

ALASKA LEGISLATURE COMMITTEE FILES 1987-1988 8672

5025 HRES SB 401 - SB 410

597

denying the person's request for a tax refund. Currently this right exists only through the Department's regulations and does not have an explicit statutory basis. Section 2 also amends AS 43.05.240(a) to reflect the new right of appeal of information requests that is being enacted as AS 43.05.055 under section 1 of this bill.

Section 3: This section makes the same changes to AS 43.05.240(b) as Section 2 makes to subsection (a) of that statute.

Section 4: This section amends AS 43.05.240(c) to reflect the fact that a formal hearing before the DOR will no longer be limited solely to questions involving the amount of tax or penalty due the state. The present language reflecting this narrow scope of appeal is replaced with more general language that speaks in terms of considering and deciding the appellant's grievance.

Section 5: This section amends the present law regarding tax assessments, AS 43.05.245. The first insertion of new language reflects the enactment of new procedures for the four principal taxes on the oil and gas industry by making it clear that nothing in AS 43.05.245 will prevent a person from presenting evidence or other information under those new procedures. The second insertion of new language reflects the fact that, under the new procedures for oil and gas taxes, tax assessments will become final under either of two specific rules set out in those new procedures.

Section 6: This section enacts new procedures for the issuance and administrative review of tax assessments for the four principal taxes. Under the present procedures, multimillion-dollar oil and gas tax assessments are issued by the audit staff without any prior discussion with the taxpayer and without any review by the Commissioner to see that they are consistent with other assessments and correctly apply the Department's policies. Under the new procedures, both the discussion with the taxpayer and the Commissioner's review will occur before an assessment becomes final (except in one situation, discussed below).

New section AS 43.05.246 provides for a closing conference to close out the audit process. 60 to 90 days before the conference, the Department is to give the taxpayer a draft of its preliminary audit conclusions. If the preliminary

conclusion is that a penalty or additional tax and interest are due, the taxpayer is given a draft of a preliminary assessment notice to that effect, together with a written narrative and supporting worksheets or schedules to show how and why the preliminary assessment has been determined.

The closing conference is not an adversarial proceeding, but rather an opportunity to correct mistaken assumptions, misunderstanding and other errors of mistakes. Incomplete information can be supplemented, and unsubstantiated items can be substantiated. The auditor in charge of the audit is required to attend unless excused by the taxpayer or for good cause. The director of the division, or the director's designee, presides at the closing conference. The director may not designate the auditor in charge of the audit as the presiding officer.

Within 60 days of the conclusion of the closing conference, the presiding officer issues a written decision. If he or she determines that no assessment should be made, the taxpayer is given written notice to that effect. On the other hand, if he or she determines that additional tax is owed or a penalty should be assessed, or both, then the written decision is to include a proposed notice and demand for payment, together with a written narrative and supporting schedules or worksheets explaining how and why the proposed assessment has been determined. If the taxpayer does not request a policy review hearing within 30 days after the proposed assessment is issued, the assessment becomes final the the taxpayer pays the assessment.

New section AS 43.05.247 provides for the policy review hearing. Such a hearing may be sought to review a proposed assessment or to review a denial of a taxpayer's request for refund of tax under AS 43.20, AS 43.55, AS 43.57 or former AS 43.21. The Department's failure to act within 60 days on a request for refund is a denial for the purposes of being able to request a policy review hearing.

The policy review hearing is to be held within 30 days of the taxpayer's request for it. As with the other deadlines under these procedures, the time may be extended by mutual agreement.

The policy review hearing allows the Commissioner, or his or her authorized representative, to review the matter to ensure that the proper policies of the Department are being applied, and the they are being applied correctly to the taxpayer's particular circumstances. The taxpayer has an opportunity to explain the nature of the grievance and the relief being sought. Although the taxpayer and the division

may present evidence in support of its position, the policy review hearing is not a trial of the facts and the formal rules of evidence do not apply.

Within 90 days after the policy review hearing, the Commissioner issues the policy review decision, stating what relief is being granted and which portions of the Department's actions are being upheld. If evidence was presented at the hearing, the decision must state which additional facts are being recognized and which are being disregarded, as well as which version of the facts is being accepted when there is conflicting evidence. The decision is also to state which provisions of the statutes and regulations are being applied, as well as the specific policy considerations for the particular interpretation and application of those provisions. This is to allow any reviewing court to understand the Department's rationale for its actions, rather than having to guess at it, so that departmental policy can be applied to the facts as finally determined by trial before the Superior Court. If the Commissioner determines that additional tax or penalties are in order, the decision shall include a final notice and demand for payment assessing the tax, with interest, and any penalties. The assessment notice must include a narrative and supporting schedules or worksheets showing why and how it was determined. Such a notice is not final for purposes of the statute of limitations, AS 43.05.260, until the narrative and supporting materials have been served on the taxpayer.

New section AS 43.05.248 provides for appeal to the Superior Court from the Commissioner's policy review decision. The procedure is similar to that under the present law, except that there is a trial de novo before the court on the disputed portions of the Commissioner's decision. Trial de novo allows an independent person (the judge), instead of a highly paid employee who serves at the pleasure of the Commissioner, to judge the facts and decide which evidence to believe and which to disbelieve or give less weight to.

Section 7: This contains the transitional rules. Under subsection (a), the right to appeal an unreasonable request for information or materials is extended to such audit requests that are pending when the bill becomes law.

Under subsection (b), taxpayers who, on the effective date, have not completed the formal hearing in their appeals under the present procedures are given the option of having a closing conference under the new procedures and then following the new procedures from that point on. The option must be exercised within 60 days of enactment.

Subsection (c) extends the right to trial de novo to all appeals of these four taxes that have not reached the Superior Court as of the date of the bill's enactment. Thus, even if a taxpayer elects not to use the new procedures and continues instead under the existing procedures, the taxpayer will have the right to have the facts tried before an independent party instead of an employee of the Department.

Section 8: This section provides for an immediate effective date.

STATE OF ALASKA
1988 LEGISLATIVE SESSION

BILL VERSION: CSSR 401 (FIN) (c1)
PUBLISH DATE: SENATE 11/26/88

344

FISCAL NOTE

REQUEST:

Revision Date: _____
Title: Relating to disclosure to the
Legislature of tax returns...
Sponsor: Faiks
Requestor: _____

Agency Affected: Revenue
BRU: Income and Excise Audit Division
Components: _____

EXPENDITURES/REVENUES: (Thousands of Dollars)

OPERATING	FY 88	FY 89	FY 90	FY 91	FY 92	FY 93
PERSONAL SERVICES		187.0	187.0	187.0	187.0	187.0
TRAVEL		82.0	82.0	82.0	82.0	82.0
CONTRACTUAL		14.1	14.1	14.1	14.1	14.1
SUPPLIES		3.0	3.0	3.0	3.0	3.0
EQUIPMENT		17.0	0	0	0	0
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING		303.1	286.1	286.1	286.1	286.1

CAPITAL						
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REVENUE						
---------	--	--	--	--	--	--

FUNDING: (Thousands of Dollars)

GENERAL FUND		303.1	286.1	286.1	286.1	286.1
FEDERAL FUNDS						
OTHER						
TOTAL						

POSITIONS:

FULL-TIME		4	4	4	4	4
PART-TIME						
TEMPORARY						

ANALYSIS : (Attach a separate page if necessary)

See attached.

Rick Halford

Prepared by: Senator Rick Halford, Co-Chairman
Division: Senate Finance Committee

Phone: 465-3753
Date: 4/25/88

Approved by Commissioner: _____
Agency: _____

Date: _____

Distribution (by preparer):

- Legislative Finance
- Legislative Sponsor
- Requestor
- Office of Management and Budget
- Impacted Agency(ies)

STATE OF ALASKA
1988 LEGISLATIVE SESSION

BILL VERSION: CS 02 401 (1)
PUBLISH DATE: SENATE 4/25/88

FISCAL NOTE

REQUEST:

Revision Date: _____
Title: Relating to disclosure to the legislature of tax returns...
Sponsor: Faiks
Requestor: _____

Agency Affected: Revenue
DRU: Oil and Gas Audit
Components: _____

EXPENDITURES/REVENUES: (Thousands of Dollars)

OPERATING	FY 88	FY 89	FY 90	FY 91	FY 92	FY 93
PERSONAL SERVICES		471.2	471.2	471.2	471.2	471.2
TRAVEL		50.0	50.0	50.0	50.0	50.0
CONTRACTUAL		20.0	20.0	20.0	20.0	20.0
SUPPLIES		5.0	5.0	5.0	5.0	5.0
EQUIPMENT		17.0	0	0	0	0
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING		563.2	546.2	546.2	546.2	546.2
CAPITAL						
REVENUE						

FUNDING: (Thousands of Dollars)

GENERAL FUND		563.2	546.2	546.2	546.2	546.2
FEDERAL FUNDS						
OTHER						
TOTAL						

POSITIONS:

FULL-TIME		9	9	9	9	9
PART-TIME						
TEMPORARY						

ANALYSIS : (Attach a separate page if necessary)

See attached analysis.

Rick Halford

Prepared by: Senator Rick Halford, Co-Chairman

Division: Senate Finance Committee

Phone: 465-1111

Date: 4/25/88

Approved by Commissioner: _____

Date: _____

Agency: _____

Distribution (by preparer):

- Legislative Finance
- Legislative Sponsor
- Requestor
- Office of Management and Budget
- Impacted Agency(ies)

FISCAL NOTE

REQUEST:

Revision Date:
Title: "An Act relating to appeals of information requests...state tax laws"
Sponsor: Senator Faiks
Requestor: Senat Finance

Agency Affected: Revenue
BRU: Commissioner's Office
Components: _____

EXPENDITURES/REVENUES: (Thousands of Dollars)

	FY 88	FY 89	FY 90	FY 91	FY 92	FY 93
OPERATING						
PERSONAL SERVICES	-	-	-	437.0	874.0	874.0
TRAVEL	-	-	-	65.5	131.0	131.0
CONTRACTUAL	-	-	-	28.8	57.6	57.6
SUPPLIES	-	-	-	5.0	10.0	10.0
EQUIPMENT	-	-	-	30.3	-	-
LANDS & STRUCTURES	-	-	-	-	-	-
GRANTS, CLAIMS	-	-	-	-	-	-
MISCELLANEOUS	-	-	-	-	-	-
TOTAL OPERATING	-	-	-	566.6	1,072.6	1,072.6
CAPITAL	-	-	-	-	-	-
REVENUE	-	-	-	-	-	-

FUNDING: (Thousands of Dollars)

GENERAL FUND	-	-	-	566.6	1,072.6	1,072.6
FEDERAL FUNDS	-	-	-	-	-	-
OTHER	-	-	-	-	-	-
TOTAL	-	-	-	-	-	-

POSITIONS:

FULL-TIME	-	-	-	6	11	11
PART-TIME	-	-	-	-	-	-
TEMPORARY	-	-	-	-	-	-

ANALYSIS: (Attach a separate page if necessary)

Prepared By: Deborah Vogt, Senior Hearing Officer
Division: Commissioner's Office

Phone: (907) 465-2300
Date: April 21, 1988

Approved by Commissioner: Hugh Malone
Agency: Department of Revenue

Date: April 21, 1988

Distribution (by preparer):
Legislative Finance
Legislative Sponsor
Requestor
Office of Management and Budget
Impacted Agency(ies)

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APR 26 1988

LEGISLATIVE FINANCE

CORRECTION

**THIS DOCUMENT
HAS BEEN REPHOTOGRAPHED
TO ASSURE LEGIBILITY**

STATE OF ALASKA
1988 LEGISLATIVE SESSION

BILL VERSION: CSSE 401 (FIN) (a)
PUBLISH DATE: SENATE 4/25/88

FISCAL NOTE

REQUEST:

Revision Date: _____
Title: Relating to disclosure to the
Legislature of tax returns...
Sponsor: Faiks
Requestor: _____

Agency Affected: Revenue
BRU: Income and Excise Audit Division
Components: _____

EXPENDITURES/REVENUES: (Thousands of Dollars)

OPERATING	FY 88	FY 89	FY 90	FY 91	FY 92	FY 93
PERSONAL SERVICES		187.0	187.0	187.0	187.0	187.0
TRAVEL		82.0	82.0	82.0	82.0	82.0
CONTRACTUAL		14.1	14.1	14.1	14.1	14.1
SUPPLIES		3.0	3.0	3.0	3.0	3.0
EQUIPMENT		17.0	0	0	0	0
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING		303.1	286.1	286.1	286.1	286.1

CAPITAL						
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REVENUE						
---------	--	--	--	--	--	--

FUNDING: (Thousands of Dollars)

GENERAL FUND		303.1	286.1	286.1	286.1	286.1
FEDERAL FUNDS						
OTHER						
TOTAL						

POSITIONS:

FULL-TIME		4	4	4	4	4
PART-TIME						
TEMPORARY						

ANALYSIS : (Attach a separate page if necessary)

See attached.

Prepared by: Senator Rick Halford, Co-Chairman
Division: Senate Finance Committee

Phone: 465-3753
Date: 4/25/88

Approved by Commissioner: _____
Agency: _____

Date: _____

Distribution (by preparer):
Legislative Finance
Legislative Sponsor
Requestor
Office of Management and Budget
Impacted Agency(ies)

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(ca)

SB 401 Analysis

Income and Excise Audit Division

Appeals Section

<u>Personal Services:</u>		137.
Revenue Auditor IV	57.8	
Revenue Auditor III	51.0	
Clerk Typist III	28.2	
<u>Travel</u>		64.1
Closing Conferences	33.6	
Policy Review	25.2	
Court Travel	5.3	
<u>Contractual</u>		9.7
Telephone	1.8	
Printing	1.4	
Office Furnitures	6.0	
Printer Maintenance	.5	
<u>Commodities</u>		2.5
<u>Equipment</u>		13.0
TOTAL - Appeals Section		<u>226.3</u>

FIELD AUDIT

<u>Personal Services</u>		51.0
Revenue Auditor III	51.0	
<u>Travel</u>		17.9
<u>Contractual</u>		4.4
<u>Commodities</u>		.5
<u>Equipment</u>		3.0
TOTAL - Field Audit		76.8

TOTAL		<u>303.1</u>
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STATE OF ALASKA
1988 LEGISLATIVE SESSION

BILL VERSION: CS CR 401 1988
PUBLISH DATE: SENATE 4/26/88

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FISCAL NOTE

REQUEST:

Revision Date: _____
Title: Relating to disclosure to the legislature of tax returns...
Sponsor: Faiks
Requestor: _____

Agency Affected: Revenue
BRU: Oil and Gas Audit
Components: _____

EXPENDITURES/REVENUES: (Thousands of Dollars)

OPERATING	FY 88	FY 89	FY 90	FY 91	FY 92	FY 93
PERSONAL SERVICES		471.2	471.2	471.2	471.2	471.2
TRAVEL		50.0	50.0	50.0	50.0	50.0
CONTRACTUAL		20.0	20.0	20.0	20.0	20.0
SUPPLIES		5.0	5.0	5.0	5.0	5.0
EQUIPMENT		17.0	0	0	0	0
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING		563.2	546.2	546.2	546.2	546.2

CAPITAL						
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REVENUE						
---------	--	--	--	--	--	--

FUNDING: (Thousands of Dollars)

GENERAL FUND		563.2	546.2	546.2	546.2	546.2
FEDERAL FUNDS						
OTHER						
TOTAL						

POSITIONS:

FULL-TIME		9	9	9	9	9
PART-TIME						
TEMPORARY						

ANALYSIS : (Attach a separate page if necessary)

See attached analysis.

Rick Halford

Prepared by: Senator Rick Halford, Co-Chairman
Division: Senate Finance Committee

Phone: _____
Date: 4/25/88

Approved by Commissioner: _____
Agency: _____

Date: _____

Distribution (by preparer):

- Legislative Finance
- Legislative Sponsor
- Requestor
- Office of Management and Budget
- Impacted Agency(ies)

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(b)

CSSB 401 (Finance)

Analysis

Oil and Gas Audit Division

<u>Personal Services</u>		471.2
Revenue Auditor V (2) @ 66.0	130.2	
Revenue Auditor IV (1) @ 57.8	57.8	
Revenue Auditor III (5) @ 51.0	255.0	
Clerk Typist (1) @ 28.2	28.8	
<u>Travel</u>		
Closing Conferences, Policy Review, Court Travel		50.0
<u>Contractual</u>		20.0
<u>Commodities</u>		5.0
<u>Equipment</u>		17.0
TOTAL		<u>563.2</u>

In future fiscal years, requests for any additional positions which may be necessary to implement the bill will be considered by the Legislature as part of the agency's budget process.

