

HOUSE / SENATE FINANCE COMMITTEE MINUTES - 1967-1982 2777

1981

HOUSE FINANCE COMMITTEE

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Beginning of Session to Reorganization

Rep. Sam Cotten, Chairman
Rep. Oral Freeman, Vice-Chairman
Rep. Brian Rogers
Rep. Pappy Moss
Rep. Joe Montgomery
Rep. Russ Meekins
Rep. Hugh Malone
Rep. Ernie Haugen
Rep. Pat Carney
Rep. Thelma Buchholdt
Rep. Al Adams

After Reorganization (June 16, 1981)

Rep. Al Adams, Chairman
Rep. Joe Montgomery, Vice-Chairman
Rep. Vern Hurlbert
Rep. Joe Chuckwuk
Rep. Jack Fuller
Rep. Bob Bettisworth
Rep. Dave Cuddy
Rep. Ernie Haugen
Rep. Sam Cotten

HOUSE FINANCE COMMITTEE MINUTES - 1981

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HOUSE FINANCE COMMITTEE

MEMBERSHIP

Twelfth Legislature - First Session

Beginning of Session to Reorganization

Representative Sam Cotten, Chairman

Representative Oral Freeman, Vice-Chairman

Representative Brian Rogers

Representative Pappy Moss

Representative Joe Montgomery

Representative Russ Meekins

Representative Hugh Malone

Representative Ernie Haugen

Representative Pat Carney

Representative Thelma Buchholdt

Representative Al Adams

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3/21/83

PRESENTATION TO
GOVERNOR SHEFFIELD'S
CABINET ON
REVENUE EXPECTATIONS



FIGURE 1a

REVENUE EXPECTATIONS

1983 DOLLARS

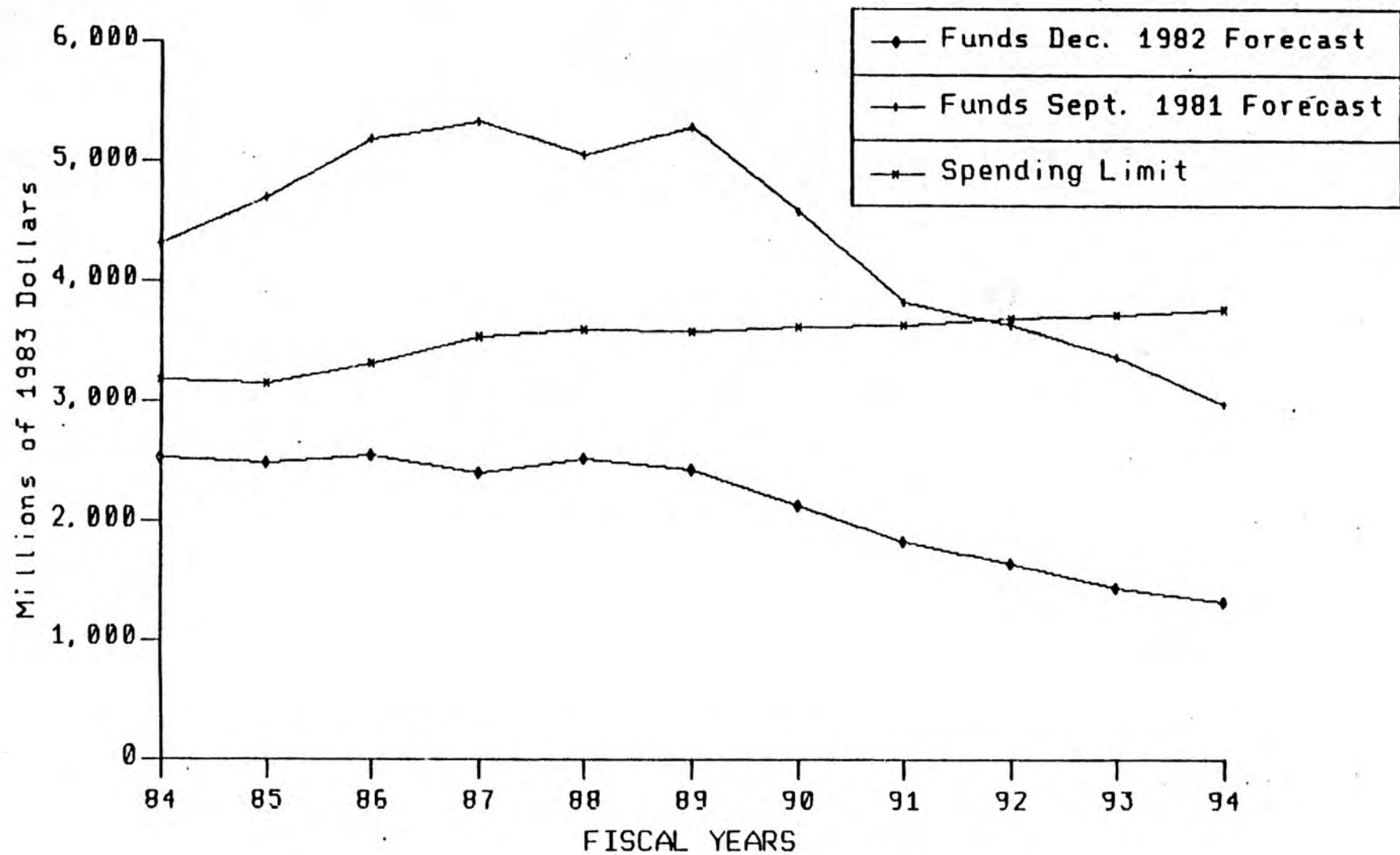


FIGURE 1

REVENUE EXPECTATIONS

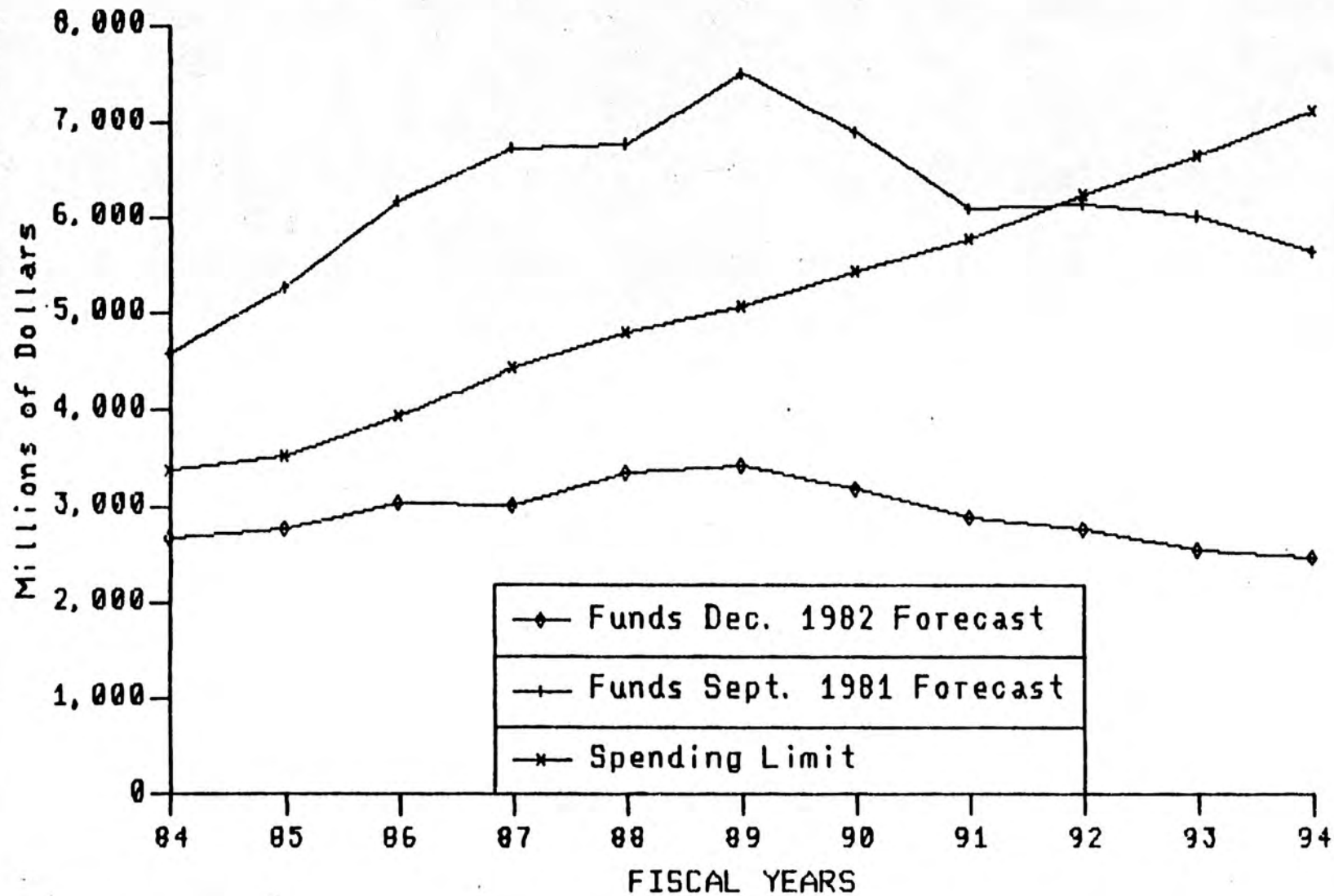


FIGURE 1

- Substantial decline in revenue expectations between 1981 and 1982
- Current revenue forecasts never exceed spending limit
- Downward shift of revenue curve reflects decline of oil prices

Assumptions

- Spending limit projection assumes 6 percent annual inflation rate and 2.3 percent annual population growth
- Both revenue curves are based on 30th percentile forecast of the Department of Revenue
- "Revenue" means unrestricted General Fund revenue

Note: Figure 1a presents the same data in 1983 dollars.

FIGURE 2a

CAPITAL AND OPERATING FUNDS AVAILABLE FOR APPROPRIATION

1983 DOLLARS

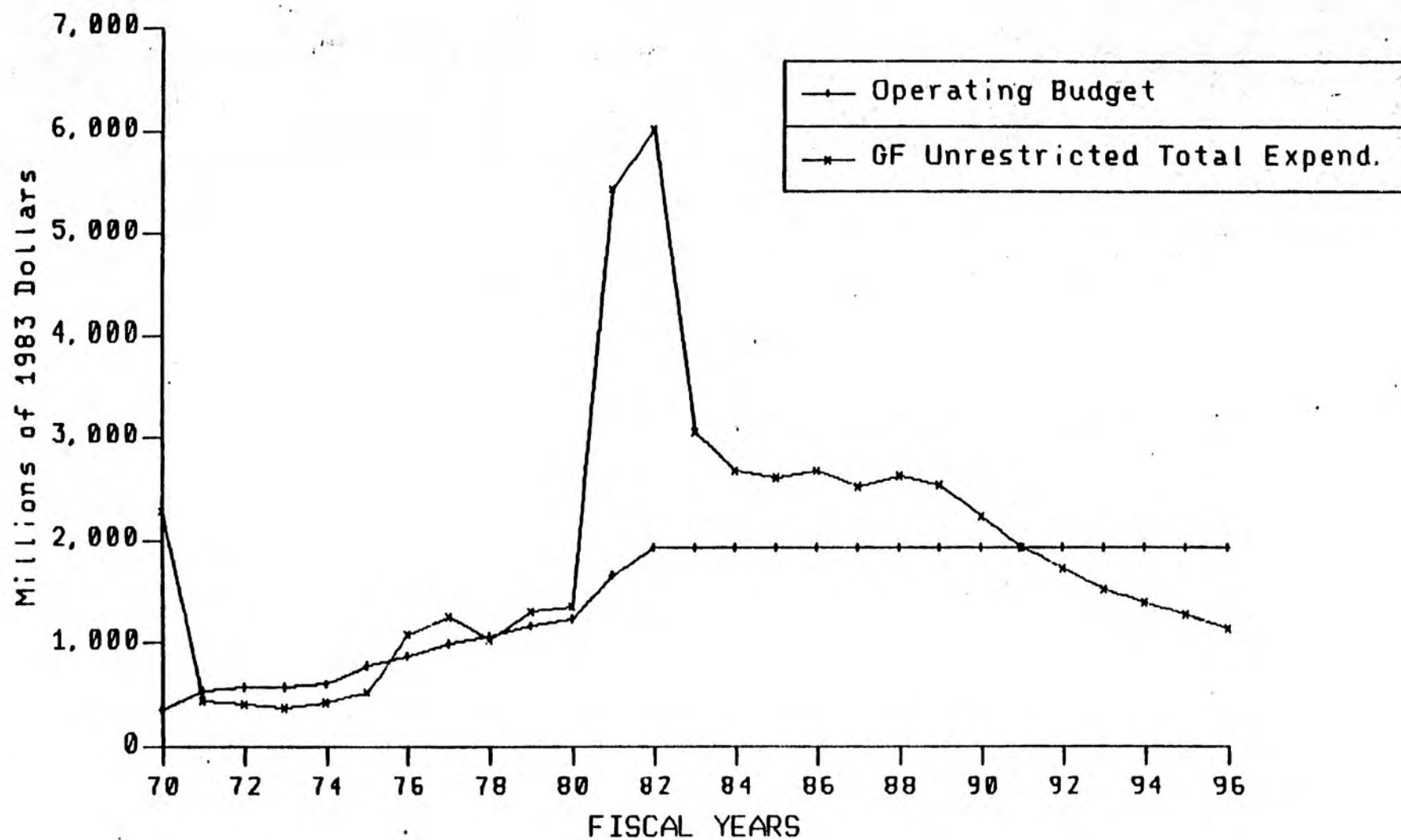


FIGURE 2

CAPITAL AND OPERATING FUNDS AVAILABLE FOR APPROPRIATION

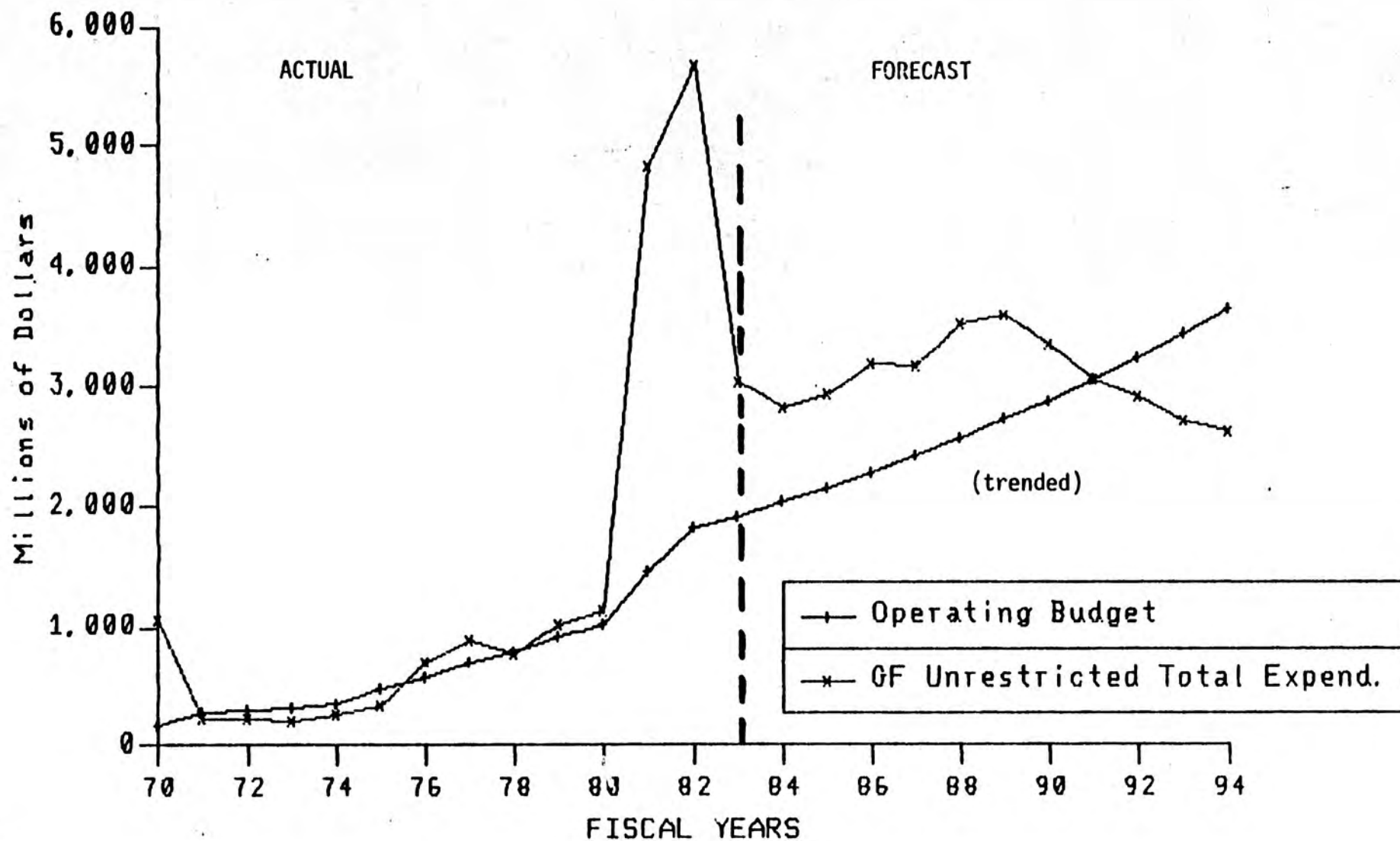


Figure 2

- ° Difference between the operating budget curve and the General Fund unrestricted revenue curve represents primarily the capital budget (including loan appropriations).
- ° Operating budget curve beyond FY 1983 is trended at 6 percent annual growth; this is not a forecast, but is presented for illustration only
- ° Money available for capital expenditures disappears in FY 1991 under a continuation budget (6 percent annual growth)
- ° State revenues peak in 1989 and decline steadily thereafter (decline in real terms is more pronounced)

Assumptions

- ° 6 percent annual increase in operating budget after FY 1983 (Governor's FY 1984 proposal actually represents a 4.6 percent decrease from FY 1983)
- ° Revenue assumption is December, 1982, 30th percentile forecast by the Department of Revenue

Note: Figure 2a presents the same data in 1983 dollars.

