years of development and construction and operations begin it suddenly turns out that the competitive disadvantage is still there. One hasn't offset them and then, where does one proceed from there. If the facility is completed the oil storage tanks nearby are beginning to receive Prudhoe Bay royalty oil, operations are about to begin and suddenly one finds out that the marketing of the products is more difficult than had been anticipated. The price obtainable for the product is less than had been anticipated. What is the recourse. Well, I suspect that the people who have undertaken to contract for the royalty oil have made a very substantial investment will come to the state and say look this is something which is of interest to you. The state suddenly doesn't want a new industry here. To go by the boards what can be done and in a sense not an explicit subsidy but an implicit subsidy is built into the thinking about the project. I take a negative tack here because I start with the premise and unless we are persuaded differently we hold to this premise that here is a competitive disadvantage in this particular environment, looking ahead say to 1982 or 1983 when the products may come on the market, competitive disadvantage operating here in Alaska and therefore I would suggest for the legislature that they look at any contract which is presented

to them with a very very jaudiced eye. Now the environment will be changing and one of the things which we feel you must consider, is whether the environment for contracting for the sale of royalty oil is best at the present time or whether it will prove with the passage of time. That is to say, at the present time you face an over expansion of petrochemical capacity, world wide, in the United States, in Japan, in Europe, incoming capacity for various reasons over the next few years. If you look beyond 83, 84, 85, 86, the world oil environment begins to change . The surpluses of today will begin to be eliminated it will be shortages but it is going to get somewhat tighter and under those circumstances the advantage of an assured flow of feedstocks, royalty oil from the State of Alaska may be much more attractive than it is today where competitive pricing is more important than availability, because crude oil is everywhere available today. Now what I am saying in sum is, that if you look at the contract then with a jaundiced eye the benefits for the state and if there are no benefits for the state you don't even consider the contract. But if the presumed benefits for the state, the hopeful benefits for the state, are still surrounded by an awful lot of questions marks than I would think that you risk very little by saying no, let's postpone this commitment of royalty oil and let's keep looking further for how and when the optimum use of it can be done. Because one is committed you not only are unable to look beyond that to what may be better, but you also as they say face the risk that an implicit subsidy is built in to the operation. I guess my advice is look carefully, exercise vigorous judgement and you probably loose more by being precipitious and saying yes, than you risk by saying hold off and let's wait and see.

Q: Senator Radar - Dr. Lipton the argument has been made that it will take a certain amount of oil to amortize the investment for petrochemical or refining or something else, any kind of a break down process here or a creation of a local industry and if the longer we wait then the less oil we have to amortize that plant and the less feasible it becomes for the industry to enter, the new industry to enter, and the argument then further goes that

if that is the case and if your prediction is correct that a contract now which will really not be producing until perhaps 80 or 83 or perhaps even 85 very near the maximum production of the field, that now is the time to award the contract because of the lead time, to is necessary. If we wait until that market exists that the lead time added on to the market conditions which you predict, is such that we cannot expect Prudhoe Bay to build that industry.

Lipton - If the people, if the group with whom a proposed contract is negotiated and which is layed before are anticipating this by 1983, 84, 85, may very well be that the terms and conditions of the contract presented to you are sufficiently firm that you can look at it even with a jaundiced eye and say this is worth taking our chances on. What I am concerned about is that it will not be as yet. Now I am not suggesting that you wait until 1985, or 86 to commit royalty oil. But what I am saying is with a passage of a year or two years may firm up the judgment or bring forth a more concrete set of terms in a contract. I am not trying to prejudge what reaches you this session, all I am saying is look at it with a jaundiced view. Now if you wait two years you haven't consumed so much of the royalty oil patrimony that there is not enough left and also the, I would hate to think that the limit of the state's availability of it's own natural resources is it's 12 1/2% interest in the established reserves of Prudhoe Bay. The next oil discovery here the state will have access to 16 2/3% of the oil it is in your new leasing bill and there will be other discoveries here, there are already. So it is not as though if you don't do it now you are going to run out of oil in order to support that kind of a project. You wouldn't want to wait until half of Prudhoe Bay has been produced already, I am not suggesting that. But I don't think that a year or two is going to make that much difference in the total availability of the oil.

Q: Senator Huber - Is this the period now when we can ask questions that are not confined directly say to present petroleum royalty

leases or can I ask some questions about gas this time.

Senator Poland - You can. We weren't going to do too much about gas today, but you are certainly welcome to ask Mr. Lipton we will go into the question and answer period now unless someone else has a specific -

Q: Senator Butrovich - Well, before John gets on to the gas, would it be alright if I could ask Mr. Lipton a couple of questions about this petrochemical bit and you say there a (inaudible) on the market as far as the products that such a plant would produce if there was a plant in Alaska. What do you think would happen if the oil line had gone down the highway as the proposed gas line is going. Do you suppose that all of that oil would be going down to the lower 48 without a petrochemical plant somewhere along the way.

Lipton - Oh yes. I am sure of it. I am sure of it. Yes. There is no great incentive now for the companies that control the other 87 1/2% of the production to put that crude oil into petrochemical facilities. As a matter of fact one of the major producers in Prudhoe Bay has just withdrawn in Texas in construction of a major ethylene operation. There is a lot of surplus capacity around today.

Q: Senator Butrovich - You are in effect saying virtually what the administration is saying, or maybe they are not saying maybe I am just reading their minds, as far as a petrochemical industry in Alaska.