FISCAL NOTE

REQUEST:

Revision Date:
Title: "An Act relating to appeals of information requests...state tax laws"
Sponsor: Senator Faiks
Requestor: Senate Finance

Agency Affected: Revenue
BRU: Commissioner's Office
Components:

EXPENDITURES/REVENUES: (Thousands of Dollars)

	FY 86	FY 85	FY 90	FY 91	FY 92	FY 93
OPERATING						
PERSONAL SERVICES	-	-	-	437.0	874.0	874.0
TRAVEL	-	-	-	65.5	131.0	131.0
CONTRACTUAL	-	-	-	28.8	57.6	57.6
SUPPLIES	-	-	-	5.0	10.0	10.0
EQUIPMENT	-	-	-	30.3	-	-
LANDS & STRUCTURES	-	-	-	-	-	-
GRANTS, CLAIMS	-	-	-	-	-	-
MISCELLANEOUS	-	-	-	-	-	-
TOTAL OPERATING	-	-	-	566.6	1,072.6	1,072.6
CAPITAL	-	-	-	-	-	-
REVENUE	-	-	-	-	-	-

FUNDING: (Thousands of Dollars)

GENERAL FUND	-	-	-	566.6	1,072.6	1,072.6
FEDERAL FUNDS	-	-	-	-	-	-
OTHER	-	-	-	-	-	-
TOTAL	-	-	-	-	-	-

POSITIONS:

FULL-TIME	-	-	-	6	11	11
PART-TIME	-	-	-	-	-	-
TEMPORARY	-	-	-	-	-	-

ANALYSIS: (Attach a separate page if necessary)

Prepared By: Deborah Vogt, Senior Hearing Officer
Division: Commissioner's Office
Phone: (907) 465-2300
Date: April 21, 1988

Approved by Commissioner: Hugh Malone
Agency: Department of Revenue
Date: April 21, 1988

Distribution (by preparer):
Legislative Finance
Legislative Sponsor
Requestor
Office of Management and Budget
Impacted Agency(ies)

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APR 26 1988

LEGISLATIVE FINANCE

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SB 401 Analysis

(c)

Hearing Officer Section

Personal Services

Revenue Hearing Officer (Anch)	86.9
Revenue Hearing Officer (Anch)	86.9
Revenue Hearing Officer (Anch)	86.9
Revenue Hearing Officer (Juneau)	86.9

Clerk IV (Juneau)	34.9
Accounting Clerk III (Juneau)	34.9
Law Clerk (Juneau)	80.0
Law Clerk (Anch)	84.9
Law Clerk (Anch)	84.9
Law Clerk (Anch)	84.9
Accounting Clerk III (Anch)	34.9
Clerk Typist III (Juneau)	29.0
Clerk Typist III (Anch)	29.0
Clerk Typist III (Anch)	29.0

Total \$874.0

Travel

Income & Excise Hearings	\$36.0
Oil & Gas Hearings	55.0
Court/Income & Excise	10.0
Court/Oil & Gas	<u>30.0</u>

Total \$131.0

Contractual

Research	\$18.0
Space Costs	35.6
Telephone	10.0
Printing	5.0
Maintenance	<u>7.0</u>

Total \$75.6

Supplies

Total \$10.0

Equipment

Office Chairs/Equipment	\$22.0
Computer Terminals/Printers	<u>38.5</u>

Total \$60.5

STATE OF ALASKA
1988 LEGISLATIVE SESSION

BILL VERSION: CSSB 401 (Fin) (d)
PUBLISH DATE: SENATE 4/26/88

FISCAL NOTE

REQUEST:

Revision Date: _____
Title: Relating to appeals of information requests...state tax laws
Sponsor: Faiks
Requestor: _____

Agency Affected: LAW
BRU: Oil & Gas Sol. Litigation Appropriation and Oil & Gas Sol. Project BRU
Components: Oil & Gas Sol. Litigation Appropriation and Oil & Gas Operations

EXPENDITURES/REVENUES: (Thousands of Dollars)

OPERATING	FY 88	FY 89	FY 90	FY 91	FY 92	FY 93
PERSONAL SERVICES		274.2	282.4	290.9	151.3	155.8
TRAVEL		9.6	9.9	10.2	5.3	5.5
CONTRACTUAL		31.8	32.8	33.8	20.4	21.0
SUPPLIES		21.3	21.9	22.6	13.4	13.8
EQUIPMENT		35.6	0	0	0	0
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING		372.5	347.0	357.5	190.4	196.1

CAPITAL						
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REVENUE						
---------	--	--	--	--	--	--

FUNDING: (Thousands of Dollars)

GENERAL FUND		372.5	347.0	357.5	190.4	196.1
FEDERAL FUNDS						
OTHER						
TOTAL						

POSITIONS:

FULL-TIME		5	5	5	3	3
PART-TIME						
TEMPORARY						

ANALYSIS : (Attach a separate page if necessary)

See attached analysis.

Rick Halford

Prepared by: Senator Rick Halford, Co-Chairman
Division: Senate Finance Committee

Phone: 465-3753

Date: 4/25/88

Approved by Commissioner: _____
Agency: _____

Date: _____

Distribution (by preparer):

Legislative Finance
Legislative Sponsor
Requestor
Office of Management and Budget
Impacted Agency(ies)

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(d)

CONTINUATION of FISCAL NOTE ANALYSIS

For Bill/Resolution No. CSSB 401 (Jud.)

This fiscal note supercedes the note of March 1, 1988. Nevertheless, observations made in that note continue to be relevant.

The addition of HB 58 provisions in section 7, particularly with respect to transfer review (AS 43.05.234(a)), edited transcripts (AS 43.05.236), and drafting regulations (AS 43.05.238) creates a substantially increased legal workload. Of these, the editing of transcripts is the most highly speculative. If legislative committees undertake major tax policy review, this function will be especially critical. We note, however, that section 1 of the original SB 401 has been deleted, thus offsetting what we believe to be a reasonable estimate of resources required under new section 7.

Under section 12, the new procedures in the bill would apply to grievances, that have not been appealed to the superior court as of the effective date of the bill. This section raises serious statute of limitation problems as well a practical ones for all current cases. Issues include whether the statute of limitations, which would have run in June 1988, for example, is tolled for a case that is (a) awaiting the commissioner's decision, (b) in hearing, (c) in conference at the division level, or (d) recently assessed or whether a case that is at any given stage at the time of this bill's effective date must begin anew if the taxpayer so desires. We believe that litigation over this section will be particularly intense because its effect could be to eliminate or substantially reduce every taxpayer's ultimate tax exposure. The total at stake in the tax cases that are in some stage of administrative appeal exceeds \$2.5 billion.

We believe that enactment of this section would require two full-time attorneys over a period of three years. Combined with the impact of section seven of the bill, we would also require one full-time secretary.

The timelines and appellate scheme in proposed AS 43.05.248 will also dramatically affect the Department of Law. Currently, the Department of Law handles only a very limited number of tax cases. The litigation model both the Department of Revenue and the Department of Law have been working toward is one in which oil and gas tax cases would not require significant attorney representation at the administrative level within the Department of Revenue. This bill, which places the trial in the court system, will require attorneys for all tax cases because only attorneys are allowed to represent the state in Alaska's superior courts.

We believe that these tax cases must be litigated in the same manner as our current oil and gas litigation, in which we use a combination of outside counsel and experts with state personnel. There are three reasons for this:

CONTINUATION of FISCAL NOTE ANALYSIS

(d)

For Bill/Resolution No. CSSB 401 (Jud.)

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1. There are millions of dollars at stake in each of the cases -- the industry will continue to devote the best legal resources available to these cases;
2. Adverse precedent in one case could seriously harm the state in other cases; and
3. The Department of Revenue, rather than the court system has a corps of decision-makers with expertise in the field of oil and gas taxation. Such a radical change of forum, in the earliest cases at least, could place the state at greater risk in attempting to recover its properly due taxes..

The following table shows the level of expenditure for the two proceedings that are most analogous to the cases that would be generated under this bill; a current tax proceeding and the Amerada Hess royalty case which involves many of the same issues presented in the major tax cases.

Amerada Hess

	<u>Total Expended</u>	<u>Annual Expended</u>
6/30/84	1,722,340.51	1,722,340.51
6/30/85	3,598,666.50	1,876,375.91
6/30/86	6,909,832.82	3,401,166.32
6/30/87	11,478,296.44	4,478,463.57
6/30/88 (Est.)		5,620,000.00
	Total	17,098,346.41
	Avg All	3,419,669.28
	Avg last 3 yrs	4,499,876.66

Production, Oil Income Tax

	<u>Total Expended</u>	<u>Annual Expended</u>
6/30/84	191,041.75	191,041.75
6/30/85	695,356.71	504,314.96
6/30/86	1,568,254.63	872,897.92
6/30/87	2,922,618.52	1,354,363.92
6/30/88 (Est.)		3,975,000.00
	Total	6,847,618.55
	Avg All	1,369,523.71
	Avg last 3 yrs	2,050,753.95

CONTINUATION of FISCAL NOTE ANALYSIS

For Bill/Resolution No. CSSB 401 (Jud.)

(d)

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The bill could effectively require the Department Law to litigate simultaneously several trial level cases, while appeals are being argued in the Alaska Supreme Court. Looking at our experience in the tax cases and in Amerada Hess we regard the current expenditure level of \$4 million annually as our base for revenue tax cases. There are several other cases that justify an effort paralleling the current tax case because of the amount at stake. There will also be numerous cases that each involve tens of millions of dollars. In FY 89 we have requested \$1 million above our base. This amount reflects our belief that cases under this bill will not be ready for Department of Law prosecution until mid-year. For FY 90 and FY 91 we believe that in order to effectively prosecute an additional four to six cases per year at the trial court level we would require an additional \$4 million. After that period the amount required should be reduced substantially because of court precedent established through the earlier cases, elimination of backlog, and new cases with substantially less at stake. Accordingly, we believe that in FY 92 and 93 our trial level expenditures could be reduced to \$2 million above base for each year and in FY 94 to our base. Additionally, we have requested \$372,500 in FY 89 for the five new staff positions described above. The impact of Section 1 and Section 7 will be felt on our staff as soon as the bill goes into effect. Two of the five positions will be deleted in FY 92 when work from the transitional period should be completed. We note that extensive litigation will be ongoing even after that fiscal year as audits and tax laws for the years after 1981 are challenged.

Appeals to the Supreme Court would occur under either the current or proposed framework. Accordingly we have not included costs for appeal.

CONTINUATION of FISCAL NOTE ANALYSIS

For Bill/Resolution No. CSSB 401 (Jud.)

(d)

CSSB 401 Fiscal Analysis

Department of Law Staff Costs

	<u>Section 7 Costs</u>		<u>Section 12 Costs</u>			<u>TOTAL</u>
	<u>Atty III</u>	<u>Paralegal Asst. II</u>	<u>Atty IV</u>	<u>Atty III</u>	<u>Leg Sec I</u>	
Per. Svcs.	63.7	43.3	72.0	63.7	31.5	274.2
Travel	2.4	2.4	2.4	2.4	-0-	9.6
Contractual	6.6	6.6	6.6	6.6	5.4	31.8
Supplies	4.5	4.5	4.5	4.5	3.3	21.3
Equipment	6.8	6.8	6.8	6.8	8.4	35.6
Total	84.0	63.6	92.3	84.0	48.6	372.5

Position and associated costs beyond FY 89 include a 3% annual inflation factor, less one-time items. The two attorneys required for Section 7 transitional litigation are deleted after FY 91. The costs for these new positions will occur in the Oil & Gas BRU as interagency funded. However, general funds must also be included in the annual separate appropriation for oil and gas special litigation to offset these costs.

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STATE OF ALASKA
1988 LEGISLATIVE SESSION

(e)
BILL VERSION: CS SB 401 (Finance)
PUBLISH DATE: SENATE 4/26/88

FISCAL NOTE

REQUEST:

Revision Date: _____
 Title: Relating to administration
of state tax laws
 Sponsor: Senator Faiks
 Requestor: Senate Finance Committee

Agency Affected: Alaska Court System
 BRU: Trial Courts
 Components: _____

EXPENDITURES/REVENUES: (Thousands of Dollars)

OPERATING	FY 88	FY 89	FY 90	FY 91	FY 92	FY 93
PERSONAL SERVICES		290.6	798.5	798.5	581.2	581.2
TRAVEL						
CONTRACTUAL		10.0	30.0	30.0	20.0	20.0
SUPPLIES		1.5	5.0	5.0	3.0	3.0
EQUIPMENT		14.7	10.0			
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING		316.8	843.5	833.5	604.2	604.2

CAPITAL						
---------	--	--	--	--	--	--

REVENUE						
---------	--	--	--	--	--	--

FUNDING: (Thousands of Dollars)

GENERAL FUND		316.8	843.5	833.5	604.2	604.2
FEDERAL FUNDS						
OTHER						
TOTAL		316.8	843.5	833.5	604.2	604.2

POSITIONS:

FULL-TIME		5	16	16	10	10
PART-TIME						
TEMPORARY						

ANALYSIS : (Attach a separate page if necessary) Funds the following positions:

- 1 Superior Court Judge, PFT, Anchorage
- 1 In-Court Clerk, Range 12B, PFT, Anchorage
- 1 Secretary, Range 12B, PFT, Anchorage
- 1 Law Clerk, Range 13A, PFT, Anchorage
- 1 Court Clerk II, Range 10E, PFT, Anchorage

Prepared by: Rick Halford Phone: 465-3753
 Division: Senator Rick Halford, Co-chairman Date: 4/26/88
Senate Finance Committee

Approved by Commissioner: _____ Date: _____
 Agency: _____

Distribution (by preparer):

- Legislative Finance
- Legislative Sponsor
- Requestor
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- Impacted Agency(ies)

The ELF

A Policy Perspective

April 1988

Division of Policy
Office of the Governor

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Preface

Since statehood, oil taxes have been a continuing and difficult policy issue for Alaskans. The current debate centers on the state severance tax and the economic limit factor or "ELF." Put simply, the ELF is a tax reduction formula meant to encourage marginal oil field development. The Governor proposed ELF legislation last year, and a bill to make a change in the ELF formula passed the House.¹ The oil companies, with one notable exception, oppose the change, and the bill has now stalled in the state Senate, where the leaders have said they oppose allowing the bill to come to a vote.

In the Alaska legislature oil tax issues have traditionally received intense scrutiny. Each side has had the opportunity to challenge the assertions of the other, bring its experts forward, and present its case. This process has not been perfect, but the legislators and the public have been able to get the facts to make informed decisions. Nothing will substitute for the give and take of a public hearing, but in the face of the Senate's refusal to allow this major policy issue the open debate it deserves, the state administration has a responsibility to make its perspective known.

We believe passage of the new ELF will help stabilize the Alaska economy at a time when it needs the reassurance of stable state spending. More stable revenues from the new ELF will help guarantee that local governments receive the money they need for roads, public safety and other services, and explains why the Alaska Conference of Mayors, among others, supports the ELF bill. Most importantly, passage of the new ELF

¹ House Finance Committee Substitute for House Bill 164, amended [CSHB 164 (Fin.) am].

will provide a more reliable incentive for marginal field development — the ELF's original purpose — by lowering tax rates on Alaska's smaller fields, such as Milne Point, Endicott, and Lisburne.

This paper attempts to fully discuss the reasons behind our perspective. We have tried to include all the relevant facts. We also have tried to avoid unnecessary complication. If others have additional information and perspectives, we welcome hearing from them.

Mary Halloran
Director, Division of Policy
Office of the Governor

Executive Summary

- The immediate revenue loss from the current ELF is about 8 percent of Alaska's oil revenues, or about \$150 million this year. This percentage loss will increase over the next six years to about 14 percent and will erode Alaska's fiscal strength.
- The 1987 application of the ELF to Prudhoe Bay was adopted within 72 hours in the closing days of the 1981 legislative session. Legislators and the Governor were assured the tax changes were revenue neutral — incorrectly as it turned out. In fact, the revenue loss has been over \$1 billion from FY82-FY87.
- Neither the Railbelt Energy Fund nor the Permanent Fund earnings reserve provides a long-term response to the on-going loss of 8 percent to 14 percent of Alaska's oil revenues and the erosion of Alaska's fiscal strength. The new ELF does.
- Prudhoe Bay and Kuparuk are extraordinarily profitable oil fields. Industry journals indicate oil companies make \$6.2 million per day in profits from North Slope operations. Currently, the oil industry is taking \$8 Outside for every \$2 it reinvests in Alaska. Without their Alaska holdings, neither ARCO nor Standard would be as strongly positioned against their industry competitors as they are today.

- The oil industry has one of the poorest resident hire records in the state, with major drilling, exploration and service companies employing about 28 percent non-residents.
- The written record of the 1981 legislative deliberations on oil taxes provides no evidence of any legal, moral, or political commitment by state officials regarding any limit on the state's appropriate share of future oil income. In fact, the legislature and the governor explicitly recognized that today's legislature would have to grapple with the revenue problems caused by the reimposition of the ELF.
- At Prudhoe Bay, at a profit of \$3 per barrel, wells that average over 2,000 barrels per day — more than 100 times greater than the national average of 14 barrels per day — are receiving the benefit of an ELF reduction designed for fields whose economics are marginal.
- The new ELF's consideration of total field productivity, as well as per-well productivity, provides a better incentive for marginal field development than the current ELF and better reflects field profitability.
- By adding total field productivity to the ELF calculation, most Alaska fields will receive a larger tax break under the new ELF than under the current ELF. Only the two giant fields, Prudhoe Bay and Kuparuk, will not receive increased tax breaks. Fields with Alaska corporation ownership, such as Endicott, will benefit more under the new ELF than the current ELF.

- The current ELF provides a substantial state subsidy to oil company drilling operations in the nation's two largest and very profitable oil fields by lowering the effective tax rate on an entire field every time a below-average producing additional well is brought on line.

Introduction

The major issue in the current debate over the ELF (economic limit factor) is whether this tax reduction to the oil industry makes sense for Alaska at this time. Among the different perspectives against which Alaskans judge the issue are the ELF's effects on the rate of oil development and jobs, and its impact on state revenue, budget stability and the economy. The purpose of this paper is to fill in as much as possible of the factual background. The following issues are therefore addressed in detail:

- (1) ELF AND OIL DEVELOPMENT: Does the current ELF tax subsidy work to increase marginal field development? Are Prudhoe Bay and Kuparuk marginal fields? Do ARCO, Standard and Exxon, the major North Slope producers, need a substantial tax break now to continue production from Prudhoe Bay and Kuparuk? How does Alaska's tax structure compare with that of other states?

- (2) ELF AND ALASKA'S ECONOMY: How much does the current ELF contribute to industry drilling activity? What will be the effect of the new ELF on drilling activity? Are oil company development dollars spent in Alaska or Outside? How many jobs does ELF create? Who gets those jobs?

(3) ELF AND ALASKA'S REVENUES: What is the difference in revenues between the current ELF and the new ELF? How does ELF affect revenue stability? What is the long-term impact of ELF on the state's fiscal strength? What roles do revenue stability and a balanced budget play in creating a stable Alaska economy?

(4) ELF AND THE PAST: What happened in 1981? Why was the ELF suspended for Prudhoe Bay? What were the commitments?

Background

The roots of the current tax debate go back to the early days of North Slope oil production. In 1979 several major oil companies sued the state, arguing that the separate accounting form of corporate income tax adopted by Alaska in 1978 was unconstitutional. The state won that lawsuit in 1986, but in 1981, in an attempt to limit the fiscal effects of possibly losing the case, the legislature changed the method for assessing oil and gas corporate income tax from separate accounting to modified apportionment.² That legislation also dealt with the ELF.

The 1981 tax package gave Alaska's oil producers a big reduction in their corporate income taxes, but legislators were assured by then-Revenue

² To tax corporate income, separate accounting focuses on the income a corporation actually produces in the taxing jurisdiction. In contrast, the apportionment formula looks at all the income produced worldwide by the corporation and attempts to attribute a portion of that income to the taxing jurisdiction. Alaska now uses a modified version of the standard apportionment method in assessing corporate tax liability.