Figure 3

- ° FY 84 earnings of the Permanent Fund are slightly over \$400 million; 10 years later, earnings are slightly over \$1.1 billion

Assumptions

- ° 10 percent average annual earnings on Permanent Fund assets
- ° Contributions to the Permanent Fund according to existing law

Note: Figure 3a presents the same data in 1983 dollars

FIGURE 3

Forecast of Permanent Fund Annual Earnings (1982 Forecast)

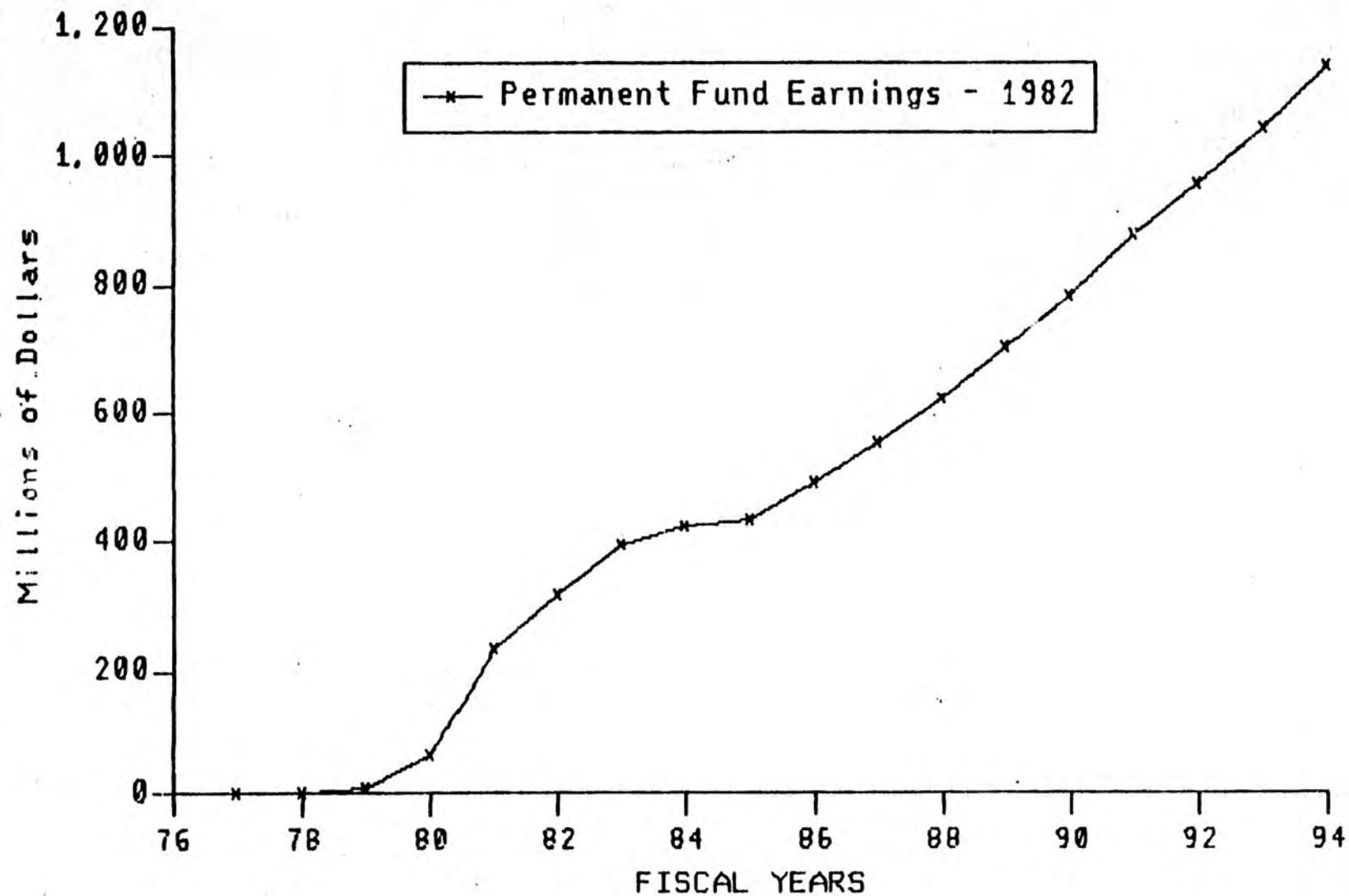


FIGURE 3a

Forecast of Permanent Fund Annual Earnings (1982 Forecast)

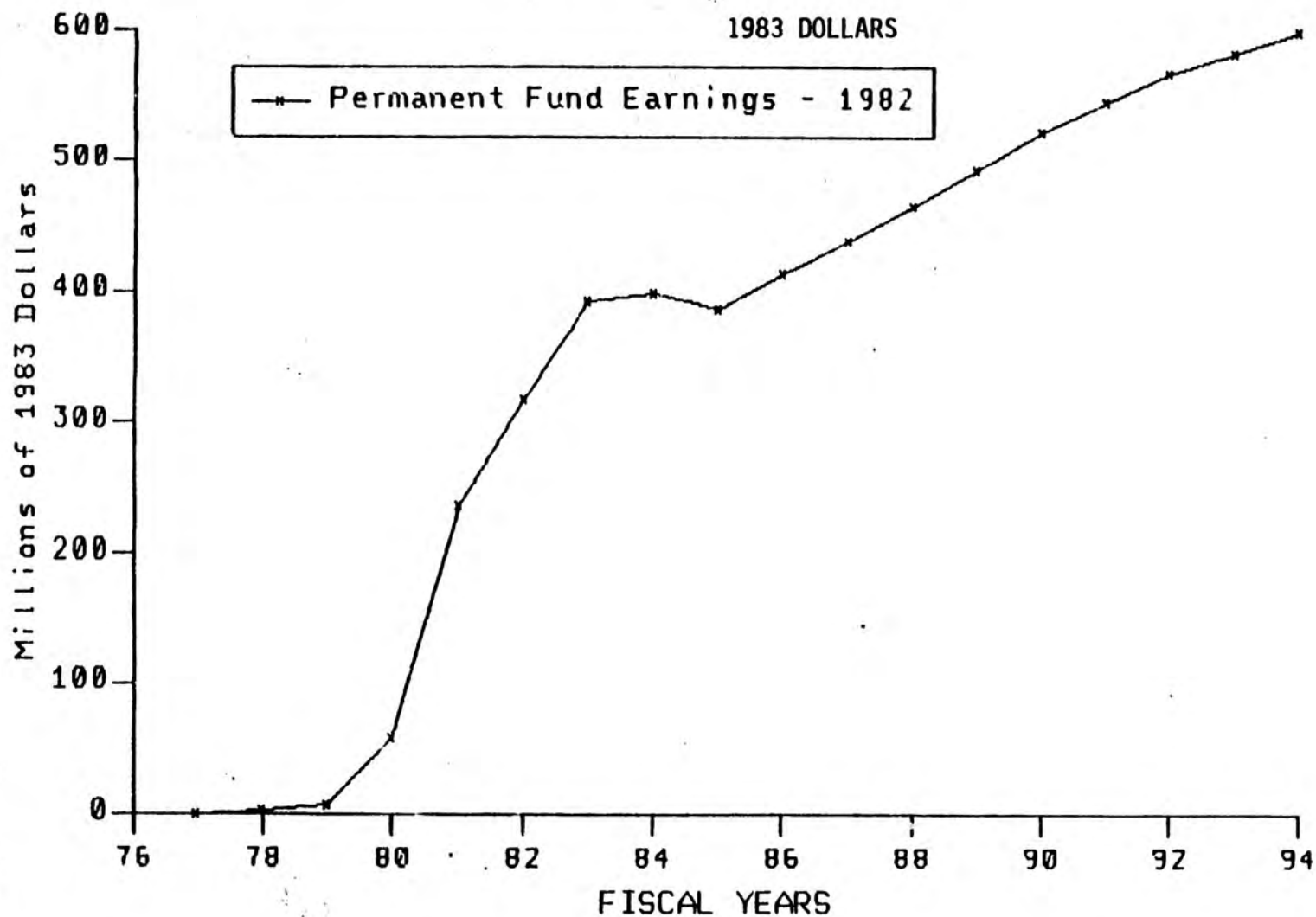


Figure 4

- ° Permanent Fund earnings represent an ever increasing percentage of funds available to the State
- ° This growth is due to increased earnings of the Permanent Fund and decreasing oil-based revenue

Assumptions

- ° 10 percent average annual earnings on Permanent Fund assets
- ° December, 1982, 30th percentile revenue projection of the Department of Revenue
- ° Contributions to the Permanent Fund according to existing law

FIGURE 4
PERMANENT FUND EARNINGS
(As a Percent of Total Revenue Available)

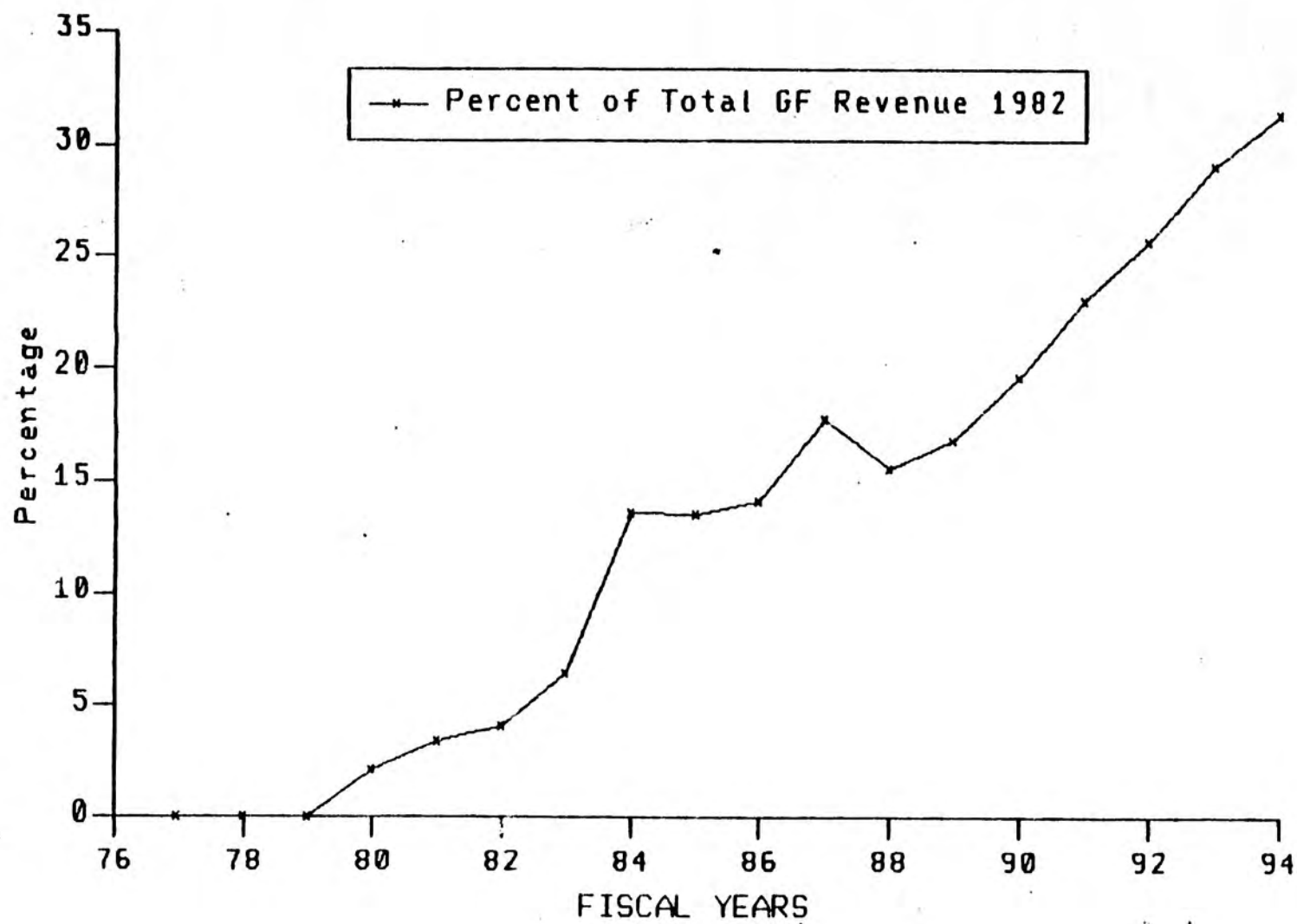


Figure 5

- ° FY 1982 appropriations represented over \$12,000 per capita
- ° FY 1994 spending would represent approximately \$4,100; however, in real terms (constant 1983 dollars), this represents approximately \$2,200

Assumptions

- ° Appropriations after FY 1983 represent December, 1982, 30th percentile revenue forecast of the Department of Revenue
- ° Appropriations prior to FY 1983 represent appropriations of unrestricted General Fund revenue
- ° Population growth rate of 2.3 percent

Note: Figure 5a presents the same data in 1983 dollars

FIGURE 5

PER CAPITA APPROPRIATIONS

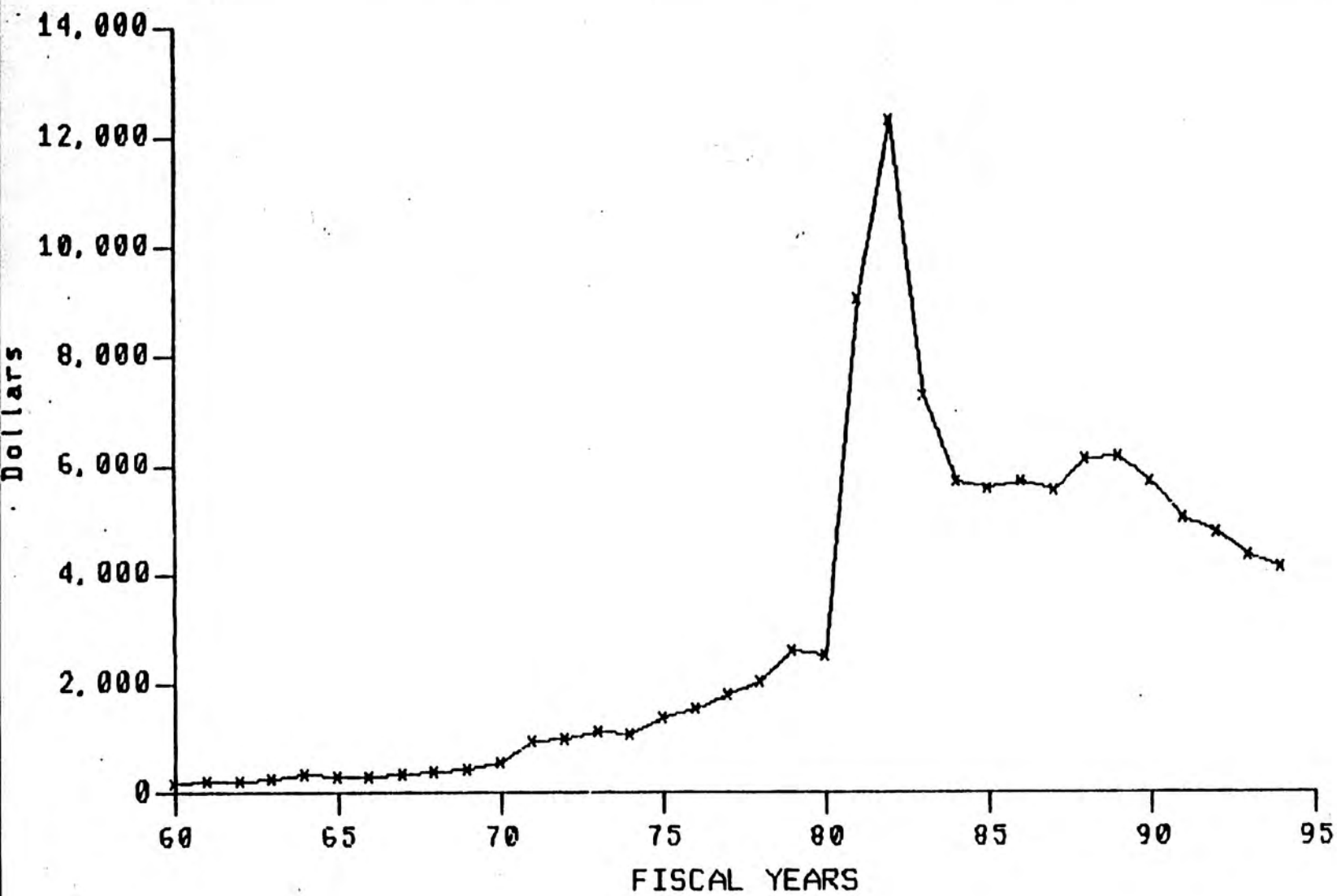
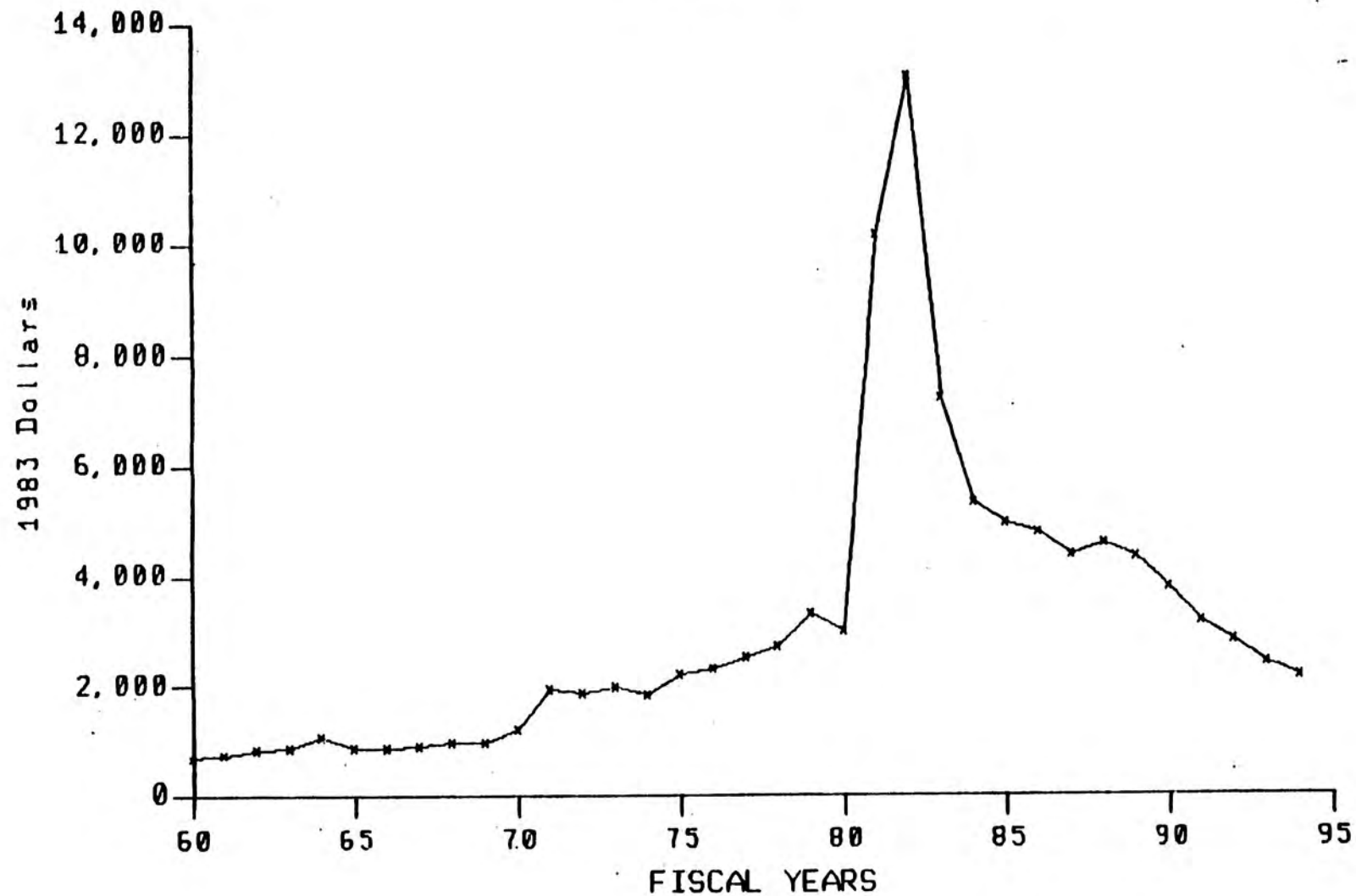


