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SRES

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BEFORE

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(NOTEBOOK)

we pay for it. And of course I recognize that we are just talking about a drop in the bucket when we talk about Alaska consumption of those products but nevertheless I am not going to take out of my mind because if in fact there was a market that could take a great percentage of petrochemical products I am sure that the entire economy of our state would benefit. If we in turn didn't have to ship that stuff down south and then ship it back and pay the freight both ways on it which is in effect what we do now and it isn't confined to oil we do it with canned salmon and practically everything else that is generated in Alaska and it doesn't make living in Alaska any easier. We do it by saying that somewhere down the road in 10 years or 15 years we are going to correct it. It really doesn't satisfy me. I would want to hear a lot of pro's and con's on the matter before I would be willing to endorse any move by the state to preclude a lot more investigating even though I would like an answer day after tomorrow. I am not convinced (inaudible) possibility. Senator I hope nothing I've said implied that it can't be done or it will not be done. I wasn't when I talked about the changing world on a whole I wasn't saying that you have to wait 10 to 12 years. I do feel though that it would be irresponsible of me to imply that all is right with the world because we would like it to be that way for all Alaska. Everything you've said about the cost of transportation back and forth about the adverse balance of trade the advantage for Alaska in having retained within Alaska some of the products based upon your natural resources and at the same time benefit from the export potential. All these things I think, this is the basis on which people are struggling to put the proper kind of contract together and I appreciate the efforts that are being done. But realistically if I am talking to you I must express what seems to be our evaluation of the circumstances of the time. Also I would caution you that even if you go to a major ethylene operation, in Alaska, you must ask yourself, the consumer of Alaska, the population of Alaska has very little use for ethylene and very little use for propylene. The question really is going

going to be what's the next step of manufacturer and which are the finished products because what your people want are either finished industrial or finished consumer products here. Some of the industrial petrochemicals which can be used in Alaska will cost a lot less and some of the consumer products. The question is will you carry the process of transformation far enough in Alaska in order to do good for the Alaskan people. Now all of these things I think are what you want to look at. When you see a contract placed before you. But I think that out of a sense of desire or even a sense of frustration because things have gone so poorly for so long. I think for that reason I don't think one should close his eyes to question marks about a proposal that reaches you. I still think you should look at it very very carefully. On the other hand if you think all of these things are desirable, perhaps a certain amount of subsidization is not unwarranted by the state. That is a decision that you have to make and there may be a lot of other benefits that make it well worth while for modest subsidization by the state.

Q: Senate Radar - Along the same line I remember when I first came to Alaska I got a haircut. I don't remember what I paid for it, maybe it was a dollar and a half but I was used to paying fifty cents or something like that. I ask the barber you know, surprised, and there was no sign, well why the high price of haircuts. Well it is the freight. The longer I live here the more truth I appreciate was in that. But we have always thought that for instance everything, I doubt that there is a single thing in this room that is an Alaskan product. Everything here is shipped in, the only thing in this building that probably wasn't shipped in is the concrete, not even the concrete, the concrete itself was shipped in but there is a lock in sand and gravel in this whole building. And for everything that is shipped up here there is an empty van or capacity or something going back south to get another load. Which means that transportation costs in some sense as we have hoped that if what we were manufacturing here and again I think that

this is part of your statement depends upon the stage of manufacture in which we take it and whether or not we can use what are now empty facilities, in that I take it from what you say that we probably could not use the same type of facilities which brought the materials that made this building, the steel and everything here, I doubt that there is a single Alaska product in the building. Is it your thought that we really can't expect that to significantly change that problem which we are facing(inaudible).

Lipton - No, really all I am saying is that have a look at what is laid before you and see how it goes. Is it really what you want, and if the advantages are there, are there question marks. is there a never never land where you don't know where the state is going to come up on the balance and if that is the case all I am saying is, that I don't think that you risk losing everything if you are very very critical of the first thing that is laid in front of you. That is not the beginning and end of all possibilities for petrochemical development in Alaska. It may very well be Senator Butrovich, that the most advantageous basis for petrochemical operations in Alaska is not feedstocks derived from crude oil, but feedstocks derived from your natural gas. See that is another possibility, but that is a long way down the line. That can be a very long way down the line.

Q: Senator Meland - Senator Poland and to Dr. Lipton and this is probably something that's left over from last Wednesday when we were talking on the franchise tax. During the recess, I think that we had at that time, Senator Butrovich and I were discussing the taxes and not necessarily the tax on oil we were talking about the tax on fish also. I don't know if the friendship between Senator John and I, I know that he knows that I come from a location that has alot of seafood off it's shores and I know Senator John is very fond of seafood. But anyway we got to discussing canned salmon and there was a little song and I promise you Senator Poland that I won't sing the song. I am more of a bar

room singer than I am a courtroom type singer but I did remember some of the words and it went something like this and I scribbled them down and it says "I like humpback salmon little humpback salmon caught by a Sitka fisherman and I forget some of the words, but it still goes like this. I don't want a T-bone steak from a steer that is roped in Texas but give me fish and I don't give a damn if I do pay taxes." Now you know that is 35 years ago when I was singing this song and you know things have changed because we really do give a damn if we pay taxes. The question Dr. Lipton, I come from a small community compared to Anchorage, we are more a rural small town, rather than a large urban type. So it is not unusual that I spent alot of my time on main street talking to the same people day in and day out. The very simple question that you can probably answer it yes or no. But the question they ask me, they say Senator Meland now you are going to go over to Juneau pretty quick and I know you are going to be talking about taxes on the oil companies, can you tell me this, if the legislature sees fit to put an extra burden on the oil companies in taxation will that in turn mean that petroleum products that we buy will be increased to offset the extra taxation sort of thing. Well, the only answer that I can give them is that I don't think the oil companies are particularly benevolent in protecting society, they are to do business and to make money hopefully they do to have thousands and thousands of shareholders that hope that they do make money. Is this the case, we increase taxes but then does the consumer when he is buying his petroleum products eventually pay, that is the question, a very simple question.

Lipton - I will give you a simple answer. It is not complete. The answer is no. The answer is no.

Q: Senator Meland - Could you elaborate a little on that.

Lipton - The taxes paid by the oil and gas industry here in Alaska, advalorem taxes on their hardware, the severence tax on their production, the income tax on the profits they

make here. All of these things represent cost to the industry the same way other costs are. But the price at which that crude oil, which has been taxed by the State of Alaska, can enter a refinery, is not higher because of those taxes. They are cost to the industry, they effect the revenues of the state and the profits of the industry but there is no way in which a company producing crude oil in Alaska can get a higher price for a gallon of gasoline or a higher price for a gallon of number two oil, or a higher price for a barrel of heavy fuel oil, just because he has paid higher taxes here in Alaska. The Alaskan crude oil goes into refineries and has to compete with crude oil from other areas. It has no direct effect upon the prices paid -

Q: Senator Meland - Tell me this then. How do the large corporations and yesterday, we were talking about hundreds of millions of dollars and billions. Now I, with my high school education know that a billion is a thousand million. Am I right? I hope I am. Now of course until I read the Juneau empire I didn't know that a billion minutes ago Christ was still on earth. You know so it is mind boggling to alot of legislators, because most legislators come from all walks of life as you know. The figures that we use when we start talking about hundreds of millions and billions is enough to compound the most brilliant minds of industry, commerce, banking or whatever you say. But do you mean to say that over a 25 year life of a field and so that the taxes are increased like a 25 billion or whatever it might be, I forget the figure I didn't, I have enough notes here, but I don't think I wrote that down. But nobody pays, you mean the companies just can drop that and still do business?

Lipton - No. If the burden of taxation is such that it begins to deprive the companies of the profits which are essential for their operations then the product will not be produced. All I am saying is and please don't interpret this as an argument in favor of higher taxation. I am trying to give you a very honest answer to a very straight forward question. Alaskan

taxation on crude oil production here in Alaska, cannot be passed on by the oil companies to their customers because they operate in the competitive environment, anymore than they are able to pass on to the customers of California who buy their gasoline and who buy their deisel oil, who buy their burning oil. They cannot pass on the run up in the cost of building the Alyeska pipeline from an original estimate of 800 million dollars to a final figure of close to, with interest, 10 billion dollars. They cannot recover that from the customers in California, because there are enough people who are willing to sell gasoline to the customers of California processed from crude oil from other areas so that they cannot raise their prices competitively. This is a real cost to the companies. They can't pass this back to the state. They can pass it forward to the consumer. It comes out of what otherwise would have been larger profits. The same thing is true with the taxation here. Now, there is an exception. The exception is your gas taxation. Where there are contracts for the sale of gas to consuming sections of the State of Alaska and those contracts specify that an increase in state taxation shall be passed on to the consumer, than the consumer pays higher prices for the gas. But where you are selling petroleum products in competitive markets where the products can be refined from Alaska crude or California crude or Indonesian crude or Saudi Arab crude you can't get a higher price from the gasoline manufactured from Alaskan crude because it is too much competition on the market.

Q: Senator Meland - But prices generally could rise.

Lipton - If all petroleum prices go up. If all petroleum cost go up, or all crude oil taxes go up, then sure the consumer has to pay more. But the taxes here is Alaska cannot effect gasoline prices in California.

Q: Senator Meland - I think I understand exactly what you are saying. Not just Alaska but generally, and generally in large companies doing business -

Lipton - If Alaska were an isolated entity. That is to say if the oil produced in Alaska were refined in Alaska and were sold in Alaska and you had sufficient capacity to do that and you had high transportation costs from outside then increases in your taxes could be passed on to Alaskan consumers. They pay more for their gasoline. You are going to keep raising the prices only so high as it finally pays to import gasoline from California and put a ceiling on it. But so long as you are operating in this kind of a competitive environment, I must give you that answer.

