State of Alaska

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To: All members of the Legislature
From: Marcia Davis, Deputy Commissioner, DOR

October 25, 2007

Dear Members:

The attached memorandum was requested of Spencer Hosie by the Department of Law regarding the litigation risk and burden associated with a profits-based oil production tax. The memo provides a short history of the ANS Royalty Litigation and outlines issues the State is likely to experience in enforcing and collecting taxes under a net tax regime. I hope you will find the document useful in your coming deliberations.

Sincerely,

Marcia Davis

Marcia Davis, *Deputy Commissioner*
Department of Revenue

MEMO

To: Department of Law, State of Alaska
From: Spencer Hosie
Subject: ANS Royalty Litigation and Gross Versus Net Tax
Date: October 17, 2007

The Department of Law has asked for a brief memo summarizing why the *ANS Royalty Litigation* took near 20 years to resolve, and whether the State may expect similarly protracted, complex litigation with a "net" severance tax, *i.e.*, a tax based on revenues net of allowable costs. As we understand it, the concern is that a net tax will inject a multiplicity of complex factual issues, thereby leading to expensive and protracted litigation.

This memo first summarizes why the *ANS Royalty Litigation* took as long as it did. It then contrasts what we believe the State should expect in enforcing and collecting taxes under a net tax regime, and how this process will differ from the civil litigation in the *ANS Royalty Litigation*. Finally, the memo concludes with several concrete examples of recent State of Alaska cases which provide reasonable benchmarks of what the State is likely to experience in enforcing a net production tax.

I. THE *ANS ROYALTY LITIGATION*.

The State of Alaska filed what would become the *ANS Royalty Litigation* in 1977. The oil phase of the case was resolved in 1992; the gas liquids phase settled in 1995. All-in, the case took nearly two decades to resolve. Through the litigation, the State recovered significantly in excess of $750 million and established going-forward royalty payment rules designed to either streamline or – preferably – eliminate prospective litigation, as discussed below.

There were four principal reasons why this matter took so long and cost so much. First, the State was not acting as a sovereign in the case, but rather as a party to a commercial contract; a litigant like any other. In that context, the State did not have the authority to serve and enforce subpoenas as sovereign, select an administrative judge, or rely on regulations to expedite dispute resolution. Instead, as in any private litigation, the State had to serve and enforce discovery through the civil discovery process, which can be (and was) extremely time consuming. This is very unlike the rights that legislation and regulations provide for enforcing a production tax, as set forth below.

Second, the *ANS Royalty* case involved numerous complicated legal questions of first impression. For example, did the DL-1 lease form permit the State to assess values in downstream markets, then netted back to Pump Station 1? Did the producers owe the State any duty above those owed to a private commercial party? How is market value to be determined under ¶ 15 of the lease, and what did the tripartite "proceeds" subparagraphs of ¶ 16 mean and require? These fundamental questions of contractual interpretation[1] required years of briefing, including discovery into the origin of other states' lease forms, leading to summary judgment decisions, all of which necessarily occurred before the State built its damage models. Put simply, even the basic royalty rules were not clear and had to be established through litigation.

Third, once having established that the State had the right to look to downstream markets to assess market value, and then to net back those values to derive a Pump Station 1 royalty value, the State literally had to track *every single barrel* of ANS previously produced to its market destination. Tracking many billions of barrels to myriad Lower 48 destinations over a near-15 year period proved a byzantinely complex and daunting task, one that took the State's

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1 In addition, the producers challenged venue in Alaska, arguing that every judge and juror in Alaska had a financial stake in the outcome given the Permit Fund Dividend. This issue was resolved only after two interlocutory appeals to the United States Court of Appeals for the Ninth Circuit.

outside accounting and economic experts years to complete. As part of this process, the State then had to assess the reasonable and actual transportation deduction for every barrel transported.

Fourth, the *ANS Litigation* involved all ANS producers and all were active in the litigation, even though the case focused on Exxon, Sohio, and Arco. The State had to conduct separate discovery of each producer within the context of a single case, and this substantially delayed completion of the lawsuit.