FIGURE 5a

PER CAPITA APPROPRIATIONS

1983 DOLLARS



Addendum

PRICE ASSUMPTIONS FOR SAUDI "MEDIUM" CRUDE FOB QOIN ISLAND:

<u>Year</u>	<u>Month</u>	<u>\$/Barrel</u>
1983	January	\$ 28.25
	February	27.35
	March	26.46
	April	25.56
	May	25.55
	June	25.53
	July	25.52
	October	25.24
1984	January	25.10
	April	25.06
	July	25.03
	October	25.08
1985	January	24.80
	April	25.26

- ° Annual growth rate in prices after April, 1985 is inflation plus 1 percent.

Notes: ° Market clearing price, February, 1983--\$28.13

- ° Prices after February, 1983 are forecasts
- ° 30th percentile forecast



Official Business

REVISED 2/18/81

Alaska State Legislature

House of Representatives

Committee on Finance

Pouch V
State Capitol
Juneau, Alaska 99811

HOUSE FINANCE COMMITTEE -- SUBCOMMITTEES

TRANSPORTATION - Freeman, Chairman
Moss, Metcalfe

NRMEC - Meekins, Chairman
Carney, Haugen, Buchholdt, Halford

U. OF A. - Rogers, Chairman
Buchholdt, Martin

SOCIAL SERVICES - Cotten, Chairman
Carney, Beirne

HEALTH - Carney, Chairman
Cotten, Bettisworth

EDUCATION - Moss, Chairman
Meekins, Barnes

PUBLIC PROTECTION - Malone, Chairman
Adams, Bylsma

JUSTICE - Adams, Chairman
Malone, Anderson

GENERAL GOVERNMENT - Malone, Chairman
Freeman, Phillips

DEVELOPMENT - Buchholdt, Chairman
Rogers, Cuddy

HOUSE FINANCE COMMITTEE
February 6, 1981
1:15 p.m.

(Tape HFC 81-1, side 1 #001)

PRESENT

Chairman Cotten called the meeting to order at 1:15 p.m. Committee members present were Representatives Cotten, Montgomery, Moss, Freeman, Haugen, Buchholdt, and Meekins. Representatives Malone, Rogers and Carney arrived later in the meeting. Representative Adams was not in attendance. Present to testify was Milt Barker, Fiscal Analyst, Legislative Finance Division.

REVENUE PROJECTIONS

Chairman Cotten said the purpose of the meeting was to receive testimony from Legislative Finance on how much money is available for appropriation, and on the difference between the Governor and Legislative Finance Division projections.

Mr. Milt Barker, Fiscal Analyst, Legislative Finance Division, presented a Memo dated February 5, 1981, Subject: Funds Available for Appropriation. (See attachment #1.) He briefly explained the Memo, and said the petroleum corporate tax receipts are subject to litigation.

(Representative Malone arrived at this time.)

Representative Meekins asked what he thought the effect of having an escrow would be on the outcome of the litigation. Mr. Barker said the Attorney General's comment on this was that he didn't think it would have any effect.

Chairman Cotten asked if the difference between the Administration and Legislative Finance figures amounts to \$596 million in tax receipts and \$170 million in interest income. Mr. Barker said yes, and advised the amount available is close to \$6.6 billion.

Representative Meekins asked what assumptions he used. Mr. Barker said he relied entirely upon Administration figures as far as assumptions go. He briefly explained. Representative Meekins commented that Administration figures usually error on the conservative side. He commented on the differences between Administration and Legislative Finance figures in previous years.

Mr. Barker presented a Memo dated January 16, 1981, Subject: Projected General Fund and Permanent Fund Balances. (See attachment #2.) He said this Memo summarizes the results of

2/6/81

various computer runs. He said of most interest would be those that reflect the different state tax structures and start with the Governor's budget level for 1982.

(Representative Rogers arrived at this time.)

There was brief discussion on the Memo.

Mr. Barker presented a Memo dated January 16, 1981, Subject: Revisions in Petroleum Taxation. (See attachment #3.) There was discussion on the Tables attached to the Memo. Representative Rogers asked what the difference was, split between the current and coming fiscal years. Mr. Barker advised the FY 82 amounts would be \$8 billion for federal, \$3.3 billion for producers, and \$5.2 for State. Representative Rogers said in effect the federal government gets 45%/50% in the coming fiscal year. There was further discussion.

There was brief discussion on the gas production estimates.

(Representative Carney arrived at this time.)

Representative Meekins asked why the magazine articles were included as an appendix to the Memo. Mr. Barker said the articles indicate the corporations have revenues far in excess of their investment needs for those revenues. He said the relevance is that they are probably going to be much closer to the federal statutory limits on their income, plus they will not have any shelters. He said this will also effect the rate of return the companies will be earning on their Prudhoe Bay investment. In answer to a question from Representative Meekins, Mr. Barker said there are several incentives in existing federal taxes which are the corporation's primary concern; he said incentives in state taxes would have a very marginal effect. Representative Rogers said the articles also demonstrate a lack of management within the corporations. He commented further. Representative Malone commented there is a striking parallel between what is happening within Sohio and the State of Alaska.

Representative Freeman commented that if they start with an estimate of \$5.8 million available, subtract the Governor's operating and capital budget amount (\$2.4 million), there is \$3.4 million left, which would mean there is \$1.8 million available for appropriation to the Permanent Fund.

(Tape change, HFC 81-1, Side 2.)

There was discussion on revenue projections provided by Administration. Representative Rogers requested information on what the Administration and Legislative Finance projections were in past years, and what the actual figures were. Mr. Barker will provide that information.

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FINANCE COMMITTEE SUBCOMMITTEES

Chairman Cotten said they would hopefully be ready to begin subcommittee work early next week. He suggested that Committee members let him know if they want to work on a specific subcommittee if they have not already done so.

ADJOURN

The meeting adjourned at 2:10 p.m.

Tape HFC 81-1, Side 1 #001 to end

Side 2 #001 to #150

---TECHNICAL PROBLEMS WITH RECORDING
EQUIPMENT. TAPE NOT CLEAR. ---

2/6/81

STATE OF ALASKA

THE LEGISLATURE

BUDGET AND AUDIT COMMITTEE

FINANCE DIVISION
FOUCH WF-STATE CAPITOL
JUNEAU, ALASKA 99811
PHONE: (907) 465-3796

MEMORANDUM

DATE: February 5, 1981

TO: Honorable Sam Cotten
Chairman
House Finance Committee

FROM: Milt Barker, ^{MB} Fiscal Analyst
Legislative Finance Division

SUBJ: Funds Available for Appropriation

The attached Table I is a simplification of page 7 in the FY 82 Executive Budget which shows the amount of general funds available for appropriation as presented by the Governor.

However, based on the two attached legislative finance memos, the amounts in Table I could be increased as follows:

	<u>Available for Appropriation</u>	<u>Cash</u>
Table I	\$6,014.1 million	\$5,665.2 million
Decontrol	185.2	185.2
	<u>\$6,199.3</u>	<u>\$5,850.4</u>
Underestimates		
Petroleum Corporate		
Income Tax	596.0	596.0
Interest Income	170.5	170.5
	<u>\$6,965.8 million</u>	<u>\$6,616.9 million</u>

Total petroleum corporate income tax receipts through FY 82 are estimated at:

"Revenue Sources"	\$2,433.0 million
Decontrol	51.1
	<u>\$2,484.1</u>
Underestimate	596.0
	<u>\$3,080.1 million</u>

These amounts are subject to litigation.

attachment

MB:bf

TABLE I
GENERAL FUND BALANCES
(\$ MILLIONS)

	<u>Available for Appropriation</u>	<u>Cash</u>
General Fund Balance 6/30/80	\$2,221.6	\$1,438.7
<u>FY 81</u>		
Unrestricted Revenue	3,631.0	3,631.0
(Net of Permanent Funds)		
Appropriations	(4,793.6) ¹	(4,341.6)
Illiquid Investment	<u> </u>	<u>(18.0)</u>
General Fund Balance 6/30/81	\$1,059.0	\$ 710.1
<u>FY 82</u>		
Unrestricted Revenue	<u>\$4,955.1</u>	<u>\$4,955.1</u>
(Net of Permanent Funds)		
General Fund Balance	\$6,014.1	\$5,665.2
(Before 1981 Session Appropriations)		

Footnote:

1. Certain appropriations to AHFC, AIDA, and for fish processing loan guarantees were made from illiquid assets.

PREPARED BY:
Legislative Finance Division
February 5, 1981

STATE OF ALASKA

THE LEGISLATURE

BUDGET AND AUDIT COMMITTEE

FINANCE DIVISION
POUCH WF--STATE CAPITOL
JUNEAU, ALASKA 99811
PHONE: (907) 465-3796

MEMORANDUM

DATE: January 29, 1981

TO: Honorable Jim Duncan
House of Representatives
Alaska State Legislature

FROM: Milt Barker *MB*
Fiscal Analyst
Legislative Finance Division

SUBJ: Decontrol

According to the Division of Petroleum Revenue, the additional amounts to be received in FY 81 and FY 82 as a result of decontrol are \$87.5 million in royalty and \$68.5 million in severance, a total of \$156.0 million. These figures are corrected from those given in the attached Fairbanks Daily News Miner article. The additional amounts to the general fund and permanent fund would be \$134.1 million and \$21.9 million respectively.

In addition, petroleum corporate income tax receipts should rise by \$51.1 million for a total addition to the general fund of \$185.2 million.

The \$51.1 million was determined by multiplying royalties by 8 to get a total increased value of production of \$700 million. From this is deducted \$156.0 million in royalties and severance before applying the 9.4% state income tax rate.

attachment

MB:bf

FAIRBANKS

Daily News - Miner

"America's Farthest North Daily Newspaper"

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FAIRBANKS, ALASKA, FRIDAY, JANUARY 23, 1981

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Decontrol could bring \$188.3 million to state

If President Ronald Reagan were to lift federal oil price controls immediately, it would mean an additional \$188.3 million in state of Alaska oil royalties and severance taxes this year.

Commissioner of Revenue Thomas Williams told the Daily News-Miner this morning that the action hinted by Reagan administration officials would mean about \$30 million more paid into the Permanent Fund and \$158 million more into the state general fund this year.

The Carter administration had been lifting federal oil price controls gradually on a schedule aimed at full decontrol in September. Reagan campaigned against oil price limits last year and his aids have said that he might lift all controls immediately by executive order. In recent days, however, Reagan has not stressed that possibility.

Lifting price controls right away also might help Reagan's plans to balance the federal budget since it would generate millions from the federal oil windfall profits tax.

Williams said a computer analysis completed today showed lifting controls Feb. 1 would mean \$80.6 million more in royalties and \$53.2 million more in production taxes for the state during this

fiscal year. The current fiscal year ends June 30.

Lifting controls would affect only the first few months of fiscal year 1982, Williams said, but this would give the state \$38.4 million more in royalties and \$16.1 million more in production taxes.

Since one quarter of the royalties goes to the Permanent Fund, Williams said, that would leave \$158 million dollars in additional revenue the state could spend this year.

On Jan. 15 Martin Anderson, chief domestic policy adviser to Ronald Reagan, told The New York Times that Reagan will carry out a campaign pledge and issue an executive order to speed up the lifting oil domestic crude oil price controls "early" in his administration.

In a story from Washington, the Times quoted Martin Anderson as saying Wednesday that Reagan stood by his oft-declared plan to "deregulate the energy market" and that he would begin moving in that direction early in his term.

Since then congressional sources have speculated that such an order might totally lift oil price controls Feb. 1.



AMERICAN IN THE MIDDLE—Former hostage Bruce German of Kensington, Md. (parka with fur) is the focus of attention from journalists and photographers this

STATE OF ALASKA

THE LEGISLATURE

MEMORANDUM

BUDGET AND AUDIT COMMITTEE

FINANCE DIVISION
POUCH WF-STATE CAPITOL
JUNEAU, ALASKA 99811
PHONE: (907) 465-3795

DATE: January 29, 1981

TO: Honorable Jim Duncan
House of Representatives
Alaska State Legislature

FROM: Milt Barker, ^{MB} Fiscal Analyst
Legislative Finance Division

SUBJ: Governor's FY 81 and FY 82 Revenue Estimates

The Governor's revenue estimates for petroleum corporate income tax and interest income stated in "Revenue Sources" appear to be low.

Petroleum Corporate Income Tax

For the petroleum corporate income tax, there are the following estimates (\$ millions):

FY	<u>Revenue Sources</u>	<u>AG</u>	<u>Legislative Finance</u>
81	\$770	\$ 935	\$ 795
82	883	1314	1238
Total	\$1653	\$2249	\$2033

Unlike the other two estimates, the Legislative Finance figures do not include income tax on TAPS operations. The difference between the two administration figures is \$596 million for the two year total. The AG's figures were developed to analyze possible changes in the tax law.

Interest Income

The FY 82 "Revenue Sources" investment earnings figure is \$195 million, the same as FY 81. Based on an average FY 82 permanent fund balance of \$2,080 million (this estimate uses Department of Revenue figures and assumes no new appropriations above required contributions) and \$350 million in the "Rainy Day" fund, a minimum of \$243 million in income would be earned with interest rates at 10%. With the Governor's proposed appropriation of \$1.8 billion to the permanent fund, \$300 million to an escrow fund, and \$350 million to the "Rainy Day" fund, the earnings at 10% on the average FY 82 balances in all these funds would come to \$365.5 million.

MEMORANDUM

TO: Hon. Ed Dankworth
Co-Chairman
Senate Finance Committee

FROM: Milt Barker *MB*
Fiscal Analyst

DATE: January 16, 1981

SUBJECT: Projected General Fund and Permanent
Fund Balances

Table I (attached) summarizes the results of one hundred twenty-eight long range projections in nominal dollars of general fund and permanent fund balances based on all combinations of the following assumptions:

- | | <u>Run #'s</u> |
|--|----------------|
| 1. Budget | |
| a) \$1521.7 billion FY 81 | |
| b) \$1788.1 billion (excludes HB 60) FY 81 | |
| c) \$2368.9 billion (includes HB 60) FY 81 | |
| d) \$2454.3 billion Governor's budget FY 82 | |
| 2. Budget Growth | |
| a) 5% per annum | |
| b) 10% per annum | |
| c) 15% per annum | |
| d) 20% per annum | |
| 3. State Tax Structure | |
| a) current statutes | 1-16 |
| b) no petroleum income tax | 17-32 |
| c) windfall deduction | 33-48 |
| d) windfall deduction, no expiration
of windfall tax | 49-64 |
| e) windfall deduction, 15% severance | 65-80 |
| f) windfall deduction, no expiration
of windfall tax, 15% severance | 81-96 |
| g) no petroleum income tax, 15%
severance, 18% oil royalty | 97-112 |
| h) no petroleum income tax, no
oil severance, 29.38% oil royalty | 113-128 |

In a memo of this same date to Sen. Ed Dankworth re: "revisions in petroleum taxation," several tax structures were determined which yielded the same or greater cash flow to the state over the

Attachment #2

Memorandum
January 16, 1981
Projected General Fund
and Permanent Fund Balances
Page 2

life of Sadlerochit oil production as current statutes without reducing producers' cash flow or rates of return. Structures (g) and (h) are included in this memo as representative.

For such equivalent tax structures, differences in general fund and permanent fund balances from the current situation show up in those cases where the oil royalty is changed from 12.5%. In these cases, more royalty proceeds go into the permanent fund and less into the general fund, and there is also less interest returned to the general fund from permanent fund earnings because permanent fund dividends increase.

Compared to current statutes, tax structure (h), which replaces severance taxes on oil and the income tax with a 29.38% oil royalty that yields the same revenues to the state, nevertheless reduces both the general fund balance and the total of the general and permanent fund balances in the year 2000.