Q: Senator Meland - Thank you and thank you Senator Poland, sorry I took so much time.

Lipton - That poem was worth everything.

Q: Senator Huber - I can't possibly get the interest of this Committee with my question. So I am in a very non-competitive position shall we say. First I want to start with the where John Radar and Senator Butrovich were and that has to do with the timing of the royalty oil processing to petrochemicals refining in Alaska. As, and I get from you that you say not quite yet. I mean we got time in this area and my concern is that I thought on the oil that it looks like we are at the 11th hour and 55th minute and on the gas maybe we are even closer to the 12th hour. That is what I am worried about because my figures show that Prudhoe Bay will start declining in oil production in less than eight years from now and at that time it would probably be impossible to start a petrochemical or refining complex in the state when Prudhoe Bay field is declining in production. I don't know I think the lead time is some 3 to 5 years or something like that to get the refinery and petrochemical complex built here. Aren't we actually late instead of early? That is the first question. The second one goes into gas.

Lipton - If you say that Prudhoe Bay production is going to

start declining, in what did you say 8 years. I said 8 years because it is a 9.8 billion barrel (inaudible)

Lipton - And you don't think that in the 9th year there will be as much production moving through that pipeline as in the 8th year.

Q: Senator Huber - Yes I think there will but.

Lipton - Why?

Senator Huber - Our production starts declining and we have to drill more wells to hold the production up. The field is beyond it's half way point. Can somebody afford to build the complex after that.

Lipton - Suppose you have three other oil producing fields that are feeding that pipeline before the peak of Prudhoe Bay production is reached. Why is everything uniquely associated with Prudhoe Bay.

Q: Senator Huber - Madame Chairman, is there some indication of that. I noticed on most oil fields on the lower 48 and the rest of the world 4 years or 5 after the discovery is made and the initial amounts of the oil in the pool are announced as proven reserves that there is changes, either downgrades or upgrades. I noticed in Alaska now, where a number of years since 1969, almost 10 and we are still holding at almost no better than 9.8 billion barrels of recoverable oil there. This is quite noticable.

Lipton - Senator Huber having spoken negatively to the response to Senator Butrovich's questions let me be very very positive. There have been other oil discoveries on the North Slope and there are resevoirs in the Prudhoe area for which at the moment there are no immediate production plans. Indeed if it turns out that there is a substantial volume of added production off the North Slope and we always optimistically

assume that from 1980 on the movement of crude oil through the pipeline is going to be on the order of 2 million barrels a day. Because we don't believe that the Prudhoe Bay is the beginning and end of everything. But if there is two million barrels a day moving for a considerable period of time and if as indications now are, a good portion of the incremental portion of the oil is going to be heavy oil, that may lend itself much more advantageously as feedstock to petrochemical operations than using what is coming out of the Prudhoe Bay field at the present time. It may be more advantageous as a basis for feedstock than it is to export at the California markets. What I am saying is that I don't believe that this is really a last gasp for Alaska. Perhaps I am too optimistic, I don't know. But I am not even saying that you forgo at the present time contracts for the sale of royalty oil. All I am saying is be critical. Look at them carefully. Similarly, if use is going to be made of your feedstocks from the state's royalty gas that may not come to for wish until 1984 or 1985, but planning is going to have to be done fairly soon. Because pipeline design and everything else which is involved will have to be initiated relatively soon. I am certainly not saying do nothing, just shuffle your feet. What I am saying is be cautious, be cautious. This is not that everything stands or falls on the basis of accepting as it is one particular contract, unless it is clearly advantageous.

Q: Senator Huber - I would like to pursue now, the natural gas. In the light of everything we have talked about on royalty oil, talking about natural gas and it's processing within the state at this time and I would like to revolve around the conditions that exist. The pipeline through Canada approved. The particulars of that being that the Canadians use the pipeline too and I believe that some of the other particulars are that the gas delivered to the lower 48 has to be at the 1,000 B.T.U. per M.C.S. level which is high methane and so forth. Do we have an opportunity in the natural gas to look later or are we going to lose our natural gas liquids and our C₂ fraction, our ethene to production in Canada and don't we have a different set of circumstances

here that if we produce it in Alaska which is the United States that we have something towards the balance of trade here. As I understand it that if we send the gas through the pipeline into Canada, to the lower 48, the only thing that the Canadians have to deliver to the lower 48 is gas of the right B.T.U. per 1,000 o M.C.S.

Lipton - No. Not so, not so.

Q: Senator Huber - If then they take out the ethene and the other liquids at that point or whatever it may be, but do we have another chance not to plan our petrochemical industry based upon natural gas now.

Lipton - First a factual statement. The gas that moves through the pipeline, there will be proprietary ownership of that gas. The Canadians can't do anything to that gas unless the owner of that gas agrees to it. There is nothing in the pipeline treaty, there is nothing in the statutes of Canada which permits them, at their option, suddenly to take liquids out of gas owned by someone else. Now if the liquids are valuable the people who own the gas are most apt to strip the liquids out, either in California or in the Great Lakes area, at the end of the pipeline. They will allow the Canadians to do it if the Canadians can give them very very high value for it but it will be more valuable on the U.S. end than it will be in Canada. But that is a minor thing. The real question you've ask I think, and the answer to that is, that yes, there is potential value to Alaska of the liquids contained in the Prudhoe Bay stream. It could be very very valuable and unless you plan for the use of it in advance you may lose the opportunity to hold them here in the state. Now there are two things that are involved. One has to do with the liquids for the entire stream of gas 2 billion cubic feet a day, a very substantial volume of liquids. This the state can encourage the use internally. It can negotiate, but what's of immediate interest, I think, is that in the royalty gas, that this not completely elude the control of the state

and as I had occasion to say previously, there is in the state's royalty gas a volume of liquids perhaps somewhere in the range of 6 or 7 thousand barrels per day out of the state's royalty share of a 2 billion cubic foot per day gas flow. Now that at least the state ought to be exploring. In other words if one can't think big and accomplish that, at the very least one doesn't want to allow everything to escape and the royalty gas is one thing that the state not only ought to be paying attention to, but on that scale I would suspect that it is perfectly feasible. It may be feasible on a large scale and that is something that has to be explored. But if not at least maximum access to the state's royalty gas and if necessary what you put back into the pipeline for export to the lower 48 states is a leaner gas stream with the liquids that are valuable to you extracted, say in Fairbanks.

Q: Senator Huber - One small clarification point and when you are referring to natural gas liquids you are including everything below the C_1 fraction, is that right?

Lipton - Yes, but I am not sure that they are all equally valuable. I mean ethane is used one way and propane and butanes are used quite a different way. If there is any natural gasoline that is a different story. Yes. That is what I am referring to.

Q: Senator Huber - I have been afraid that we may lose our ethane by definition because it is a dry gas that normally goes with the methane if it hasn't been extracted for commercial purposes, it's a perfectly suitable type like gas. I just want to make sure we are talking about natural gas. We are all of a sudden defining that. Madame Chairman, I wonder could I just defer to Senator Butrovich for a question.

Q: Senator Butrovich - Mr. Lipton you were saying that the plants would probably be set up in California or some place. Can you tell the Committee or at least tell me what is the royalty cost of moving dry gases compared to wet gases?

Lipton - I couldn't tell you off hand. An awful lot depends upon how tight the capacity of the gas line is. That is one thing I do know. If you have got alot of capacity in the gas line the difference in cost is immaterial. But if you are tight on capacity, the difference I couldn't tell you off hand. I just don't have it with me.

Q: Senator Butrovich - Do you say the difference in cost -

Lipton - If there is capacity in the line.

Q: Senator Butrovich - Well, of course I am speaking only of the line that would carry the gas down the Alcan.

Lipton - What I mean by capacity line is. A pipeline is designed for a certain maximum flow. At any particular time you may not be using the full capacity in other words (inaudible) If you are not running the line at maximum capacity, then I think it makes very little difference on how much of the pumpable liquids you have removed and how much you have left in the line.

Q: Senator Butrovich - I know nothing about that, but I have been lead to believe by other people that there is a great difference in cost in moving liquid gas as compared to dry gas.

Lipton - If you are losing the line of designed capacity, yes. I don't know off hand what the difference is, unfortunately.

Q: Senator Butrovich - Is there any place along the line that we could actually get that information.

Lipton - No problem, I will get in touch with my staff and I'll get you the answer.

Q: Senator Radar - Madame Chairman, I had a question along the same line if I might. We are being suggested, and I think it is the same line. That we should make a decision now on our

gas petrochemical industry so that there can be a design which is the most efficient a 7/8 design or an 8/8 design, a design which accomodates a line which would not operate at full capacity and therefore carry the liquids easily, or a line which would operate at full capacity and therefore more economic line and so on and so forth. It has been suggested at least to me by some people, that the decision to be made, should be made now, if the design of the Canadian pipeline is to begin now. Is that, how do you meet that kind of an argument or that presentation. Just comment on it.