Commissioner Tom Williams — incorrectly as it turned out — that most of the state revenue lost from the income tax would be offset by gains from a severance tax increase adopted at the same time. The bill also suspended the applicability of the ELF to Prudhoe Bay "for the first ten years following the commencement of commercial production."

The tenth anniversary came in June of 1987, triggering reinstatement of the ELF to Prudhoe Bay. Since the ELF is a formula that reduces severance tax rates, it gave the oil companies a tax cut in addition to the net tax reduction they won in 1981. The 1987 cut was substantial — worth over \$15,000 per hour to the Prudhoe Bay producers or about 8% of Alaska's revenues from oil operations.

The ELF Formula: Well Productivity & Field Productivity

The ELF bill, CSHB 164 (Fin) am , substitutes a new formula for calculating the "economic limit" — the point at which production is no longer profitable. The new formula will reduce the tax reduction provided to Prudhoe Bay and Kuparuk, and increase the tax reduction afforded to smaller fields, such as Endicott, Lisburne or Milne Point.

The ELF is a number between one and zero that is multiplied by the nominal tax rate, producing the effective tax rate. The nominal severance tax rate at Prudhoe Bay is 15 percent. With the average FY 88 Prudhoe Bay ELF at .82, the field's effective tax rate is 12.3 percent ($.15 \times .82 = .123$).

The current ELF is determined by *per-well productivity* in the field, measured by the number of barrels produced by an average well in an

average day. If well productivity is high, the ELF is relatively close to 1 (.9 for example), and the field gets a small tax reduction. Fields with low per-well productivity have a smaller ELF (.5 for example), and get a larger tax break. Most fields in Cook Inlet are currently paying no severance tax because their very low per-well production gives them ELF's of zero.

(Zero times the nominal tax rate gives an effective tax rate of 0.0 percent.)

In Cook Inlet, the current ELF works properly, encouraging production of marginal fields.

But the super-giant Prudhoe Bay field³ is a different story. At Prudhoe Bay, wells that average over 2,000 barrels per day — more than 14 times greater than the Texas average and more than 100 times greater than the national average — are receiving the benefit of an ELF reduction designed for fields whose economics are marginal.

This inappropriate ELF break results from the fact that the current ELF takes account only of productivity *per well* and not overall *field* productivity. By giving a profitable field a larger tax break than a marginal field, the current ELF distorts the purpose of this tax subsidy.

Consider, for example, the case of Milne Point, a small field near Prudhoe Bay. Soon after the Milne Point field opened in late 1985, revenue officials, state economists and the management team at Conoco, the oil company operating the Milne Point field, discovered that per-well productivity, if used by itself, can be an inadequate measure of a field's ability to pay severance tax.

³ Production from Prudhoe Bay, the largest field in the United States, is five times that of the nation's second largest field (Kuparuk). Industry publications consistently refer to Prudhoe Bay as "super-giant."

The average well in the Milne Point field initially produced 950 barrels per day, giving it an ELF very nearly the same as the Kuparuk field, where the average well produced 1,000 barrels per day. Total Kuparuk production was then 250,000 barrels per day, while Milne Point produced less than one-tenth of that amount.

But due to its smaller size, operators at Milne Point had far fewer barrels of production over which to spread operating costs than the Kuparuk field. Although the two fields had almost identical per-well productivity, the smaller Milne Point field was less profitable, and in January 1987 the owners elected to shut down production. This experience illustrates the deficiency of an ELF formula based solely on per-well productivity.⁴

The new formula incorporated in the ELF bill will correct this perverse and unintended effect *by adding total field productivity to the ELF calculation*. Fields producing less than 120,000 barrels per day, such as Milne Point and Endicott, will have a lower ELF (bigger tax break) than under current law, while fields producing more than that amount will have a higher ELF (smaller tax break). This change will affect estimated FY 89 severance tax rates as follows:

⁴ Under provisions of the current severance tax law, Milne Point producers requested and received additional tax reductions after showing that the field would be uneconomic to operate without the reductions. The administrative uncertainties of this avenue would be eliminated for smaller fields by the automatic reduction provided by the new ELF. Large fields facing similar problems could still apply for and receive the special "hardship" reductions.

EFFECTIVE FY 89 SEVERANCE RATES

	<u>Existing Law</u>	<u>New ELF</u>	<u>Percent Change</u>
Prudhoe Bay	11.9 %	14.8 %	23 %
Kuparuk River	6.9 %	11.3 %	65 %
Endicott	12.3 %	8.9 %	-27 %
Lisburne	6.8 %	3.6 %	-47 %
Cook Inlet Fields	0.0 %	0.0 %	0 %

That this approach benefits producers in smaller fields is reflected in the March, 1987 testimony of Conoco supporting the new ELF: "This legislation is a positive first step in encouraging the development of marginal fields in Alaska."⁵

ELF Subsidy Effect

In the summer of 1987 oil producers increased the rate at which they were drilling additional wells at Prudhoe Bay and Kuparuk. Since total North Slope production is limited by pipeline capacity to just over 2 million barrels per day, more producing wells means that average production per well is being reduced. Lower per-well production, in turn, means a bigger tax break for producers under the current ELF.

⁵ Tom Painter, Conoco Anchorage Division Manager, Transcript of Joint House Finance and House Resources Committees Hearing on House Bill 164, March 19, 1987, pp. 49-54.

Because the drilling increase started about the same time as ELF's application to Prudhoe Bay, state officials investigated the possibility of a cause-and-effect relationship between the two. The ELF's role could not be precisely determined. At the same time, because of the current ELF's sensitivity to per-well productivity changes, the investigation found that the current ELF provides a substantial — and unintended — state subsidy to oil company drilling operations in the nation's two largest and very profitable oil fields.

An example of how this subsidy works was provided by ARCO official James Weeks, during 1987 testimony before the House Finance Committee.⁶ Weeks' example showed how a new Kuparuk well, so long as it produced below the Kuparuk per-well average, would result in a lower severance tax payment on the now-higher total Kuparuk production than the severance tax would have been on the lower total Kuparuk production without the well. In Weeks' example, the result was an overall tax savings or subsidy to the producer of \$37,846 yearly from drilling that single additional well.

Weeks' example showed that the per-well emphasis of the current ELF formula will cause the effective tax rate on an entire field to drop when a below-average producing well is brought on line. Despite the increase in total production, the state will receive less tax revenue than if the well and its production had never occurred. This would be a perverse effect even in a marginal field.

Because this subsidy takes the form of a tax reduction rather than a payment from the state's treasury, the subsidy is restricted to fields paying

⁶ A copy of the ARCO handout and the state's analysis of it are in Appendix D.

severance tax. In short, the subsidy is not available to fields like Cook Inlet, where no severance tax is currently paid.

White Weeks' example was restricted to one hypothetical new well at Kuparuk, and may or may not reflect what is currently happening at Kuparuk or Prudhoe Bay, recent econometric modeling studies by the Department of Revenue estimate the Prudhoe Bay drilling subsidy in the range of \$19 million in FY 88, and about \$40 million in FY 89. The model indicates that a tax break that would have totalled about \$240 million during FY88-89 has been increased to approximately \$300 million by the additional drilling.

Not only is this subsidy going to be costly to Alaska, it is an extraordinarily inefficient way to create jobs or additional oil production.⁷ The overall effect of this subsidy may be that, by accelerating drilling that would have occurred later anyway, it robs jobs and economic stability from the future for the sake of higher production and profits in the short term.

ELF and Jobs

Alaskans are concerned about the effects a change in the ELF may have on jobs. Oil industry proponents have said that the recent increase in drilling has created 2,400 new jobs — 800 drilling jobs and 1,600 additional jobs. They implied that those jobs would be lost if the proposed new ELF is adopted.

⁷ A March 1988 analysis by the Dept. of Revenue implies that each barrel gained through the subsidy through the year 2000 costs the state \$175 in foregone revenue.

The figure of 2,400 new jobs (or even 800) bears no resemblance to the reality reflected in Department of Labor employment figures taken from employer records. Total oil and gas employment on the North Slope during the fourth quarter of 1987 was 3,994 jobs, down by 122 jobs from a year earlier. Drilling employment at the end of 1987 was actually about 50 jobs less than at the end of 1986. Some modest employment increase may occur this spring, but nothing on the scale of 800 new jobs is conceivable, given that 1987 year-end North Slope drilling employment was only around 500 with 12 rigs operating.⁸ The Department of Natural Resources estimates the rig count will climb to 14 on the North Slope this spring. The resulting rise in employment might be 80 to 100. Each rig employs an estimated 40 to 50 workers, depending on the type of drilling.

In total, the oil industry generates about 8,500 jobs in Alaska, about 4 percent of Alaska's work force — and only about 6 percent of the entire private sector work force. Unfortunately, many of those employed by the oil industry are not Alaska residents.

The drilling companies now operating on the North Slope employ about 28 percent non-Alaskans. The hiring record of the major drilling firms ranges from 57 percent non-residents to 15.4 percent non-residents. The hiring of non-residents by other oil industry segments (exploration and services) also runs about 28 percent , with the exception of the production/management sector, which has trimmed its non-Alaskan hiring to about 11 percent.⁹ These statistics make for one of the poorest resident hire

⁸ Statewide oil industry employment, however, was up by about 200 jobs over this period. For more detail on recent employment trends, see *Alaska Economic Trends*, Alaska Department of Labor, October 1987.

⁹ The Department of Labor developed the statistics by cross-checking employment records with Permanent Fund dividend records.

records in the state, according to the Department of Labor.

Industry-wide, these non-Alaskans have total earnings of about \$80 million, which is the highest amount of wages paid by any industry to non-residents. Much of this non-resident income, of course, does not circulate in or benefit the Alaska economy.

As oil fields mature, labor required to produce a given amount of oil tends to increase. Over the long run, oil and gas employment is likely to increase in Alaska due to these technical factors, regardless of the state's action on the ELF bill. A huge tax increase might discourage additional field development, but economic studies by the state and others indicate that the economic effects of the ELF change will be marginal.¹⁰ Also, correcting the misapplication of the current ELF to Prudhoe Bay and Kuparuk, while improving incentives for smaller fields, is not likely to adversely affect future field developments. From an Alaskan perspective, given the record of the oil industry to date, a real concern will continue to be whether the jobs generated by additional oil development will be filled by residents or non-residents.

¹⁰ "[T]he economic limit factor in Alaska's severance tax...has limited ability and high revenue cost for conserving oil and gas from producing fields," according to University of Alaska researchers led by Mathew Berman in Alaska Petroleum Revenues: The Influence of Federal Policy, Institute of Social and Economic Research, October 1984, pp. xxvii. See also, "Severance Tax Impact Often Misinterpreted," by John Lohrenz, in Oil and Gas Journal, June 18, 1984, pp. 133-137; "Analysis of ELF Alternatives," by Charles Logsdon, Alaska Dept. of Revenue, October 14, 1986; and "A Model to Assess Economic Feasibility and Optimum Production Volume for North Slope Fields," by R. Marks and J. W. Moore (both with the Alaska Dept. of Revenue) in Journal of Petroleum Technology, August 1987, pp. 943-54.

Profitability

Does the oil industry in Alaska need a tax break now to continue production at Prudhoe Bay and Kuparuk? This question is at the heart of the current oil tax discussions.

Companies with major oil interests in Alaska are all publicly traded on the stock market. Alaska industry operations have attracted the interest of numerous trade publications, investment advisory services, and occasionally academic and government researchers. All the studies indicate that Prudhoe Bay and Kuparuk are extraordinarily profitable oil fields.¹¹

According to a recent study, published February 1, 1988, in *Petroleum Intelligence Weekly (PIW)*, a respected trade journal, oil companies are currently making after-tax profits of \$6.2 million per day from North Slope operations. State and local revenue from North Slope oil, by comparison, is estimated by *PIW* at \$4.7 million per day. (The *PIW* article and the state's analysis of the *PIW* figures are found in Appendix B.)

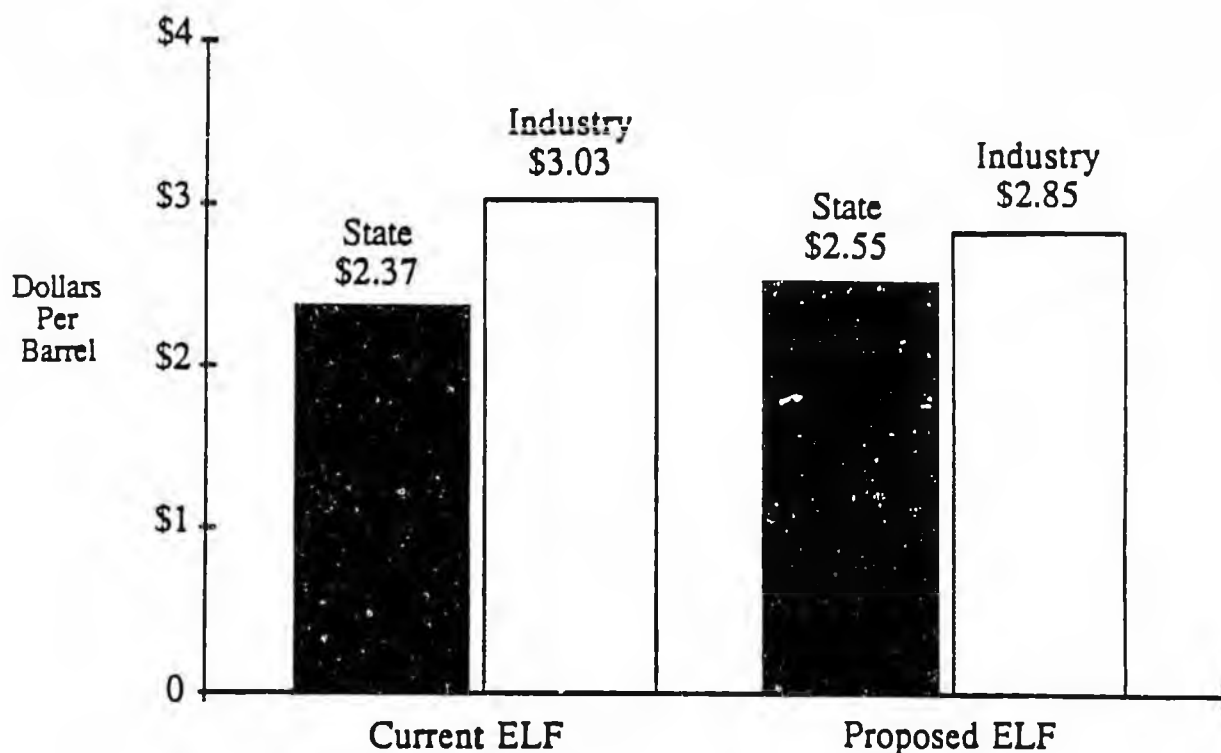
Under the new ELF, oil companies' profits would continue to be larger than state revenue, though not by as big a margin. Industry profits would decline to \$5.6 million daily, after all expenses, taxes and royalties are paid. As Figure 1 shows, the ELF will have only a small impact on the relative shares of revenue going to the state and the producers.

¹¹ In addition to the *PIW* analysis described below, the following studies have been released in 1988: "Alaska's Oil Promise Remains Strong," in *International Petroleum Finance*, March 18, 1988, p. 8; "Alaskan Resource Wealth -- The Inestimable Bounty" in *Atlantic Richfield Company -- Restructured and Resourceful, Part II*, by Salomon Brothers (Bernard Picchi, author), March 31, 1988, p. 3-4; "\$30 a Barrel Profits in an \$18 World," in *Forbes*, March 21, 1988, pp. 110-114; and "Income and Investment Flows From Alaska Oil and Gas Producing Activities," by Edward Deakin, in *Joint Special Committee on Tax Policy, Final Report*, Alaska State Legislature, January 1988.

Figure 1

State and Industry Shares

(Dollars Per Barrel)



Shares under current ELF are from *Petroleum Intelligence Weekly* Feb. 1, 1988; shares under the proposed ELF are by the Division of Policy, April 11, 1987.

Data on the cash flowing to and from North Slope operations suggest that since 1978 in Alaska, only a fraction of the funds generated by North Slope oil have been reinvested in Alaska. According to the *P/W* figures, the companies' current cash flow (profits and depreciation) from the North Slope comes to \$10.6 million per day.¹² The Division of Policy estimates that the rate of oil industry reinvestment in Alaska is \$1.9 million per day. Thus, as shown in Figure 2, the oil industry today is taking \$8 Outside for every \$2 it reinvests in Alaska.