Finally, in the *ANS Royalty Litigation*, the State necessarily approached the ANS industry as a whole, *and* as a matter of first impression. In the 1980s, the State did not have deep institutional knowledge of how the ANS business worked, how the producers conducted business, what transportation costs were reasonable and what not, how the producers handled common (or "joint") cost accounting, and similar issues. In contrast, the State now has significant institutional expertise, having audited ANS producers for decades.

II. WILL A NET PRODUCTION TAX SPAWN MULTIPLE *ANS ROYALTY*-LIKE CASES?

Tax is not royalty. In enforcing its production tax statute and regulations, the State acts as a sovereign. The Legislature has authorized a regulatory structure that gives it the right to compel document production, to set a reasonable schedule, and to proceed under the functional equivalent of an Administrative Law Judge (hearing officer). These procedural differences are substantive and real. A single taxpayer case should proceed from audit to hearing in no more than two years, as described below. Two years is a long time, but a far cry from the two decades in *ANS Royalty Litigation*.

Second, unlike the royalty context, the basic tax rules will be set forth by statute, with the disputes on the margin, *e.g.*, wrong costs deducted, or costs inflated, etc.... In a tax context, the basic structure and rules are a given; in the *ANS Royalty Litigation* case, these rules had to be established through hotly contentious litigation.

Third, presumably the State will vigilantly audit ANS taxpayers under any production tax, gross or net. *Audits should be conducted on a yearly basis, and if an issue arises, it should be dealt with promptly.* The *ANS Royalty Litigation* took decades in part because it involved decades of production by the time it was resolved; this will not be the case in the tax context.

Fourth, given taxpayer confidentiality, and the nature of the tax audit process, any tax proceeding would be taxpayer-specific. A single taxpayer proceeding should move much faster than a multi-party case such as the *ANS Royalty Litigation*.

Finally, and as noted above, the State now has deep institutional knowledge concerning the ANS business, including market values and transportation costs. This knowledge comes from the *ANS Royalty Litigation* itself, plus several follow-on cases (described below), and numerous tax audits and cases. The State now has accumulated decades of experience in auditing production and transportation costs, as well as a group of outside expert consultants who are well-versed in these matters.

To be clear, all else equal, a net tax will be more complex to administer and enforce than a gross tax. If the past is any guide, the taxpayers may well game costs, *e.g.*, suddenly allocating an inappropriately large percentage of joint or common costs to their Alaska business. But the additional complexity should be manageable, and the State can discourage overly creative cost accounting by vigilantly auditing and enforcing the statute and regulations from the outset.

III. ROYALTY "REOPENER" CASES: A TAX PARADIGM.

The State recently had several "reopener" cases which serve as useful examples for what might be expected under a net production tax.

As part of the *ANS Royalty Litigation* settlement, the State and each of several producers agreed to formulas for future royalty payments, along with a short-fuse dispute resolution mechanism. That mechanism includes limited discovery, short deadlines, and a three-judge arbitration panel empowered to make a binding decision. If either party grows dissatisfied with the operation of the agreed royalty formula, it has the right (in certain general circumstances) to trigger a "reopener," which serves to start the dispute resolution process.

The State has had several such *ANS Royalty Litigation* "reopener" proceedings. Each has involved limited and manageable discovery, a relatively quick path to hearing, and a binding decision or settlement promptly after the arbitration hearing begun. On average, these matters have taken 20 to 22 months of active litigation, despite involving complex cost and revenue issues (and zealous producer counsel). For example, in the first of several reopeners, outside counsel became involved in August 2003, trial was in April 2005, a binding decision in the State's favor received in June 2005, and the State was paid promptly thereafter.

As noted, these "reopeners" are good models for what to expect under a net tax, as both involve: (1) established rules (by statute in tax); (2) streamlined administrative process; (3) company specific proceedings; and, (4) proceedings that benefit from State's historical, institutional knowledge.