Lipton - I think the immediate problem in design or at least before the design is too frozen is whether or not there are going to be facilities to off-take say a Fairbanks or wherever. This can be built into the design of the pipeline. Thereafter I don't think it is a matter of 7/8 or 8/8, the difference there implies that 12 1/2 % of the natural gas is taken out to be retained in Alaska. Now it is very difficult for me to conceive that Alaska is going to be able to use that full 1/8 of everything of the methane, the ethane, the propane, the butanes and everything else. That to me strikes me as an unlikely thing in view of your energy requirements even in terms of industrialization. What would you use that amount of methane for. Now you may have a methanol operation, that is a different story. Maybe you can conceive of the movement of the utilizing the methane for methanol operation. If this can be done, then sure it is going to effect the whole design of the pipeline, but the other possibility again, which I say that if the maximum can come to forlition at least the state shouldn't lose whatever it can get out of it and that is if you extract the liquids, not necessarily all the liquids you have a major extraction of the liquid component in the natural gas stream and you utilize that productively in the state the propanes, the butanes maybe even some of the methane and then pass on a leaner gas stream for export purposes you'll get the B.T.U. value of whatever you left there, even if you leave some of the ethane in you will get the B.T.U. value of the ethane, you will get the B.T.U. value of the

methane. But you have left for yourself the liquids which are more valuable per M.C.F. or per gallon than the B.T.U. value there and this is what you want to maximize on and that What I am really saying 's that if one can design an optimum operation so that all of the state's royalty gas is upgraded in value within the state than that 'is the ideal case. But if you can acheive the ideal case I wouldn't want you to forgo something less than the ideal case which is that you utilize the higher value of the liquids that can be extracted even if you must sell everything else for B.T.U. value.

Q: Senator Radar - I am sure you said it but I am not sure I heard it. Again we are being asked to make a decision at this time, as soon as possible here, by the Alcan people on a design basis to tell them what we intend to do with what we can take out of that line and use in Alaska for petrochemical or otherwise and as I understand your answer is that we are going to have to tell Alcan or Northwest or whatever they call themselves that until we have a petrochemical industry we can't give you that information and that at this time we don't have one and therefore they will have to design a pipeline to carry what they anticipate to be the production of the Prudhoe Bay field.

Lipton - No. You don't have to have a petrochemical industry. If they're asking you now, how much of that gas are you going to retain in the State of Alaska, I don't think there is any earthly way in which you can answer them today. You have to pursue what the possibilities are for the utilization and if you are talking about taking all of the state's royalty gas. You can take it for several different reasons. One because you can use the B.T.U.'s right in the state that is you just burn it as gas. Or alternatively, that if you break that gas up, the components of the natural gas will have greater value in the state than the B.T.U. value of it. For example propane uses bottle gas to be used for heating, cooking things in the villages in place of a fantastically high price which is paid at the present time. This is very very valuable in the State

of Alaska tremendously valuable. If you could use a methane for a methanol operation for export operations this would increase the value over the pure B.T.U. value if you just let it into the pipeline stream. But you have to know reasonably well what you can use the different components of the natural gas for. Now the maximum, to say we are going to take the full 12 1/2 % of the natural gas and keep it here in Alaska to say that for the pipeline people before you know that you can do it, might put you in a position where later on there is no capacity, although I don't doubt, I don't believe that. 8/8 of 7/8 of what, of what level of gas production, of what level of gas production. The State of Alaska can have some option on capacity as well, you know, it is not that you are going to design it smaller because you are going to take the gas, there may be some prorating of gas. They are not going to design, the first day that gas flows through the pipeline there is not going to be an optimum utilization of the designed capacity. The state ought to have some option on some flexibility on how much of that pipeline capacity it is going to use, but above that what I am saying is that if you can't early on, come to a fixed conclusion as to how all of the gas is going to be used at least you should be planning for the utilization of the liquids out of the royalty gas stream. At the very least and couple that with a certain flexibility as to what can be done later on.

Q: Senator Radar - But how can we get that option. How do we get that option. How do we preserve that option in the future as I don't understand the regulatory scheme and the federal decisions that are being made.

Lipton - Well they really haven't been made. There aren't any. The trouble is there aren't any now they are in the process of being made.

Q: Senator Radar - Yes but aren't those being made in irrespective of this reservation that we are talking about and won't they be made , I have a hard time saying yes, I would like to keep this option open. Unless you are saying that we should

keep it open. I am wondering can we keep it open other than by telling whoever is designing the gasline that we are going to take it off or we are not going to take it off or we just say that we don't know.

Lipton - Well I think one of the things, the way I suppose that it has to proceed is that you discuss a certain flexibility for the state in terms of volumes and you say to the pipeline people that when they go into negotiation over all of the terms and conditions of construction from the regulatory standpoint this is something that has got to be taken into account. I mean after all the state has a tremendous economic interest in this thing and I don't think you can be pushed completely aside.

Q: Senator Radar - Well let me ask you, as I understand an argument you have right now involves taking off oil in Fairbanks and that is that the pipeline was designed to carry the full flow of the production North of Fairbanks, South of Fairbanks and that therefore when they take the gas off in Fairbanks, they should pay the rate of the complete tariff to Valdez because of the fact that the design is there, the pipeline is there, it is going and the lesser, the fuel savings on the pumping they are only carrying a lesser amount is insignificant, as I say that is under litigation. Perhaps you want to comment on that. But secondly, it has been suggested to us that if we don't want to same kind of an argument and pay the full tariff of gas from Fairbanks to Chicago or someplace else whatever you are going to figure to be the terminus that we have to at this time tell the pipeline people whoever they may be the regulatory agencies, that we are going to take it off or else they are going to ask us to share in that cost in that unused capacity or whatever it is if we don't and therefore the time is upon us as Senator Huber says that the argument is being made that we are at the 11th hour if we are to avoid that problem. Perhaps you could consider both of them, maybe they are not problems, I don't know.

Lipton - Let me address myself to the 11th hour first. If you are at the 11th hour, you see, and decisions have to be made

and you are capable of making decisions, you should do it. But one can be at the 11th hour and not be able to make the decision, as the philosopher said there is some questions to which there are no answers. I don't think you can allow yourself to be put in the position where you make a definitive decision when the basis for it isn't there. Let me back up to the crude oil pipeline thing, it is an interesting analogy. I remember very well the long and arduous debates which transpired before this legislature on the subject of the right of way leasing for the pipeline. Now the discussion of the pipeline putting in facilities for the off take of oil for the use in Alaska along that route, that was made very very clear in legislative debate, right down the line. There was never any question that this was the intention and this was made very very clear. So that in a sense the operators of the pipeline were not without prior knowledge of the fact that along the route of the pipeline there would be off take and if they knew no other location along the route where there would be off take the one obvious place was Fairbanks. It might have been elsewhere as well, but Fairbanks was a pretty obvious place. So this was not a matter of all of a sudden they were confronted with a completely unknown thing. Secondly as far as the tariff is concerned the pipeline is not operating at capacity now and it is not a matter of their being deprived of ability to put oil all the way through the pipeline in a sense and the amount of oil which unbalances their system for what is it 12,000 barrels a day being delivered to Fairbanks it doesn't look to me as though this is a, I want to prejudge what is in the administrative process and I am sure it is going to go up in the courts but it would take an awful lot of convincing that the only economical basis upon which they can operate that pipeline is to charge the same tariff from Prudhoe Bay to Fairbanks as they charge from Prudhoe Bay to Valdez. The design of the natural gasline the analogy is well taken and it means that you have to have as much foresight as possible but I don't know how you can presume to give an intelligent and definitive answer in advance. Much as one would like to, how does one do it and therefore I say one has to explore what degree of flexibility

is available to the state in terms of access to capacity and again when we talk about capacity what's going to be the design capacity of the line. Is it going to be 2 billion cubic feet per day or more. It is going to be more than that I think for ultimate deliverability. Now there may be times when the amount of gas which can be delivered into that pipeline, I say at 2 billion cubic feet a day can include or exclude the state's royalty gas, depending upon what the level of production is from the wells. In other words if you have without royalty gas, capacity to move 2 billion cubic feet a day without royalty gas then you could produce over 2 billion cubic feet a day of gas if the well facilities will permit it. You've got flexibility at that end also. I don't think that all of the onus of deterministically should rest just upon Alaska and it's royalty gas decision.

Q: Senator Radar - Well, are you suggesting that we could use our conservation authority as to limiting, or as to setting the level production of the conservation matter to assist our economic determinations here.

Lipton - No. I wasn't suggesting that at all. What I was suggesting is that there may be flexibility in total amount of gas that is available. In that case one of the (inaudible) is involving your designed capacity say from Prudhoe Bay to Fairbanks to perhaps take a somewhat larger than 2 billion cubic feet a day.

Q: Senator Radar - As I understand it you are saying that resevoir mechanics would permit perhaps a 20% take off -

Lipton - It doesn't require 20% we are talking about 12 1/2%.

Q: Senator Radar - Yes but perhaps as high as 20% or more flexibility automatically just as a matter of resevoir engineering.

Lipton - Not necessarily at any moment of time. That is again a matter of production experience. It may not be the same in the

early period. It may be different when you start going to cap gas and so on. The only thing I am saying is that the State should make as many decision as it can. It cannot be coarsed into making decisions without knowledge that is not there. Therefore in the absence of that one shoots for a much flexibility as possible in the negotiations.

Q: Senator Huber - I would like to continue just a little more now on the same line. I guess maybe starting from the back. As of today Mr. DeLong is down from Fairbanks. He gave the Fairbanks delegation copies of the suit that they are now in. I don't want to discuss the merits of that suit but the suit is with SOHIO and it is exactly what we are talking about. Because of preempting what they say is capacity in the line as far as Fairbanks they say that it should pay the same rate all the way through. Now my problem now is that if we get in the same position in the gas line because our indecision or our lack of action becomes procrastination aren't we setting up the same identical thing inspite of the fact that we have got a blueprint in front of us. Let me ask a question to show what I mean Madame Chairman. I don't know whether it is of you or Mr. Lipton or who. But Mr. Lipton I certainly would like to comment on it. If we were not procrastinating now and say we can't make the decision at this time what are we doing forinstance to look at Big Delta as the takeoff point for the state's royalty gas and at that point we consider the total use of it because we have the Javerscreek coal field and the two of them can be combined to use the entire methane flow from the manufacture of menthanol. It is a good open area there is no problem with air pollution or anything at this time, lots of air movement in the area and plenty of water, plenty of ground water, plenty of cooling. It would be a very good area for a petrochemical industry. Now, Madame Chairman, if we don't try to look at that in a way to move the product to market, we have an unused Haines pipeline there in and Southeastern certainly needs the economy from that. It is sittin there empty. It could be used just as easily to carry the products

out, liquid products, including methanol. Here is something that looks like it is synergistically available to us and a way to do it if we don't wait, but if we wait until that is planned capacity, has made it so that the gas transportation is going to cost us a lot more money than we have decided that our product is forever going to be sent to a foreign country to do it and then sell it back to us or to the lower 48 without getting maximum use or even maximum benefits to the entire country not to mention Alaska. So if we aren't doing that now as (inaudible) unless somebody tells me. Have we got a project down by somebody to look into it. We haven't so when does our indecision, because we can't make a decision now, become procrastination, or is it going to straighten itself out. We need to do something. But what.