The next to last state tax structure listed, (g), is one which increases total state cash flow from Sadlerochit the maximum amount possible without harming producers and does so with the minimal increase in oil royalties required to accomplish this. This overcomes the factors mentioned in the previous paragraph and results in an increase in both the general fund and permanent fund compared with current statutes.

In all the scenarios with growth rates in the budget of 10% or less, the general fund balance is still growing in the year 2000. Even in some of the more favorable cases that assume 15% growth, the general fund balance is still increasing in FY 2000, although at a slackening rate. In less favorable 15% cases, the balance is declining in the year 2000 and in the worst 15% case (no petroleum income tax, FY 81 budget of \$2368.9), the general fund balance hits zero in FY 98.

In all the 20% budget growth scenarios, the general fund is depleted by the year 2000 or shortly thereafter. Elimination of the petroleum corporate income tax results in the soonest insolvency. It is apparent from Table I that this is the only change in current tax structure that would make much more than a year's difference in the state's fiscal solvency.

Another interesting aspect of the projections is that in all the cases with budget growth of 10% or less, interest income

Memorandum
January 16, 1981
Projected General Fund
and Permanent Fund Balances
Page 3

alone in FY 2000 is greater than the budget appropriation. Even with 15% growth, this holds true in the best cases. However, if all surpluses were accumulated in the permanent fund, rather than in the general fund as was done for these runs, the obligation of paying dividends would take half of the interest income shown as long as the program remained in effect.

Some further model runs from the year 2001 to 2040 were done assuming that there are no permanent fund dividends and no revenues other than interest income after the year 2000. The runs were developed assuming that the current state tax structure remains in place until the year 2000. With the Governor's budget for FY 82 and 10% and 15% budget growth, the general fund balance is zero in FY 2025 and FY 2003 respectively. With an FY 81 budget of \$1521.7 and 5% and 10% growth, the general fund balance is still rising in the year 2040 though at a decreasing rate in the 10% growth case. With an FY 81 budget of \$1521.7 and 15% growth, the general balance would be gone in FY 2010.

It should be recognized that in all these runs interest is calculated at 11%. This in effect implies an inflation rate around 10%. In this context, budget growth cases of 5% and 10% imply rather stringent budgetary control. Certainly, in the 5% case, and probably in the 10%, it means declining real per capita budgets.

Assumptions

Permanent Fund Dividends - 50% of permanent fund income is assumed to be paid in dividends. This amount is included along with permanent fund contributions of 25% under the heading "payments to funds" in the runs.

FY 81 Budget - these are based upon Table II (attached); the \$1521.7 billion figure can be considered to be the sum of the total operating plus special appropriations from Table II plus \$175 million in capital of which \$125 million is funded from renewable resources funds.

Property Tax and Non-Petroleum Revenues - these are the September 1980 projections of the Department of Revenue (see Table III, attached, which displays these as well as the department's estimates for other revenue sources).

Interest Income - this is calculated by the model.

Memorandum
January 16, 1981
Projected General Fund
and Permanent Fund Balances
Page 4

Royalty, Severance, and Petroleum Income Tax Revenue - these estimates are taken from a financial model of Sadlerochit oil and gas production. See January 16, 1981, memo to Sen. Ed Dankworth re: "revisions in petroleum taxation."

The revenue estimates are conservative in that they exclude petroleum revenues from Cook Inlet (estimated to peak at \$172.8 million in FY 84 by the Department of Revenue), production of the Kuparuk or Lisburne reservoirs, or any production from the Beaufort Sea or other areas yet to be explored; and further, they exclude income taxes from pipeline operations.

Oil Prices - these are assumed to escalate 12% per annum after FY 82 with inflation being 10%.

Attachments

TABLE I

Year of Zero General Fund Balance with 20% Budget Growth

FY 81 BudgetFY 82 Budget

<u>Tax Structure</u>		<u>\$1521.7</u>	<u>\$1788.1</u>	<u>\$2368.9</u>	<u>\$2454.3</u>
a)	Current Statutes	FY 2002	FY 99	FY 96	FY 98
b)	No Petroleum				
	Income Tax	98	96	92	94
c)	Windfall Deduction	2001	99	95	97
d)	Windfall Deduction, No Expiration	2000	98	95	97
e)	Windfall Deduction, 15% Severance	2002	2000	97	99
f)	Windfall Deduction, No Expiration, 15% Severance	2002	2000	96	98
g)	No Petroleum Income Tax, 15% Severance Tax, 18% oil royalty	2002	2000	96	98
h)	No Petroleum Income Tax, no oil severance, 29.38% oil royalty	2001	98	95	97

TABLE II

**FY 81 GENERAL FUND OPERATING & CAPITAL BUDGETS
(\$ MILLIONS)**

Operating		\$1,186.6
New Legislation	\$ 306.6	
Less: Income Tax Refund	(90.2)	
Permanent Fund Dividends	<u>(129.3)</u>	
		87.1
Miscellaneous Front Sections Ch. 120		<u>8.3</u>
Total Operating		\$1,282.0
Capital	367.4	
Less: Native Claims	<u>(292.6)</u>	
		72.1
Special appropriations	1,374.7	
Less: Permanent Fund	(900.0)	
General Fund Reserve	(350.0)	
Fish Processing Loan		
Guarantee	<u>(60.0)</u>	
		64.7
Loan Funds	696.3	
Less: Illiquid Assets	<u>(452.0)</u>	
		244.3
HB 60		<u>580.8</u>
Total Capital		<u>961.9</u>
Total Operating & Capital		\$2,243.9
Plus: Renewable Resources		<u>125.0</u>
Total Budget		\$2,368.9
Less: HB 60		<u>(580.8)</u>
Total Budget excluding HB 60		\$1,788.1

Source: "FY 81 Free Conference Committee Report -
Summary of Appropriations"

TABLE III

DEPARTMENT OF REVENUE SEPTEMBER 1980 ESTIMATES
(\$ Millions)

<u>Fiscal Year</u>	<u>Royalties</u>	<u>Severance</u>	<u>Property Tax</u>	<u>Petroleum Income Tax</u>	<u>Non-Petroleum Revenue</u>
1981	1502.4	1183.5	170.0	770.0	200.0
1982	2354.9	1753.3	170.0	882.9	222.2
1983	2924.4	2104.4	198.2	1013.8	246.9
1984	3431.1	2416.8	225.3	1165.7	274.3
1985	4003.4	2816.2	248.9	1333.1	304.7
1986	4451.8	3130.8	271.3	1469.1	338.5
1987	4955.5	3483.9	271.8	1635.3	376.1
1988	5482.7	3856.7	271.4	1809.3	417.9
1989	5969.5	4238.9	270.2	1969.9	464.2
1990	6208.5	4418.4	267.8	2048.8	515.8
1991	6264.1	4446.7	259.1	2067.2	573.0
1992	5976.9	4189.0	249.5	1972.4	636.6
1993	5713.6	3954.4	239.3	1885.5	707.3
1994	5281.5	3581.0	228.1	1742.9	785.8
1995	4905.9	3252.7	216.3	1618.9	873.0
1996	4595.6	2981.0	203.7	1516.5	969.9
1997	4302.7	2731.5	190.3	1419.9	1077.6
1998	4029.0	2503.6	175.9	1329.6	1197.2
1999	3773.3	2295.0	160.8	1245.2	1330.1
2000	3534.2	2104.3	144.8	1166.3	1477.7

MEMORANDUM

TO: ☐ Hon. Ed Dankworth
Co-Chairman
Senate Finance Committee

DATE: January 16, 1981

FILE NO:

TELEPHONE NO:

FROM: Milt Barker *MB*
Fiscal Analyst

SUBJECT: Revisions in Petroleum
Taxation

Attached are Tables I-IV which show the results of eighteen runs of a financial model of the Sadlerochit reservoir. In addition to providing the revenue projections used in the memo to you of this same date re: general fund and permanent fund balances, the model calculates the division of the net cash flow from oil and gas production from Sadlerochit and the rate of return to the producers on their invested capital.

Federal Income Tax

The shares of the companies and federal government are highly dependent upon the effective federal income tax rate paid by the companies. The model was run using both the 46% statutory rate and an assumed 25% effective rate which could occur from investment tax credits, foreign tax credits, existing accelerated depreciation allowances or the proposed "10-5-3" depreciation proposals before Congress which would further accelerate depreciation.

Producers Rates of Return

Two rates of return are shown for each tax structure in Tables III and IV. The "rate of return" figure, by nature of the mathematical calculation involved, assumes that cash generated from a project (Sadlerochit oil production in this case) is reinvested for the remainder of the life of the project at the same interest rate at which it was earned. The other rate of return figure assumes the project cash flow is reinvested at a 20% interest rate.

Where a project is of the magnitude and profitability of Sadlerochit, it is unlikely that the huge cash flows can be reinvested at such a profitable rate. Thus, the latter rate of return figure may be more appropriate in this case, or at least for some of the producers. As the attached articles from the Wall Street Journal and Business Week indicate, Exxon and Sohio have insufficient investment channels readily available to absorb their cash flows, and, at least in Sohio's case, a significant portion is going into money market investments for the time being.

Petroleum Income Tax

As the tables show, eliminating the petroleum corporate income tax would reduce state revenues by \$89 billion from Sadlerochit production alone. The producers' unadjusted rate of return would rise to 84.22% from 76.45% under a 25% effective federal income tax rate. There would be further benefits to the producers from the elimination of income taxes on Cook Inlet production, any future production, and oil and gas pipeline operations.

Windfall Deductions and 15% Severance Taxes

Granting the producers a deduction on the petroleum corporate income tax for windfall profits taxes costs the state \$8 billion and increases producers' returns from 76.45% to 78.33%.

A severance tax increase to a flat 15% more than offsets this, increasing state revenues by \$45 billion net. However, returns to producers fall to only 76.14%, barely below the existing situation, because most of the gains to the state come in the later years of production.

This occurs for two reasons. First, the net gain to the state from the severance tax increase comes mainly after 1990 when the windfall profits tax begins to expire and after which, there is no value to a deduction for such on the state income tax.¹ Secondly, the 15% severance tax is assumed to be a flat rate to maximize the deduction for severance taxes permitted against the windfall profits tax. Thus, in comparison with the current severance tax which has an economic limit factor (ELF) that reduces the effective severance tax rate as production declines, the 15% flat severance will yield relatively greater amounts in later years.

¹Comparison of individual years shows that there is even a small net gain to the state during the years the windfall profits tax is in effect, but this could be a net loss if oil prices increase faster than the 2% real increase per year assumed in the runs. During the flush years of Sadlerochit

contributions. Furthermore, it would avoid going to a flat 15% severance which might have discouraging effects on some high cost or marginal properties.

Of course, the economic limit factor could be retained with a 15% severance. However, the economic limit factor may be less important in an era of decontrolled prices. There will always be marginal properties. But with rising real oil prices, they will eventually be produced. What the ELF does is shift production from the future to the present. With the state's current revenues, this may not be so important. And the particular problem the ELF was designed to solve, a high severance tax rate in Cook Inlet resulting from a cents per barrel tax being applied to controlled prices, will no longer exist with the decontrol of oil prices.

Producers Held Harmless

The last two tax structures represent the maximum the state could take and leave the producers as well off as they are now. With a tax structure somewhere in between these last two and the two immediately preceding, both the state and producers can profit at the expense of the feds.

ASSUMPTIONS

Oil and Gas Production - production of oil and gas and associated water is generally consistent with Case D (gas sales, source water injection) of the March 1980, "Three Dimensional Reservoir Study--Sadlerochit Formation" by van Poolen. Production rates from the study have been smoothed and total recovery of oil is estimated more conservatively at 9.17 billion barrels as opposed to 9.37 billion for Case D. Total gas recovery is 20.4 trillion cubic feet as opposed to 24 trillion cubic feet in Case D. Operating costs have been adjusted accordingly. Production volumes and operating and capital costs (in 1977 dollars) are detailed in the "Producer Benefits Model Data Array" that precedes the runs.

Development Costs - Table V, attached, details investment costs prior to start-up of production in 1977. The cost basis used in the model runs to calculate rate of return on these investments is \$4.4 billion. The \$5.0 billion from Table 7 on an after-tax basis, assuming a 20% effective

Memorandum
January 16, 1981
Revisions in Petroleum Taxation
Page 5

income tax rate, becomes \$4 billion. Because production was put on a fiscal year basis for purposes of revenue projection while costs remained on a calendar year, this \$4 billion in after-tax costs was compounded forward one-half year at 20% to give \$4.4 billion. Note that the 1969 investment costs include only bonuses paid on productive leases, a total of \$84.5 million, rather than the full \$900 million.

Attachments

TABLE I

SHARES OF NET CASH FLOW AT 46% FEDERAL TAX RATE
(\$ Billions)

<u>State Tax Structure</u>	<u>State</u>	<u>Producers</u>	<u>Federal</u>
Current Statutes	\$327 (30%)	\$372 (34%)	\$404 (36%)
No Income Tax	238 (22%)	420 (38%)	445 (40%)
Windfall Deduction	319 (29%)	376 (34%)	408 (37%)
Windfall Deduction, 15% Severance	372 (34%)	350 (32%)	381 (34%)
Windfall Deduction, No Expiration	298 (27%)	268 (24%)	536 (49%)
Windfall Deduction, No Expiration, 15% Severance	353 (32%)	253 (23%)	496 (45%)
No Income Tax, 19.2% Severance	327 (30%)	374 (34%)	401 (36%)
No Income Tax, No Severance, 29.38% Oil Royalty	327 (30%)	376 (34%)	399 (36%)
No Income Tax, 15% Severance, 16.84% Oil Royalty	327 (30%)	376 (34%)	399 (36%)
No Income Tax, No Severance, 30.48% Oil Royalty	336 (30%)	372 (34%)	394 (36%)
No Income Tax, 15% Severance, 18% Oil Royalty	335 (30%)	372 (34%)	395 (36%)

TABLE II

SHARES OF NET CASH FLOW AT 25% FEDERAL TAX RATE
(\$ Billions)

<u>State Tax Structure</u>	<u>State</u>	<u>Producers</u>	<u>Federal</u>
Current Statutes	\$327 (30%)	\$516 (47%)	\$259 (23%)
No Income Tax	238 (22%)	583 (53%)	281 (25%)
Windfall Deduction	319 (29%)	522 (47%)	261 (24%)
Windfall Deduction, 15% Severance	372 (34%)	486 (44%)	245 (22%)
Windfall Deduction, No Expiration	298 (27%)	372 (34%)	432 (39%)
Windfall Deduction, No Expiration, 15% Severance	353 (32%)	352 (32%)	398 (36%)
No Income Tax, 19.2% Severance	327 (30%)	519 (47%)	256 (23%)
No Income Tax, No Severance, 29.38% Oil Royalty	327 (30%)	523 (47%)	253 (23%)
No Income Tax, 15% Severance 16.84% Oil Royalty	327 (30%)	523 (47%)	253 (23%)
No Income Tax, No Severance, 30.48 Oil Royalty	336 (30%)	516 (47%)	249 (23%)
No Income Tax, 15% Severance, 18% Oil Royalty	335 (30%)	517 (47%)	250 (23%)

TABLE III

PRODUCERS' RATES OF RETURN
AT 46% FEDERAL TAX RATE

<u>State Tax Structure</u>	<u>Rate of Return</u>	<u>Rate of Return With 20% Reinvestment Rate</u>
Current Statutes	59.04%	26.00%
No Income Tax	65.12	26.52
Windfall Deduction	60.71	26.15
Windfall Deduction, 15% Severance	58.94	25.95
Windfall Deduction, No Expiration	60.35	25.67
Windfall Deduction, No Expiration, 15% Severance	58.55	25.48
No Income Tax, 19.2% Severance	59.63	26.03
No Income Tax, No Severance, 29.38% Oil Royalty	60.47	26.10
No Income Tax, 15% Severance, 16.84% Oil Royalty	60.47	26.10
No Income Tax, No Severance 30.48% Oil Royalty	59.64	26.04
No Income Tax, 15% Severance, 18% Oil Royalty	59.72	26.04

TABLE IV
PRODUCERS' RATES OF RETURN
AT 25% FEDERAL TAX RATE

<u>State Tax Structure</u>	<u>Rate of Return</u>	<u>Rate of Return With 20% Reinvestment Rate</u>
Current Statutes	76.45%	27.33%
No Income Tax	84.22	27.86
Windfall Deduction	78.33	27.49
Windfall Deduction, 15% Severance	76.14	27.28
Windfall Deduction, No Expiration	78.18	27.01
Windfall Deduction, No Expiration, 15% Severance	75.96	26.80
No Income Tax, 19.2% Severance	77.00	27.34
No Income Tax, No Severance, 29.38% Oil Royalty	77.97	27.42
No Income Tax, 16.84% Oil Royalty	77.95	27.42
No Income Tax, No Severance, 30.48% Oil Royalty	76.79	27.35
No Income Tax, 15% Severance, 18% Oil Royalty	76.90	27.36

TABLE V

SADLEROCHIT INVESTMENT COSTS 1964-1974
(\$ Millions)

<u>Year</u>	<u>Original Dollars</u>	<u>1977 Dollars Plus Interest</u> <u>2/</u>
1964	3.9	64
1965	5.3	47
1966		
1967	1.5	9
1968	11.0	56
1969	155.5 <u>1/</u>	668
1970	116	415
1971	83	247
1972	31	77
1973	62	128
1974	156	269
1975	1170	1684
1976	1137	1364
TOTAL	1195	5028

NOTES: 1/ Includes only the bonuses paid on productive leases.

2/ Original dollars are compounded annually at 20% to account for both inflation and interest costs.

SOURCES: 1964-1974: Alaska's Prudhoe Bay Oil: Profitability and Taxation Potential; Tanzer Economic Associates, July 9, 1976; pp. 19-23.

1975-76: Prudhoe Bay Unit Operating Agreement; April 1, 1977; p. 34F-2. The above 1964-1974 total costs were deducted from the oil rim share of total costs reported in the operating agreement. The remainder was allocated to 1975 and 1976 on the basis of the Tanzer estimates for those years.

