Alaska Oil and Gas Association

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TESTMONY BY THE

ALASKA OIL AND GAS ASSOCIATION

TO THE SENATE JUDICIARY COMMITTEE

REGARDING SB 2001 & CSSB 2001(RES)

ON THE TOPIC OF "ACTUAL vs. REASONABLE COSTS"

October 30, 2007

Mr. Chairman and Members of the Committee:

For the record, my name is Thomas K. Williams. I am Senior Royalty & Tax Counsel for BP Exploration (Alaska) Inc. and a former tax administrator for the State of Alaska. I appear before you today to testify in my role as chair of the AOGA Tax Committee.

My present testimony pertains to the topic of "Actual vs. reasonable costs" as scheduled for consideration today.

Before I get to AOGA's concerns and questions about this topic, let me say that the issue of "actual vs. reasonable costs" was a very real one facing the Department of Revenue ("DOR") when I was Director of the former Petroleum Revenue Division (now the Tax Division) from 1975 to '79 and Commissioner of Revenue from '79 to '82. Back then this same issue arose in the context of the costs to transport ANS crude oil by marine tankers from Valdez to markets on the West Coast, Hawaii, St. Croix in the U.S. Virgin Islands, and – in the earliest years – the U.S. East and Gulf coasts.[1]

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[1] The capacity of refineries on the West Coast and in Hawaii to refine ANS was about 900,000 barrels a day. Prudhoe Bay reached 1.2 million barrels a day in 1978, and once ANS production exceeded West Coast refiners' capacity to refine it, the excess had to be shipped to the more distant locations on the U.S. Gulf and East coasts because ANS could not be exported. At first this oil was delivered into a stationary VLCC (very large crude carrier) anchored at sea off the Pacific coast of Panama, and then the oil was pumped out the other side of that VLCC into ships small enough to go through the Panama Canal to the Gulf and East coasts. Later Panama built a trans-isthmus pipeline allowing large tankers from Valdez to unload directly into the pipeline, which could then carry the oil to the Atlantic coast of Panama where it was loaded directly into large tankers there. This eliminated the stationary VLCC and avoided the risk of accidents while loading and unloading oil into and from that VLCC in the open sea, and it reduced transportation costs because it allowed larger ships to be used on the Atlantic leg of the trip. Panama, of course, could calculate the savings in Atlantic ship costs with fair accuracy and set its pipeline tariff accordingly.

As for shipments to St. Croix, the Hess refinery there was exempt from the Jones Act requirement to use American-built, American-manned ships to transport oil there from another U.S. port. The cost differences between Jones Act ships and non-Jones Act ones was often large enough to allow a large foreign-flag VLCC to sail all the way around

The respective marine transportation costs had to be "netted out" or subtracted from the market value of the ANS delivered at each Outside market destination in order to determine the corresponding "netback" value of that oil at Valdez, and from the Valdez netback the pipeline transportation costs were further "netted out" to get the corresponding "netback" in the field, which was formally called the "gross value at the point of production" in the production tax statutes starting in mid-1977.

From a tax administrator's perspective, the advantage of using "reasonable" costs instead of "actual" costs is that you don't have to audit "reasonable" costs. You just find a publication or other recognized authority that tells you what the "reasonable" costs are in the current market conditions, and bingo! you're done. In fact, for international marine transportation there actually was such a publication or authority, the Average Freight Rate Assessment ("AFRA") published (by subscription) by the London Tanker Brokers' Panel. Those AFRA rates were particularly helpful for us in DOR to find the delivered cost to acquire a comparable foreign crude at a market destination where ANS was also going and competing against that foreign supply.

But AFRA didn't give us the "reasonable" cost or market value[2] of water-borne transportation in Jones Act ships. When we first heard about a new "USFRA" (for "United States freight rate assessment") in 1978, we were very inclined to consider using it to determine the "reasonable" costs for Jones Act tanker transportation from Valdez to the other U.S. ports where ANS was being shipped — very inclined, that is, until we discovered that the tanker fleet for ANS would dominate the rates quoted in this USFRA.

This illustrates one of the problems with using "reasonable" costs — finding an authoritative source you can trust and rely on. Oftentimes there simply isn't one, and sometimes a reliable source that you have found either goes out of business or becomes unreliable or inaccurate.

If you don't have a reliable, accurate and up-to-date source that allows you simply to look up the "reasonable" costs, the only other way to implement the "reasonable" cost approach is to examine and audit the costs for everyone involved in the activity in question. In a sense this is the worst of all possible worlds from a tax administrator's perspective, because you have to do all the auditing and other work that you would have to do in an "actual" cost system, and once you have that done you have the further challenges of proving to everyone that your "actual" cost figures are indeed accurate and representative of current market conditions. Given the constraints of tax confidentiality, how could you use cost information from other taxpayers to show any particular taxpayer how you came up with your "reasonable" cost figure?[3] Moreover, how could your "reasonable" cost figures be anything but badly out of date, given that the taxpayers'

South America to the Virgin Islands for less cost per barrel than shipping ANS there via Panama.