Senator Poland - I do know the state is having a study done on the liquids. Beyond that I don't know.

Senator Huber - I am just worried that we are studying it to death. Because if we aren't at the 11th hour and the 55th minute now or the 59th minute I don't know where we are. Mr. DeLong of North Pole Refineries seems to think so. He talked all during the lunch hour to the Fairbanks delegation in regards to this. He isn't just the only one I have told my other people that the Department of Natural Resources has not been interested in talking with us and that included the methanol story now for a number of years. These people come down here and they have spent their money before. They have told me that we are no longer interested in spending money by coming to Alaska and knocking on the door when the Department of Natural Resources will not even listen to what we have to say. They say we have got other plans, we are not interested. Yet if we are truly at the 11th hour or the 11th hour and the 59th minute we got here by our own indecision which is nothing but plain procrastination.

Senator Poland - Mr. Lipton we very much appreciate the time you have been able to spend with us now and to give you something to really work with before you come back to see us in the Spring.

Senator Meland - Madame Chairman could I, before you leave do you want the words to I like humpback salmon, I will give them to you.

Lipton - I would like that very much.

Senator Radar - The tune is even better than the words.

TESTIMONY OF MILTON LIPTON
BEFORE THE HOUSE/SENATE RESOURCES COMMITTEES
January 25, 1978

MILTON LIPTON: Let me just suggest very quickly the kind of topics that I would like to discuss with you and the things I will lay before you briefly before I subject myself to your questioning, because I think the committee is much more interested in addressing the questions to me. But very briefly, there are three things I thought I would discuss with you bearing upon the subject of the income tax legislation which is before you. The first thing is the income tax issue itself, why it is an issue, and what the alternatives are facing the legislature. The second is some discussion of the overall tax burden here in Alaska which is imposed upon the oil and gas industry producers, and then, third, a comparison of the bills that originated in the House and in the Senate, what the pros and cons of each would seem to be, what the implications of each are.

Well, then, on the subject of why the issue of amending the income tax, it seems to me that, by now, after years of discussion, there is rather general agreement that the present method by which the State of Alaska's corporate income tax is administered with respect to the oil and gas industry is deficient. I say generally agreement. We, of course, as consultants to the legislature have been saying this for some time. I believe that in the last session, when the submission on taxation was made by Sohio, it appeared as we have said before, that approximately 25% of the income from Prudhoe Bay operations, as estimated first by ourselves, then by Sohio, approximately 25% was actually allocated to the State of Alaska by the present method of apportionment. Now there is before you a submission on a comparative state tax burden study by Arthur Andersen.

I will say more about that in the context of the total burden of taxation. But it's interesting that in their own analysis, using their assumptions, that the net income from TAPS and Prudhoe Bay of the four companies that comprise the largest percentage participation, in both the producing operations and the transportation operations, over 25 years, according to their assumptions, and the assumptions are carefully spelled out, they estimate that the net income from production and TAPS transportation will aggregate about 37 billion dollars over the 25 years. Their own estimate of the income allocated to the State of Alaska by the present apportionment formula under your present income tax law, would be 16 billion dollars. That is to say, less than 50% of the income which they estimate to be generated in Alaska, would actually be allocated to Alaska. If you applied your income tax rate to their estimate of income generated by Prudhoe Bay production and TAPS transportation, the aggregate taxation that would accrue to Alaska would have been \$3.5 billion dollars over 25 years. Under the allocation system they estimate that there will actually be paid to the state about \$1.5 billion. So the deficiency, then, in the income tax statute as it is now applied to oil and gas, comes to about \$2 billion dollars by their estimate. This is why I say there is now fairly general agreement that the application of the apportionment formula to an oil and gas producing industry in Alaska under the conditions that obtain here in Alaska results in this kind of a deficiency.

Now, there are alternatives which can be taken. One alternative is the approach that is embodied in the bill passed by the lower house here, which essentially redefines corporate income, which has to be allocated among the states....Alaska, and changes the apportionment

formula. This is one possible approach, and it is designed to yield higher corporate income tax payments from the oil and gas industry. A second approach is that of the bill that was before this committee of the Senate in the last session, and this involves separate accounting of oil and gas producing and transportation operations in Alaska to arrive at the income generated by those activities in Alaska to which there would be applied your regular, statutory corporate income tax... I'll return later on to discuss these two alternatives.

But there is a third alternative, and this alternative is that the Legislature may decide not to amend the income tax statute. This, in fact, is urged upon you by the industry, and the industry's position, I believe, is that the aggregate tax burden in Alaska is already the highest among the major oil producing states in the United States. By inference, this says that the deficiency in the income tax statute in the allocation of income to you, the deficiency in your corporate income tax receipts from the oil and gas producing industry is at least and probably more than made up by higher severance and ad valorem taxation which the Legislature has already imposed upon the industry. Now, this is not without relevance, I believe. It says something about the revenues that Alaska is already receiving; it has economic implications for the companies making up the oil industry both in Alaska and outside of Alaska, and therefore for the kind of decisions that they will be making. So I believe that there is a relevance for the Legislature in looking at it, and looking at it carefully, what the aggregate tax burden is, how it is built up, and what the implications are, and so I turn to that now.

I had this study by Arthur Andersen and Company only as long as it took me to fly from New York here; it's 12 hours from airport to airport so I had a fair amount of time to read this and other material, but I read it once and I must say that it all made the 12-hour trip pass very very quickly. What I say now about the study, I say tentatively but my first reading of the report suggests that it is a carefully prepared, highly useful document. I think it's been done in a highly professional manner and I don't believe that there is a real quarrel with what Arthur Andersen has done in any respect. One has to be careful in interpreting what the implications are, and I want to discuss those with you, but so far, insofar as they spell out what their assumptions are and how they built up their model, I think it is correct to say, as they conclude, that the aggregate burden of taxation on the oil and gas industry in Alaska is higher than in any of the other states. What does that mean? First of all, it's higher as measured by the technique used by Arthur Andersen; that is to say, they apply the statutes of other states to Alaska and to selected oil and gas operations in Alaska, that is to say to the Prudhoe Bay producing field with the model they constructed and the profitability of the Prudhoe Bay field for Sohio, British Petroleum, Exxon, and ARCO, and they applied it to TAPS and they measured what the presumed tax liability would be for these four participants for this Prudhoe Bay and TAPS operation and they said "What would have been the liability of those companies if in fact the California statutes applied here in Alaska, the Louisiana statutes applied here in Alaska, or the Texas statutes applied here in Alaska?" and their conclusion from one of their models, the simplest of the models, was that if the burden of taxation in Alaska

is 100%, then the California tax regime would lead to tax liability that would be 92% of Alaska's, eight percentage point difference; Louisiana's 85% of Alaska's. Well, absent Alaska, you get some interesting differentiations among the other states. If Alaska's not in the picture, California would be the highest, and Louisiana would have a tax burden only 93% of Alaska's, so there is always somebody who is at the top and there's a range of differentiation among them, but nonetheless I think the figures are revealing. More importantly, however, I think it raises several questions which you the Legislature must answer. The questions are easy to phrase; you must answer the questions. From the standpoint of a state perspective, oil and gas operations in Alaska differ very significantly from those in California, Louisiana, and Texas. First of all, oil operations in Alaska are very highly concentrated in production - production of oil and gas - and the transportation of oil and gas within the state, transportation related to the actual production. Highly concentrated in this respect. California, Louisiana, Texas have oil operations which are very much in balance. Production in each of the states, major producing states, but refining in all those states, major refining states, marketing, consumption of petroleum products in each of those states, all integrated operations of the companies operating there. So that, in effect, the way in which the taxation as applied to their industries is a reflection of the fact they have all aspects of oil industry operations reasonably balanced within their state. Secondly, each of these states has highly diversified economic and industrial activity. California, a major oil producing state, has important agricultural industries, important industrial activities, and important trade, service, and financial activities associated with all of that. Texas the same thing, an important

agricultural state, an important industrial state. Louisiana the same. What I'm saying, in effect, is that Alaska, or California, or Texas, or Louisiana, any state, conceives of its tax regime, what kind of taxes it levies, how it taxes various industries, and which specific tax it selects for different industries, especially extractive industries, must be related to the economic and industrial makeup of the state itself, and to say that Alaska has the highest burden of taxation is meaningful, but it must also be viewed in the context of what the economic and industrial composition of Alaska is also, and to say that the burden of taxation is to Louisiana taxes one of Alaska would be somewhat less is not to say the Louisiana legislators would have that complex of oil industry taxation if Louisiana looked like Alaska, or if California looked like Alaska. But these are questions which you yourself must judge, that the burden of taxation is meaningful, but it must also be construed and appreciated in the context of what the economic and industrial structure of your state is. Now, from the standpoint of the industry, whether the tax is unduly burdensome or not is not solely determined by whether the Alaskan taxes are higher than California's or Louisiana's or Texas', but whether they are so onerous that they militate against investment, particularly investment in exploration and development, and I put it to you that so far, there is in fact no indication that that's the case. Now, the Andersen study is uniquely oriented, as I said, to one aspect of oil and gas operations in Alaska, albeit the most important one at the present time, that is to say the Prudhoe Bay production and TAPS transportation, and I think their conclusions are highly relevant and I think meaningful in that respect. I would like to lay before you something which we had said from the first time we appeared before this Legislature to discuss taxes.