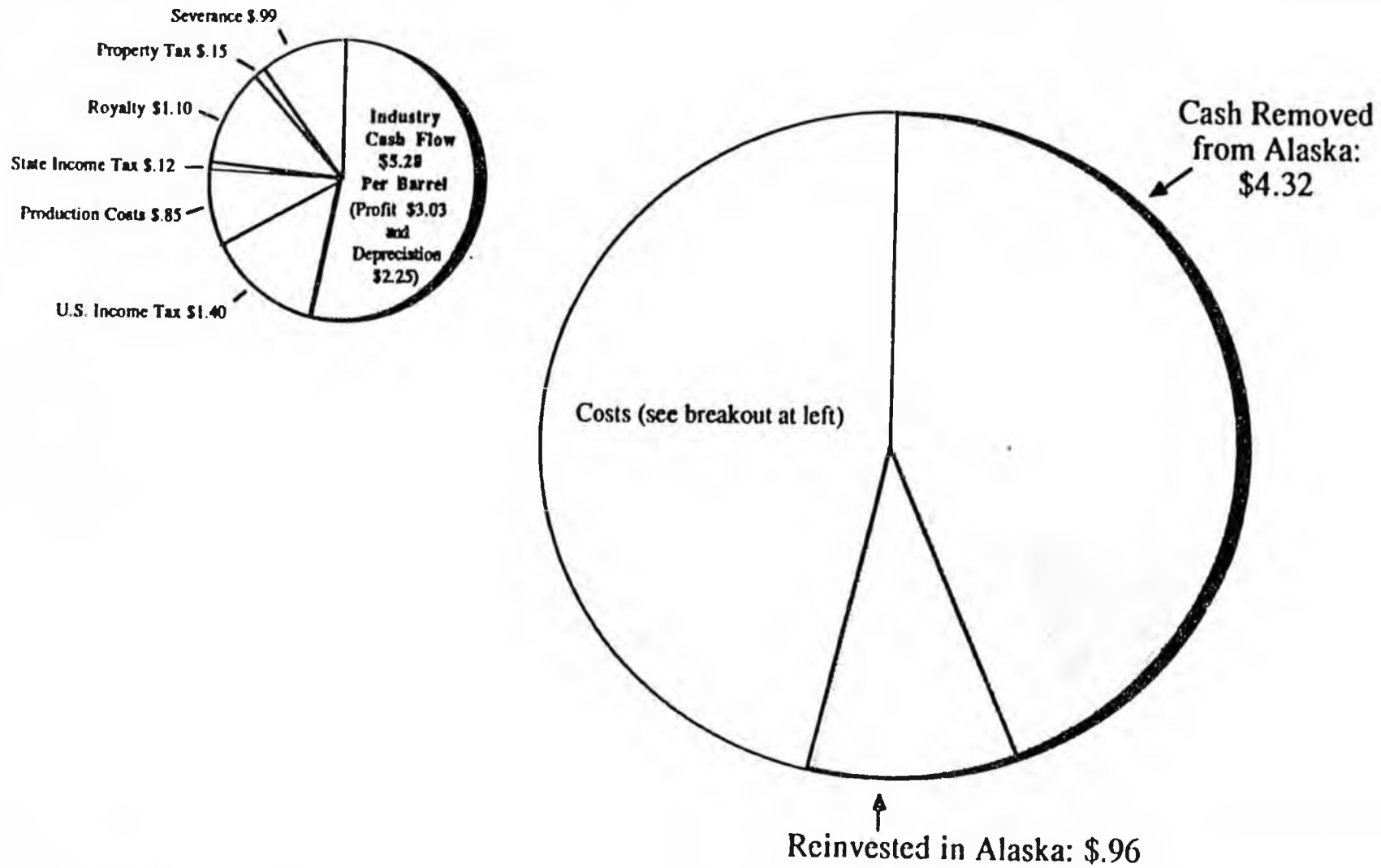
This "takeout" from Alaska's North Slope production has made the major producers in Alaska uniquely successful companies. A March 21,

¹² The *P/W* figures do not include depreciation on the pipeline, so the cash flow to producers from North Slope operations is understated.

Figure 2

The Economics of North Slope Oil

(Dollars Per Barrel)



Source: Division of Policy, based on
Petroleum Intelligence Weekly
February 1, 1988.

Office of the Governor
Division of Policy
4/12/88

1988 *Forbes* article examined ARCO's phenomenal success: "...a return on equity of 23 percent, just about the best in the industry and roughly twice the industry average." Astute corporate management, company restructuring, and its Alaska resources let ARCO "claim the highest per-barrel profit of any marketer on the West Coast." Key to ARCO's current strength, said *Forbes*, "is its commanding position in the U.S. largest oil reserve, the Alaskan North Slope, from which it derived 68 percent of its production last year." With \$3 billion in cash reserves, ARCO is actively investing its Alaskan profits elsewhere.

A report by Salomon Brothers, March 31, 1988, similarly calls ARCO "the premier equity investment in the domestic oil industry." The report goes on to say, "Arco's Alaskan resource base is without parallel in the industry in terms of its size alone. Arco's net share of the original oil in place in its Alaskan oil fields, 20 billion barrels, is equal to 75 percent of the proved oil reserves of the rest of the country." Top ARCO management also cited its Alaska holdings as key to the company's profitability: "ARCO Alaska's low-cost producing ability provides the base for ARCO's West Coast downstream infrastructure: its integrated transportation and refining and marketing assets." ¹³

Production

Oil development patterns are not easily predictable so forecasts of future production should be interpreted cautiously. Department of Revenue modeling studies nevertheless suggest that while the new ELF

¹³ "Alaska Operations," Harold Heinze, President, ARCO Alaska, Inc., Oil Industry Analysts Meeting, March 31, 1987.

could initially cause lower production, any impact would be small. The probabilities are that the new ELF will decrease North Slope output by a cumulative 1 million barrels during the FY 1988-93 period — equal to about 12 hours of flow through the TAPS pipeline. The cumulative production loss through 2005 is estimated at about 21 million barrels, or about 10 days of North Slope production. Losses taper off in later years but become gains sometime after 2020, when the new ELF increases incentives for production in the later stages of oil field life.

The ELF is a minor factor in industry decisions to pursue Prudhoe Bay development. What matters most is oil prices. For example, a spokesperson for ARCO, commenting on that company's plans to drill five Prudhoe Bay development wells in September, 1987, stated, "resuming production drilling in Prudhoe is good news and strictly the result of higher oil prices."¹⁴ A March 31, 1988, stock research report notes, "West Sak field production could start in 1992, because the field is profitable at oil prices of \$15-20 per barrel."¹⁵

How does increased production benefit Alaska? Nearly all manufacturing and assembly of equipment used in the oil industry is done outside Alaska so economic impacts from that sector are small, according to Department of Labor economists. The ARCO newsletter of January 1, 1988, states, "Between 1980 and 1986, North Slope development accounted for approximately \$10.5 billion in hard goods alone, according to ARCO Alaska, Inc., Standard Alaska Production Company and Conoco." The newsletter indicates one-eighth of that amount (\$1.35 billion) was spent in

¹⁴ Alaska Report, p. 1, 7/22/87.

¹⁵ Atlantic Richfield Company---Restructured and Resourceful, Part II, by Salomon Brothers, March 31, 1988, p.1.

Alaska, with the remainder going Outside, with Texas and California the largest beneficiaries.¹⁶ Employment opportunities, however limited, and revenues to the state, are the most readily discernible benefits to Alaska.

Comparing Taxes

Though the existing tax at Prudhoe Bay is 12.3 percent, the *nominal* rate at Prudhoe Bay, without the ELF, is 15 percent. But no field in Alaska pays the full tax rate. Furthermore, the severance tax rate contrasts with the low corporate income tax rate.¹⁷

Each state designs its severance tax structure for its particular conditions in that jurisdiction. The range of profitability among fields in Alaska is very different from any other state. In none of the other states is there an oil field even close to the size of Prudhoe Bay. But because the fields in other states are much nearer to oil markets, the wellhead price of a barrel is much lower in Alaska. Unlike other states, Alaska gains little

¹⁶ On Top of ANWR, ARCO Alaska, Inc., January 1, 1988.

¹⁷ Here is how Alaska's effective severance tax rate compares to other major oil-producing states on a percentage basis:

<u>State</u>	<u>Severance Tax as a Percent of Value</u>
Alaska (Prudhoe proposed)	14.8 %
Wyoming (state & average local)	13.0 %
Louisiana	12.5 %
Alaska (Prudhoe existing)	12.3 %
Alaska (Kuparuk proposed)	11.9 %
Alaska (Kuparuk existing)	8.0 %
Oklahoma	7.0 %
Texas	4.6 %
New Mexico	3.8 %

This chart is based on average effective severance tax rates in FY 1988. Under current law the Prudhoe Bay rate will decline to 11.9 percent in FY 1989.

from the manufacturing and retail sales of most of its petroleum resources — although the producers realize additional profits from transporting, refining, and selling North Slope oil. Differences like these make simplistic comparisons regarding which state has the "highest" or "lowest" severance tax of limited use.

On a dollars-per-barrel basis, for example, Alaska's tax rate is among the lowest of all the producing states.¹⁸ If the oil fields in these states were somehow transported to Alaska, all would find their severance taxes reduced or eliminated. The reason for this apparent paradox is that all are so much smaller than Prudhoe Bay or Kuparuk. Prudhoe Bay wells, according to Standard Alaska, are producing an average 2,300 barrels per day. The average oil well in Texas, in contrast, produces 145 barrels per day. A well producing at that rate in Alaska, like most oil wells in Cook Inlet, would pay no severance tax whatever under either the existing or proposed ELF. Similarly, virtually all the fields Outside that would pay tax under the current ELF would pay less tax under the new ELF.

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<u>State</u>	<u>Approximate Severance Tax Per Barrel</u>
Wyoming (state & average local)	\$2.02
Louisiana	\$1.94
Alaska (Prudhoe proposed)	\$1.26
Oklahoma	\$1.08
Alaska (Prudhoe existing)	\$1.05
Alaska (Kuparuk proposed)	\$1.04
Texas	\$0.71
Alaska (Kuparuk existing)	\$0.62
Alaska (Cook Inlet)	\$0.00

Estimates for other states are derived from the effective tax rates of other states at a well-head price of \$15.50 (Gulf Coast).

The "Commitment"

The ELF issue in 1988 is the legacy of a 1981 tax bill that passed in an extraordinary hurry. The issue of how to respond to the North Slope oil producers' legal challenge to separate accounting was the focus of attention for much of the 1981 legislative session. However, the proposal that modified the ELF was first unveiled to a free conference committee on June 22, 1981. Two days later, it passed both houses and was on its way to the governor. There was little time to study the bill; moreover, the fiscal note prepared by then-Commissioner Williams included no projections beyond FY 1985. The confusion concerning what legislators and Governor Hammond meant when they adopted the 1981 legislation is not surprising.

A 1981 post-session analysis by the Legislative Finance Division showed that the ELF provision would cause state revenue to fall sharply in FY 1988. When Governor Hammond reluctantly signed the bill, he expressed "full confidence in the ability of the legislature to deal at that time" with any adverse revenue consequences.

Governor Hammond insisted that the oil tax changes adopted in 1981 not reduce the state's share below the 30 percent that was thought to be the rough percentage level of the state's share *at that time*. Hammond sought to insure that the tax changes would be "revenue neutral;" i.e., that the changes would leave state oil revenue largely unaffected. It is now clear that the changes adopted in that bill were far from neutral as to state revenue: between fiscal 1982-87 total tax collections were reduced by over \$1 billion compared with what would have been collected had the changes not been made.

As shown in Appendix C, the 1981 record contains statements by Hammond, then-Rep. Rick Halford, Commissioner Williams and others addressing the future need to revise the 1981 scheme by 1987 or 1988. But the written record of the 1981 deliberations provides no evidence of any legal, moral, or political commitment by state officials to limit the state's appropriate share of future oil income. Additionally, company officials testified to the Legislature that the state's share should equal the industry share.

Revenue Effects

As originally introduced by the Governor in 1987, the ELF legislation would have kept the ELF from applying to Prudhoe Bay for an additional five years. The measure that passed the House and now awaits action in the Senate takes a more comprehensive approach: the new ELF applies at Prudhoe Bay, but the formula for calculating the new ELF includes consideration of field productivity in addition to well productivity. The new formula gives Prudhoe Bay a much smaller tax break now, but a larger tax break later when the giant field finally reaches its marginal years of production. Tax revenue from nearby Kuparuk, the second largest producing field in the United States, would also increase. All other producing fields would either pay no tax at all or receive a bigger tax break than they get under the current ELF.

The net effect of the new ELF, using the Department of Revenue's March, 1988 "mid-case" assumptions, would be \$150 million in additional state revenue in FY 1988, and \$152 million in FY 1989. To put this amount

in perspective, \$150 million is about the amount of the combined annual general fund budgets of the departments of Fish and Game, Labor, Commerce, Natural Resources, Revenue and Environmental Conservation, and about one-quarter of the amount the state spends each year on elementary and secondary education. As the table below shows, the revenue gain from the new ELF depends, in part, on the level of oil prices.¹⁹

<u>Average Oil Prices</u> ²⁰	Incremental FY 89 Revenue From the ELF Bill, <u>CSHB 164 (Fin) am</u>
\$11.00/B	\$114 million
\$12.00/B	\$125 million
\$13.00/B	\$136 million
\$14.00/B	\$146 million
\$15.00/B	\$157 million
\$16.00/B	\$167 million

According to Department of Revenue projections, the dollar gain from the new formula would peak in FY 91 at \$223 million, and then gradually diminish as Prudhoe Bay production declines. The yearly dollar gain from the new ELF will vary with oil prices and total oil production. Over the next six years, the percentage loss to the state's oil revenue from

¹⁹ Other factors would also affect the fiscal effect of the proposed legislation. The table is based on the "mid-case" assumptions in the current Department of Revenue forecast.

²⁰ Weighted average of U.S. West Coast and Gulf Coast selling prices for Alaska North Slope crude.

the current ELF will increase from approximately 8 percent this year to nearly 14 percent in fiscal year 1993. (Complete long-run projections are contained in the ELF legislation fiscal note, in Appendix A .)

Budget Stability and the Economy

In opposing the ELF legislation, one senator argues that "the solution to Alaska's economic problems is not increasing taxes to fuel more government spending," but instead to just cut state spending.

How big a cut would be required to balance the budget? With only weeks to go in the legislative session, Alaska faces a revenue shortfall of about \$150 million to \$400 million, depending on the optimism of the forecaster. Theoretically, the budget could be balanced by cutting hundreds of millions of dollars from spending, but this approach is hard to take seriously in light of the vital impact of state spending on a recovering economy. In fact, the legislature has already recognized the role of state spending in the economy's health in its early passage of the "jobs" bill.

Budget cuts over the last three years have brought per capita real spending down — dramatically. The deepest recession the state has ever experienced was one consequence. Now — as that recession is ending — is not the time for extracting hundreds of millions of dollars from Alaska's economy.

With state spending now well below its 1979 level and the economy starting its recovery, Governor Cowper has proposed a maintenance level budget. The House and Senate can reduce the budget shortfall by eliminating proposed expenditures. But, close to half the budget is pass-

through entitlement programs to local governments, schools, and individuals, politically difficult areas to cut. It appears the majority of Senators and Representatives do not believe this is the time for inflicting the stress of another multi-million dollar spending cut on the Alaska economy. Although reductions and reallocations will certainly occur, deep cuts are not a realistic possibility.

So what options are left? The use of the Railbelt Energy Fund has been proposed. But many Railbelt voters rebel against "their" money being spent to solve a statewide problem, and the construction industry opposes any non-construction use of the money.

Another option is to use the cash reserves (earnings reserve account) of the Permanent Fund. Using the reserves would reduce future dividends. However, the necessary appropriation could be a "loan" with a promised but problematical payback in the future. Combined, the Railbelt Energy Fund and the Permanent Fund earnings reserves are the state's cash reserves since last year the Budget Reserve Fund was emptied to help meet last year's revenue shortfall. Without these funds as backstops, Alaska is left with no emergency monies to meet another precipitous drop in oil prices.

Leaving aside the obvious difficulties inherent in the use of either the Railbelt Energy Fund or Permanent Fund earnings to fill the budget shortfall this year, there remains the issue of revenue stability. This issue deserves very serious consideration for two reasons. First, Alaskans desire and need public services. Second, there clearly exists a now-demonstrated tie between Alaska's revenue stability and Alaska's economic stability.²¹

²¹ For evidence of the relationship of state budget stability to economic activity in Alaska, see "Can State Spending Speed Alaska's Recovery," by Professor Scott Goldsmith and Lee Gorsuch, Institute of Social and Economic Research, University of Alaska, December 8, 1987.

Both reserve sources are only stop-gap measures, providing one or two years of fiscal relief, at most. Neither fund provides an answer to the ongoing loss of more than 8 percent of Alaska's oil revenues and the erosion of Alaska's fiscal strength year after year. The new ELF does. It's a long-term solution to what will otherwise be a long-term loss.

Finally, the legislature simply could pretend that there is no problem. Led by the Senate, the legislature gambled last year that oil price increases would cover the shortfall in the budget with extra revenue. It worked then, due in part to the unexpected receipt of some monies owed the state by the federal government.²² The legislature could roll the dice again. The risk is that the extra revenue will not materialize and that the state will be unable to pay its bills. If oil prices don't rise, current cash flow projections show that the risk could become reality as early as February or March 1989.

Division of Policy

April, 1988

²² The funds received were \$160 million which had been held in escrow by the federal government pending resolution of the Dinkum Sands boundary dispute.

Appendix A

STATE OF ALASKA
1988 LEGISLATIVE SESSION

BILL VERSION: CSH8164 (FIN) 37
PUBLISH DATE: _____

FISCAL NOTE

REQUEST:

Revision Date: April 4, 1988
 Title: An Act Relating to the Oil and Gas Properties Production Tax & Effective Date
 Sponsor: Rules/Governor
 Requestor: _____

Agency Affected: _____
 BRU: _____
 Components: _____

EXPENDITURES/REVENUES: (Thousands of Dollars)

OPERATING	FY 88	FY 89	FY 90	FY 91	FY 92	FY 93
PERSONAL SERVICES						
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING						

CAPITAL						
---------	--	--	--	--	--	--

REVENUE	150,150	152,330	203,450	222,850	213,940	207,490
---------	---------	---------	---------	---------	---------	---------

FUNDING: (Thousands of Dollars)

GENERAL FUND						
FEDERAL FUNDS						
OTHER						
TOTAL						

POSITIONS:

FULL-TIME						
PART-TIME						
TEMPORARY						

ANALYSIS : (Attach a separate page if necessary)

See Attached

Prepared by: Charles I. Logsdon *Charles I. Logsdon* Phone: 277-5627
 Division: Oil and Gas Audit Date: April 4, 1988

Approved by Commissioner: *[Signature]* Date: 4/4/1988
 Agency: Revenue

Distribution (by preparer):
 Legislative Finance
 Legislative Sponsor
 Requestor
 Office of Management and Budget
 Impacted Agency(ies)

This bill would effectively increase the severance tax rate on fields producing greater than approximately 120,000 barrels per day. At the same time, fields producing less than this amount would be taxed at a lower rate. The relative increase or decrease would depend on the relative per well productivity of the field. The estimates contained in this fiscal note are based on the Department of Revenue March 1988 mid scenario assumptions about production, wells, and oil prices.

The attached tables illustrate the revenue and tax rate impact of the bill by North Slope oil field. The sensitivity of the tax revenues to change in oil prices is also illustrated.