Going to the Well: 'Big Oil' Firms Find That Outlets For Investment of Their Large Earnings Are Limited

Going to the Well

'Big Oil' Finds Outlets Limited as It Attempts To Invest Its Earnings

Critics Charge Exploration Is Sidestepped; Firms Say It Is Major Budget Item

A Place for Sun Co.'s Profit

By PAUL BLUSTEIN

Staff Reporter of THE WALL STREET JOURNAL

Two months ago Jack Neasey, senior vice president of Sun Co., the nation's 10th-largest oil company, was voicing an extraordinary problem: With 1979 profits up by the company was practically in the position of having too much money to invest at once. The only constraint the company was facing, he said, was "the question of how many opportunities we can take on at one time."

Two days ago, Sun found a place for some of its expansive profits—it offered \$2.3 billion for the bulk of the U.S. oil and gas properties of Seagram Co. The proposed acquisition's price tag was second only to Shell Oil Co.'s \$3.65 billion takeover of Belridge Oil Co. last year.

For many large U.S. oil concerns the embarrassment of riches brought their way by last year's record profits is both an odd and a vexing problem. Even though their capital budgets are at record levels and far exceed their profits, these companies say they have more financial resources than they can profitably spend.

Exxon Corp., the world's largest oil concern, has a \$7.5 billion spending program for this year, a 25% increase from last year's initial appropriation. But Exxon would like to spend even more, says Roger Headrick, the deputy controller. "We're not financially constrained from doing so," he says. "We're what you might call opportunity-limited."

"Don't Worry About Money"

At Standard Oil Co. of California, Mobil Corp., Phillips Petroleum Co. and Getty Oil Co., capital spending is proceeding as though money were no object—which it isn't. "I've told our operating people that if they've got a sound oil and gas project they can handle, don't worry about the money—I'll find a way to get it," says Howard Bell, California Standard's vice president of finance.

Mr. Bell's main problem is making sure his managers don't misinterpret his encouragement as a license to squander. He fears that his people will start pushing favorite projects that have failed financial reviews in the past.

To many critics of the oil industry, the cash-rich oil firms seem to be investing too much of their capital conservatively in existing oil and gas properties rather than taking more risks on exploration or even on alternative fuels. "They (the oil companies) figure it costs less to buy a barrel of oil that's already been located than to find new oil in the U.S.," says a Wall Street analyst.

One congressional critic complains that "with all the oil and other energy supplies the U.S. needs, I question whether the companies are really doing all they can to solve the problem." He notes that the oil companies "are cautious" about going into debt and have been spending "plenty on buying existing reserves." Why, he asks, do the oil companies "insist on decontrol of oil prices and object to the 'windfall profits' tax if they've got so much money already?"

Profits Come First

The companies' response is that while their pockets may be deep, they aren't so deep that they can afford to ignore the basic principles of looking for the most profitable rate of return. "It isn't that we've got so much profit that we don't know what to do with it," says Exxon's Mr. Headrick.

It's not only profit considerations that are preventing the oil industry from spreading more of its cash around. Major acquisitions outside the oil business, companies say, would almost certainly face government opposition and building badly needed new refineries would come up against widespread environmental resistance. The companies also tick off the obstacles that are preventing greatly expanded exploration and drilling programs: tough environmental regulations, shortages of skilled manpower and drilling equipment, and, overseas, the nationalization of much of "big oil's" assets.

Oilmen reject the notion that their budgets aren't big enough.

The industry has allocated \$50.5 billion for capital projects in the U.S. this year, according to the Oil & Gas Journal, up from the \$33.5 billion initially forecast for last year and the \$40.1 billion actually spent. Foreign spending, according to the trade publication, will rise this year to \$10.5 billion from \$7.9 billion in 1979.

A large portion of the increase in this year's spending will simply reflect inflation. The cost of drilling, in particular, has soared in recent years: According to the American Petroleum Institute, the cost of drilling rose by 21% in 1978 from 1977.

\$18.2 Billion for Exploration

As for the argument that too much of the industry's capital spending is going for investments in existing oil properties, oil executives assert that exploration is the single biggest item in most major companies' budgets. U.S. exploration spending this year should total \$18.2 billion, the Oil & Gas Journal estimates, with crude-oil production adding another \$11.9 billion. Exploration and production combined will account for two-thirds of all spending, the trade publication says.

Exxon, for example, is planning to spend over 80% of its capital budget this year on petroleum. About three-fourths of that, or \$4.6 billion, will be aimed at crude-oil exploration and production. The exploration budget includes Exxon's investments in well over 200 "wildcat" wells—that is, wells

Please Turn to Page 26, Column 1

drilled in geological structures where oil and gas haven't previously been found—about the same as last year.

With so much cash already available for exploration and production, why, critics ask, does the industry need the considerable additional profits that will flow from the price decontrol of domestic oil? The industry argues that exploration programs will be greatly expanded only if the oil companies are guaranteed a high rate of return on new oil production.

Without the additional profits from price decontrol, the oil companies say they have dug into their coffers as far as they can. "Last year we put more into the ground than we had cash flow," says LeRoy Culbertson, Phillips's senior vice president for planning and budgeting. Phillips could borrow more to increase its exploration and production budget, but "with interest rates the way they are, we're not too enthusiastic about that," he says.

Even Exxon, with shareholder equity of \$22.5 billion, had a relatively modest long-term debt of \$4.3 billion at the end of 1979 and doesn't show any interest in going much beyond that level. Last year, the company's new debt (less repayments) added only \$850 million to cash flow, bringing the total to about \$8.4 billion. Thus, Exxon could greatly increase its capital spending if it could find enough worthwhile projects.

Some companies assert that their finances already are stretched to capacity. "We have more projects than we have money to drill," says a spokesman for Standard Oil Co. (Indiana), a company that in recent years has aggressively bought large quantities of unexplored acreage. Officials of Atlantic Richfield Co., Cities Service Co., Marathon Oil Co. and Conoco Inc. also say they are restricted by their financial situations.

But for those companies searching for investments, the acquisitions of other oil concerns, of oil and gas reserves and of unexplored acreage are clearly the most attractive. Investing in business unrelated to oil is generally regarded as inviting opposition by Washington—at least, if the acquisitions are on the scale of a Phillip Morris or a Boeing (the Senate Judiciary Committee recently reported out a bill, endorsed by the administration, that would prohibit major oil companies from making large acquisitions unless they demonstrably increase competition or enhance energy production). Analysts point out that an acquisition would have to be of that nature to make an appreciable difference to the biggest oil companies' profits. Acquisitions on the scale of Exxon's \$1.17 billion takeover of Reliance Electric last year, they say, add no more than a few pennies to earnings per share.

As for investing in alternative energy projects, there is some doubt that Washington will make these ventures attractive enough to lure oil-industry money. "When these guys start putting money in synthetic fuels and synthetic gas and tar sands and so on, it will require enormous amounts of capital," says Constantine Fliakos, an analyst at Merrill Lynch, Pierce, Fenner & Smith.

Conventional investment possibilities often can be ruled out by government policies that can cause costly delays, oilmen say. "There are plenty of opportunities, but trying to find one that you can put along in

front," says a vice president of Standard Oil Co. (Ohio). He adds, "Everyone was all set to drill in the Beaufort Sea (off the north coast of Alaska) a while back, but now there's some environmental injunction against it." It's particularly difficult to obtain drilling permits in California, industry executives say, because of tough state environmental regulations.

Such logjams recently caused Shell Canada Ltd. to lower its 1980 capital-spending budget by about 23%. The company, a unit of Royal Dutch/Shell Group, cited delays in certain projects, notably a proposed \$6 billion synthetic oil-processing plant that is still awaiting the Canadian government's approval.

Another roadblock is the scarcity of trained technicians and of drilling equipment. Says Getty's central division production manager, James Starrak: "We've had wells held up six, eight or even nine months waiting for drilling rigs." Competition for manpower is fierce, with independent oil concerns offering fat salaries to lure trained employees from the major companies. "We like to have 100 engineers in our division, and we've been hiring 15 to 18 a year out of college," Mr. Starrak says. But the company is still between five and 13 short.

Plowing back profits can be particularly difficult abroad. Overseas operations provided the bulk of many oil companies' earnings gains last year, mainly because of the absence of foreign price controls. But in many oil-exporting countries, "big oil's" assets have been nationalized. Thus, says Robert Wycoff, Atlantic Richfield's senior vice president for planning and finance, "they don't have the opportunities to invest internationally that they used to have because they no longer own many of the producing properties overseas."

William Randol, an analyst at Salomon Brothers, cites the example of Iran. Under the shah, the consortium of companies that operated Iran's oilfields used sophisticated drilling techniques, such as water-flooding and gas injection, to exploit oil deposits. These projects were halted after the fields were expropriated. "Not only is this something that the companies won't have to spend money on anymore, it also has unfavorable implications for the world supply situation because the Iranians won't do what the companies were doing," Mr. Randol says.

The end result of heightened nationalism abroad? More money is being spent domestically. Nicholas Gal, financial-analysis manager of the American Petroleum Institute says: "Since 1974-75, there has been a decisive trend toward directing an increasing percentage of capital and exploration expenditures toward the U.S."

California Standard, for example, which still gets most of its crude oil from Saudi Arabia, will spend nearly two-thirds of its \$2.6 billion 1980 budget in the U.S. Most of the domestic spending—about \$1.1 billion—is aimed at finding and producing crude oil. Projects include two exploratory wells in Alaska costing about \$25 million apiece, two dozen gas wells in Louisiana and the Rocky Mountains costing between \$4 million and \$7 million each, and a \$42 million steam-flooding project to increase heavy-oil production in California's San Joaquin Valley.

Spending money at home has public-rela-

tion, there is the fear that a percentage was tacked onto the bids that the firm submitted for a big offshore lease sale a few years back. After the tracts had been appraised, a company source says, "word was going around that the suggested bids were sent up to the chairman's office, and he grossed them up because he wanted our spending figures to look bigger."

Investing a mountain of cash before the oil runs out

AN OIL GIANT'S

Just 10 years ago, Standard Oil Co. (Ohio) was a regional refiner and marketer, eking out a modest living. Today it is swimming in money. Once severely short of crude, Sohio's bonanza from its huge reserves of Alaskan oil skyrocketed 1979 profits to \$1.2 billion, a phenomenal 2,200% blast in just one decade. This year those profits will come in closer to \$2 billion. A distant 17th in earnings in 1970, Sohio has now joined the exclusive society of oil industry giants: Its net income for the first half of 1980 ranks No. 6, and its 15.9% return on \$2.8 billion sales for the second quarter is far and away the highest in oil's major leagues.

But the very speed of Sohio's rise to Croesus-like wealth has caught its managers in a maelstrom. Trained to operate a company of decidedly shorter horizons, they have only general notions about what to do with their riches and have implemented no plans to maintain their magnitude. The company has ballooned in size so suddenly that it lacks the staff, expertise, and investment vehicles to make decisive use of its money. Yet Sohio's leaders recognize that delaying

new investment will draw harsh criticism from politicians, because Sohio is now reaping a windfall beyond any other oil company. Cash and marketable securities have reached \$25 billion and are still growing. Return on investment, just 3.6% in 1976, leaped to 25.2% by June 30. And the pressure to deploy the resources is heightened all the more by the fact that Sohio's oil at Prudhoe Bay, its only big asset, is quickly draining, with nothing in the wings to replace it.

Sohio is now in a three-way dilemma: It must use its cash rapidly, it sees too few areas for U.S. oil investments, and it says it has decided that its main hope for the future is in diversification outside conventional energy, where it has had little experience and minimal success.

To be sure, not all of Sohio's unpreparedness is its own fault. Just 18 months ago, Sohio was burdened with debt and strapped with exorbitant production and transportation costs for its oil, then selling at \$13.66 per bbl. A number of industry analysts suspected that the company had made a bad deal when it decided in 1969 to trade majority

ownership in itself to British Petroleum Co. in exchange for the undeveloped Prudhoe reserves. Its subsequent \$6.2 billion investment in those reserves left the company hard-pressed for cash.

But four events occurred that Sohio's executives never anticipated, and they rapidly changed the company's fortunes. They were:

- The near-tripling in world oil prices in the last 19 months, which has caused Sohio's average market price to jump to \$25 per bbl. and its wellhead price (market price less transportation costs) to rise from \$5.37 to \$16.50 per bbl.
- A 25% increase, to 1.5 million bbl. per day, in the amount of Alaskan oil being pumped through the Trans-Alaska Pipeline system: Sohio owns 53% of the daily output.
- An increase from about 400,000 bbl. to 600,000 bbl. a day in the amount of its oil that Sohio has been able to land on the West Coast, partly because of shifts and drops in Iranian crude deliveries. This has cut the high cost of transporting most of the company's oil by tanker through the Panama Canal.
- Gradual federal decontrol of Alaskan

Why Sohio needs to make its plans quickly

Alaskan oil has put it in the big leagues...

	1970		1979		
	Profits Millions of dollars	Rank	Profits Millions of dollars	Rank	Percent Increase
Exxon	\$1,310	1	\$4,300	1	231%
Texaco	822	2	1,800	4	119%
Gulf	550	3	1,300	6	136%
Mobil	483	4	2,000	2	314%
Standard of California	455	5	1,800	3	296%
Standard of Indiana	314	6	1,500	5	378%
Sohio	52	17	1,200	7	2,208%

Data: Standard & Poor's Compustat Service

Steve Hart—BW

...but it is not spending
like a major...

1979
Capital expenditures
(Billions of dollars)



Data: Standard & Poor's Compustat Service

DILEMMA

oil prices. Currently, one-third of the oil can sell at world price levels. By December, 55.2% of the oil will be sold at prices fixed by OPEC.

But even though these four elements have combined to propel Sohio into sudden wealth, they should not have taken Sohio's managers completely unaware. The disruption of Middle Eastern supplies has long been a likely possibility. It could have been expected that Alaskan oil would become more important, higher priced, and ultimately would find refineries or pipelines on the West Coast. Sohio had factored "best" and "worst" case contingency plans into its thinking, but these were not far-reaching enough and did not identify specific areas and companies in which to make investments and build staff and expertise. Such contingency planning is admittedly difficult. The scope and nature of possible disasters or bonanzas almost certainly require the most original thinking that a company is ever called upon to do.

It is, Sohio's chairman, Alton W. Whitehouse Jr., declares that "the payoff has been higher and faster than we expected." Yet Whitehouse, an attorney

who negotiated the BP deal, must scramble now to enjoy its rewards.

The company is in a position unique in its industry. It obtains nearly 90% of its cash flow from Prudhoe. Already, 13.4% of this field's original reserves of 9.4 billion bbl. are gone. In seven years (chart), more than half the oil will have been depleted. The oil that remains will then begin to flow more slowly and become more costly to extract. Even this year the new windfall profits tax on oil, plus other federal taxes, and levies imposed by Alaska—whose rates are the highest in the nation—will combine to keep Sohio's profits from increasing much further. Taxes are expected to eat up as much as 92¢ of every dollar increase in oil revenues.

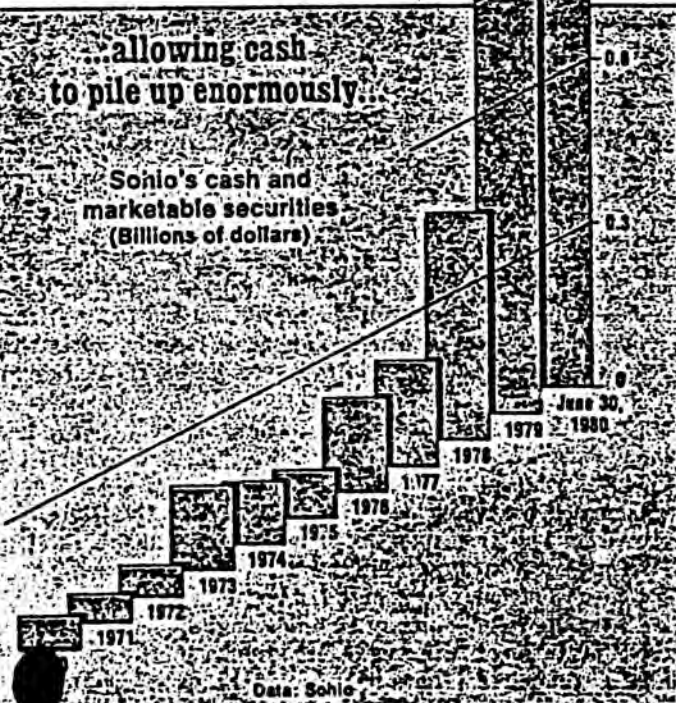
This makes Sohio's bonanza strictly temporary, and it places the company at a watershed. It either must undergo what will probably amount to the biggest redeployment of assets in the annals of U.S. business, or it will end up producing what Whitehouse calls "the biggest burp in corporate earnings history." With utter irony, Whitehouse and his staff say they have concluded that



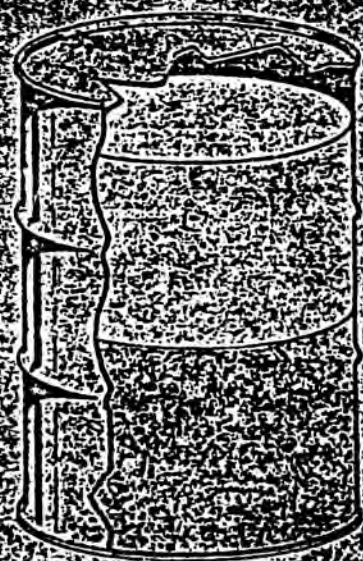
Sohio Chairman Whitehouse

...allowing cash to pile up enormously.

Sohio's cash and marketable securities (Billions of dollars)



...while its Prudhoe Bay oil has a limited future.



Original Prudhoe Bay reserves: 9.4 billion bbl.

Oil remaining in field as of June 30, 1980: 8.1 billion bbl.

Oil expected to be left as of June 30, 1987: 4.3 billion bbl.

(Flow of oil begins to slow now)

Oil expected to be totally depleted by year 2007.

Data: Sohio

The tables include a second set of runs involving a windfall deduction which assume that the windfall profits tax does not expire but remains in effect for the life of the field. In this case, allowing the producers a windfall deduction would cost the state \$29 billion. However, given the oil price assumptions used here, a 15% severance still more than offsets a windfall deduction. Again, part of this is on account of the declining severance tax that would otherwise be in effect due to the ELF factor.