We did not think from the beginning that your tax policies had to be uniquely constrained by the Cook Inlet experience. We did not think that your tax policy ought to be carried away by the exuberance of Prudhoe Bay. We thought your tax policies should be oriented pointing to a continuing incentive for the development of the potential oil and gas resources of the state. Now, what the Legislature has done over these years is to consider three different types of taxation imposed upon the oil industry which have different implications... For example, you have amended your severance tax over time. Now we've always said that one of the characteristics of the severance tax is that it's an impost on the gross revenue achieved from a producing operation, on the gross revenue, therefore it is not sensitive to the profitability of production, to differences in producing fields, and for that reason there has to be an almost natural ceiling of how much of the gross revenue you take away in the form of a severance tax before you start interfering with the incentives of industry to develop marginal fields. But this Legislature has also, in its wisdom, taken that into account, so that for some time now, you have had a severance tax which is graduated, and in a sense differentiates in the burden of severance taxation between fields which may have the same gross revenue but which have one of the highest peak rates of severance taxation among the oil producing states of the United States, one of the peak rates, that's the peak rate only for those producing operations where well producibility is very high. You have a uniquely low severance tax rate for those producing operations whose well productivity is very low; as a matter of fact you have what I believe no other states have, which is a complete abatement of severance taxation for marginal production in this state.

So that if you apply other states' taxation measures including severance taxation to what is the optimum circumstances of producibility at the present time in Alaska, wells that are producing on the average between 5 - 7,000 barrels a day, you turn out to be comparatively high, but if you carry this out for marginal operations in Cook Inlet excepting only insofar as the cents per barrel aggregates the problem that we talk about in a different context, you don't have onerously high severance taxes compared to other states. The income tax we've always suggested to you is the least onerous form of taxation insofar as it affects investment decisions by industry, because it doesn't impinge upon the margins. The income tax liability only goes up when profitability goes up. So there are qualifications to the way in which one must regard the simple statement that the total burden of taxation here in Alaska is already the highest. It is the highest if you compute it with the most productive operations in the state; it would not be so if you looked elsewhere. Nonetheless, I think it's true that insofar as the state's budgetary needs or revenue deficiencies are always seem to be made up by oil industry taxation, this becomes a disabling and discouraging thing for investment. If it is perceived that this is the way in which the taxation proceeds in Alaska, that if there is a budgetary need or a revenue deficiency that almost with regard to the continuity of taxation or the principle of taxation, the incremental revenue or budgetary needs will come from oil industry taxation. This can not be a matter of indifference to companies that have their choice of operating one place to another. And, if too frequently changes in taxation are dictated only by budgetary needs or revenue deficiencies, without regard for continuity in the tax regime of the state, then I think it can be disabling.

Now, nothing I said here should imply that Alaska ought to go ahead and amend its income tax. But neither does any of the evidence that I've seen that's placed before the legislature convincingly militate against review of the income tax, particularly if you choose seriously to consider amendment to the income tax which tries to offset the existing deficiency in your statute. If you do that, and you do it clearly in the context of the longer run tax treatment of the industry; for example, if it conduces to greater stability in your severance and ad valorem tax policy; that is to say if you amend the income tax to bring your income tax revenues more nearly into line with the actual income generated from oil and gas operations within the state, and if this, in the mind of the Legislature, is not just an addition to the aggregate load of tax revenues from oil and gas operations over the next 25 years, but is conducive to greater stability, that is to say otherwise it militates against what might have been alternatively increases in the cents per barrel tax, for example, then I think it could be a feature not only which increases the revenue for the state, but probably is more conducive and more constructive for the industry as a whole in terms of their ability to project the tax regime under which they operate. What I'm addressing myself to here now is not so much an aggregate increase over all the tax revenues from the oil industry - this is something you must decide, whether it's required, whether it should come - but the suggested amendments to the income tax as a constructive change in the overall panoply, the whole series of taxes which you impose on the oil industry.

Before I discuss the two specific bills before you, let me just say that, repeat an argument that you've heard, that any deviation from the commonly utilized apportionment formula will lead, for the companies

operating up here, to some form or another of double taxation; that is to say that they will be taxed on income earned up here in Alaska or apportioned to Alaska, and that if a formula or separate accounting is used that differs from what other states do, then in fact, one place or another, the companies will be paying taxation to two states on the same margin of oil and gas operation. It is cited, I'm sure you've seen this figure, that of the 44 states that have corporate income taxes, 40 use the formula. But of the 40, four of those 40 have themselves, in the infinite wisdom of their own legislatures, altered the formula. It's not the common formula that's used by all of them, 4 have altered the formula, New York, Florida, Massachusetts, Wisconsin, use sales as one of the factors in the formula, you know the property factor, the payroll factor. These four states still use the sales factor, but they've increased the weight of the sales factor to more than one-third, for reasons that their own legislatures considered to be appropriate to their own states, as I'll have occasion to mention, Oklahoma and Indiana use separate accounting for oil producing operations in their states under specified circumstances. And then in many of the states the definition of income which then is going to be apportioned by formula, differs from state to state. So there are variations already; there really isn't this unique uniformity which say that if Alaska deviates, it is outside of the fold. And as I said before, where there are these deviations, the selection of separate accounting, or in so many of these states, differences in the burden of taxation because California uses ad valorem taxation, has no severance tax, other states where they have severance taxes would not allow ad valorem tax, other states have combinations of them, some states don't even have corporate

income taxes. Where these differences occur obviously there are differences which are related to the economic and industrial structure of the state. I would like you to consider the things we're now going to say about income taxation in the context of the specific problem which you face here in Alaska, that you have a disproportionate amount of all oil and gas activity, largely focused on one function, which is the production of oil and gas and the related function of the pipeline transportation.

First, on the senate bill on separate accounting. What I'm going to try to do, again, is briefly discuss what I feel are the plusses and minuses, the advantages and disadvantages of the alternative approaches and you will bear with me if I'm repeating things which you have heard before. The issue has come up many times.....I would say that a major advantage of separate accounting is that it provides a direct determination of the income generated in Alaska by oil and gas producing operations. This is the function of separate accounting - to give you an independent estimate, independent determination, independent judgment, which means that when you tax that income under your corporate income statute, you are taxing the income which by definition, by calculation and by reporting has been generated by activities of the industry here in Alaska. This I say is a major attraction, advantage, a plus of separate accounting. I think there's another advantage for the state, not only in terms of the income tax itself; I think it provides meaningful data on the profitability of industry's producing and transportation operations here in the state which would be helpful and useful to the Legislature in its review of all oil and gas taxation. You would know something about this particular industry which is so important in your state and its profitability against which you can

review every aspect of taxation, not only the fact that you apply your income tax rates directly to income generated in the state. On the other hand, this is the negative aspect of it, I suppose. There are administrative difficulties. The administrative difficulties begin, of course, I think the greatest ones are probably the determination of expenses, the deductions, and depreciation, and the difficulties become particularly acute when the expenses or the expenditures represent transactions within a major corporation, that is to say, purchases by an Alaskan affiliate from an out-of-state affiliate which are the prices involved, the costs involved are they (IA) Why the problem of administration? It is said that companies can fool around with their tax returns when costs in Alaska are not actually out-of-pocket costs but payments due to other corporations. I have to assume, I don't know whether the Legislature agrees with it, I would have to assume that the personnel both of oil companies reporting tax accounts to the state of Alaska and the personnel of the revenue service here in Alaska auditing those accounts are all honorable gentlemen. I wouldn't assume that there's going to be malfeasance in the actual reporting. But the problem is more likely to be that where regulations laid down by the revenue department allow discretion on the part of the reporting company, they will, within the range of discretion permitted by the regulation, always choose those figures, those numbers, which minimize their tax burden in Alaska. Obviously they will do that. The question then is, to what extent can your regulations narrow the range of discretion and at least roll up a reasonable allocation of costs to the revenue and the gross profits generated here in Alaska. So far as TAPS is concerned, this is not a special problem here in Alaska, because TAPS is going to be

regulated elsewhere and the costs, their depreciation and the determination of profit of TAPS for better or for worse will fall under the jurisdiction of both the Federal government and the Alaska Pipeline Commission. But in any event, I would put it to you, that if the formula as now applied only yields 25% of the Sohio estimated..... only allocates 25% of taxable income to the State of Alaska, there is such a margin of advantage to be gained than improving upon the form of state corporate income taxation, that there could be considerable leeway for discretionary movements of costs back and forth before you are really disadvantaged; that is to say I believe that the administration can adequately be done and the margin of discretion not so great but that you would still have a major net advantage to the state. Now, it's been said that this separate accounting is impossible to administer. I've heard said that as a matter of fact there are representations and...(IA) before you that the quotation is impossible to administer and determine. As I mentioned before, there are two states that actually utilize separate accounting. For better or for worse, it can be done, it can be. There are problems there, but there can be adequate administration not too complicated and range of discretion may not be something you can entirely avoid, but within the range of advantage to the state. There's a second area, problem area of administration, however, that's worth very careful attention on your part and that's how do you arrive at the value of the oil before you start deducting the costs, depreciation charges, to arrive at the profit for a producing operation. How do you arrive at the value of the oil as the basis for calculating income?