FY 1989 PRICE/REVENUE SENSITIVITY OF CSHB164(fln) am
(Millions \$)

	\$10.00/bbl	11.00	12.00	13.00	14.00	15.00	16.00	17.00
Prudhoe	93.16	102.47	111.79	121.10	130.42	139.73	149.05	158.36
Kuparuk	21.54	23.69	25.84	28.00	30.15	32.30	34.46	36.61
Milne	0	0	0	0	0	0	0	0
Endicott	-6.49	-7.14	-7.79	-8.43	-9.08	-9.73	-10.38	-11.03
Lisburne	-3.72	-4.10	-4.47	-4.84	-5.21	-5.59	-5.96	-6.33
TOTAL	104.48	114.93	125.37	135.82	146.27	156.72	167.17	177.61

CHANGE IN REVENUE CSHB164
(Millions \$)

YEAR	PRUDHOE	KUPARUK	MILNE	ENDI	LISE	W SAK	PT THOM	SEAL IS	NIRKUK	TOTAL
1988	130.03	30.30	0.00	-4.27	-5.93	0.00	0.00	0.00	0.00	150.15
1989	133.82	31.40	0.00	-9.46	-5.43	0.00	0.00	0.00	0.00	152.33
1990	172.12	39.56	0.00	-2.04	-5.19	0.00	0.00	0.00	0.00	203.45
1991	190.27	40.37	0.00	-2.25	-5.53	0.00	0.00	0.00	0.00	222.95
1992	183.74	39.51	0.00	-2.40	-7.01	0.00	0.00	0.00	0.00	212.94
1993	180.62	38.38	0.00	-5.24	-6.27	0.00	0.00	0.00	0.00	207.49
1994	176.59	35.55	0.00	-5.55	-5.74	0.00	0.00	0.00	0.00	199.74
1995	171.39	30.60	0.00	-7.41	-7.18	0.00	0.00	0.00	0.00	187.40
1996	162.33	22.19	0.00	-7.59	-7.93	0.00	0.00	0.00	0.00	163.59
1997	164.10	14.09	0.00	-7.22	-3.17	0.00	0.00	0.00	0.00	162.70
1998	157.08	6.98	0.00	-3.34	-3.44	0.00	0.00	0.00	0.00	148.78
1999	144.16	2.76	0.00	-4.23	-3.30	0.00	0.00	0.00	0.00	134.33
2000	137.86	1.22	0.00	-2.29	-3.44	0.00	0.00	0.00	0.00	129.25
2001	127.38	0.46	0.00	-0.61	-3.29	0.00	0.00	0.00	0.00	117.94
2002	118.80	0.08	0.00	0.00	-3.79	0.00	0.00	0.00	0.00	109.09
2003	122.08	0.06	0.00	0.00	-3.43	0.00	0.00	0.00	0.00	112.71
2004	116.55	0.04	0.00	0.00	-3.29	0.00	0.00	0.00	0.00	107.32
2005	103.99	0.03	0.00	0.00	-3.50	0.00	0.00	0.00	0.00	95.03
2006	91.47	0.00	0.00	0.00	-3.26	0.00	0.00	0.00	0.00	82.11
2007	80.13	0.00	0.00	0.00	-7.52	0.00	0.00	0.00	0.00	72.57
2008	69.43	0.00	0.00	0.00	-3.12	0.00	0.00	0.00	0.00	62.31
2009	61.76	0.00	0.00	0.00	-4.73	0.00	0.00	0.00	0.00	57.03
2010	55.85	0.00	0.00	0.00	-3.28	0.00	0.00	0.00	0.00	52.48

CHANGE IN SEVERANCE TAX RATE PERCENT OF VALUE CSHB164

YEAR	PRUDHOE	KUPARUK	MILNE	ENDI	LISE	W SAK	PT THOM	SEAL IS	NIRKUK
1988	0.0249	0.0391	0.0000	-0.0249	-0.0392	0.0000	0.0000	0.0000	0.0000
1989	0.0281	0.0448	0.0000	-0.0322	-0.0321	0.0000	0.0000	0.0000	0.0000
1990	0.0323	0.0481	0.0000	-0.0340	-0.0324	0.0000	0.0000	0.0000	0.0000
1991	0.0373	0.0513	0.0000	-0.0323	-0.0251	0.0000	0.0000	0.0000	0.0000
1992	0.0394	0.0539	0.0000	-0.0323	-0.0277	0.0000	0.0000	0.0000	0.0000
1993	0.0421	0.0530	0.0000	-0.0328	-0.0270	0.0000	0.0000	0.0000	0.0000
1994	0.0450	0.0545	0.0000	-0.0194	-0.0282	0.0000	0.0000	0.0000	0.0000
1995	0.0488	0.0491	0.0000	-0.0251	-0.0282	0.0000	0.0000	0.0000	0.0000
1996	0.0548	0.0405	0.0000	-0.0315	-0.0289	0.0000	0.0000	0.0000	0.0000
1997	0.0548	0.0234	0.0000	-0.0253	-0.0314	0.0000	0.0000	0.0000	0.0000
1998	0.0574	0.0171	0.0000	-0.0375	-0.0345	0.0000	0.0000	0.0000	0.0000
1999	0.0593	0.0083	0.0000	-0.0320	-0.0368	0.0000	0.0000	0.0000	0.0000
2000	0.0597	0.0042	0.0000	-0.0231	-0.0373	0.0000	0.0000	0.0000	0.0000
2001	0.0595	0.0017	0.0000	-0.0102	-0.0391	0.0000	0.0000	0.0000	0.0000
2002	0.0592	0.0001	0.0000	0.0000	-0.0413	0.0000	0.0000	0.0000	0.0000
2003	0.0559	0.0000	0.0000	0.0000	-0.0425	0.0000	0.0000	0.0000	0.0000
2004	0.0553	0.0000	0.0000	0.0000	-0.0433	0.0000	0.0000	0.0000	0.0000
2005	0.0509	0.0000	0.0000	0.0000	-0.0440	0.0000	0.0000	0.0000	0.0000
2006	0.0462	0.0000	0.0000	0.0000	-0.0475	0.0000	0.0000	0.0000	0.0000
2007	0.0409	0.0000	0.0000	0.0000	-0.0434	0.0000	0.0000	0.0000	0.0000
2008	0.0344	0.0000	0.0000	0.0000	-0.0411	0.0000	0.0000	0.0000	0.0000
2009	0.0289	0.0000	0.0000	0.0000	-0.0357	0.0000	0.0000	0.0000	0.0000
2010	0.0209	0.0000	0.0000	0.0000	-0.0214	0.0000	0.0000	0.0000	0.0000

APPENDIX B
ALASKA NORTH SLOPE ECONOMICS *
Weighted Average of West and Gulf Coast Sales as Reported in PIW

<u>REVENUE, COSTS & INCOME PER BARREL</u>				
	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>
Wellhead price/barrel	\$16.72	\$10.17	\$7.54	\$9.47
LESS:				
Royalty/barrel	\$2.01	\$0.73	\$0.86	\$1.10
Severance/barrel	\$2.21	\$0.87	\$1.00	\$0.99
Property tax/barrel	\$0.21	\$0.18	\$0.16	\$0.15
Producing cost/barrel	\$0.00	\$0.75	\$0.80	\$0.85
Depreciation/barrel	\$1.53	\$2.17	\$2.21	\$2.25
State income tax/barrel	\$0.29	\$0.00	\$0.08	\$0.12
US income tax/barrel	\$4.54	\$0.84	\$0.89	\$1.40
PLUS:				
Pipeline profit/barrel	\$2.18	\$0.64	\$0.58	\$0.43
EQUALS:				
Industry profit/barrel	\$7.22	\$1.56	\$2.13	\$3.03
<u>NET INCOME SHARES</u>				
<u>Shares in dollars per barrel</u>				
Industry profits/barrel	\$7.22	\$1.56	\$2.13	\$3.03
State & local rev./barrel	\$4.71	\$1.84	\$2.10	\$2.37
Federal rev./barrel	\$4.54	\$0.84	\$0.89	\$1.40
<u>Shares in billions of \$ per year</u>				
Industry profits/year	\$5.004	\$1.102	\$1.530	\$2.211
State & local revenue/year	\$3.269	\$1.294	\$1.512	\$1.728
Federal revenue/year	\$3.148	\$0.592	\$0.640	\$1.022
<u>Shares in percent of total</u>				
Industry profits	43.8%	36.9%	41.6%	44.6%
State & local revenue	28.6%	43.3%	41.1%	34.8%
Federal revenue	27.6%	19.8%	17.4%	20.6%
<u>ALASKA REINVESTMENT PERFORMANCE</u>				
<u>Reinvestment in billions \$/year</u>				
Cash flow (billions \$/year)	\$6.065	\$2.630	\$3.119	\$3.853
Reinvestment (billions \$/year)*	\$0.860	\$1.322	\$0.650	\$0.700
<u>Reinvestment in \$/barrel</u>				
Cash flow per barrel	\$8.75	\$3.73	\$4.34	\$5.28
Reinvestment per barrel*	\$1.24	\$1.88	\$0.90	\$0.96
Percentage reinvested in Alaska	14%	50%	21%	18%

* Revenue, costs and income data from *Petroleum Intelligence Weekly* (attached); reinvestment performance estimated by the Division of Policy. See the following page for additional notes.

Division of Policy, 4/11/88

Notes to analysis of *PIW* data on North Slope economics:

1. *PIW* data for the first and second half of 1986 and 1987 were averaged using equal weights to produce the average annual values shown on the preceding page.
2. *PIW* values stated separately for U.S. West and Gulf coasts were combined to provide weighted average figures; the following weighting factors were used (West/Gulf): 1985-50%/50%; 1986-52.5%/47.5%; 1987-56.66%/46.67%; 1988-60%/40%.
3. Annual revenue figures assume production levels of 1.90 MMB/D, 1.93 MMB/D, 1.96 MMB/D, and 2.00 MMB/D in 1985-88 respectively.
4. Data for 1988 are extrapolated assuming costs and revenues continue at the per barrel levels reported in *PIW* for the first two months of 1988.
5. Reinvestment estimates for 1985-6 are from Income and Investment Flows From Alaska Oil and Gas Producing Activities, by Edward Deakin, May, 1987. Estimates for 1987-8 are Division of Policy estimates based on industry statements of current and planned project activity.
6. Cash flow is understated by an estimated \$2.00 per barrel because depreciation on pipeline investments are not accounted for separately in the *PIW* data. (Pipeline tariffs are deducted before determining the wellhead price per barrel.)

Division of Policy
11 April 1988

PETROLEUM INTELLIGENCE WEEKLY

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Office of the Governor, Juneau 3/23/88

• Living With \$15 Oil p.5 • Shift In Tanker War..... p.7

Short-Haul Sales By Saudis Key To Overseas Stockbuild

Oil markets should be very careful in drawing grand conclusions about Saudi Arabia's oil policies on the basis of its latest foray to charter ships for moving crude oil into its overseas stockpile. The fact is that Saudi Arabia is in the process of placing a large chunk of stockpile crude with several of the Aramco partners on a delivered basis, and it chartered the tankers almost entirely to replenish those supplies, according to well informed PIW sources in shipping circles. The stockpile moves say more about Riyadh's wish to retain a basic presence as a short-haul crude supplier in the Caribbean and Europe (p5) than about its long-term goals or role within Opec (PIW Jan. 25, p1). PIW confirms that the Saudis have lined up five ships to move 10-million barrels of oil into overseas storage in the coming weeks, plus at least one other vessel to supply non-Aramco clients like Ashland and Marathon. In the past, the Saudis have used the Western Hemisphere stockpile for occasional spot sales, and more routinely to supply term customers on a prompt basis.

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By taking nearby crude from the stockpile now, the Aramco partners get the benefit of the oil in the heart of the winter season, rather than in late March or early April when oil loaded today in Saudi Arabia would arrive at Atlantic Basin destinations. The stockpile barrels are within the overall 1.4-million b/d of crude the partners obtained from the Saudis in January, and are expected to take in February. They do not represent any extra supply. Overall Saudi output volume is still below Opec quota in the 3.8- to 4-million b/d range (excluding the Neutral Zone). This suggests Riyadh is willing to cautiously and temporarily stick with other Opec producers in sharing some of the burden of

(continued on p. 4)

Alaskan Oil Profits Staying Buoyant Amid Volatile Prices

With oil markets again threatening a possible sharp drop in prices, US Alaskan production looks surprisingly well positioned to cope with a repeat of the collapse of 1986. Despite high transport costs that would appear to make Alaskan North Slope output highly vulnerable to lower prices, it is currently making good profits at \$14.50-\$15.50 delivered prices, and has shown it can break even at \$10 a barrel. Profits also bounce back quickly as prices recover, according to a PIW analysis of Alaskan North Slope economics (see table). Producers briefly suffered losses of a few pennies a barrel in mid-1986 when the delivered price at the Gulf Coast fell to \$10. But profits rebounded to an average \$3.50 in 1987, and even managed to average over \$1 a barrel in disastrous 1986. ANS crude — which is one-fourth of US production — realizes a healthy \$2.60-\$3.20 a barrel now, depending on sales destination.

Even if prices dropped below \$10, very little North Slope production would be shut in, mainly because of the large amounts already invested in current output and its importance to US supply. What's more, the oil is primarily absorbed into the refining and marketing systems of producing companies, and low crude prices usually provide

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HEAD OFFICE: One Times Square Plaza, New York, N.Y. 10036. Telephone: (212) 575-1242; Telex: 62371 Petrom; Facsimile Phone No. (212) 391-3906
LONDON: 121 Charterhouse Street, EC1M 6AA. Phone (01) 608-1321; Telefax (01) 608-1324. SUBSCRIPTIONS: \$1,150 annually to all areas by air or courier

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 Office of the Governor, Juneau 3/23/88

offsetting improvements in the profitability of downstream refining. Meanwhile, the long-term outlook for Alaskan North Slope crude is encouraging a continuing buildup of production capacity, in sharp contrast to plunging production in other US areas. ANS output surged over 2-million b/d in late 1987 as Alaska displaced Texas for the first time as the largest source of US crude. The North Slope is still regarded as holding the best potential for finding big new fields. But discoveries have to be large to offset growing development and operating costs, already apparent at the Kuparuk River and Endicott fields, and for enhanced recovery in super-giant Prudhoe Bay (PIW Jan.25.p10).

Since the 1986 price collapse, the economics for Alaskan North Slope crude sold on the West Coast have become relatively more profitable than the longer shipments to the Gulf and East Coasts, which used to earn almost as much. As a result, more North Slope crude is moving to the California market, with the West Coast absorbing 60% of last year's higher production versus 50% in 1985. Profits on West Coast sales are now about 65¢ a barrel higher than those to Atlantic ports, compared to a gap of 10¢ in 1985. This mainly reflects the much larger \$11.66 a barrel drop in ANS prices to Gulf and East Coast destinations in the last two years compared to a drop of just under \$10 on the West Coast. The bigger decline in the east is hard to explain but is probably only partly due to the highly competitive Atlantic Basin crude oil market.

THE COMPARATIVE ECONOMICS OF ALASKAN NORTH SLOPE PRODUCTION (in dollars per barrel)

	Sales To US East Coast						Sales To US West Coast					
	1985	1987	1988	1988	1988	Year	1985	1987	1988	1988	1985	Year
Delivered Price	Current	2nd H	1st H	2nd H	1st H	Year	Current	2nd H	1st H	2nd H	1st H	Year
Soho Price	\$15.50	\$18.45	\$17.00	\$12.00	\$16.80	\$27.00	\$14.50	\$17.45	\$16.00	\$11.00	\$15.80	\$25.00
Average Price(a)	15.25	18.82	18.99	12.31	18.72	29.91	14.28	18.48	18.58	10.79	14.54	24.23
Less:												
Shipping Cost	3.35	3.21	3.19	3.38	3.72	4.21	0.99	0.98	0.94	0.94	1.14	1.29
Valuez l.o.b.	11.90	13.61	13.80	8.93	12.00	22.70	13.28	14.52	14.62	9.81	13.40	22.94
Less:												
Pipeline Loss	0.05	0.10	0.05	0.05	0.05	0.10	0.05	0.10	0.05	0.05	0.05	0.10
Pipeline Tariff	3.20	3.95	3.95	4.50	4.50	6.00	3.20	3.95	3.95	4.50	4.50	6.00
Wellhead Price(b)	8.85	9.56	9.80	4.38	7.48	18.80	10.81	10.47	10.62	5.28	8.85	16.84
Less:												
Royalty(c)	1.00	1.11	1.14	0.47	0.85	1.98	1.17	1.23	1.24	0.58	1.02	2.02
Severance(d)	0.91	1.00	1.30	0.59	0.99	2.19	1.05	1.09	1.40	0.70	1.17	2.22
Property Tax	0.15	0.15	0.15	0.18	0.18	0.21	0.15	0.15	0.15	0.18	0.18	0.21
Producing Cost	0.85	0.85	0.85	0.75	0.75	0.90	0.85	0.85	0.85	0.75	0.75	0.90
Deprecation(e)	2.25	2.25	2.25	2.17	2.17	1.53	2.25	2.25	2.25	2.17	2.17	1.53
Pre-Tax Profit	3.49	4.20	4.11	0.23	2.51	5.78	4.54	4.90	4.72	0.88	3.55	9.96
Less:												
State Income Tax(f)	0.10	0.13	0.12	0.01	0.08	0.29	0.14	0.15	0.14	0.03	0.11	0.30
US Windfall Tax(g)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
US Income Tax(h)	1.19	1.43	1.40	0.11	1.16	4.50	1.54	1.67	1.61	0.41	1.64	4.58
Oil Profit	2.20	2.84	2.58	0.12	1.28	4.88	2.86	3.08	2.98	0.45	1.81	5.08
Pipeline Profit	0.43	0.53	0.53	0.64	0.64	2.18	0.43	0.53	0.53	0.64	0.64	2.18
Overall Profit	2.63	3.17	3.12	0.76	1.92	7.17	3.29	3.62	3.51	1.09	2.45	7.26

a) Average of all producers. b) Price at Pump Station #1. c) Royalty 12.5% after deduction of gathering costs (63¢ 1988, 66¢ 1987 & 1986, 85¢ 1985). d) Severance Tax based on wellhead price after deduction of royalty (11.94% from 2nd Half 1987 to present, 14.96% 1985 to 1st Half 1987). e) Includes depletion. f) Average state income tax rate of 3% for all producers. g) Windfall profits tax not applicable at lower wellhead prices. h) US income tax rate 34% 1987 to present and 46% previously, after deduction of costs, state taxes.