Lipton - What I'm saying is, look, Alaska by all counts is not an obvious place to put a petrochemical industry. It just isn't an obvious place to put a petrochemical industry. If you start initiating a petrochemical industry in Alaska you do it for a reason.

Now, one reason could be that the feedstocks are cheaper here in Alaska than somewhere else and that overcomes high construction costs and that overcomes high transportation costs. You go where the feedstocks are relatively low in cost. Well that's not true here. The feedstock is not low in cost here. That is the royalty oil is not low cost oil here as compared to what it would cost if it were transported by tanker to a different petrochemical location which is closer to markets and you don't have to pay high cost transportation to move the petrochemical intermediates you see. Alright. There is another reason for bringing a petrochemical industry to Alaska or some other location. That is to say, if there is a shortage of feedstocks and you can put a petrochemical facility in an area where because you put it there you get feedstocks which you couldn't get elsewhere. Then you go that route. That is to say if there is a shortage and the only way I can latch on to 150,000 barrels a day of Alaskan crude oil, I can't get it from the private producers in Prudhoe Bay because they have internal uses for it, it is highly competitive elsewhere. But if I come to Alaska by golly the State of Alaska will commit their royalty oil. Then there is a reason for doing it, that becomes a specific advantage. The access to the feedstock is a very valuable advantage. The trouble is we are not at that point yet. I don't think we are at that point yet. We are at the point now where feedstocks are readily available at highly competitive prices and where is the advantage of Alaska. Alaska is in the wrong place. Alaska will be in the right place when the tightness of crude oil around the world, the tightness of gas liquids around the world makes it very very attractive to negotiate with the State of Alaska and have access to the royalty oil. In other words, your royalty oil has a scarcity value where as today your royalty oil has no scarcity value and as a matter of fact suffers a cost, a price. It's going into a world where people are more concerned about price than they are about availability. When they are less concerned about price and more concerned about availability your royalty oil, your royalty gas, your liquids becomes very much more attractive. Now the question is where is this transition, how long is it going to take before the perception of

the attractiveness of it. I think that people who negotiating here are seeing it already. They are very anxious to tie up the state's royalty oil, that's why they are here and they are struggling themselves to figure out how can we get assured access to the state's royalty oil that is going to be very valuable in the future and overcome what looked to be a lot of these competitive disadvantages now. This is what they are working towards. They see it, that is why they want to be up here. Not because of the cost advantages.

Q: Senator Butrovich - Well, Mr. Lipton, you know we ship automobiles and television sets and everything else from Japan what is the situation for instance in Japan as far as petrochemicals are concerned? Are the products from petrochemical plants do they have all they need? I hate to display my ignorance but I don't know.

Lipton - No, no. You are asking a question that is very difficult to answer. There are groups here that are trying to build a petrochemical facility in Alaska who are trying to negotiate firm contracts for the sale of their petrochemicals in Japan. Now, I am going to give you a judgement, it is a judgement based upon our exposure and our experience and how we see things and when they come back with firm contracts from Japan I am going to look very very foolish. But, the way we see the eastern hemisphere petrochemical situation there is a very very substantial surplus. Japan has got a lot of capacity. Not only is there Japanese capacity in Japan but there is Japanese owned capacity or Japanese investment in capacity elsewhere in Southeast Asia. On top of that the Japanese who have always felt that they were at the mercy of foreign oil from other sources. They have no oil production whatsoever there. Virtually all the energy consumed in Japan is imported. Crude oil has got to be imported mostly from the middle east. The natural gas they have is imported as liquified natural gas and they are always worried about the assured availability of their feedstocks. Both the refining (inaudible) petrochemicals.

Now Saudi Arabia, Iraq, Iran are all anxious to develop petrochemical facilities for the same reason that Alaska wants to. But these are government owned operations now with huge oil reserves, and what they are saying is that if you will put your petrochemical facilities in our country you are assured of access to the feedstocks so the Japanese are negotiating with the Shah of Iran to build a big refinery petrochemical complex there. But you know it goes very slowly. It goes very slowly because the high cost of transportation of petrochemical products, intermediates and derivatives to the Japanese markets or the Southeast Asian markets is a stumbling block. This negotiation has been going on for years. What I am saying is that there is this surplus and I think it is going to be very very difficult to get the Japanese today to contract for the initial delivery for products in 1983 and to continue thereafter for 20 years thereafter. It is a devilishly difficult thing to do in this kind of an environment. If it can be done, I think it is magnificent. It is going to be very very difficult to get firm, oh, letters of intent galore. Yes, under proper circumstances competitive prices we shall be pleased under those circumstances to buy this that and the other. The letters of intent but a firm contract take or pay, I doubt it very much.

Q: Senator Butrovich - Madame Chairman, I hear what you are saying Mr. Lipton however, you did say that geography was against us and I couldn't agree more, but I also everything I read on the national economy has balance of trade. You can't read anything because some economist, some expert is saying that we correct the balance of trade all those little figures we look at in the paper every day are not going to include too much. I don't know whether they are right or wrong. We are in a position geographically to do something about balance of trade if it is practical and when you said that we were the victims of geography, that was an understatement. You realize that all traffic south from Alaska is empty traffic and all traffic north is loaded traffic and all raw products generated in Alaska, shipped to the South 48 and then shipped back to Alaska in finished product and