Well, you do it already. It has to be done now for purposes of royalty and production tax calculations. So for better or for worse,

you do have a valuation of your oil at the wellhead for which you can derive, through separate accounting, an estimate of the producing profits, the producing income. But what if the value of the oil at the wellhead is depressed by low prices obtained for your oil at the refineries in the lower 48 states to which it goes. What if that happens? If the price obtained in California, or in Texas or Louisiana, if these are depressed prices, then your wellhead values are also depressed, for royalty purposes, for severance tax purposes, and they will also be depressed for income tax purposes. Why depressed? U.S. regulations, which may depress, so long as we have price control, which may depress the netback value. California's surpluses would require higher transportation costs to move it to the Gulf. A lot of things can interfere with your obtaining as high a value as you think might be warranted at the Prudhoe Bay point of production. What can the state do about it? But the basic concept is whether you want to accept that or not. That is to say, if Alaska's income tax revenues are going to be related to the profitability of production, and if the reality of operations are such that somehow the wellhead values are depressed by adverse marketing circumstances, whether it's by U.S. government fiat which sets price controls or whether it's California surpluses or whatever, this is a fact of life. Now, the separate accounting technique does in fact expose you to the uncertainties of the value of the oil produced. If the value of the oil produced in the future improves through a combination of circumstances including the virtual elimination of U.S. government price controls over the years ahead, increase in world oil prices, increasing tightness in world oil balances sometime in the 1980's, all these will work to the improvement in the value of your oil in its

markets, and also at the wellhead, and it will improve the profitability of the producing operation and this will be reflected in your corporate income tax revenues if you apply your statutory rate to a separate accounting of profitability. At a point in time when, as today, the value of a good portion of your oil is depressed by circumstances beyond the control either of the companies or the State of Alaska, this would give you lower corporate income tax revenues from separate accounting than would otherwise be the case. But now lower revenues than you would get under your present apportionment formula.

One of the arguments, one of the criteria which has always been stipulated as an important principle of taxation by the industry and I think considered by the Legislature also, is how equitable is the burden of taxation among taxpayers, how equitable is it among taxpayers? I put it to you that you cannot through your present income tax statute get an equitable burden of income taxation upon the companies operating here in Alaska, not through the apportionment formula. You can get equitable burden of taxation through separate accounting, because in effect what you say is that we will tax each company 9.4% on what, on that company's profits or income generated here in Alaska, Under your present statute, the burden of corporate income taxation is very inequitable here in Alaska, very much so. Industry hasn't said much about it, but it is so and the best evidence of that is in the Andersen report itself, where again they have for the four major participants in Prudhoe Bay and in TAPS calculated both the profitability, the income of those four companies, according to their model, and what the tax liability of those four companies would be, it leads to some very astonishing results. For example, the Andersen estimates of Exxon and ARCO's profits from their parallel participations in Prudhoe Bay and in TAPS, is over

25 years of operation, 343. The tax liability, if it were proportionate to equities of these companies, they have the same equity, the tax liability would be \$343 million over the 25 years, Exxon, \$343 million, ARCO, \$343 million. Applying the income tax liability under your present statutes, Andersen estimates that Exxon will pay \$530 million taxes in the state of Alaska. ARCO will pay \$208 million to the State of Alaska. Both with the same income from the producing and transportation operations, but with a tax liability that differs over 25 years by as much as \$300 million. This is a corporate income tax statute that you have which not only is deficient in raising the corporate income tax revenue for the state proportionate to the profits generated in the state, but which produces an inequity such as this between two taxpayers who in Prudhoe Bay and TAPS would actually be earning approximately the same profitability on their operations.

Turning to the house bill, and I'm going to compare the two, one against the other in just a moment. If you turn to the house bill, there are three interesting, three features, which depart from the present statute. The first one is a change in the definition of the corporation's income which is going to be allocated. The second is a change in the formula which takes care of the allocation. And the third is a change in the definition of what goes into the formula which is at least by inference intended to bring with the tax regime of Alaska or expose to Alaska corporate income taxation a portion of the profitability of oil companies operating in the Federal offshore areas but serviced from Alaskan (JA). The change in the definition of corporate income that's going to be allocated is a simple one. It says in the bill that the income to which the apportionment formula will be applied will be either

book income as reported to stockholders by the corporation that's operating here in Alaska, that is to say its world-wide income as reported say in its annual report to stockholders certified by its own public accountants, or taxable income as reported to the Federal government or federal income taxation, whichever is the larger. There can be several reasons for moving from your present base of allocation to book or to federal. One is whether or not the Legislature believes that the definition of taxable income as laid down by the Federal government is the definition you want to accept. You heard the arguments in the last session of the Legislature that the Federal government, in defining taxable income for oil and gas operations, provides a whole series of possible tax advantages which in effect tend to reduce the taxable income on which the Federal tax is computed and you use that and reduce the taxable income which is allocated to Alaska. Well, this is a question for the Legislature to decide, whether or not the Federal concept of expensing of intangibles, which is probably the most important one, or accelerated depreciation, or whatever is involved should enter into tax base or into taxable income or not. These things could be changed, that is the basis of your present statute, if you want to say that companies can't expense intangibles, that they'll have to capitalize and depreciate intangibles for purposes of Alaskan computation. But the other reason, which I think is a more pragmatic one, is just taking one or the other, whichever is higher, gives you a higher base upon which to make your allocation. Very pragmatically, what it does is it increases the income of the corporation in the eyes of the revenue department of Alaska when it starts applying its allocation. It's just it would yield a higher total income for apportionment. Now, the change in the formula for apportionment involves the

elimination of the sales factor and its replacement by an extraction factor. As you've all heard, the sale factor militates against the apportionment of income to Alaska because the bulk of the oil and later on the gas produced in Alaska will not be sold in Alaska so you have relatively low sales in proportion to the profitability of the producing operation. And so you have small sales factor, and by averaging process, you have a small apportionment factor as a whole. If you substitute for sales extraction, you will then be taking into account the volume of oil produced here in Alaska in proportion to the corporation's total production of oil and gas.

Now, it looks on the face of it as though this approach is a cleaner approach from an administrative standpoint. Book value, as determined by the corporation, book income as determined by the corporation, without any reference to the Federal taxation or the Alaskan taxation or anything else. They're reporting what they think is the appropriate income to their stockholders, the State of Alaska takes that and, since most corporations will almost inevitably, not always, but most often show higher book income than Federal taxable income, it's a safe bet that if you have your choice of the best of either one from year to year, you're going to be increasing the whole thing. And you keep the formula except you change one factor. But I put it to you that I don't think that the administration of either the income base or the formula is really as simple or clear cut as it seems. First of all, if we choose either book value or Federal tax--book income or Federal tax income, whichever is higher each year, this would be determined by your revenue department and it means looking behind the figures to a certain extent, there will be variations from year to year, back and forth adjustments, I submit there are a lot of difficulties which may

be involved. It will have to be monitored. I don't mean to exaggerate the difficulties, but neither do I think we should exaggerate the simplicity of administration. The extraction factor can cause very, very serious doubt. The volume of oil and gas produced in Alaska on a (I.A.) basis is probably fairly easy to estimate company by company. You go to the world-wide production of oil and gas by these companies, you are moving outside the regime of the U.S. and you're looking at oil production and increasing the gas production under institutional and governmental arrangements which not only vary fantastically from country to country, but are in a process of change over time. For example, if you went back 10 years when virtually all the production of major internationally integrated companies was under concessions, it was very easy to compute what their gross production of oil was and what their net production of oil was after a royalty sale. But now, concessions are increasingly disappearing, so the concept of equity oil is disappearing. You have production under work contracts, profit-sharing contracts, production-sharing contracts, joint-venture contracts, and the way the company is compensated, whether it be in dollars or in oil, and the definition of whether that oil is owned by the company or is lifted by the company in behalf of the national oil corporation and moved into international trade on behalf of the national corporation, these are fantastically difficult things to disentangle. And I suspect that when it comes to getting the denominator of this factor in your apportionment formula, oil and gas production in Alaska as a fraction of world-wide oil and gas production, there can be many difficulties. And the problems will have to be resolved, not just once, but almost year after year is the circumstances of operations in the different

companies in the world, the Middle East, and in the Far East, and in Latin America, and in Europe. The answer is that you've got a pragmatic approach in the house bill that I agree would...all of the revenue department calculations, would yield higher tax revenue; I suspect that you really don't know how much more it would yield. You don't know how much more because the effect of the change in the definition of taxable income and the change in the formula can only be obtained if you go back in history. If you look over the last 5 years, you know what the difference would have been in those past 5 years, but it's very difficult to know what it would have been over the next 5 years or the next 10 years. You've got a pragmatic approach which says we are raising the taxable income which we're going to allocate, we're going to improve the allocation formula, pragmatically we're pretty sure that is's going to yield higher income tax revenues from Alaska.

Now the third feature is the bringing into the numerator of the formula the property, payrolls, and extraction, the appropriate offshore figures if in a sense the servicing is from an Alaskan base, and if there is not obligation to another state, which says in effect that Alaska will have allocated to it a portion of the unitary corporate income world-wide allocated to Alaska, not only in proportion to the property paid on the extraction from the State of Alaska itself but also from Federal offshore areas which are proximate to Alaska and served from Alaskan bases. This is a straightforward concept the legalities of which I leave to the lawyers. You must decided in your wisdom whether or not you want to attempt this or not.

Well, I've tried to touch on the highlights of these alternatives. Now let me simplify by making the comparison and telling you what in my judgment are the most relevant differences between them.