Another big change in the last few years is the more even split between producing company profits and the tax take of federal and state governments. With Alaskan wellhead prices well below the floor level of US "windfall" taxation, the tax burden has shrunk to an estimated \$3.35 a barrel currently. Reduced corporate income tax rates from 46% to 34% starting in 1987 has also helped producers. However, Washington claims that the companies may owe \$200-million in "windfall" profits taxes for 1984 and 1985 due to disparities in pricing and pipeline charges among the various Alaskan oil producers (PIW June 13, '83,p3).

The settlement of a 7-year legal dispute over Alaskan pipeline tariffs has also put an extra squeeze on profits since 1986, with the Trans-Alaskan Pipeline providing 15% of North Slope profits now compared to 30% in 1985. Aimed at fostering greater competition for North Slope leases, the resolution with the seven owners (BP 50%, Exxon and Arco

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20% each, and the rest split between Mobil, Phillips, Union and Amerada Hess) sharply reduced tariffs, settled back claims of overcharges and put the pipeline on a real-rate-of-return basis starting in 1986 (PIW Nov. 4, '85, p8).

The existence of a semi-secret and unofficial "mini-Brent" North Sea market might help London's International Petroleum Exchange win a central role in the globalization of oil futures dealing. Mini-Brent could provide a model for the IPE as it prepares another relaunch for its failed Brent futures contract following the New York Mercantile Exchange's refusal to trade US crude futures in London as a joint venture (PIW Jan. 25, p8). Shocked and disappointed by Nymex's rejection of joint trading of West Texas Intermediate futures, the IPE is considering a number of alternative options, with a restyled 1,000-barrel Brent contract based on cash settlement rather than physical delivery at the top of the list (PIW Jan. 25, p8). Other possibilities include a London-based West Texas Intermediate contract administered independently of Nymex, and a link to another US exchange such as the Chicago Board of Trade, which dabbled with oil futures several years ago.

Steady but largely unpublicized trade in the unregulated mini-Brent market leaves little doubt that demand exists for a financial tool of this type geared to European crude. Also known as the Brent partial market, and only reluctantly revealed to PIW by major players, mini-Brent is the brainchild of US investment banks. But its future is now in doubt due to new UK laws which may leave room for the IPE to take over instead. Mini-Brent works because the investment banks are willing to buy and sell futures contracts for part-cargoes of Brent in 50,000 barrel increments under their own set terms, normally closing out at an agreed cash-settlement price as 600,000-barrel forward Brent cargoes begin to trade in the physical market. However, this trading could fall foul of the forthcoming UK Financial Services Act (PIW Jan. 11, p2). The IPE, as a recognized futures exchange, might win approval of a similar standard contract, using well-established procedures of exchange-of-futures-for-physicals for participants wanting to take delivery. The IPE is now seeking industry advice on how to tailor a new contract, but there's virtually universal agreement that simply restyling the existing 1,000-barrel contract won't work.

Even with its poor track record in marketing and planning, the London futures exchange is still eager to launch its own crude contract that will spark trade both locally and from Mideast and Far East time zones, largely out of New York's normal reach. It plans "some form of significant trading incentive scheme to encourage initial participation" and scope for broader membership, aimed at attracting more active floor traders. While Nymex boasts almost 800 members and last year traded an average 40-million b/d, there are currently just 57 authorized IPE dealers. There's general dismay in European trading circles over the Nymex's "parochial" decision not to come to London, coupled with the recognition that Eastern Hemisphere traders increasingly want to use crude futures (PIW Dec. 7, p6). The IPE has already been approached by the Singapore International Monetary Exchange on possible broad cooperation.

**In Opec
tives To
ounting**

Like the big Mideast exporters, Opec's key African members are moving fast to cushion themselves against rapid swings in output even in a weak market. But they are using very different means to achieve the same ends. Resisting straight market-related pricing, the Africans are looking to product sales, processing deals of various kinds and enhanced margins for foreign equity producers to sustain volumes. Though techniques differ, almost all Opec exporters are adapting to an oil market in which some price volatility is seen as inevitable, making maintenance of sales to key customers in ways that cause the least market disruption a top priority (PIW Jan. 25, p1). The various methods reflect marketing strengths of individual producers and preferences of traditional customers, among other factors.

Among African producers, Libya appears to have significantly reduced its vulnerability to short-term market swings. Though volume has fallen somewhat, Tripoli seems to be offsetting much of the recent loss of up to 200,000 b/d in third-party crude sales to traders without flooding the Mediterranean with discounted crude. They've

APPENDIX C -- EXPLANATION OF 1981 OIL TAX LAW CHANGES

I. Introduction

The 1981 oil tax legislation (ch. 116, SLA 1981) replaced the separate accounting oil and gas corporate income tax, enacted in 1978, with a modified apportionment-based corporate income tax. To make up the substantial loss in revenues caused by this shift, the legislation also raised the severance tax rate on Prudhoe Bay from an effective rate of just over 11% (with the ELF) to 15%. This increase was accomplished by raising the nominal rate from 12.25% to 15% and effectively suspending the ELF until the tenth anniversary of Prudhoe Bay production in 1987. (For fields beginning production after June 1981, the nominal rate was set at 12.25% for the first five years of production.) Taken together, the two changes were intended to be revenue neutral.

In addition to the two primary changes -- eliminating separate accounting and increasing the severance tax -- the 1981 law also:

- (a) made retroactive technical amendments (known as the "warts" amendments) to state tax laws in order to improve the retrospective constitutionality of separate accounting;
- (b) corrected tax problems posed by the sharing of oil and gas revenues among Native corporations under §7(i) of the Alaska Native Claims Settlement Act;
- (c) allowed for the retroactive deduction of federal windfall profit tax payments; and
- (d) instituted a graduated, stair stepped rate, beginning at 1%, for the taxation of corporate income under \$100,000, and raised the top rate from 9.4% to 11% for one year.

Tax "stability" was not the issue in 1981. The 1981 law was passed solely in response to litigation filed by the oil industry challenging the 1978 separate accounting corporate income tax. Unlike the separate accounting law, which was passed after nearly a decade of study, discussion, and debate, the 1981 oil tax changes were not designed to make the state's tax system fair and predictable, or to encourage future exploration and production. Instead, the 1981 law was designed to limit the state's potential liability as a result of the oil companies' legal challenge to the 1978 separate accounting law. Because the oil industry benefitted from the 1981 law, it did not object to the changes in the state's oil tax structure.

At the time the 1981 law passed, many assumed that the oil tax issue would be revisited, after a decision on the 1978 law was made, and before the June 1987 reimposition of the ELF. The state won the separate accounting litigation in the trial court in May 1983 and on appeal to the Alaska Supreme Court in August 1985. The statute's constitutionality was affirmed by the U.S. Supreme Court in January 1986.

II. How It Happened

A. Activity Before 1981

The 1977-78 Alaska Legislature and Hammond Administration, confronted with the prospect of the first commercial production from Prudhoe Bay, instituted a comprehensive revision of the state's oil and gas tax structure. In 1977, the legislature, with the active support of the governor, increased the maximum severance tax rate from 8% (first put in effect in 1970) to 12.25%. An economic limit factor [ELF] formula replaced the statutorily-reduced rates for well production less than one thousand barrels per day (from 1973-1977, a well's first 300 barrels were taxed at 5%, and the next 700 barrels at 6%). The ELF was designed to give the severance tax a curved or sliding scale, instead of stair stepped, rate.

In 1978, the separate accounting oil and gas corporate income tax was enacted. The law was developed and passed in response to detailed analyses, prepared for the legislature and administration from 1970-78, showing that the state's existing apportionment-based corporate income tax would result in Prudhoe Bay oil producers paying less than a third of the statutory rate of 9.4% of net income. The apportionment tax also had the inequitable effect of imposing different tax levels on producers with the same profits in Alaska, in effect penalizing producers with a larger degree of investment and employment in Alaska.

In early 1979, the major Prudhoe Bay oil producers filed suits challenging the constitutionality of the 1978 separate accounting law. Concerned over the amount of revenues at risk in the litigation, in the fall of 1980 the Hammond Administration engaged in substantive settlement discussions with those companies. The options proposed would have required the sacrifice of several hundred million dollars of state revenue in order to settle the litigation.

B. The 1981 Session -- Policy Background

At the beginning of the 1981 session, House and Senate leaders urged the Administration to pursue solutions to the problems posed by the oil industry suit that would not require revenue losses to the state. On March 18, 1981, the leadership of

both chambers, including Senate President Kerttula and Finance Chairmen Dankworth and Bennett, House Speaker Duncan and Finance Chairman Cotten, and Governor Hammond, Attorney General Condon, and Revenue Commissioner Tom Williams, joined in a statement declaring that "any significant decreases in state oil and gas revenues appear both unwarranted and unsupported by a majority of Alaskans. . . . All agree that any changes which would give large sums of money to the oil industry at the expense of the people of Alaska are unacceptable."

House leaders did not agree with the Administration's view that existing law needed to be changed. They were more optimistic that the separate accounting statute would be upheld, as it was in 1986. They believed that the tax structure put in place in 1977-78 was sound, and preferable to the alternatives of a higher severance tax or an apportionment-based income tax. They also believed any changes to state tax laws should be made after, not prior to, any unfavorable court decision, and that the potential problem of having to refund money to the oil industry was better left to the future, if and when it was more than a hypothetical possibility.

C. The 1981 Legislation

Because the Administration felt that some action was required to limit the risk posed by the separate accounting lawsuit, the House developed a "backstop" bill (in conjunction with the Administration), which set an oil and gas reserves tax in place to take effect and preserve state revenues if the 1978 separate accounting law were to be found unconstitutional.

Governor Hammond introduced the backstop bill in May 1981 (as SSHB 200). It passed the House (as SB 524) in early June. A free conference committee, consisting of Senators Ray, Bennett, and Dankworth, and Reps. Gardiner, Vaska, and O'Connell, first met on June 11.

During the latter half of the session, Senator Dankworth had attempted to develop a bill that would succeed in settling the separate accounting litigation while preserving, in substantial part, past and future state oil revenues. He was unsuccessful, and gave up the idea of ending the existing separate accounting litigation. He then attempted to craft a bill that would repeal the separate accounting law prospectively and maintain future state oil revenues at a level roughly comparable to those collected under the separate accounting law.

On June 17, following the reorganization of the House, Rep. Halford replaced Rep. Vaska on the conference committee and became the House chair. At that time, the oil industry circulated a settlement proposal which repealed separate accounting, increased severance taxes, and instituted a 10% investment tax credit. The oil

industry estimated the proposal's revenue loss to the state for FY 82-85 at \$1.37 billion; legislative staff estimates of revenue losses ranged from \$1.5 to \$2.1 billion.

Senator Dankworth prepared a draft bill embodying the settlement proposal and distributed it to the conference committee on June 22. At a later point in the June 22 meeting, he also distributed a draft bill that modified the settlement proposal in two important ways, in order to make the bill as revenue neutral as possible. He abandoned the 10% investment credit and suspended the application of the ELF during a field's first ten years of production in order to achieve a 15% effective severance tax rate at Prudhoe Bay. As a result of these changes, the oil industry was not willing to settle the litigation, and stated in testimony that they would continue the separate accounting litigation even if the modified proposal were enacted.

Prior to the next meeting of the conference committee on June 23, Governor Hammond wrote a letter to all legislators clarifying his position on the oil tax issue. He stated his preference was for a public vote on the backstop bill versus the oil industry settlement proposal. Alternatively, he urged the Senate to pass the backstop bill, and stated he preferred passage of any proposal to doing nothing. He noted that legislative action should "[r]educe the likelihood that the oil tax issue will continue to be a perennial political liability for those in public office."

On June 23, Senator Dankworth submitted to the conference committee the legislation ultimately signed by Governor Hammond, described on the first page of this appendix. The June 23 bill, known as "Dankworth 3," retained the basic characteristics of Senator Dankworth's earlier proposal, but suspended the application of the ELF during the first ten years of production only if the ELF was greater than .7. The change did not affect Prudhoe Bay, but did provide a tax break for Kuparuk.

The June 23 legislation received only cursory examination in the free conference committee and on the floor of the House and Senate before its passage on June 24. No committee report or written analysis was provided by either the bill's sponsor, Senator Dankworth, or the Administration. A bare bones fiscal note, which projected total revenue losses from FY 82-85 of \$141 million, did accompany the bill during the legislature's deliberations. Specifically, the note showed revenue losses of \$21 million in FY 82, \$117 million in FY 83, \$18 million in FY 84, and a gain of \$15 million in FY 85. No figures for the effect of the reimposition of the ELF on Prudhoe Bay in 1987 were provided. Revenue Commissioner Williams personally prepared the fiscal note and provided no supporting documentation for it, other than stating the estimates were based on confidential figures provided by the oil industry.

Speaker Hayes refused to allow a minority report opposing the legislation,

authored by Rep. Gardiner, to be published in the House Journal. At pages 2-3 of the minority report, after questioning the validity of the \$141 million estimate, Rep. Gardiner stated the fiscal note "failed to point out an even more significant revenue loss which will occur in the latter half of this decade, due to the sharp decline in severance tax collections from Prudhoe Bay after the reimposition of the economic limit factor in 1987. This loss is on the order of two billion dollars." (The two billion dollar estimate was based on the optimistic oil price assumptions prevailing at the time.) The bill passed over the strenuous objections of the former House majority.

At the time he signed the 1981 law, Governor Hammond noted that the new law would only reduce state income by .6%, relying on the figures in the fiscal note.

The key arguments made in opposition to the 1981 law were:

(a) It was not revenue neutral, because the estimates for the amounts to be collected by the new apportionment formula were overstated and speculative.

(b) A future legislature and administration would be saddled with a huge drop in revenues by the reimposition of the ELF in 1987.

Other arguments concerned the harmful effects of a shift from a net income-based separate accounting tax to a gross revenue severance tax.

Both Commissioner Williams and Governor Hammond explicitly recognized that a future legislature would have to deal with the post-1987 revenue effects from reimposition of the ELF. In the press statement issued on July 21, 1981, at the time he signed the oil tax bill, Governor Hammond declared, "As for the possible revenue effects in 1988 and beyond, I have full confidence in the ability of the Legislature to deal at that time with whatever is required to retain the state's 'fair share' of our oil wealth."

In responding to a question about the post-1987 ELF revenue loss at the June 23 conference committee meeting, Commissioner Williams noted that a future legislature would have the option of reimposing separate accounting if it proved constitutional. A newspaper account of the meeting reported that "If the projected revenue loss proves true, Williams said the Legislature would have the option of hiking taxes." (*Anchorage Daily News*, June 25, 1981, p. A4, "Lawmakers Pass Revision of Oil Tax Law.")

During the June 24 House floor debate on the 1981 bill, Rep. Gardiner noted the ELF factor would cause multi-hundred million dollar losses after 1987. Rep. Halford responded that "by that time [1987], if the companies continue to challenge the portion of funds that are in the state's hands under chapter 21 [separate accounting], we should have an answer to that lawsuit. And with that answer, we should be able to develop possibly a more consistent taxing policy at that time. That's

pretty far in the future, but we'll have more information available to us at that time."

III. Postscript

The revenue losses resulting from the shift to the modified apportionment method have exceeded considerably the \$141 million estimate for FY 82-85 made in 1981 by Commissioner Williams. Analyses by the Department of Revenue shows the FY 82-85 revenue loss of the 1981 law at over seven hundred million dollars. Through FY 87, the state lost over one billion dollars in revenue as a result of passage of the 1981 law.

The problems arising from the reimposition of the ELF are the subject of the main body of this report.

Appendix D

DRILLING/WORKOVER DISINCENTIVE COMMITTEE SUBSTITUTE HB 164

SEVERANCE TAX CALCULATION

CURRENT LAW

Field Rate x Wellhead Price x Severance Tax x ELF

90,168,000 BOPY x \$9/BO x 0.15 x 0.52134

= \$63,461,050/year

Addition of 1 well:

90,277,000 BOPY x \$9/BO x 0.15 x 0.5204

=\$63,423,203/year

A decrease of \$37,846 year

PROPOSED LAW

Field Rate x Wellhead Price x Severance Tax x ELF

90,168,000 BOPY x \$9/BO x 0.16 x 0.7296

=\$88,811,873/year

Addition of 1 well:

90,277,000 BOPY x \$9/BO x 0.15 x 0.7292

=\$88,870,484/year

An increase of \$58,611 year

[Copy of ARCO Handout, March 27, 1987]

TECHNICAL NOTE ON ARCO'S KUPARUK EXAMPLE

Tax Effects of Drilling an Additional Well Under Current Law

Mr. James Weeks, Kuparuk Unit Manger for ARCO, provided testimony to the House Finance Committee on March 27, 1987. Examples of severance tax effects (see preceding page) accompanied his testimony. The examples compare the severance tax effects of adding one additional well in the Kuparuk field under the current ELF and under the proposed ELF. The examples show that the addition of one well producing just under 300 barrels per day would increase output from 90,168,000 barrels of oil per year (BOPY) to 90,277,000 BOPY. At the \$9.00 per barrel price assumed in ARCO's example, annual gross revenue to the owners increases by \$981,000.

$$(90,277,000 \text{ BOPY} - 90,168,000 \text{ BOPY}) * (\$9/\text{barrel}) =$$

$$(\quad 109,000 \text{ BOPY} \quad) * (\$9/\text{barrel}) = \$981,000$$

The first of ARCO's two examples shows how under current law the owners would collect an annual severance tax *rebate* of \$37,846 on this additional revenue. The effective severance tax rate on the new production is thus -3.9 percent. The effect is analogous to a personal income tax where the effective tax rates become lower as increasing income moves the taxpayer into a higher bracket.

The second ARCO example illustrates how this will be changed under the proposed law. Instead of giving the owners a \$37,846 windfall, the proposed law will collect \$58,611 (6.0 percent) of the incremental \$981,000 for the state in severance tax. The table below summarizes the effects under the current and proposed severance tax laws, as shown in the ARCO examples.

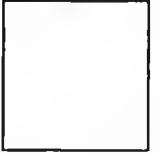
TAX EFFECTS OF DRILLING ONE ADDITIONAL WELL (ARCO Kuparuk Example)

	Change In Annual Gross Revenue	Change In Annual Severance Tax	Tax Rate On Incremental Production	Average Tax Rate Before Drilling	Average Tax Rate After Drilling	Percent Change In Average Tax Rate Due To Drilling
Current Law	\$981,000	(\$37,846)	-3.9%	7.820%	7.806%	-0.180%
Proposed Law	\$981,000	\$58,611	6.0%	10.944%	10.938%	-0.055%

Prepared by Division of Policy, April 1987.