State Held Harmless

Three of the tax structures shown in the tables are designed to keep the state's share of the net cash flow constant while eliminating the petroleum income tax. One way of doing this is to increase the state's severance tax to 19.2%. Another method is to delete the severance tax and increase the oil royalty to 29.38% from the current 12.5%. A third method shown is increasing severance to 15% and royalty to 16.84% or approximately one-sixth, which is the royalty used by the federal government, several states, and many private parties today. All of these methods increase the shares and rates of return for the producers.

The latter two have equivalent effects on the producers because both the state's royalty and severance taxes up to 15% are, in effect, deductions from the windfall profits tax. Short of reducing the state's take, these latter two tax structures maximize the producers' benefits from Sadlerochit under existing federal tax law.

Increased royalties could require renegotiation of the Prudhoe Bay leases which could involve other issues, e.g. underlifting. This method would also increase permanent fund

production, the effective severance tax rate is a little over 10%. A 15% severance tax thus results in a gain of about 4.5% after allowing a deduction against the income tax for the severance increase. On the other hand, the value of the windfall deduction with a 15% severance is $9.4\% \times (70\% - 70\% \times 15\%)$ or 5.59% (70% is the windfall tax rate; 9.4% the state income tax rate); but the windfall rate is applied only on the value of the oil above a base price which escalates with inflation. Given the oil price and inflation assumptions used here, \$33.52 per barrel in FY 82 with an adjusted base price of \$15.37, the effective windfall deduction has a value of 3.03% of the wellhead price for FY 82. As the price of oil increases in excess of inflation, the value of the deduction will approach 5.59%.

the company has too much money and must spend it too quickly, when so few U.S. plays are available, to stay in the major leagues in oil. Within 20 years, they say, Sohio will be forced to obtain most of its profits from businesses other than conventional oil and gas.

Some of these new businesses will remain in the realm of energy. For example, Sohio wants to enlarge its holdings of coal. It will also try to become a power in synthetic fuels, according to Glenn R. Brown, a senior vice-president who now heads a task force of 13 planners hustling to firm up specific projects and acquisitions.

But Brown's team has picked a host of additional nonenergy businesses as targets, including nonfuel minerals, chemicals, genetic engineering, and semiconductors and other information processing equipment. Says Brown: "Even if our intent was to spend as much money as we could in energy in a timely and profitable way, we couldn't spend all the money available to us."

Sohio, which has not previously disclosed these plans, has thus become the first major oil company to make plain that it views diversification out of conventional energy not merely as a hedge against declining oil supplies but as the main path to its livelihood within the next two decades. In the next 10 years alone, according to a Sohio plan being revised because it was not aggressive enough, conventional oil and gas would be reduced to 75% of its business. Especially because it is owned mainly by a British company, Sohio may now find itself bearing the brunt of public criticism for siphoning oil dollars into nonenergy ventures at a time of dwindling world supplies.

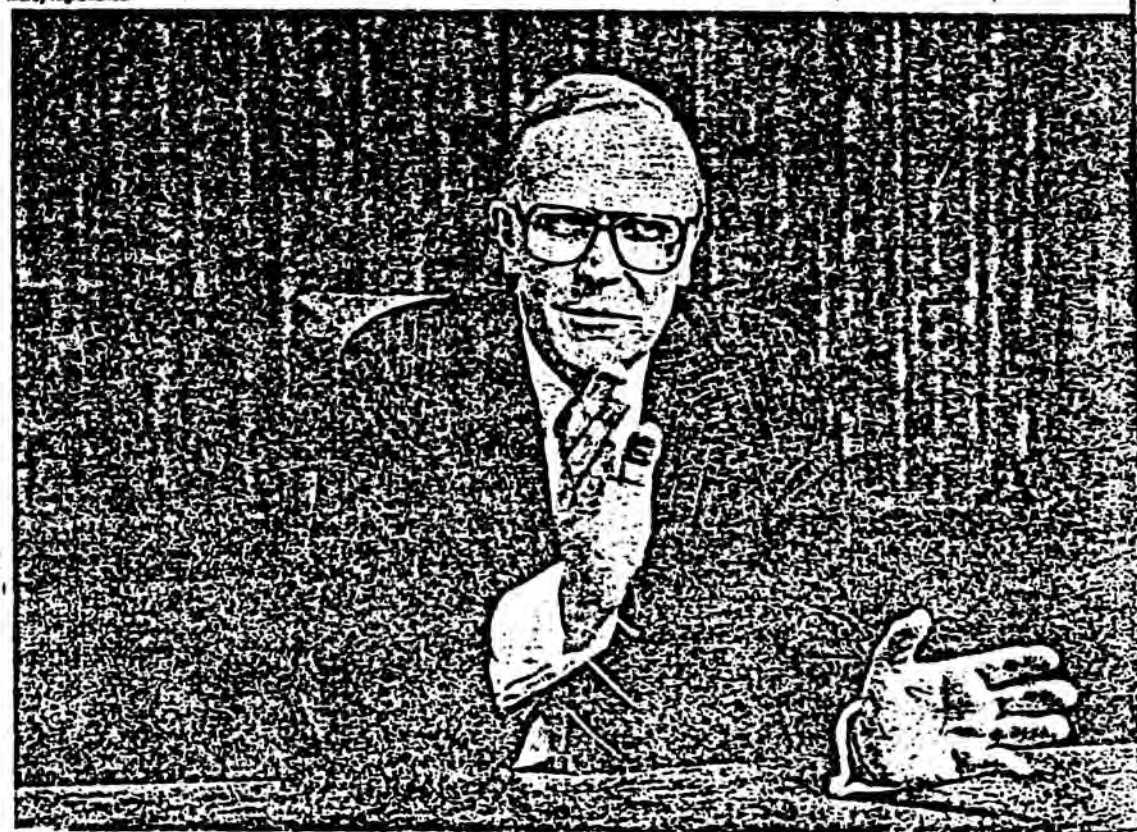
This turn in circumstances is bizarre. For nearly seven decades, Sohio officials have patiently awaited a return to greatness in oil. Sohio was the base of John D. Rockefeller's Standard Oil empire, which began with a refinery in Cleveland, Sohio's headquarters city. Rockefeller then spent 41 years building the mightiest corporation the world had ever seen, until the federal government used anti-trust law to break up the company. Out of 34 pieces, Sohio, the cornerstone, was relegated to the role of a crude-poor, regional refiner and an operator of gasoline stations in its home state.

Sohio's own timidity and ineptitude in finding new supplies of crude caused it to remain relatively insignificant until 1969, when former Chairman Charles E. Spahr bought BP's Prudhoe oil in exchange for a special issue of common stock calculated to give BP 53% ownership of Sohio when the company's Alaskan production hit a steady level of 600,000 bbl. a day—a point reached last Sept. 28. Now, the magnitude of Sohio's success has made it so large a part of BP that both companies are working to prevent an equally drastic failure when Prudhoe plays out. Sohio and BP began their marriage with a great deal of autonomy, but the companies are now growing much closer. They have set up a joint research and development committee and have exchanged directors and planning information. BP's and Sohio's future plans, says Robin W. Adam, a managing director of BP, "must be coor-

169,000. Sohio is just now studying how many employees to add. And Sohio still leases cramped headquarters space in buildings spread all around downtown Cleveland. More important, Sohio's past forays into nonoil ventures—coal, chemicals, and hotels—often have been marked by lack of success or commitment as the company focused on developing Prudhoe.

As if that were not enough, Sohio is the one oil major that still has a distinct dearth of knowledge within the key potential profit sector of its own business: exploration. The company has developed substantial knowhow in Alaska since it spent \$27 million in 1978 to buy BP's Alaskan exploration and production operation, which provided a core of 60 exploration staffers and a fount of Arctic-area geological data. But outside of Prudhoe, Sohio has had among the worst exploration track records. The company

Marcy Highman



Chief planner Brown: Diversification includes thrusts into coal, chemicals, and nonenergy businesses.

ordinated," if not necessarily the same.

But even with BP's help, there is no assurance that Sohio can develop the expertise and management infrastructure, and find the proper opportunities, to maintain its new size. In stark contrast with its peers in oil, which long ago acquired large and sophisticated staffs and widespread expertise along with plants, strategies, and vehicles for investment, Sohio has yet to emerge from the mold of the regional player. Its total employment has been essentially flat at 22,000 for the last decade, compared with industry leader Exxon Corp.'s

now produces 702,200 bbl. a day from Prudhoe, not including additional barrels sold to pay royalties to Alaska. In the rest of the world, Sohio produces an inconsequential 19,600 bbl. a day, and even that is down from 30,600 bbl. a day 10 years ago.

Sohio is run by executives who cut their teeth on refining and marketing, currently the two least-promising sectors of oil. "We're a peculiar group," observes one insider. "If you look through our senior management, all have been involved in refining and marketing. Two or three were involved in the

[Alaskan] series of great decisions. But none has ever been involved in the pursuit of oil and gas. We were never really there."

Now the company is trying to overcome its oil handicaps on a crash basis. Sohio's exploration operation, still led by [redacted] while BP executives, has become an hiring hall that is attempting to 155 new employees by Dec. 31 to a staff that still numbers just 230. Since 1978, Sohio also has quadrupled its unexplored domestic leaseholdings to 2.73 million acres, mainly by trading \$142 million worth of stock in December to

force in exploration: It lacks geological data and it has little chance of picking up good drilling sites or trained technicians because of shortages of each. "When Sohio started getting cash in 1978, most of the good acreage had already been snapped up," notes Richard Nehring, an analyst with Rand Corp. in Santa Monica, Calif.

Sohio's total acreage, in fact, pales next to that of the domestic industry leader, Standard Oil Co. (Indiana), which holds an immense 34.9 million acres. The scramble to develop such large tracts, now that oil has become so

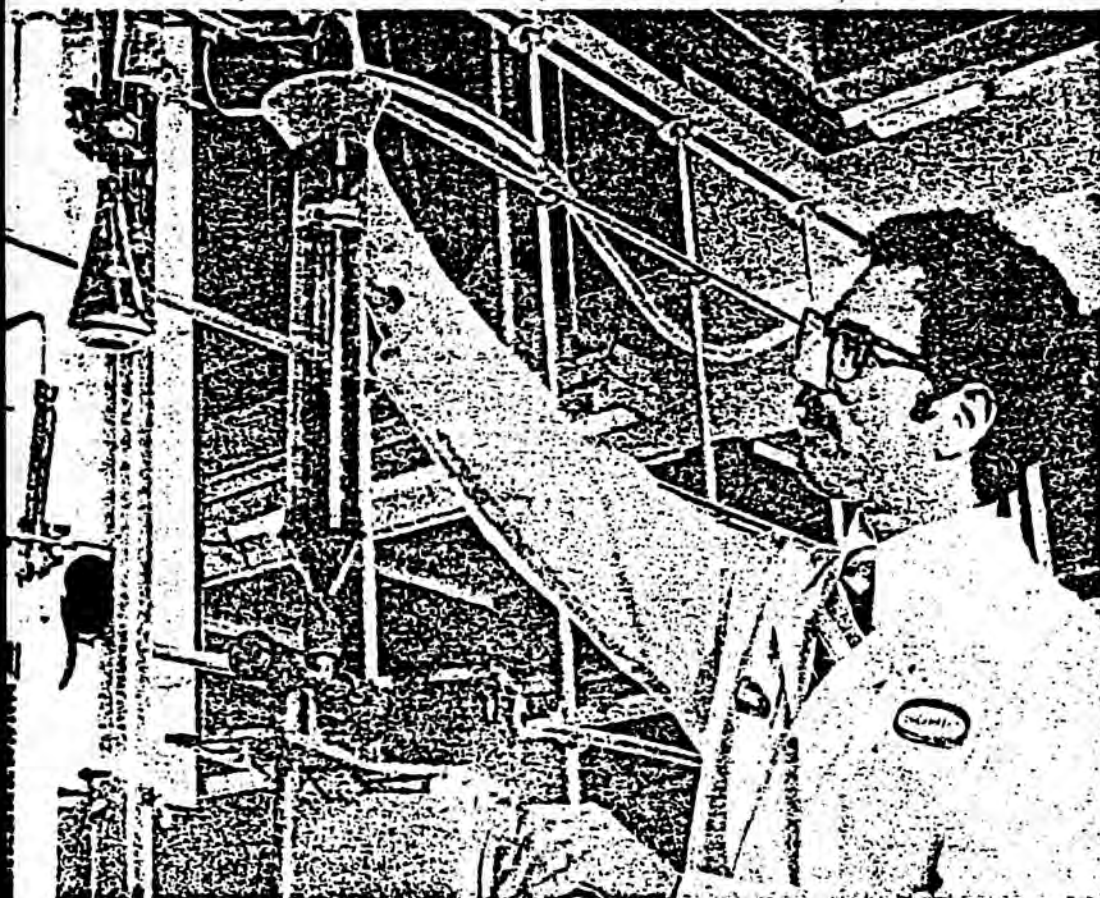
political risks are too high. So far, the company's only involvement is in Algeria, where Sohio has agreed to join with state-owned Sonatrach to explore 900,000 acres, because Algeria requires such ventures of companies in lieu of a \$3-per-bbl. premium otherwise required to buy Algerian oil.

Sohio seems content to leave foreign exploration to its parent. BP has doubled its own exploration spending during the last two years, and Adam says that push will be accelerated. BP traditionally was crude-rich, but it has been forced to become a net buyer of oil because of the disruption of oil from Iran and Kuwait and the nationalization of Nigerian fields, where BP had major interests.

Whitehouse says he has "not ruled out a major acquisition" of proven U.S. oil reserves, but he looks askance at the potential profitability of such a move. "Nobody is going to get any bargains," he asserts. "People who own oil that's already been discovered can calculate its future value as well as we can, so the return would be somewhat mundane," adds Paul D. Phillips, senior vice-president for finance and administration and a key influence in top management.

The whole spate of problems that Sohio sees in conventional oil and gas are what has led its planners to draw hasty plans to diversify. Last October, after less than a year of preparation, they presented the board with a \$25 billion, 10-year spending plan, with the money split evenly between the company's existing business and a host of proposed developments in coal, synthetic fuels, minerals, information processing equipment, chemicals, and other high-technology businesses. This was the plan designed to reduce cash flow from oil and gas from 90% to 75%. Further investments in nonoil properties were to reduce the contribution of oil and gas to less than 50%.

But it is a measure of the speed of change in Sohio's cash-rich environment that this plan has already been sent back for revision. In just the last few months, Sohio officials say, they have come to realize that their prior projections of the amount of money available for expansion were far too low. The company is now working on a plan whose total expenditures would exceed the \$25 billion by 1990. "In the space of just five or six months, our cash flow situation just



Sohio synfuels research: Aiming to spend up to \$5 billion for a big share of the new industry.

acquire two Denver-based energy companies, Webb Resources Inc. and Newco Exploration Co. The company expects to spend more than \$100 million this year to drill as many as 70 exploratory wells, up from just two in 1979, and it has budgeted \$3 billion in constant 1980 dollars for further exploration during the next 10 years, not including more land acquisitions.

Such plans are impressive in comparison with Sohio's past record in oil prospecting. But Whitehouse is the first to admit they will not be enough to solve the company's basic challenge: to replace the 5 billion bbl. of oil at Prudhoe that [redacted] made Sohio the nation's largest [redacted] of domestic reserves.

Indeed, outsiders agree, Sohio is too late an entrant to make itself a major

lucrative, has caused an industrywide shortage of petroleum geologists, engineers, and other skilled oilfield workers. The shortage has caused intercompany raids on existing employees. For example, Indiana Standard's subsidiary, Amoco Production Co., saw turnover of employees in 1979 run to a serious level of 20% to 30%, says exploration manager Anthony L. Benson. "Even the major companies [in exploration] are having a very tough time getting and keeping good people," says Benson.

These limitations have left Sohio with two other options in oil: foreign exploration or the acquisition of a company that holds U.S. oil reserves. Neither is of much interest to Sohio, says Whitehouse. He has studiously avoided looking for oil outside the U.S., where he says

turned around astronomically," exclaims David J. Atton, manager of corporate planning. "All of a sudden, our nice, orderly schedule of getting ready to make large discretionary investments by 1982 has had to be crunched right up to today."

Aside from the time pressure imposed by the draining of Prudhoe, Sohio executives feel they must invest quickly to avoid a hostile public reaction to the enormity of their windfall. During the years when the company pushed debt to \$5.1 billion, or 74% of total capital, to finance continual cost overruns at Prudhoe and on the oil pipeline, Sohio's hard-pressed managers could scarcely wait for

bonds, bank debt, and other obligations. This year, financial chief Phillips says, he may retire another \$150 million in debt, although payments of just \$97.5 million are required.

Still, the \$2.5 billion hoard is growing, and Phillips' debt reductions have enhanced profitability. The debt retirements are expected to help reduce Sohio's interest expense from \$439 million in 1979 to \$350 million this year, while the company's interest income from the cash has jumped from \$81 million to an estimated \$200 million—an amount that itself is higher than Sohio's entire profits in any year until 1978. At the same time, Phillips has managed to trim debt

Sohio, however, has never built a major gas pipeline. Nor, without acquisitions, will it have the technicians to back up its most ambitious plan—to spend up to \$5 billion to become a major in the synfuels game. Indeed, the company is in the second decade of management trauma. As a strictly regional concern entering the 1970s, Sohio was forced to ask its limited number of managers to perform tasks far above their level of know-how. In just one instance, Whitehouse dispatched a young engineer with no financial training, Ronald A. McGimpsey, to back up Phillips in trying to arrange what became the largest private debt placement in history to finance the Alaskan oil pipeline. McGimpsey, a quick study, is now Sohio's treasurer.

But the new scramble will be far more pervasive. Sohio is discovering that management capability problems can grow in geometric proportion to a company's size. Sohio is filling out its executive ranks as quickly as possible with new officers, mostly lured from other large corporations, to provide better depth. In just the past several months, Sohio has raided three other oil company managements to hire a new controller, a senior vice-president for oil exploration, a vice-president for petroleum engineering, and a new chief executive for Sohio's faltering coal subsidiary, Old Ben Coal Co. The company also has lured Thomas C. Norris of Consolidation Coal Co. to be a vice-president of corporate planning, and James P. Burgoon, a planner at Diamond Shamrock Corp., to be vice-president of planning and development at Sohio's chemicals and plastics company, Wistron Corp. "We will expand our management group rapidly and adroitly, by every means available, as we move to a large and inevitably more complex company," Whitehouse declares.