First off, either one of them, if adopted by the Legislature, would increase substantially the state's corporate income tax revenue. Either one of them. I think there's an available estimate by how much the separate accounting would. I don't think one can get quite that close in the other case, in the case of the House Bill, but either one would increase substantially the state's income from the corporate income tax. Both of them, I think, involve complications of administration. I don't think either of them involve administrative complexities so great that that should be the reason for the Legislature to say, "No, we won't adopt the House Bill," or "No, we won't adopt the Senate Bill." There are administrative complications, but I don't believe that these are complications so great that that should be the decisive consideration in the mind of the Legislature. The revenue department could administer either one of them, and whatever the complications may be, there will be certain uncertainties and there will be costs of administration, but there could be an adequate degree of administration, I think, of either one of these bills. I don't think the choice between either one should rest upon administrative difficulty - you shouldn't reject them for administrative difficulty, accept one or the other because of less administrative difficulty.

The big advantage of separate accounting, as I said before, its unique advantage, is that it addresses itself directly to the income generated in Alaska. This is an important feature of the bill, and I think there's an advantage for the State of Alaska in taxing the income that is generated here and measured directly here. As I said, not only is the basis of your income tax, but also because it gives you a fix on the circumstances of the industry with respect to all forms of taxation.

Now the industry may fear that this leads inevitably to higher taxation in all directions. I submit that's not necessarily so. There are times when your direct approximation of industry profitability may cause this or successive Legislatures to go slowly on oil industry taxation when you have the realities in front of you. The purpose is not to get higher taxation, but it gives you a direct fix on what the profitability of the industry's operations are. In contrast, and this is a very important feature of the House Bill, and also of your present law incidentally, it largely, it largely isolates the income taxed in Alaska, and hence the Alaskan corporate income tax revenues, from what happens in Alaska. In other words, you're getting your share of the corporation's world-wide income. Now, if Alaskan profits go up, okay, their world-wide profits go up, but you get a very small share of that factor. But if Alaskan profits go down, therefore the corporation's world-wide profits go down, but not by a very big percentage, and what you get allocated to Alaska is what you get in your income tax revenues, is largely isolated from the impact of adverse events here in Alaska. Now, your present statute does that also, because you work with, again, with Federal taxable income allocated by formula, and in the House Bill, you work with book income as reported to stockholders, a change in the formula. You largely isolate your income tax revenue from what specifically happens to the profitability of Alaskan operations, because you're taking a share of world-wide, and you're taking it by a fixed formula. What happens in Alaska doesn't have that effect on the world-wide operation of many of these companies. Now, is this a plus or a minus in the eyes of the Legislature? That's for you to decide. From the standpoint of revenue, it isolates you. From the standpoint of a form of oil and gas industry taxation which has the least effect upon decision making, upon marginal

operation, and so on, the closer you get to true income when you tax it, the better you are off. But you submit yourself to certain uncertainties. You take the plusses when profitability is higher, you suffer the minuses when profitability goes down, or does not go up as high as you would have liked it to have gone up, where your budget estimates anticipated it would go up. Separate accounting gives you your revenues on the direct taxation of the income generated here, or the estimate of it given the vagaries of all administration accounting. The feature of the House Bill is it largely isolates you from the specifics of Alaska's oil and gas profitability and the income generated directly here in Alaska. And of course the third distinction is that the House Bill could bring taxable income and income tax revenues to Alaska indirectly from off-shore operations, indirectly insofar as the offshore operations proximate to Alaska raise the total earnings of the corporation. and your formula is improved by getting their property and payrolls and production off-shore into your apportionment formula. It could give you indirectly both taxable income and income tax revenues from those operations. Again, the Legislature must decide whether this, from a standpoint of revenue, is attractive to the state of Alaska from the standpoint of relations with other states and with the Federal government, and attempt to extend the range of taxation of Alaska, whether this is something you prefer to do or not to do, but this again is a legislative choice.

Now, what I try to do in summary, as you consider these two bill, is to make these four points. One - either one of them will raise quite substantially the income tax revenue from the companies operating here in Alaska in production and transportation. The feature that stands out in separate accounting is it gives you a direct fix on the income generated by operations within the state. And that of course, I think, is of value

to the Legislature quite above the tax, knowing that. The feature of the House Bill is that it isolates you from the uncertainties of the income generated directly here in Alaska, gives you a share through apportionment, or through allocation, of the corporation operating here, a share of that corporations world-wide income. A fourth feature of the House Bill does not attempt to extend the jurisdiction of the Alaskan corporate tax regime to the offshore areas by a change in the numerator of three factors of your apportionment formula.

I've exhausted that particular material I wanted to call to your attention, and I hope I haven't exhausted your attention span. Now I'll place myself at your mercy and whatever questions you have.

QUESTIONS AND ANSWERS OF MILTON LIPTON
BEFORE THE HOUSE/SENATE RESOURCES COMMITTEES
January 25, 1978

Q. POLAND: I'm going to lead off with the first one, and it has nothing to do with income tax, because it's an issue that I know is going to come before us this session and that is the floor, cents per barrel.

LIPTON: The legislative history cents per barrel was introduced simultaneously with the step schedule of severance taxation at the last moment at the time when the legislature was most concerned that unanticipated high pipeline tariffs would depress wellhead values, resulting in lesser income than the state would like to put into its budget over I think it was a 2-year period when projections were being made in the cents per barrel being produced. Let me just say that from the revenue standpoint, it's a tremendous problem to the projections that the State has to make from time to time and what seek and what it's going to get from oil and gas operations. The establishment of the floor, it gives you assurance that whatever happens, this is the least that you're going to get. But it also says something that you don't say in any other aspect of your severance tax legislation, namely that the State abstracts itself from the realities of the environment in which the oil companies are operating, that come hell or high water, whether the industry, for whatever reason, is

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able or not able to get the wellhead value on which the State's percent of wellhead value tax is calculated, the State would get at least that. It's clearcut as a revenue measure. It denies the principle of taxation which is built into the percent value. It says that the higher the producibility of the wells, the greater will be the tax imposed, percent of that gets higher; as your producibility goes down it gets lower. But let me just give you some facts on how it's operating today, the cents per barrel. Now the example that I'm going to give you is based upon restricted production because of the pipeline problem up at Prudhoe Bay, and we have used by our calculations what you're using, the assumption that average production per well is 5,000 barrels per day. This is under conditions of restricted production. Now, there are two cases which we've taken in order to illustrate the way in which it operates. We've taken what I would call a "best netback" case, which in effect is a close approximation to where a company such as ARCO would be producing, out of it's share of 5,000 barrel per day wells, and marketing it's oil in California, so that it gets a relatively favorable netback; that is to say when you're finished selling your oil at over \$13/barrel to refineries in California, you pay your ocean transportation and your pipeline costs, you come up with a wellhead value of something slightly over \$6.52. Now, under those circumstances, the severance tax liability of a company such as ARCO operating under those circumstances, is about the same whether they pay cents per barrel or percent of wellhead value. It comes out to around 62.6 or 62.7¢ per barrel. This is what they would pay in severance tax to the State of Alaska on the basis of it's production from the 5,000 barrel/day well. And that works out to about 9.6% of wellhead value, in either case; that is to say the break-even point, the point of indifference whether you're percent of wellhead value or cents per barrel is around, the break-even point is very close to \$6.50,

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and so they would be paying 62.6-62.7¢, and that's about 9.6% of wellhead value. Now if you take the opposite extreme, take a company such as SOHIO, which is producing and selling its oil in the most distant market, the US Gulf Coast, and you deduct very high ocean transportation costs, including trans-shipment to get through the Panama Canal, and you deduct its pipeline tariff, and all of these are based upon the company's own pipeline tariffs, which they are in effect charging at the present time, then you get a netback value of something under \$3.80. Over \$6.50 to less than \$3.80. So far as these two companies are concerned, these are realities of life. The one company, able to get its oil at a good price in California with relatively low transportation costs having a netback of over \$6.50; the other is equally a fact of life, the inability to market all of its production with a very substantial volume of oil, a significant proportion of its total, having to incur high transportation costs to the U.S. Gulf, and then netting back less than \$3.80. It will pay exactly the same severance tax, 62.7¢. It will pay the same severance tax because the cents per barrel floor is operative. It will pay the same severance tax. That severance tax is 16.5% of its wellhead value, which is actually higher because it's on a cents/barrel basis than the top of your range in your severance tax bill, which is 12.25% of escalating value % of wellhead value. So here you have the contrast between the implications for the State of Alaska and the implications for the producing companies. For the State of Alaska, the floor, the cents/barrel, provides guaranteed income a part, and the devil take the economic circumstances under which the company is operating, whereas, in the companies, they in effect, have to commit themselves to the severance tax liability, despite the fact it becomes a very large proportion of their wellhead value. I pointed this out

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previously in the case of Cook Inlet, where the problem was not the ability to dispose of the oil with differences in netback values, where the problem was a distinction between upper tier oil and lower tier oil imposed upon the producers in Cook Inlet by the administration of price ceilings by the federal government, where your cents/barrel floor became very very onerous some of the particularly low profit operations in Cook Inlet, simply because the cents/barrel was an exaction from them for the purposes of your revenue, but became a very large percentage of what the value of their oil was at the wellhead by virtue of federal tax regulations. Now, this is a dichotomy, you know, this is a dilemma that one can't get away with. If the state wants underpinning in terms of its severance tax revenues and opts to do this by cents/barrel route, it inevitably is going to involve inequities and tax burdens upon certain producers either because of federal controls on the process they're allowed to sell it on, or because of the economic facts of life that only a certain proportion of the production has to go to a distant market at a relatively high cost themselves; which to a very considerable extent they absorb, although to the extent that it depresses their wellhead values, it affects your royalties, although not your severance tax revenues, so, this is a dilemma which you face, whether or not you will insist upon protection for the state's revenue, and the devil take the economic reality, or whether you go the other route. Now I suspect that there's always a compromise in the way in which these things are determined upon in the course of amending your regulation, and it certainly, I would think that the cents/barrel which you adopted in the last session of the legislature, that is to say the particular amendment to the severance tax bill which you enacted last session, was designed under normal circumstances not to impose onerous

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

LIPTON: (INTERRUPTS) (16.5)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

LIPTON: Louisiana and Oklahoma

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

LIPTON: I would doubt very much if you'll have all the facts, but I think you may have, the first thing I think you have to listen to more than anything else is just what the facts along this line are going to be, what are now the alternatives to the companies involved in the construction line.