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I am interested in hearing your views on the ELF or any other oil and gas issues. Please return this form to my office.

Do you feel that the current ELF formula should or should not be changed? Why?

Do you have any questions or comments on other oil and gas issues?

Have you moved? Do we have your correct address?

Understanding ELF

Senate Special Committee on Oil and Gas

Senator Bettye Fahrenkamp, Chairman

Senator Jack Coghill

Senator Paul Fischer

The Facts

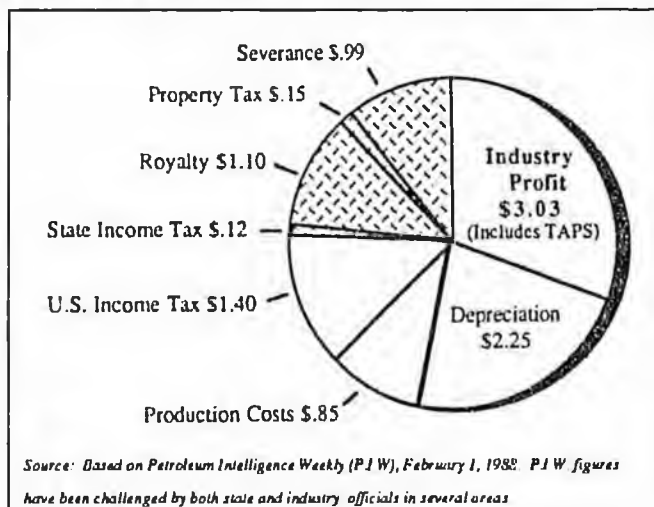
The Economic Limit Factor, or ELF, is used to calculate the amount of tax on each barrel of oil produced.

Oil revenues account for over 84% of state revenues.

Current year petroleum revenues come from:

Royalty	46.3%
Corporate Income Tax	6.5%
Oil and Gas Property	5.2%
Severance Tax	40.2%
Other (Rents, Bonuses)	1.8%

The ELF affects only the severance tax.



In early 1988, this is what a typical barrel of North Slope crude yielded the state, the oil producers, and the Federal government.

What is the ELF?

The ELF (Economic Limit Factor) is a formula for computing the "effective" severance tax rates for different oil fields. It has the effect of reducing the severance tax by variable amounts depending on the per-well production of individual fields. It is a number between zero and one that is multiplied by the basic or "nominal" 15% severance tax rate for Prudhoe Bay and Kuparuk.

What is the purpose of the ELF?

When it was originally created in 1977, the intent was to keep taxes low at marginal fields, such as in Cook Inlet, to encourage production. As a field declines, the ELF is designed to reduce its tax burden until it reaches its economic limit, the point at which it would be forced to shut in further oil development. At that point the severance tax would be reduced to zero. Most fields in Cook Inlet are currently paying no severance tax because their low per-well production gives them an ELF of zero.

What happened in 1981?

Because of oil industry suits challenging the constitutionality of using "separate accounting" to compute corporate income taxes, oil and gas taxation statutes were revised. Separate accounting, which considered only those profits made on Alaska operations, was replaced with a modified apportionment method, which uses a percentage of a company's worldwide earnings. To make up the dramatic loss in revenues caused by this shift, the severance tax rate on Prudhoe Bay, the largest oil field in the United States, was raised from an effective rate of just over 11% to 15%. This was done by rounding the ELF to 1.0 on Prudhoe Bay until June, 1987, and raising the nominal rate from 12.25% to 15%. At the time, many policy makers assumed future legislatures would reassess the effects of these changes after the lawsuits had been settled. (Separate accounting's constitutionality was upheld in 1987.)

What happened on June 20, 1987?

The rounding rule of the ELF for Prudhoe Bay expired. On that day, the effective severance tax rate was reduced from 15% to 12.45%. Because the ELF constantly changes as per-well productivity declines and additional wells are drilled, the rate is expected to decline significantly in future years. For the fiscal year ending June 30, 1988, it is estimated that state revenues were reduced by approximately \$116 million due to this change.

The Issues

There has been substantial controversy over whether the current ELF formula is accomplishing its original goals. Legislation has passed the House that would change the formula. The answers to the following questions will present opposing views.

Does the current ELF work to encourage development of marginal fields?

YES. All fields, regardless of their size, eventually become economically marginal as operating costs rise and profits shrink. Average production in Prudhoe Bay has declined from almost 10,000 barrels per well per day to about 2,300. The ELF helps to prevent leaving oil in the ground that could have been produced economically without the severance tax. It encourages the drilling of more production wells, which keeps production from declining too early. The current ELF encourages full development of all fields. At Milne Point, the ELF reduced the severance tax to zero for the last six months of production.

NO. There is nothing "marginal" about Prudhoe Bay. Even at current rates, the average well at Prudhoe produces 230 times as much oil as one in Texas. According to Petroleum Intelligence Weekly (P.I.W.) and International Petroleum Finance, each barrel of oil from Prudhoe earns the producers well over \$3.00 profit after taxes. At that rate, a tax break is not needed to remain highly profitable. The ELF formula should be changed to delay the tax break until it is really needed. It also is not working as intended because it does not encourage production at truly marginal fields, like Milne Point, which has been shut in since 1986.

What is the effect of the current ELF on the state's economy?

POSITIVE. The ELF creates positive incentives for oil and gas development. Since the ELF went into effect for Prudhoe Bay last June, the industry claims that there are eight new drill rigs working, creating 2400 direct and indirect new jobs for Alaskans. A survey of companies that do business with Alaska's oil industry shows that employment and sales have risen sharply since June.

NEGATIVE. The State Department of Labor disputes the high number of jobs created and cites the industry's history of hiring non-residents. Very little of the increased activity has been felt locally. Even more significantly, when the \$300 million in lost revenues over the next two years are translated into state budget cuts, the ripple effect will cause over 7,000 Alaskans to lose their jobs. This will deliver a severe blow to the Alaska economy just as it begins to climb out of a recession.

How does the current ELF formula affect state revenues?

INDUSTRY. As a percentage of the State's revenues, the ELF represents a reduction of about 7% in FY 88. The actual amount of reduction depends on the price of oil. However, all petroleum revenues are a product of the value of oil and production levels, and higher prices may actually increase total petroleum revenues despite greater dollar "losses" due to the ELF.

STATE. The Department of Revenue estimates that the first year of ELF reapplication will cost the state \$150 million. Using the March mid-case revenue projections, losses will gradually increase, peaking at \$223 million in FY 1991. At this point the loss will represent 14% of total oil revenues. Over the next five years, almost a billion dollars in revenue will be lost by not changing the ELF.

Has the current formula encouraged the drilling of unnecessary wells in Prudhoe Bay?

NO. Wells are not being drilled unnecessarily just for the tax benefit of the ELF. The ELF does reduce the total oil production tax at Prudhoe Bay for each new well that is drilled. The average tax benefit in FY 1989 will be \$210,000 per well. This reduction helps in deciding whether to drill a well or not, but it is not enough by itself to justify spending \$2 million to drill a well. Without additional wells and workovers to keep existing wells in production, Prudhoe would already be in decline.

YES. In the summer of 1987, just as the ELF kicked in, producers accelerated drilling programs at Prudhoe and Kuparuk. Because pipeline capacity is limited to 2 million barrels a day, increasing the number of wells results in lower production per well, a smaller ELF factor and lower taxes. These wells will be needed sometime in the future but are being drilled early to receive a state subsidy. It is irresponsible state policy to subsidize drilling in one of the world's most profitable oilfields while underfunding education, roads, and the needs of children and youth.

How important is tax stability for oil industry investments? Isn't this like changing the rules in the middle of the game?

YES. The oil industry is prepared to invest over \$20 billion on oil-related work in Alaska over the next ten years. Without assurances of a stable tax climate, they might think twice about it.

NO. Oil and gas taxes over the past decade have been quite stable. The last major change, in 1981, lowered taxes. Last June, tax rates were again lowered for Prudhoe Bay producers when the ELF kicked in. The new formula would have the effect of keeping rates at about their pres-

would have the effect of keeping rates at about their present levels. Each year, legislators have a responsibility to reassess tax laws, which are a vital aspect of public policy. Stability is preferred, but sometimes changes are necessary.

State oil and gas tax policy has been formulated to ensure the state is receiving a proper share of its nonrenewable resource. Over half of the oil ever discovered in Alaska has already been produced. The producers, the state, and the federal government all share in the oil wealth.

What has been the state's share of oil production over the past few years?

INDUSTRY. When Governor Hammond signed ELF legislation in 1981, he did so on the condition that it would maintain the state's combined royalty and tax share from its non-renewable resource at above 30 percent of the total value of the oil. The state has been receiving far greater than a 30 percent share. According to oil industry analysis, the state's share will rise from 57% this year to over 67% by 1991 at \$15-16 prices and to 103% at lower prices.

STATE. Using figures reported in the Petroleum Intelligence Weekly (P.I.W.), this is how the the oil wealth has been divided:

Year	Oil Industry	State and Local	Federal
1985	43.8%	28.6%	27.6%
1986	36.9%	43.3%	19.8%
1987	41.6%	41.1%	17.4%
1988	44.6%	34.8%	20.6%

How do Alaska's severance tax rates compare with other states?

INDUSTRY. Alaska's nominal severance tax rate of 15% is the highest in the nation. Louisiana is second at 12.5%. Oklahoma has a 7% rate; Texas has a 4.6% rate and California does not have a production tax. Even with the application of the ELF, the effective rate for Prudhoe Bay is the second highest in the U.S.

STATE. Each state designs its oil and gas tax rates differently. Our severance tax rate is applied to the wellhead value of the oil, which is now about \$5.00 below most other states. Because of this, the amount of tax per barrel is the lowest of all the producing states. If the ELF were applied to oil fields in the lower 48, severance taxes would be reduced or eliminated. An average oil well in Texas, producing only 10 barrels per day, would pay no taxes here at all under the existing or proposed ELF. In addition, we have a low corporate income tax rate of 9.4%. According to P.I.W., oil companies in Alaska pay an effective corporate income tax rate of only 3%.

The New ELF

Last session, the Governor introduced legislation to delay the scheduled June reduction in Prudhoe Bay severance taxes. The House of Representatives further revised the formula for calculating the ELF factor. Instead of using the amount of production from individual wells as a measure of field productivity, the new proposal would take into account total production from the entire field. The new formula would limit the tax reduction for Prudhoe Bay and Kuparuk and increase it for most other, less profitable fields.

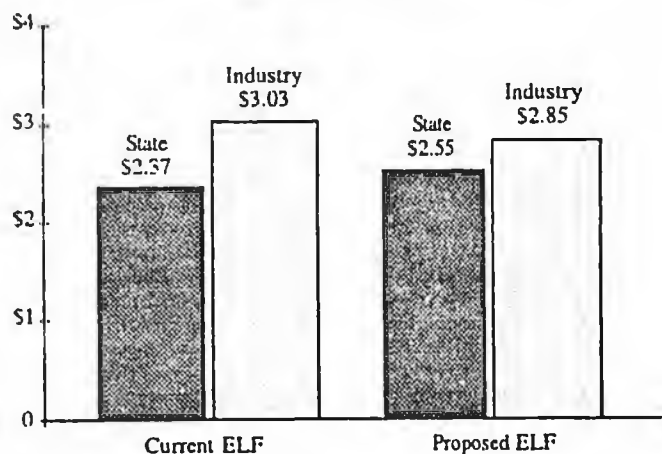
How would the new formula change oil industry development investment decisions?

NEGATIVE. The new legislation will result in fewer wells being drilled. Production will be taxed at a higher rate, leaving less money available for investment. Under the present formula, the drilling of additional wells lowers the ELF and therefore the tax rate. The new formula would deter full development drilling.

POSITIVE. The new formula would provide investment incentives where they are really needed. For example, Milne Point is a small, marginal field on the North Slope. Current low oil prices, high operating costs, and state taxes and royalties have forced production to be shut-in. Conoco, the oil company operator of Milne Point, has testified that the new formula would lower its tax rate and allow it to resume production.

NEUTRAL. Oil prices are the major factor in investment decisions and the ELF change should have little effect. Recent articles in Forbes magazine and Petroleum Intelligence Weekly report healthy profits being made on Alaskan production. The reports find that, on the North Slope, profits can be made even at \$10 a barrel.

State and Industry Shares
(Dollars Per Barrel)



Shares under current ELF are from Petroleum Intelligence Weekly Feb. 1, 1988; shares under the proposed ELF are by the Division of Policy, April 11, 1987.

S B

4 10

HOUSE COMMITTEE REPORT

(7)

Date referred: 2/10/88

FURTHER REFERRALS:

Resources

DATE: 2/23/88

The Labor & Commerce Committee has considered HB 454

"An Act relating to the operation of state hatcheries; and providing for an effective date."

RECOMMENDS:

- replace with SHB454 (L+C) the same title
- attached amendment(s) a new title
- do pass
- do not pass
- no recommendation
- individual recommendations
- additional referral to the _____ Committee

ADOPTS: _____ letter of intent

ATTACHES NEW FISCAL NOTE(S):

- fiscal impact same as previous fiscal note published _____
- zero fiscal note same as previous zero fiscal note published _____
- zero with analysis

SIGNING DO PASS:

Cliff Davidson

[Signature]

Alto Kosman

[Signature]

SIGNING OTHER RECOMMENDATIONS:

W. F. Moore no rec

Pat A. Bunker Moore

David Wiley NO rec

David Wiley

Chairman's signature

FISCAL NOTE

REQUEST:

Revision Date: 2/22/88
Title: An Act relating to the operation of state hatcheries
Sponsor: Eliason
Requestor: Eliason

Agency Affected: Fish and Game
BRU: FRED
Components: _____

EXPENDITURES/REVENUES: (Thousands of Dollars)

OPERATING	FY 88	FY 89	FY 90	FY 91	FY 92	FY 93
PERSONAL SERVICES	0	0	0	0	0	0
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING	0	0	0	0	0	0
CAPITAL	0	0	0	0	0	0
REVENUE						

FUNDING: (Thousands of Dollars)

GENERAL FUND						
FEDERAL FUNDS						
OTHER						
TOTAL	0	0	0	0	0	0

POSITIONS:

FULL-TIME						
PART-TIME						
TEMPORARY						

ANALYSIS : (Attach a separate page if necessary)

[Handwritten signature]

Prepared by: _____
Division: F.R.E.D.

Phone: 465-4160
Date: 2/22/88

Approved by Commissioner: *[Handwritten signature]*
Agency: Fish and Game

Date: 2/22/88

- Distribution (by preparer):
- Legislative Finance
 - Legislative Sponsor
 - Requestor
 - Office of Management and Budget
 - Impacted Agency(ies)

REPRESENTATIVE
BEN GRUSSENDORF

P O Box 828
SITKA, ALASKA 99835
(907) 747-8458

RULES COMMITTEE
LEGISLATIVE COUNCIL

DISTRICT 3
SLENN COVE
PELICAN
PORT ALEXANDER
SITKA
TENAKEE

Alaska State Legislature



WHILE IN JUNEAU
P.O. Box V
JUNEAU, ALASKA 99811

(907) 465-3824
(907) 465-3720

House of Representatives SPEAKER OF THE HOUSE MEMORANDUM

To: Rep. Dave Donley
Chairman
House Labor & Commerce Committee

From: Rep. Ben Grussendorf
Speaker of the House

Date: February 22, 1988

Subject: Proposed committee substitute for House Bill 454
"An Act relating to the operation of state hatcheries."

Attached to this memorandum is a proposed substitute for House Bill 454, a measure authorizing the Commissioner of Fish & Game to contract for the operation of state-owned hatcheries that the department has determined it can no longer operate. The bill provides that the aquaculture association located in the same region as an affected hatchery will be given a preference right in the operator selection process. Should a regional aquaculture association be unable to meet the criteria established by Fish & Game, the department would then select an operator through the procurement process provided for in AS 36.30.

The proposed substitute for House Bill 454 differs only slightly from the original. The substitute allows the Commissioner of Fish & Game to waive the submission of an application for a permit to operate a hatchery. This lengthy permit process is normally required prior to the opening of a new hatchery, a situation not contemplated by this legislation. The substitute bill also deleted the word "transfer" from section one, and instead uses the phrase "provide for" the operation of the hatchery. This change clarifies the fact that the State of Alaska

retains all ownership rights in the hatchery, as well as the right to manage the resource.

House Bill 454 and Senate Bill 410 are an appropriate response by the Department of Fish & Game to intent language placed in the FY 1988 budget that required the department to develop ways to relieve the burden on the general fund caused by state hatchery operation. If the Legislature enacts either bill in short order, the Department of Fish & Game will have enough time to contract for the operation of some hatcheries prior to the start of Fiscal Year 1989, and more importantly before the Spring salmon runs. With the provisions in the legislation which allow operating cost recovery through the limited harvest of excess salmon, at least some of the new operators will be able to begin operation with no impact on the general fund in FY 89.

I hope the House Labor & Commerce Committee will consider this proposed substitute for adoption and will act on the legislation in an expeditious manner.

5-1885B
Bannister
2/22/88

Original sponsors: Grussendorf and Sund

1 IN THE HOUSE

2 CS FOR HOUSE BILL NO. 454 ()
3 IN THE LEGISLATURE OF THE STATE OF ALASKA
4 FIFTEENTH LEGISLATURE - SECOND SESSION

5 A BILL

6 For an Act entitled: "An Act relating to the operation of state hatcher-
7 ies; and providing for an effective date."

8 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

9 * Section 1. AS 16.10 is amended by adding a new section to article 8
10 to read:

11 Sec. 16.10.480. CONTRACTS FOR THE OPERATION OF STATE HATCHERIES.

12 (a) If the department determines that it is unable to continue op-
13 erating a state-owned hatchery or that it is in the best interest of
14 the state to provide for the operation of the hatchery by another
15 person or by another person in cooperation with the state, the depart-
16 ment may enter into a contract for the operation or cooperative opera-
17 tion of the hatchery.