The posts that Whitehouse is giving to the new managers clearly indicate the company's future business interests.

Most notably, Whitehouse has picked John E. Miller to replace Joseph D. Harnett as Sohio's president and second-in-command. Harnett, a refining and marketing operations specialist who lost to Whitehouse in a race to succeed Spahr in 1978, retired at age 62 on Aug. 1. Miller, although heavily involved in the Alaskan adventure, has most recently been senior vice-president for technology and chemicals rather than an oilman. Trained as a chemical engineer, Miller is perceived as more broadly qualified than Harnett to lead a diversified company.

As the day-to-day operations chief,



Finance chief Phillips: Despite huge prepayments of debt, the \$2.5 billion cash pile still grows.

the arrival of what they came to call the "green mountain"—the cash that would eventually accrue from the sale of the oil. Now, however, the mountain has grown "clearly very conspicuous," worries planner Atton. "I think people [here] feel that a very important factor is what the impact of this cash buildup is going to be in public circles. If you have too much cash on hand, maybe somebody will help you get rid of it, somebody who in our view has no right to it."

Thus, while Sohio executives will not telegraph their next move, outsiders expect that a major acquisition to spend some of the money could come at any time. Already, Sohio has made some use of its windfall by using huge chunks of cash to prepay long-term debt. In 1979 the company was due to pay \$241 million but actually paid off \$829 million of

to \$4 billion, or 47% of capital. He says he now wants to cut that figure further to between 30% and 40%.

This will give Sohio the borrowing power it lacked when debt was high, adding to what has become the company's new embarrassment of riches. If, however, the company is required to help finance the proposed natural gas pipeline that would carry Prudhoe's untapped cache of some 26 trillion cu. ft. of natural gas to market in the lower 48 states, Phillips says it may well exercise that borrowing power. Sohio owns 25% of the gas. Even at currently controlled domestic prices, the company's portion of the Prudhoe reserves would be worth more than \$15 billion. Phillips estimates Sohio's share of the pipeline's construction costs at more than \$2 billion, an amount that appears easy to afford.

Miller will face the awesome task of implementing Sohio's plan to become a big force in synfuels—a business in which the economics remain questionable and technology is still evolving. Even so, chief planner Brown says his target is to be producing, alone or through joint venture, as much as 100,000 bbl. a day of shale oil by 1990. This, he estimates, will cost between \$2 billion and \$4 billion. Sohio currently has shale oil reserves of 1 billion bbl. Brown says his plans also call for starting construction of a coal gasification plant with a capacity of 250 million cu. ft. per day by the late 1980s, at an expected cost of more than \$1 billion. These projects, he says, would make Sohio "one of the major players in the synfuels game."

Indeed, such plans are ambitious by any measure. Exxon, one of the more bullish companies about the future of synfuels, predicts an industrywide U.S. production level of 1 million bbl. a day of oil and 1.6 billion to 2.7 billion cu. ft. of gas. To meet its goals, Sohio would have to carve out a huge 10% of the shale oil business and probably a larger share of synthetic gas. Whether money alone will enable the company to accomplish that is an unanswered question. "There will probably be no more than 10 majors in synfuels, and Sohio should be one of them because of its capital capabilities," suggests an optimistic Thomas A. Petrie, an analyst with First Boston Corp. But even Brown's superiors are not so sure that huge market shares ought to be the ultimate goal. Within the last two months, Brown says, they have asked him to give more thought to synfuel workability and profitability than market share.

Confrontation with Congress

The company's synfuel plans are not only its most lavish but also the ones that may cause a final showdown with the government. There is already some apprehensiveness in Congress at the idea that BP, itself owned in part by the British government, is now the majority controller of the largest pool of U.S. crude. De facto control by BP of a big piece of the U.S. synfuels business, whose technical development is to be financed largely by \$20 billion in federal funds, may create a direct confrontation. "I think the synfuels industry should be controlled by Americans," declares Senator Howard M. Metzenbaum (D-Ohio), a frequent oil industry critic who chairs the Senate Judiciary Committee's subcommittee on antitrust, monopoly, and business rights.

Energy Dept. officials say they have had no reason to be concerned with BP's ownership of Sohio so far, mainly be-

cause U.S. access to all Prudhoe oil is guaranteed by federal law, which prohibits exports of domestic petroleum. But political repercussions of Sohio's new plans, in synfuels and nonenergy businesses, are an unknown, because the ventures have yet to be implemented.

Energy officials and Congress have allowed diversification moves, such as Getty Oil Co.'s purchase this summer of ERC Corp., a reinsurance company, to pass without criticism. But oil industry executives continue to be nervous that any large move away from conventional oil and gas by companies larger than



British Petroleum's Adam: Planning of Sohio and BP "must be coordinated."

Getty may provoke stern governmental reprisals. "For a major to make any big nonenergy acquisition now, the political flak would be enormous," declares one. The fallout could include serious congressional consideration of the pending bill, sponsored by Metzenbaum and Senator Edward M. Kennedy (D-Mass.), that would prohibit oil companies from making any acquisitions of nonenergy companies unless those companies had annual sales volume of less than \$100 million.

To avoid political conflicts, Sohio and BP officials have been extraordinarily careful to project an image of autonomy during the years that BP gradually increased its stake in Sohio. However, BP now consolidates Sohio's results with its own, making Sohio appear far too important to BP for the parent to allow its U.S. company complete freedom of action. By the end of last year, Sohio accounted for 29% of BP's \$3.6 billion in

profits and 36% of its \$24 billion of assets. Actual cash payments to BP from Sohio dividends and special Prudhoe Bay royalties amounted to \$287 million. The profit contribution and cash payment should increase dramatically this year.

For his part, Whitehouse has maintained for so long that he is an independent operator that he now shows annoyance even at the mention of the subject. "We generate our own long-range plans, period!" he snaps. "I don't foresee ever being in a posture other than that." But should management of the two companies ever disagree, BP now has legal veto power, and its officers clearly realize they hold control. "I think it would be most unlikely that any chief executive would want to push through the board a plan that he knew the major stockholders objected to," says W. Alastair L. Manson, president of BP's New York-based subsidiary, BP North America Inc., and a Sohio director.

Working with BP

So far, however, the two companies seem to be functioning smoothly together. In fact, BP already has aided Sohio in oil prospecting, production, and transportation. This summer, it will dispatch two employees to sit on Sohio's strategic planning staff. And the companies have formulated almost identical strategic plans, and appear on the verge of several joint ventures. Like Sohio, BP has been nearly 90% dependent on the oil business, but has decided to spread out. On Aug. 12 it succeeded in a \$1 billion tender offer to buy Selection Trust Ltd., a minerals company with sales of \$752 million in 1979. Sohio, meanwhile, has had a two-man team studying entry into the same nonfuel minerals industry, insiders say. Both companies also plan expansions of their coal holdings separately or through joint purchases.

A joint research and development coordination committee is now examining alternative energy sources, new chemicals, and coal conversion techniques. More important, BP officials confirm, Sohio's entry into some of the high-technology fields it knows nothing about may be initiated with BP's help. For example, BP has sold computer software in Britain for the last 15 years, and managing director Adam hints it would be "perfectly feasible for Sohio to serve as BP's agent should the British company decide to market its software in the U.S."

Such aid will be badly needed, judging from Sohio's track record in nonoil businesses. While it concentrated on Prudhoe, Sohio allowed its handful of enterprises in coal, chemicals, and plastics to atrophy. A hotel business, Hospitality Motor Inns, founded in 1964 by Sohio,

was sold in two pieces in 1972 and 1979 for a total \$41 million after the company was unable to achieve more than scant profitability.

"All our businesses other than oil were on short rations for a decade," concedes one Sohio executive. More attention will now be paid; Sohio next year will bring on stream a \$100 million acrylonitrile plastic resin plant, doubling the company's capacity to more than 800 million lb. per year. This will entrench Sohio as the largest producer of this plastic, used in packaging and auto parts. Sohio's plans for coal are much larger. It will spend \$1 billion by 1990 to try to at least double its reserves to more than 2 billion tons and triple annual production to 30 million tons. By 1979 standards, a level of 30 million tons would have made Sohio the nation's fourth largest coal producer.

Two troubled businesses

While it goes about making these expansions, Sohio also will have to figure out how to make chemical and coal operations more profitable. During the last 10 years, the company has more than tripled retail sales of its biggest chemical lines—fertilizer materials—to 665,000 tons per year, but the chemical company's operating income has steadily declined from a peak of \$54.1 million in 1975 to \$18.1 million last year on sales of \$1.1 billion. In coal, Old Ben has been a notoriously troubled operator, whose deep, high-sulfur-coal mines in Indiana and Illinois have suffered from labor and productivity problems. Coal production over the last 10 years has actually declined, from 11.7 million to 10 million tons, and pretax income last year skidded to \$2.5 million, a level amazingly 22% lower than in 1978, the year of the national coal strike. As if the challenge of merely straightening out these businesses was not enough, Sohio's Brown suggests the company might now delve into a host of related ventures, mining minerals in addition to coal, and possibly moving into major petrochemicals, such as ethylene.

The company, however, does not pretend that its redeployment of assets will be easily achieved. "Prudhoe Bay," admits Whitehouse, "is a tough act to follow." Whether the BP connection will help Sohio pull it off, or hurt because it will focus even more attention on an oil company diversifying, remains to be seen. "Every step of the way, they are going to be questioned because of their unique position in Prudhoe, and because of their controlling foreign ownership," declares First Boston's Petrie. "It's not easy for an oil company to do anything today, but it's going to be more difficult for Sohio."

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JOINT MEETING
House Finance Committee
and
House Gas Pipeline Committee
February 10, 1981

(Tape HFC 81-2, Side 1)

PRESENT

Chairman Gardiner called the meeting to order at 3:05 p.m. 1
Legislators present: Representatives Cotten, Rogers, Haugen,
Moss, Halford, Randolph, Montgomery, Freeman, Meekins, Hayes,
Buchholdt, Gardiner, Carney, Vaska, Hurlbert and Adams. Present
to provide testimony: Terry Lenzer, State's counsel for TAPS
court case; and Bob Maynard, Attorney General's Office.

SB 113 -- TAPS COURT CASE -- TESTIMONY

TAPE #	SUBJECT
001	GARDINER -- Call to Order -- 3:05 p.m. Subject: SB 113 ("An Act making special appropriations for oil and gas matters; and providing for an effective date.") (see attachment #1 and 2.)
023	TERRY LENZER -- opening remarks regarding Phase I and Phase II of TAPS court case.
228	GARDINER explained why they are receiving testimony at this time.
252	ROGERS/LENZER -- "opposition" spent over \$7 million in 1979. State spent \$2 million.
301	BUCHHOLDT/LENZER -- Projections of additional revenue to state.
334	COTTEN/LENZER -- timing of decision/new commissioners/ wealth of state.
419	FREEMAN/LENZER -- cost of suit/what was accomplished/how long it will last.

(NOTE: TECHNICAL PROBLEMS WITH TAPE RECORDER. REMAINDER OF MEETING NOT
RECORDED.)

In answer to a question from Representative Rogers, Mr. Bob
Maynard, Attorney General's Office, explained the lower tariff
would benefit oil companies who do not have an interest in the

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North Slope Pipeline. He said it might make their finds more productive. Representative Rogers asked if there were any other participants in Phase I of the suit. Mr. Lenzer said the Department of Justice, Anti-trust Division was a very active participant. He said the Arctic Slope Native Corporation was also involved.

Representative Halford questioned the costs of Phase I vs. Phase II. Mr. Lenzer said the bulk of the expenditures have been for Phase I. He commented further. Mr. Lenzer said they are always open to discuss settlement of the case with the carriers if it is in the best interest of the State. He said they did approach the carriers last year to see if they were interested in settling; at that time they were not. He said the legislature and governor would have the final say in any agreement to settle. Mr. Maynard commented there is always the possibility of negotiation, but that possibility only exists because the litigation is there.

Representative Moss asked if the funds in SB 113 would be spent in one lump sum. Mr. Maynard advised the tax part would be expended over the next six or seven years. He said they would not get the money until expenses are incurred, so he assumed the state would continue to draw interest on the funds until the money is expended.

Representative Freeman requested an explanation of what the money would be used for. Mr. Maynard said the total appropriation is divided into two lawsuits: the oil and gas corporate income tax and the transatlantic pipeline rate case. He explained the transatlantic pipeline rate case is divided into two appropriations: one to the Alaska Pipeline Commission, and the other to the Department of Law. He explained the conflict of interest the state has with the Alaska Pipeline Commission. Mr. Maynard advised the bulk of the appropriation is for Phase I and II of the suit. He said the reason they are requesting a lump sum appropriation is that, historically, they begin running out of money in January and, because of the time it takes to get an appropriation through the Legislature, they have to cut back and shift the utilization of their people, which creates problems. He said they need to be able to plan ahead. Mr. Maynard explained the Senate Finance Committee appropriated enough money to fund them through FY 82. He explained that under that approach they would have to come back next year for additional funding.

Mr. Maynard advised that under the Transatlantic Pipeline effort, part of the money is for an Attorney VI in the Department of Law to work fulltime overseeing the expenditure of money and efforts of the case. Mr. Lenzer advised that of the appropriation for the pending litigation, one-third of the total amount is to go to consultants (such as eye witness experts); one-third will be for

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legal fees; and one-third for support staff, the computer program, and additional disbursements. He commented briefly on the costs relating to the litigation.

Representative Hayes said the request raises two areas of concern: one, by funding that far into the future they may be precluding future legislatures from an opportunity to review the case; and two, he wondered how accurate the \$24 million estimate to fund through 1987 was. Mr. Lenzer agreed it is extremely difficult to predict the costs of the case. He commented on the difficulties created when they run out of funds and have to wait for an appropriation.

Representative Vaska expressed concern that by appropriating this amount they would be taking powers away from future legislatures and administrations. He asked if following the Senate's lead would cause any problems. Mr. Lenzer replied that as long as they can predict in advance what their needs are, they are in pretty good shape. He said problems arise when they don't have any money and don't know when or if additional funds will be made available. Mr. Maynard commented the problem with the Senate plan is that in FY 82 they will probably be in the same situation they are in right now. He said the appropriation is for \$11 million which does not budget for any "surprises". He commented that historically surprises have been the "norm" of this law suit. He said it is possible that the money will be spent even sooner than they anticipate. He said there is a need for flexibility.

Chairman Cotten asked if what they were saying was that it would be okay to go with the Senate approach, but the Legislature could expect them to be appearing before them again next January with a request for an appropriation. Mr. Maynard said this was correct.

Representative Rogers suggested the full amount should be funded. He said that "building a case is like building a bridge", and unless they carry through to completion, the money already spent will have been wasted.

Chairman Cotten asked if taking the Senate approach would hinder or reduce the certainty of completion of the contracts. Mr. Maynard said to a certain extent, yes. He said they could live with that approach. He said they have lived with it in the past, but there have also been cut backs in the past.

Chairman Cotten commented that by requiring people to come back for additional funds, the Legislature has an opportunity to get an update on the progress of the project. Mr. Lenzer commented the Legislature has supported the effort in the past, and has always treated them fairly. He said he is prepared to come up and give a status report any time the Legislature requests. He

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said problems may arise on the amount of time available as they get into hearings when they are defending their witnesses, preparing to cross examine, and also are preparing the rebuttal. He commented that uncertainty about funding at that stage could be devastating to the State's case.

Mr. Maynard commented the more fiscal years funded, the more certainty they have. He said the basic problem is timing.

There was brief discussion on the Alaska Pipeline Commission's conflict of interest.

The meeting adjourned at 4:15 p.m.

Tape HFC 81-2, Side 1 #001 to 419
(Technical problems with tape recorder;
rest of tape not clear.)

Funding Information
General Fund \$27,677,800
Other Funds -0-
\$27,677,800

Introduced: 1/28/81
Referred: Finance

IN THE SENATE

BY THE RULES COMMITTEE BY
REQUEST OF THE GOVERNOR

SENATE BILL NO. 113

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWELFTH LEGISLATURE - FIRST SESSION

A BILL

For an Act entitled: "An Act making special appropriations for oil and gas matters; and providing for an effective date."

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

* Section 1. The sum of \$24,551,000 is appropriated from the general fund to the Department of Law for legal expenses in connection with the interstate and intrastate TAPS tariff proceedings.

* Sec. 2. The sum of \$1,056,200 is appropriated from the general fund to the Alaska Pipeline Commission for the purpose of making the commission staff's presentation in the intrastate TAPS tariff proceedings.

* Sec. 3. The sum of \$2,070,600 is appropriated from the general fund for expenses in connection with the pending litigation challenging the corporate oil and gas income tax, to be allocated as follows:

Department of Law \$1,027,600

Department of Revenue 1,043,000

* Sec. 4. The appropriations made by this Act are not one-year appropriations and do not lapse under AS 37.25.010.

* Sec. 5. This Act takes effect immediately in accordance with AS 01.10.070(c).

The purpose of the appropriation concerning the Trans-Alaska Pipeline rate case is to fund the proceeding to its conclusion. The amount requested for the Trans-Alaska Pipeline proceeding is \$25,607,200, with the Department of Law to receive \$24,551,000 and the Alaska Pipeline Commission to receive \$1,056,200.

The appropriation to be received by the Department of Law will be used (1) to pay the state's outside counsel and consultants and (2) to fund an attorney VI position in the Department of Law to serve as project director, and an accounting clerk II position. Present estimates of the time period for the expenditure of this appropriation is to the end of fiscal year 1986. It is reasonable to expect that some portion of the activities will slip into fiscal year 1987; the funds requested, however, will fund those activities.

The purpose of the tariff proceeding is to determine the amount that pipeline owners may charge for the shipment of a barrel of oil through the Trans-Alaska Pipeline from Prudhoe Bay to Valdez. The amount charged for the shipment has a direct relation to the amount the state receives both for royalty oil and for its severance and corporate income tax. Basically, the higher the tariff, the lower the wellhead value of Prudhoe Bay oil and consequently the less the state receives for its royalty share and from taxes. Further, a low tariff will aid in the exploration, discovery, and production of new fields on the North Slope by making marginal fields more economic.