How do they see their own alternatives. What is the Federal Government realistically thinking about. I don't think the Federal Government is

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

SUMMARY OF MILTON LIPTON TESTIMONY
BEFORE THE SENATE RESOURCES COMMITTEE
January 25, 1978

Prepared by REED STOOPS
Senate Resources Staff Assistant

Tax
Deficiency

Milton Lipton initiated his presentation by illustrating a deficiency in Alaska's present corporate income tax statutes. According to the Andersen Report, the total net income accruing to the four major oil companies over a 25 year period from Prudhoe Bay production and TAPS transportation will be \$37 billion. Current methods of apportionment would only subject \$16 billion to state income tax. At a taxation rate of 9.4% that means \$1.5 billion in income tax revenues under current law as opposed to \$3.5 billion if the entire net profits were subject to state income tax.

Alternative
Approaches

Three alternative approaches to correct the "deficiency" discussed were the oil and gas corporate franchise tax (CS HB 322) which redefines corporate income and changes the apportionment formula, a method of "separate accounting" (SCS CS HB 322) for the oil and gas industry, and maintenance of the status quo.

Andersen
Report

He then offered the following comments on the Arthur Andersen Report, a comparative state tax burden study, prepared at the request of the Alaska Oil and Gas Association:

- (1) The report is highly professional, accurate, and conclusions relevant "as measured by the technique used...". The Alaska tax burden is higher than the other seven states analyzed, but only as the tax law relates to Prudhoe Bay.
- (2) The other states used in the comparison are different from Alaska in that the industry here is concentrated heavily in production and transportation and we lack the economic and industrial diversity present in the other states.
- (3) Whether or not the tax is "unduly burdensome" to the industry is not solely determined by relative rates of taxation, but by whether the tax structure "militates against investment." "...so far, there is in fact no indication that this is the case."

Severance
Tax

The income tax also should be placed in perspective amongst other types of taxation imposed by the state. The severance tax, applied to gross revenues from oil production, under current law is graduated and differentiates between fields with the same gross revenue but different producing characteristics. Therefore, Alaska has a high peak tax on highly productive wells, but also a uniquely low tax rate on marginal wells. As Prudhoe wells produce on the average of 5-7,000 barrels a day, the tax rate is high. On Cook Inlet, the tax rate is relatively low.

Continuity
of Tax
Policy

He notes that the income tax is the least "onerous" to the industry as it effects investments. But the state should guard against creating a perception that its tax policies on oil and gas are subject to continual change as our budgetary needs change. Continuity of the tax regime is very important to investment decisions by the industry. Therefore any change in the income tax should be done only in the context of a long term policy which creates greater stability in Alaska's severance and ad valorem tax policy.

Apportion-
ment
Deviation

Before comparing the House and Senate approaches, Lipton briefly discussed the argument that deviation from the current method of apportionment will lead to inequities or double taxation. Of 44 states with corporate income taxes, 4 already use variations of the standard apportionment formula, and 2 use forms of separate accounting. These deviations relate to differences in the economic and industrial structure of the states, as is true in Alaska.

Separate
Accounting

Senate version (SCS CS HB 322)

Advantages

(1) Gives Alaska a direct determination of income generated by oil and gas operations by taking only revenue generated in state.

(2) Gives the state data on profitability of the industry useful in future review of oil and gas taxation policies.

(3) Will increase revenue to the state, especially where wellhead prices increase (Note: this may be an advantage or disadvantage with respect to the House version. Revenues may also decrease if wellhead prices decrease.)

(4) Should create greater equity amongst oil and gas taxpayers operating in Alaska, (Note: Andersen Report shows differing tax liabilities between Exxon and ARCO based on comparable revenues.)

Disadvantages

(1) Administration difficulties

(a) determination of expenses allows for discretion by industry

(b) determination of base value of oil before deductions. problems may be created by depressed prices caused by price control, marketability, etc.

House version (CS HB 322)

Advantages

(1) Changes definition of corporate income to include either book income (income reported to stockholder) or Federal taxable income, whichever is higher. Gives the state a higher base upon which to tax.

Redefinition

of
Apportionment

(2) Substitutes an extraction factor for the sales destination factor in the apportionment formula - will increase revenue to the state as a production factor is much higher than a sales factor in Alaska.

(3) Incorporates OCS into the formula when it is served by a land base in Alaska. (Note: possible legal complications).

(4) Revenues are somewhat isolated from conditions in Alaska as the tax is based partially on world-wide performance of the industry. (This may be an advantage or disadvantage depending upon future wellhead prices).

Disadvantages

(1) Administrative difficulties

(a) hard to ascertain world-wide production of oil when complex foreign contracts exist

(b) verification of book and federal taxable income reported by industry.

Major points in conclusion:

Either bill would increase the state's corporate income tax revenue.

Summary
Points

Both bills involve administrative difficulties, but neither is insurmountable.

Separate accounting provides "a direct fix on income generated by operations within the state" and has value beyond the tax.

The House version isolates Alaska from uncertainties of income generated only in Alaska by sharing to a degree in world-wide profits. It also attempts to extend tax jurisdiction to Outer Continental Shelf development.

Question and answer session follows (refer to page 24)

TESTIMONY OF
HERMAN LOEB
DIRECTOR OF EXPLORATION ENVIRONMENTAL AFFAIRS
PENNZOIL COMPANY

STATE CAPITOL - STATE OF ALASKA

JUNEAU, ALASKA

February 10, 1978

Members of the Senate Resources Committee: My name is Herman Loeb. I am the Director of Exploration Environmental Affairs for the Pennzoil Company. I live in Houston, Texas.

At the very beginning, let me state that my remarks will not deal with the intricacies of your tax laws or pending legislation except in the most general sense. Instead, I would like to touch on Pennzoil's approach to exploration and factors that influence the spending of exploration dollars by the Company, and most particularly in the State of Alaska. The tax structure of the State is a vital part of this package and will influence the focus of exploration efforts of any company, large or small.

The Pennzoil Company is primarily a natural resources domestic exploration and production company. We are no stranger to the State of Alaska. We drilled two wildcats in 1967 and 1968 in the Lower Cook Inlet on State leases (Strichikoff Area), and in 1969 opened an exploration office in Anchorage. I have a personal stake in this dialogue because in 1969 I had the assignment of establishing the exploration office in Anchorage. We built a home, the whole bit, and were fortunate enough to be able to stay in the State until 1973.

As a working geologist, I rapidly became aware of the tremendous potential for oil & gas in the State. The number of undrilled, unexplored sedimentary basins was and still is unbelievable. I had worked older known geological areas in West Texas, the Rocky Mountains, South Texas, and South Louisiana where the idea of an undrilled basin was unheard of and didn't exist.

Pennzoil was not alone in its awareness of this oil & gas potential in the State. Many smaller exploration-minded companies

and independents were ready to move their people to Anchorage. This Committee knows the next verse---it is simply as it was---the "land freeze". First, Udall, then Hickel, then Morton. Spice that with passage of the Native Claims Act, approval of the pipeline, and the eventual State selection process and you add up to almost a decade of problems. These factors made it impossible for the smaller companies to buy leases, drill wells, or operate.

Some with plans to come North delayed that decision and never came. We came early, but to my extreme personal regret, we left early also in 1973. My family and I hated to leave, but there was no place to make Pennzoil dollars multiply and no sound reason for management to keep an office in Anchorage.

Let me state at this point that there is extreme competition in the industry. We have been busy and successful in operations in the OCS in the Gulf of Mexico. We acquired our first leases in 1970, and to date we have production with our partners that produces approximately 70,000 BOPD and 1 billion cu. ft. of gas per day. We bid with major companies and against them. We like it--we think we can make a "better mouse trap" and we can play the exploration game. However, we must know the rules. It's impossible when the rules change and the tax structure is an integral, important part of the pre-game plan.

Elements of risk are vital in our shop when top management decisions as where to put its people and spend its revenue dollars are made. There is an inherent risk every time we drill a well; first, if we can drill the hole; then if we are fortunate enough to encounter hydrocarbons in commercial quantities; and finally, if we can complete successfully. The calculation of risks and the

overall evaluation of these factors are the heart of any successful exploration effort. The regional geology, the reservoirs, costs to operate, access to locations, availability of suppliers and material, competition both internal and external, and taxes comprise some of the key elements. A stable predictable tax system is necessary to properly evaluate rates of payout and capital requirements.

The most positive approach to a possible remedy to some of the State's revenue needs is to encourage additional exploration. The State could utilize another Prudhoe Bay. You need the smaller companies such as Pennzoil, as well as the larger companies, to drill some of your unexplored sedimentary basins.

The industry exploration dollars are going to be spent in areas where oil & gas leases are available, where lease schedules and terms are clearly defined, and where the elements of risk conducive to ascertainable planning for capital, equipment, and manpower are positive and most of all where a fair, equitable tax climate prevails. These factors we hope will be considered in your approach to tax legislation.

In closing, the industry will initially tend to go where it's wanted, and a stable, fair tax program would undoubtedly provide an impetus to further exploration in the State.

Again, we appreciate the opportunity for comment.

Statement of David S. Mace
Sohio Petroleum Company
before the
Senate Resources Committee
Alaska State Legislature
May 22, 1978

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before the
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