2 AS 43.55.150(b) equates "reasonable" costs of transportation with the fair market value of that transportation: "If the department finds that the conditions in (a)(1), (2), and (3) of this section are present, the department shall determine the reasonable costs of transportation, using the fair market value of like transportation, the fair market value of equally efficient and available alternative modes of transportation, or other reasonable methods. ..."

3 AS 43.55.040(1), as amended by § 21 ch 2 TSSLA 2006, finally creates a reasonable and workable solution to the problem of using tax information from one taxpayer in a proceeding against another taxpayer.

information from which your figures are derived would have to be audited first to ensure their reliability? What you would have is a tax that no taxpayer could comply with correctly when its tax comes due. It would be a tax that either requires almost numerous filings and refilings of amended returns by taxpayers as your "reasonable" cost data are published or updated on the basis of new audit results, or it would be a tax whose correct amount cannot be determined at all until all taxpayers are audited. The challenges for DOR in setting up and maintaining accurate records of each taxpayer's payments, corrections and final cost figures would be enormous. But relying on audits as the only way to determine the correct amount of "reasonable" costs would amount to "taxation by audit" instead of self-reporting and self-assessment, and it would be a particularly difficult and inefficient way to administer a tax that supposedly is self-reported and –assessed.

Rather than taking any of these unappealing alternatives, we opted in 1979 and 1980 to use "actual" transportation costs as much as we could[4] and save ourselves these troubles.[5]

From a taxpayer's point of view — and now I am putting my hat back on as chair of the AOGA Tax Committee — the "reasonable" cost approach suffers from three major problems. First, taxpayers only know about their own business and their own "actual" costs. Anything different from a taxpayer's own factual costs cannot be right, because the factual costs are what they are, and the facts cannot be different from what they are. It is a rare tax indeed that does not look at the actual performance or results of a taxpayer's business or business-related activities, and as long as a tax is taking such latter items into account, it is fundamentally unsound to ignore "actual" costs or similar "actual" results and to base the tax instead on some different cost or result, no matter how "reasonable" its derivation may be.

Second, unless there is some reliable, authoritative source about "reasonable" costs under the current conditions that is available to taxpayers before their tax returns and payments come due, it will be impossible for taxpayers to compute, report and pay the correct amount of tax on that due date. In the case of operating and capital costs to explore for, develop or produce oil or gas on the North Slope, there is no such reliable, authoritative source available at all, much less one that can be available on a timely basis.

Third, if DOR would be determining the amount of "reasonable" costs to explore for, develop or produce oil and gas on the North Slope on the basis of taxpayers' verified and audited "actual" costs for these activities, it would still be impossible for taxpayers to report and pay the correct amount of tax when it comes due. In addition, the problems of filing and refiling amended tax returns, or of having "taxation by audit," will be about as difficult and onerous for tax-

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4 *See* 15 AAC 55.180; *cf.* AS 43.55.150(a) and (b).

5 A further reason for going with a taxpayer's "actual" costs of transportation is that DOR's first netback-calculation regulations were adopted in 1979, and that was in the context of the former separate-accounting income tax, not the production tax. The first netback-calculation regulations for the production tax were adopted in 1980. If you are calculating a taxpayer's income, as you would be with an income tax (even separate-accounting), you really cannot use some artificial computation of the "reasonable" costs of the taxpayer's transportation if it has "actual" costs that you can audit and verify.

payers as they would be for tax administrators.

It is also worth remembering that, to the extent the “actual” lease expenditures can be based on joint-interest billings by the operator to the other participants in the operations, the total “actual” costs under those billings will be the same for each participant, with the only difference being the size of each one’s share of that total. Even if DOR were not to rely on the audits by non-operating participants of the billings to ensure the accuracy and appropriateness of the amounts so billed, it would only have to do one audit of each set of billings by the operator,[6] instead of having to do completely independent audits for each participant’s “actual” costs. So using “actual” costs could prove to be significantly less burdensome for DOR to administer, audit and enforce than one might first expect.

Thank you for giving AOGA this opportunity to testify.

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[6] On a related but different issue, see AOGA’s “white paper” on the prudent use of joint-interest billings and the risk that DOR’s present discretionary authority to allow or require the use of such billings may be lost if AS 43.-55.165(c) and (d) are repealed.