The Trans-Alaska Pipeline proceeding has been divided into two phases: Phase I was to determine the methodology or formula to be used to set oil pipeline tariffs, and Phase II would address the accuracy and appropriateness of the specific numbers reported by the pipeline owners (for example the amounts expended to build the pipeline). Phase I of the case has been decided by the administrative law judge, with the result generally favorable to the state. That portion of the case is now on appeal to the full commission. It is expected that any decision by the full commission will be appealed to the courts and eventually to the U. S. Supreme Court. \$825,000 of the requested amount is expected to be allocated to the Phase I effort, with \$782,000 expected to be expended for lawyers, and \$53,000 expected to be expended for other disbursements.

Phase II of the case is a more complex and detailed proceeding, requiring extensive discovery and an extensive presentation of facts. The Phase II case has as its major component the attack on the prudence of the costs incurred by the pipeline companies in building the Trans-Alaska Pipeline. It is expected that extensive discovery will continue until the end of 1981, with hearings beginning shortly thereafter and lasting approximately two years. It is expected that briefs will be filed with the administrative law judge in 1984, with an appeal to the commission in 1985, and proceedings in the courts through 1986 and possibly fiscal year 1987. The bulk of the amount requested for the Department of Law is to fund the efforts relating to the cost of construction issues over the next five to six years. The amount for this portion of the litigation is estimated to be \$21,994,000 to be spent as follows: \$7,001,000 for lawyers,

SB 113

\$1,131,000 for investigators, \$3,029,000 for paralegals, and \$2,329,000 for document evaluation and computer analysis of the millions of documents to be reviewed and analysed, \$6,966,000 for consultants and expert testimony, and \$1,538,000 for other expenses such as travel, depositions, printing and copying, and commodities. The issues in Phase II, apart from cost of construction, are expected to require the expenditure of \$4,552,000 over the next five years, with \$1,804,000 to be expended for lawyers, \$81,000 for paralegals, and \$2,667,000 for consultants. Finally, \$750,000 is requested for the Department of Law for administering and overseeing the expenditures of money and the proceeding. The Department of Law money would be to fund an attorney VI position for the duration of the litigation to serve as project director and also to fund an accounting clerk II position for that period.

The amounts requested for the Alaska Pipeline Commission total \$1,056,200. Of that amount, \$902,300 is for professional services, and \$153,900 is for administration and other expenses.

The Alaska Pipeline Commission regulates intra-state oil and gas common carrier pipelines. The commission's staff has, over the last three years, taken substantial responsibility for the presentation of evidence on various issues to the commission, including issues concerning cost overruns, jurisdiction, the methodology to be used in determining intra-state tariff rates, and issues concerning special carrier rules. Since the state has interests or positions which are different from those of the APC staff, it is necessary to hire other legal and technical experts to aid the APC staff in its TAPS case preparation and investigation.

Funding of this budget request will avoid conflicts of interest between the state and the commission, and it will enable the APC to continue to meet its responsibilities for the intrastate TAPS proceeding. Funding is exclusively to meet costs for the duration of the TAPS proceedings. It does not include on-going operating budget costs for commissioners, staff salaries, and other APC expenses. Funding for these activities will be requested through normal operating budget requests.

Sincerely,

Jay S. Hammond
Governor

Attachment #2

AN

2/10/81

HOUSE FINANCE COMMITTEE
February 12, 1981
1:30 p.m.

{Tape HFC 81-3, Side 1, #001}

PRESENT

Chairman Cotten called the meeting to order at 1:30 p.m. All members of the Committee were present, with Representatives Haugen, Meekins and Malone arriving later in the meeting. Also in attendance: Commissioner of Revenue Tom Williams and assistant, Department of Revenue; Director Jay Hogan and Milt Barker, Fiscal Analyst, Division of Legislative Finance.

REVENUE PROJECTIONS

Chairman Cotten advised Commissioner Tom Williams would present an overview of the Department's revenue projections.

(Representative Haugen arrived at this time.)

Chairman Cotten noted the Committee recently heard the revenue projections overview presented by Legislative Finance and, referring to pages 6-7 of Revenue Sources, FY 1980-82 (see Attachment 1), he asked that Commissioner Williams explain how the Department of Revenue arrived at its figures and compare them with those of Legislative Finance.

Commissioner Williams stated the Department stands by its revised FY 81-82 estimates published in January of this year. He explained direct actuals were not taken, that this is only an estimate and not meant to be a forecast of projected revenues. There was discussion on Prudhoe Bay production and income over the last five years.

Chairman Cotten asked why corporate income didn't increase as did severance and sales taxes. Commissioner Williams advised this is because corporate tax is measured by gross income and increases at a lower rate and also that there are additional capital costs and higher taxes. Representative Rogers asked about estimating corporate income tax, and Commissioner Williams explained the difficulties in finding out drilling costs, for instance, because of the disclosure law. He noted decontrol went into effect February 1, 1981.

With regard to capital expenditures, Milt Barker asked about depreciation. Commissioner Williams noted payments are made in estimated installments and that 1978 was the first year all four quarters were paid in the same year.

(Representative Meekins arrived at this time.)

Commissioner Williams continued to give a year-by-year breakdown on the payments made. He noted they are presently auditing a number of oil companies and that, in fact, everyone is on the schedule, including the "Big Three". Chairman Cotten asked for a breakdown on royalties and severance taxes for FY 1981 and 1982. Commissioner Williams advised for 1981, the figure was \$80.59 million in royalties and \$53.16 in severance taxes, totaling \$133.75 million; and for 1982, \$38.45 in royalties and \$16.11 in severance, totaling \$54.56 million. He explained they are not set up to do an income forecast, that it would have to be done manually.

(Representative Malone arrived at this time.)

In answer to a question from Representative Moss on the estimated figure for vehicle registration, Commissioner Williams indicated no, there would not be a problem dollar-wise in eliminating these fees, but that there are serious policy implications involved that would have to be dealt with in the future. Representative Rogers commented there is current legislation pending that would remove those fees. Representative Moss asked if there would be a problem with any federal money, and Commissioner Williams replied he did not know, but he suspected there would be none.

Representative Moss then questioned Commissioner Williams about the sale of state property (p. 7, Attachment 1) and was informed this is the land that goes out each year for small homesteads and that some land has to do with court settlements.

Commissioner Williams indicated the Department's figures are based on what is being collected now. He commented the numbers referred to for the Attorney General's Office were personally calculated by himself, but that they represent figures that are four years old. He explained they started with severance and royalty taxes, corporate income and capital investments, etc. And since 1977, he added, the figures were adjusted to reflect inflation. He stated they project \$44.54 billion between 1980 and 2005. He restated that these figures represent merely an analytical tool--not a revenue forecast--to arrive at a common starting point. Representative Malone stated he is more concerned with what revenue will be during the current budget year, rather than further down the road. During discussion, Commissioner Williams stated the corporate income tax payments average out to \$190.0 million per quarter.

Chairman Cotten commented that, with the exception of the pipeline, the figures presented by Legislative Finance and Revenue come out basically the same. He requested the Department provide the Committee with worksheets on the methods used to

calculate its figures and to include information on what effect decontrol is expected to have under Title 4321. Commissioner Williams assured the Committee this information will be available by the March forecast, which will incorporate all the forecasts.

[Tape HFC 81-3, Side 2, #001]

Representative Malone commented he noticed the general fund and permanent fund balances were estimated the same as for FY 81. During discussion, Commissioner Williams pointed out this relates to the timing of income and appropriations by the Legislature. Referring to state royalty oil, Representative Malone asked if the Department has done any analysis; i.e., are the producers underpricing their oil, and is the State losing money? Commissioner Williams advised that issue--third party sale--is of primary importance when auditing. He added the problem is on the intra-corporate sales. Representative Malone then asked if the Department had adequate resources to operate that kind of audit, and Commissioner Williams replied that, with respect to the auditing of income and severance taxes, the answer is yes. However, he added, they could use another position or two in royalties. He informed the Committee the audit schedule is on a two-year basis--the companies are audited every two years--but that, under special circumstances, that can be speeded up. He advised the Department audits books with regard to sales, and those results are reported to the Department of Natural Resources, which takes the appropriate action.

ADJOURN

There being no further business to come before the Committee, the meeting adjourned at 2:30 p.m.

Tape HFC 81-3, Side 1, #001 - End
Side 2, #001 - #216

General Fund Unrestricted Revenues

In Thousands of Current Dollars

	FY 1980 <u>Actual</u>	FY 1981 Revised <u>Estimate</u>	FY 1982 <u>Estimate</u>
<u>Taxes</u>			
<u>Income</u>			
Corporate - General	17,900	35,000	36,000
Corporate - Petroleum	547,500	770,000	882,900
Fiduciary (1)	100	-0-	-0-
Individual (1)	100,500	-0-	-0-
<u>Gross Receipts</u>			
Alaska Business License	4,200	5,300	3,200
Fish - Canned Salmon (2)	4,300	12,100 (3)	6,600
Fish - Shorebased (2)	7,600	10,400 (3)	7,800
Fish - Floating (2)	2,700	4,000 (3)	3,100
Salmon Enhancement (4)	-0-	-0-	1,500
Insurance Companies	10,400	11,300	12,500
Other	2,100	2,600	2,900
<u>Severance</u>			
Gravel, Timber, etc.	1,600	1,300	3,000
Oil & Gas Production (5)	506,200	1,178,200	1,747,100
Oil & Gas Conservation	300	600	600
<u>Property</u>			
Oil & Gas	168,900	170,000	170,000
Vehicle Registration	100	200	200
<u>Sale/Use</u>			
Alcoholic Beverages	7,400	7,900	8,200
Fuel Taxes - Aviation	4,000	4,100	4,300
Fuel Taxes - Highway	18,900	18,500	20,900
Fuel Taxes - Marine	3,200	3,400	3,600
Tobacco Products	1,600	1,700	1,800
<u>Other</u>			
Estate	200	200	200
School (6)	2,600	-0-	-0-
Total Taxes	<u>1,412,300</u>	<u>2,236,800</u>	<u>2,916,400</u>
<u>Licenses & Permits</u>			
Business	8,100	8,300	9,700
Non-Business	10,700	12,000	12,500
Total Licenses & Permits	<u>18,800</u>	<u>20,300</u>	<u>22,200</u>
<u>Intergovernmental Receipts</u>			
Federal Shared Revenues (5) (7)	<u>4,800</u>	<u>19,400 (8)</u>	<u>8,000</u>
<u>State Resource Revenue</u>			
<u>Sale/Use</u>			
Bonus Sales	342,400 (7) (9)	6,400 (10) (11) (12)	-0- (11)

Investment Earnings	119,900	195,000	195,000
Rents (7)	3,000	2,	4,000
Royalties (5) (7)	688,200	1,098,700 (13)	1,757,100
Sale of State Property	5,700	9,300	5,600
<u>Facilities Related Charges</u>			
Airports	800	600	800
Ferry System - Southeast	18,700	21,600	24,400
Ferry System - Southwest	2,400	2,400	2,700
Other	4,100	4,300	4,700
<u>Service Related Charges</u>			
Court System	2,800	3,100	3,300
Other Service Related Charges	2,000	3,600	3,900
Total State Resources			
Revenues	<u>1,190,000</u>	<u>1,347,500</u>	<u>2,001,500</u>
<u>Miscellaneous Revenues</u>			
	<u>6,700</u>	<u>7,000</u>	<u>7,000</u>
Total Gross Unrestricted Revenues	<u>2,632,600</u>	<u>3,631,000</u>	<u>4,955,100</u>
Less: Native Claims Payments	<u>131,400 (14)</u>	<u>-0-</u>	<u>-0-</u>
Total Net Unrestricted Revenues	<u>2,501,200</u>	<u>3,631,000</u>	<u>4,955,100</u>

- 1) Ch. 1 SSSLA 1980, repeals the Alaska Net Income Tax for individuals and fiduciaries and provides for individuals to continue receiving tax credits for political contributions and household and dependent care service, retroactive to January 1, 1980. Ch. 2 SSSLA 1980, provides refunds of 1979 individual income taxes.
- 2) Ch. 79 SLA 1979, effective June 30, 1979. FY 1980 represents a transition period with six months of collections under old tax rates and six months of collections under new tax rates.
- 3) FY 1981 represents additional revenue collected due to fisheries processors filing a substantial amount of 1979 tax return extensions which are not expected to be collected until FY 1981.
- 4) Ch. 154 SLA 1980, effective July 2, 1980, levies either a 2 percent or 3 percent Salmon Enhancement Tax to be determined by qualified regional aquaculture associations.
- 5) Assumes gradual decontrol of oil prices by October 1, 1981.
- 6) Repealed by Ch. 64 SLA 1980, retroactive to January 1, 1980. Some insignificant amounts of revenue are expected to be collected in FY 1981 due to employers still collecting in calendar year 1980.
- 7) Net of 25 percent Permanent Fund contribution.
- 8) Anticipated revenue (\$9.8 million) due to State's winning Court decision may not be collected because of appeal to the Supreme Court.
- 9) Reflects bonuses for undisputed State lands in the Teaufort Sea lease sale. Another \$110.9 million associated with the Dirkum Sands is subject to an agreement with the United States regarding its allocation.
- 10) Reflects lease sale of \$12,771,301.22 held September 16, 1980.
- 11) The Department of Natural Resources projects additional lease sales to be held in 1981 and 1982. However, bonus bids are impossible to anticipate prior to the sales and therefore no estimates are included in this report.
- 12) Net of 50 percent Permanent Fund contribution by Ch. 18 SLA 1980.
- 13) The FY 1981 royalty value reflects the retroactive payment due the State, by the North Slope producers, for the recently negotiated settlement regarding field costs previously deducted from the royalty wellhead value.
- 14) Native Claims Settlement Fund payments out of current royalties have historically been treated as if they were not received, and the figure reflects the total amount of such payments during FY 1980. An additional \$292,585,066.52 was paid as an appropriation on June 30, 1980, thereby fulfilling the total \$500,000,000 obligation under Sec. 6 of the Alaska Native Claims Settlements Act, but the money for this appropriation is counted as received under the historic practice.

STATE OF ALASKA

THE LEGISLATURE

BUDGET AND AUDIT COMMITTEE

FINANCE DIVISION
POUCH WF-STATE CAPITOL
JUNEAU, ALASKA 99811
PHONE: (907) 485-3796

MEMORANDUM

DATE: February 12, 1981

TO: Honorable Sam Cotten
Chairman
House Finance Committee

FROM: Milt Barker, Fiscal Analyst
Legislative Finance Division

SUBJ: Revisions in Petroleum Taxation - Further Comments

Real Dollars

Table I (attached) should accompany my earlier memo of January 16, 1981. It shows the total revenue to the State from Sadlerochit oil and gas production over the life of the reservoir in both nominal and real dollars. The real amounts are in 1978 dollars; they were determined by present valuing the nominal dollar stream at 10%, the inflation rate used in the computer runs. The relative merits of the various alternatives appear to be practically the same whether the ranking is done in real or nominal dollars.

No Consideration of Gas Revenues

The last five alternatives in the table were developed to give either the state or the producers the same total dollars over the life of Sadlerochit from both oil and gas. However, they do so by recouping the lost income tax revenues solely from oil. Inasmuch as the timing of production and value of gas relative to oil is all very speculative, any alternative of the above nature is probably impractical. If gas revenues and their timing were known, there would be an advantage to any of the strategies that recouped lost gas income tax revenue through an increase in oil severance up to 15% or an increase in oil royalties since this would reduce the companies windfall profit taxes.

Acceptable tax revisions probably mean that increased oil taxes or royalties can only be established to offset income tax losses from oil, while increases in gas taxes or royalties would offset income tax losses on gas.

February 12, 1981

Table II (attached) follows this criteria in analyzing the option of recouping income tax receipts through increased severance taxes. The severance tax on oil could still be increased to 19.2% and yet give the producers returns from oil equivalent to those under current statutes. An increase in oil severance to only 17.1% would keep the state's cash flow in real dollars from oil at the same amount as under current statutes.

If income taxes on gas are to be recouped by an increase in gas severance, the rate would have to be around 18.4%.

attachments

MB:bf

TABLE I
STATE REVENUE FROM SADLEROCHIT
FY 1978 - FY 2013
(\$ Billions)

<u>State Tax Structure</u>	<u>Nominal Dollars</u>	<u>Real Dollars (10% Discount Rate)</u>
Current Statutes	\$327	\$71
No Income Tax	238	54
Windfall Deduction	319	68
Windfall Deduction, 15% Severance	372	77
Windfall Deduction, No Expiration	298	65
Windfall Deduction, No Expiration, 15% Severance	353	75
No Income Tax, 19.2% Severance	327	72
No Income Tax, No Severance, 29.38% Oil Royalty	327	72
No Income Tax, 15% Severance, 16.84% Oil Royalty	327	72
No Income Tax, No Severance, 30.48% Oil Royalty	336	74
No Income Tax, 15% Severance, 18% Oil Royalty	335	74

TABLE II

STATE AND PRODUCERS' RETURNS FROM SADLEROCHIT @ 46% FEDERAL INCOME TAX

SEPARATE CONSIDERATION OF OIL AND GAS

	1981 - 2005 (Period Considered by AG)			1981 - 2013 (Period Includes 20.4 TCF Gas Recovery)		
	Present Value of State Cash Flow @ 10% Discount Rate (\$ Billions)	Present Value of Producers' Cash Flow @ 20% Discount Rate (\$ Billions)	Producers' Rates of Return	Present Value of State Cash Flow @ 10% Discount Rate (\$ Billions)	Present Value of Producers' Cash Flow @ 20% Discount Rate (\$ Billions)	Producers' Rates of Return
<u>Oil Only</u>						
Current Statutes	51.3	10.4	53.34%	53.9	10.7	53.34%
No Income Tax, 17.1% Oil Severance	50.8	11.1	55.62	54.0	11.4	55.62
No Income Tax, 19.2%	54.1	10.4	54.02	57.6	10.7	54.02
<u>Oil and Gas</u>						
Current Statutes				62.2	12.8	58.96%
No Income Tax, 17.1% Oil and 18.4% Gas Severance				62.2	13.5	61.29
No Income Tax, 19.2% Oil and 18.4% Gas Severance				65.6	12.8	59.46

Prepared By:
Legislative Finance
2-12-81