18 (b) Notwithstanding AS 36.30, when selecting a contractor under
19 (a) of this section, the department shall give a preference to the
20 regional association organized under AS 16.10.380 that is located in
21 the region in which the hatchery is located. If the department deter-
22 mines that the preferred regional association does not meet the crite-
23 ria established by the department for the contract, the department may
24 not award the contract to the preferred regional association and shall
25 procure the contract under AS 36.30 after considering the recommenda-
26 tions of the preferred regional association.

27 (c) A contract entered into under this section must provide that
28 the hatchery will be operated under AS 16.10.400 - 16.10.445 and
29 16.10.460 - 16.10.470 and the regulations adopted under those

1 sections.

2 (d) The department may issue to a contractor who operates a
3 hatchery under this section a permit to harvest adult salmon during
4 the term of the contract in a quantity sufficient to allow the con-
5 tractor to recover all or part of the contractor's costs of operating
6 the hatchery.

7 (e) A contract under this section for the operation of a
8 hatchery may not affect the state's ownership of the hatchery and does
9 not affect the state's responsibility to manage the resource.

10 * Sec. 2. AS 16.10.400(a) is amended to read:

11 (a) The commissioner or a designee may issue a permit, subject
12 to the restrictions imposed by statute or regulation under AS 16.-
13 10.400 - 16.10.470, to a nonprofit corporation organized under
14 AS 10.20, after the permit application has been reviewed by the re-
15 gional planning team, for

16 (1) the construction and operation of a salmon hatchery;

17 (2) the operation of a hatchery under AS 16.10.480.

18 * Sec. 3. AS 16.10.400(b) is amended to read:

19 (b) The application for a permit under this section shall be on
20 a form prescribed by the department and be accompanied by an applica-
21 tion fee of \$100. The commissioner may waive the submission of an
22 application for a permit to operate a hatchery under AS 16.10.480.

23 * Sec. 4. AS 16.10.400(e) is amended to read:

24 (e) A qualified regional association formed under AS 16.10.380,
25 if it has become a nonprofit corporation under AS 10.20, has a prefer-
26 ence right to a permit under (a)(1) of this section if its proposed
27 hatchery is provided for in the comprehensive plan for that region
28 developed under AS 16.10.375 and the fresh water source exceeds one
29 cubic foot per second minimum flow. Another [ANY OTHER] local

1 nonprofit hatchery corporation approved by a qualified regional asso-
2 ciation has an identical preference right.

3 * Sec. 5. AS 16.10.410(c) is repealed and reenacted to read:

4 (c) The hearing shall be conducted by the department. At a
5 hearing for a permit under AS 16.10.400(a)(1), the applicant shall
6 present a plan for the proposed hatchery, describing the capacity of
7 the hatchery and other relevant facts that may be of interest to the
8 department or the public. Interested members of the public shall be
9 afforded an opportunity to be heard.

10 * Sec. 6. AS 16.10.450 is amended to read:

11 Sec. 16.10.450. SALE OF SALMON AND SALMON EGGS BY HATCHERY.

12 (a) Except as otherwise provided in a contract for the operation of a
13 hatchery under AS 16.10.480, a [A] hatchery operator who sells salmon
14 returning from the natural waters of the state, or sells salmon eggs
15 to another hatchery operating under AS 16.10.400 - 16.10.470, after
16 utilizing the funds for reasonable operating costs, including debt
17 retirement, expanding its facilities, salmon rehabilitation projects,
18 fisheries research, or [FOR] costs of operating the qualified regional
19 association for the area in which the hatchery is located, shall
20 expend the remaining funds on other fisheries activities of the qual-
21 ified regional association.

22 (b) Fish returning to hatcheries and sold for human consumption
23 shall be of comparable quality to fish harvested by commercial fisher-
24 ies in the area [,] and shall be sold at prices commensurate with the
25 current market.

26 * Sec. 7. This Act takes effect immediately under AS 01.10.070(c).
27
28
29



**STATE OF ALASKA
OFFICE OF THE GOVERNOR
BILL ANALYSIS**

DEPARTMENT Fish and Game	DIVISION FRED	BILL NUMBER SB 410/HR 454	SPONSOR Eliason, Jones, Kerttula, Grussendorf
SHORT TITLE OF BILL			
DEPARTMENT POSITION The department supports this bill as is.			
PREPARED BY Brian J. Allee	DATE 2/22/88	COMMISSIONER'S SIGNATURE <i>Don Williams</i>	DATE 2-22-88

SUMMARY

OTHER AGENCIES AFFECTED BY BILL Department of Commerce and Economic Development	CONSTITUENT GROUP(S) AFFECTED BY BILL Regional aquaculture associations, commercial fishermen, sport fishermen
ORGANIZATIONAL SUPPORT FOR BILL Regional aquaculture associations, sport fishermen, commercial fishermen	ORGANIZATIONAL OPPOSITION TO BILL

FISCAL IMPACT: NONE FISCAL NOTE ATTACHED

BACKGROUND/LEGISLATIVE INTENT The 1987 Legislature placed intent language in the FY 88 FRED Division budget that directed the division to develop innovative programs for hatchery operation through cooperation with the regional aquaculture associations (RAA). Contracting operations of state-owned hatcheries to RAAs was recommended by a government/public work group formed to address the intent. Building on the private nonprofit laws that have proved effective, this amendment allows FRED to cooperate with the RAAs in developing innovative

Continued on page 2.

ANALYSIS OF BILL/PROGRAM EFFECTS This bill amends existing statutes to extend a preference right to operate under contract existing state hatcheries in the same manner that qualified RAAs have for the development of undeveloped hatchery locations. This preference right for qualified RAAs to operate existing state hatcheries will allow sole source contracting for the operation of state hatcheries if the state is unable to continue due to insufficient operating funds. These contracts will stipulate that the state remain in control of the total program through a permit, a public hearing, and completion of an annual operational plan, all of which are subject to the approval of the Commissioner of the Department of Fish and Game. Additionally, the RAAs, in order to recover the cost of hatchery operations, will be able to sell salmon returning to the facility which are surplus to the common property fishery.

AMENDMENTS PROPOSED

Amend to allow the Commissioner to waive the submission of an application for a permit to operate a hatchery due to the fact that the application process is designed for new hatcheries only, and is unnecessarily time-consuming in this situation.

PLEASE ATTACH A SEPARATE SHEET FOR ADDITIONAL COMMENTS OR ANALYSIS.

(Background/Legislative Intent con't.)

programs. Further, the amendment provides certain assurances to the state, which must maintain jurisdiction over the facilities, to the general public, which bonded themselves for original capital costs to construct the facilities, and to the fishery user groups who depend on the hatchery-produced fish to supplement the natural stocks in off-years. These assurances arise from the proven technical and managerial expertise of the RAAs, along with their financial capability and socially and legally acceptable practice of special harvests of hatchery returns to pay hatchery operational costs. This approach allows for continued hatchery production while reducing the impact on the general fund.



STATE OF ALASKA
OFFICE OF THE GOVERNOR
BILL ANALYSIS

DEPARTMENT Fish and Game	DIVISION FRED	BILL NUMBER CS for SB 410/HB 454	SPONSOR Eliason, Jones, Kerttula/ Grussendorf
SHORT TITLE OF BILL			
DEPARTMENT POSITION The department supports this bill.			
PREPARED BY Brian J. Allee	DATE 2/22/88	COMMISSIONER'S SIGNATURE <i>Donna Kellmuth</i>	DATE 2-22-88

SUMMARY

OTHER AGENCIES AFFECTED BY BILL Department of Commerce and Economic Development	CONSTITUENT GROUPS AFFECTED BY BILL Regional aquaculture associations, commercial fishermen, sport fishermen
ORGANIZATIONAL SUPPORT FOR BILL Regional aquaculture associations, sport fishermen, commercial fishermen	ORGANIZATIONAL OPPOSITION TO BILL
FISCAL IMPACT <input checked="" type="checkbox"/> NONE <input type="checkbox"/> FISCAL NOTE ATTACHED	

BACKGROUND/LEGISLATIVE INTENT The 1987 Legislature placed intent language in the EY 88 FRED Division budget that directed the division to develop innovative programs for hatchery operation through cooperation with the regional aquaculture associations (RAA). Contracting operations of state-owned hatcheries to RAAs was recommended by a government/public work group formed to address the intent. Building on the private nonprofit laws that have proved effective, this amendment allows FRED to cooperate with the RAAs in developing innovative

Continued on page 2.

ANALYSIS OF BILL/PROGRAM EFFECTS The committee substitute for Senate Bill 410 has incorporated all the amendments proposed by the Department of Fish and Game and has had the thorough review of the Attorney General's Office.

AMENDMENTS PROPOSED

None.

PLEASE ATTACH A SEPARATE SHEET FOR ADDITIONAL COMMENTS OR ANALYSIS.

(Background/Legislative Intent con't.)

programs. Further, the amendment provides certain assurances to the state, which must maintain jurisdiction over the facilities, to the general public, which bonded themselves for original capital costs to construct the facilities, and to the fishery user groups who depend on the hatchery-produced fish to supplement the natural stocks in off-years. These assurances arise from the proven technical and managerial expertise of the RAAs, along with their financial capability and socially and legally acceptable practice of special harvests of hatchery returns to pay hatchery operational costs. This approach allows for continued hatchery production while reducing the impact on the general fund.

FISCAL NOTE

REQUEST:

Revision Date: 2/22/88
Title: An Act relating to the operation of state hatcheries
Sponsor: Eliason
Requestor: Eliason

Agency Affected: Fish and Game
BRU: FRED
Components: _____

EXPENDITURES/REVENUES: (Thousands of Dollars)

OPERATING	FY 88	FY 89	FY 90	FY 91	FY 92	FY 93
PERSONAL SERVICES	0	0	0	0	0	0
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING	0	0	0	0	0	0
CAPITAL	0	0	0	0	0	0
REVENUE						


FUNDING: (Thousands of Dollars)

GENERAL FUND						
FEDERAL FUNDS						
OTHER						
TOTAL	0	0	0	0	0	0

POSITIONS:

FULL-TIME						
PART-TIME						
TEMPORARY						

ANALYSIS : (Attach a separate page if necessary)



Prepared by: _____ Phone: 465-4160
Division: F.R.E.D. Date: 2/22/88

Approved by Commissioner: Donnellworth Date: 2/22/88
Agency: Fish and Game

- Distribution (by preparer):
- Legislative Finance
 - Legislative Sponsor
 - Requestor
 - Office of Management and Budget
 - Impacted Agency(ies)

STATE OF ALASKA
THE LEGISLATURE

POUCH Y STATE CAPITOL
JUNEAU ALASKA 99811
907 465 3800

LEGISLATIVE AFFAIRS AGENCY

MEMORANDUM

February 22, 1988

SUBJECT: Sectional analysis of proposed
CSSB 410 (Resources)
(version 5-1821 L)

TO: Senator Dick Eliason

FROM: Theresa L. Bannister ^{TS}
Legislative Counsel

You have requested a sectional analysis of the above described bill.

As a preliminary matter, note that a sectional analysis or summary of a bill should not be considered an authoritative interpretation of the bill and the bill itself is the best statement of its contents.

Section 1. Sec. 16.10.480(a) authorizes the Department of Fish and Game under certain circumstances to contract with another person for the person to operate a state-owned hatchery or for the person to operate the hatchery cooperatively with the state.

Sec. 16.10.480(b) requires the department, when selecting a contractor to operate a state-owned hatchery, to give a preference to the regional association organized under AS 16.10.380 that is located in the region of the hatchery. Directs the department not to contract with the preferred regional association if it determines that the association doesn't meet its criteria, and in that case, to procure the contract under AS 36.30 after considering the association's recommendations.

Sec. 16.10.480(c) requires that the operation contract provide that the hatchery will be operated in accordance with certain statutes and regulations.

Sec. 16.10.480(d) allows the department to issue to the contractor during the contract an adult salmon harvest permit that will be sufficient to allow the contractor to recover all or part of its hatchery operating costs.

Sec. 16.10.480(e) prohibits a contract for the operation of state-owned hatchery from affecting the state's ownership of the hatchery. Declares that the contract does not affect the state's responsibility to manage the resource.

Section 2 allows the commissioner of the department to issue a permit subject to certain restrictions for the operation of a hatchery under sec. 16.10.480.

Section 3 allows the commissioner to waive the submission of an application for a permit to operate a hatchery under AS 16.10.480.

Section 4 clarifies that the subsection does not apply to a permit to operate a hatchery under AS 16.10.480.

Section 5 clarifies that an applicant for a permit to operate a state-owned hatchery under AS 16.10.480 does not have to provide certain information about the hatchery at the hearing for the permit.

Section 6 exempts the operator of a state-owned hatchery under sec. 16.10.480 from the sale requirements of the subsection to the extent that the operation contract provides differently than the section.

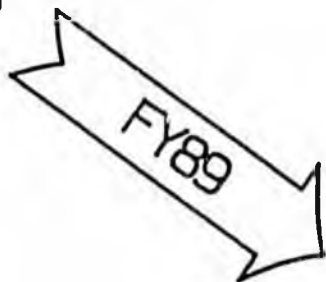
Section 7 provides the bill with an immediate effective date.

TLB:gc
WKG1:104

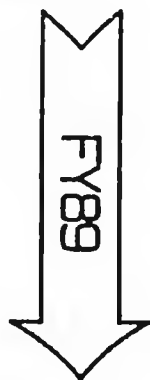
HIDDEN FALLS
KITOI BAY
CANNERY CREEK
TRAIL LAKES



Operated by State on \$1.4 million General Funds and \$0.5 million in other funds. Level of operation not optimal.



Operated by State at optimal levels on \$2.4 million in General Funds



State not operating but reprogramming \$1.4 million in General Funds into areas of deficiency in program.

Snettisham chum salmon increase	-\$271.2
StateWide Sockeye	-\$351.4
Snettisham Sockeye CIF	
Gulkana Expansion	
Main Bay Hatchery Sockeye	-\$151.5
Russell Creek Hatchery	-\$293.7
Crooked Creek Hatchery replace	-\$194.1
Interagency funding	
Tutka Hatchery Program	-\$ 90.0

Fish and Game reconsiders sole-source hatchery contract

By KIRK McALLISTER

THE JUNEAU NEWS

1/21/88
The Office of the Ombudsman has sharply criticized the Alaska Department of Fish and Game for trying to award a sole-source contract to an aquaculture group that wants to manage a state-owned fish hatchery on Baranof Island.

Fish and Game wanted to transfer management of the Hidden Falls Hatchery to the Sitka-based Northern Southeast Regional Aquaculture Association as part of an effort to cut the cost of the statewide hatchery program.

But the ombudsman's concern about running afoul of the new state procurement code caused Fish and Game to reconsider the sole-source contract, said Brian Allee, director of the Division of Fisheries Rehabilitation En-

hancement and Development.

The department will now put the management of Hidden Falls out to competitive bid, along with three other hatcheries in Prince William Sound, Kodiak Island and Cook Inlet. Contracts are expected to be final by July 1.

"There's a funding crisis in ocean ranching and turning over the management of these four facilities is a response to that," Allee said. "Our thinking was that the aquaculture associations have the financial wherewithal and expertise to operate these hatcheries."

Hidden Falls, which raises mainly chum salmon for the commercial seine fishery, is widely considered one of the best hatcheries in the state's system, which includes 19 hatcheries, 23 fish ladders, two spawning channels and four laboratories. Alaska's salmon hatchery system is

the largest in North America and one of the most technologically advanced in the world.

In 1987, state hatcheries produced about 6 million salmon, while the private non-profit hatcheries contributed about 19 million fish, according to a FRED division report. But the division has suffered a 30 percent funding cut since 1985.

"The Alaska salmon ocean ranching program has generated \$75 million and 2,000 jobs so it is also an economic development program," Allee said. "It's been a biological and economic success so we're doing what we can to keep it going."

Since 1984, Hidden Falls has produced more than 500,000 chum salmon per year, worth about \$2.5 million to the commercial seine fleet, which harvests most of the

fish. Hidden Falls was built in 1978 and began operating in 1979. The \$3 million initial construction cost was funded by a statewide bond issue.

When the ombudsman reviewed Fish and Game's justifications for asking for a sole-source contract, the legislative watchdog agency didn't buy off on the department's reasoning.

"... It is doubtful that the Northern Southeast Regional Aquaculture Association is the only organization with the expertise and knowledge to operate the Hidden Falls Hatchery," wrote Acting Ombudsman Bruce Aronson in a letter to Fish and Game commissioner Don Collinsworth. "Circumventing the procedures for soliciting a professional services contract by requesting an extension

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tion from Alaska Statutes not only leaves your department open to just criticism but also possible successful legal action."

In his letter to Collinsworth, Aronson suggested that the commissioner "... take a long pause before proceeding with negotiations on this contract." Aronson also said the ombudsman may consider at a later date "investigating the significant issues raised by the complainant."

The ombudsman's letter was prompted following a complaint from Dale Young, who is no stranger to the hatchery business, having served as Southeast regional hatchery manager for Fish and Game from 1976-82.

"We're not trying to stir up trouble, we just want the state to follow the rules," said Young, who along with some partners is trying to develop a hatchery-salmon farm at Baranof Warm Springs.

Jim Cochran, who has served as the hatchery manager of Hidden Falls since it first opened, said the facility has four full-time, eight seasonal and two support workers who could lose their jobs if the state transfers management of the hatchery. He said that doesn't seem fair to him since their apparent reward for making Hidden Falls the state's top hatchery is to lose their jobs.

"It may or may not be a good management decision to contract the management of the hatchery, but what concerns me more than anything is that I can't find any justification for putting 14 employees out of work," Cochran said.

Cochran and Young have discussed submitting a bid for managing Hidden Falls, which is now possible since the bids will now be open to anyone.

Meanwhile, the change of heart by Fish and Game has left some confusion with NSRAA, which had been negotiating for months on a contract for managing Hidden Falls.

Pete Esquiro, general manager of the aquaculture association, said NSRAA would continue to pursue the Hidden Falls contract and planned to submit a bid under the new competitive process. Under their management plan, some of the 14 current hatchery employees could keep their jobs, he said.

Esquiro said his group was interested in Hidden Falls because of its value to commercial fishermen, who control the board of the aquaculture association.

"An added benefit to this is that if the state doesn't have to spend general fund money managing Hidden Falls, it can increase chum and sockeye production at Snettisham (hatchery), which would help the gillnet fleet," he said.