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COMMENTS ON THE CRUDE OIL WINDFALL PROFIT TAX ACT

Statement before the

U.S. Senate
Finance Committee

by

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Washington, D.C.
July 18, 1979

The so-called "windfall" profits tax on domestic crude oil production may be viewed as a corollary of the announced price decontrol of domestic crude oil which the President has ordered to be phased in beginning June 1, 1979. Decontrol will gradually raise all domestic oil prices to world levels by October 1, 1981.

As we know, world oil prices are not determined by competitive market forces but by the governments of a group of major oil exporting countries, acting in concert through OPEC. In addition, several of these countries have individually imposed production ceilings which are well below their current sustainable production capabilities from their recoverable resource bases.

It is assumed, correctly, that the OPEC-administered prices are substantially higher than if they were set by market forces in the absence of any supply restrictions other than those dictated by technical considerations. Consequently, it is argued that while U.S. consumers should pay the full world price for all oil, domestic and foreign, since this price represents the effective replacement cost of the commodity under existing circumstances, domestic producers should not receive the full world price since it includes a cartel-administered increment above the market-clearing price level. Hence, the proposed windfall profits tax on the differential between controlled U.S. prices and world prices.

The theory certainly has merits on perceived grounds of equity and fairness. To justify it on economic grounds as well requires the assumption that the government can apply the collected funds more effectively towards solving our energy problem than the oil industry would if it were allowed to retain them. I submit, this assumption is questionable.

Nevertheless, on balance I believe a windfall profits tax of limited scope and duration on domestic oil production may be justifiable. However, the tax passed by the House of Representatives, H.R. 3919, has a number of shortcomings, some of which I would like to discuss briefly.

The bill contains three tiers for taxing purposes. Tier One consists essentially of "lower tier" crude oil which is taxed on the full differential between the domestic lower tier price of about $6/bbl and the landed world price, currently about $21.00/bbl. This taxation assumes implicitly that the entire differential is due to OPEC's cartel power, since it would be most unusual to enact a special tax on a price increase brought about by legitimate competitive market forces. Yet, there is no question that a large part of the vast differential between lower tier and current world prices is due to factors other than OPEC's cartel power.

In both the last 10 years and the last five years before the first OPEC price revolution of 1973, world oil demand rose at an annual rate of about 7.5%. This must therefore be considered the long term growth rate at the prices prevailing during that period. Had that growth rate continued, total non-communist world oil demand in 1979 would be about 22 million b/d higher--or 42%--than the likely actual demand figure for this year. Not even under the most sanguine supply assumptions could such a volume have been reached or approached.

Thus, even in the absence of any individual or collective OPEC supply constraint or price administration, the world price of oil, including of course U.S. oil, would have had to rise sufficiently in real terms to reduce the world petroleum demand growth rate by at least 50% over the last six years from its previous long term rate to balance supply and demand.

Yet, lower tier oil prices were frozen in mid-1973 and have not even been fully adjusted for inflation since then. Thus, the big spread between domestic lower tier and foreign oil prices is due not only to the fact that OPEC raised world prices administratively above the market-clearing level, but also to the fact that the U.S. government has kept the price through federal controls below the market-clearing level.

Furthermore, drilling costs for development wells have increased faster than the U.S. inflation index and most producers lost the advantage of the depletion allowance in the year following the price freeze. These factors also indicate that under free market conditions the price of lower tier oil today would be substantially higher than $6.00, without any assist from OPEC.

The House bill's phasing out of all lower tier oil for tax purposes by June 1984 is a partial recognition of this inequity. But in view of the considerations I have mentioned it should probably be phased out more rapidly than over a 5-year period. The Administration's proposed May 1983 phase-out date is at least somewhat better in this regard. This would also shorten the time during which lower tier producers have a clear incentive not to maximize output so as to keep more oil in the ground for the time when they will receive upper tier prices for the old oil.

Oil in the proposed Tier Two category, which initially would consist mostly of Upper Tier oil, i.e. oil discovered after 1972 and before June 1, 1979, has been priced much closer to world levels under existing controls than lower tier oil. In January 1979, before the OPEC price explosion, its price was approximately $2.50/bbl below, or 16% less, than the average cost of landed foreign crude oil. Some of this upper tier oil is relatively expensive to produce, and as the fields from which it is produced get older and require secondary recovery and other additional maintenance expenditures, its real cost can be expected to rise further. Given these circumstances, the 60% tax on the price differential could be excessive from the point of view of future production maximization. In this connection, the possibility must be considered that following OPEC's 60% price increase this year, world prices could once again show a decline in real terms in some subsequent years, particularly if conservation,recession and substitution temporarily depress demand. This is what happened in the period 1974-78, following the OPEC price rise of 1973. This would of course depress producers' revenue on Tier II production from its then prevailing level and make the 60% profit tax more burdensome,relative to production costs.

Tier III prices appear to be the most generous for the industry, since the base price for taxing purposes for much of the oil in this category is $16 and for some of it--newly discovered oil--would be adjusted upward at a faster rate than actual U.S. inflation. Furthermore, much of the oil in this category is taxed at a 50% rather than the 60% rate applying to Tier One and Two.

Yet, I believe the taxation proposed in Tier Three to be the least justifiable of the three tiers and the one most likely to be counterproductive to the national goal of maximizing domestic oil production, for it would tax all new oil for the next 11 years and all existing Alaskan North Slope production in perpetuity.

There can be no question that in principal any tax increase on new oil is a disincentive. True, we don't know how much more oil will be produced in the U.S. at $23/bbl than at, say, $18. But by the same token we don't know how much production we would lose if we held prices to the lower level. When the world oil price rose nearly fourfold in 1973/74 it was said the increase was in excess of what was needed to stimulate new production. Yet, last year a substantial volume of oil production would have been unprofitable at prices just a few dollars below the prevailing world level. The North Sea, the Alaskan North Slope and the Athabasca tar sands are cases in point.

If the amount of new oil discovered under untaxed world prices should turn out to be relatively small, the Treasury will not have lost a significant amount of tax revenue. If production turns out to be large the country will have been much better served than if the money had been collected from the oil producing industry and channelled into a fund for the construction of synthetic fuel facilities. These facilities should of course be constructed and government funding of some sort is likely to be required to get this new industry off the ground. But to deprive the oil industry of funds for investment in conventional oil and gas production in order to have more money available for investment in synthetics would make no sense whatever, since environmentally, economically and technologically, conventional oil and gas is clearly superior to the still non-commercial synthetic fuels with their innumerable unknowns.

To tax Alaskan crude oil would put a special profit constraint on the most costly frontier oil ever discovered in the U.S. If world prices for some reason had dropped one or two dollars this year, instead of rising as they did, at least the portion of Alaskan crude shipped to the Gulf Coast would have become literally unprofitable. Would the Administration or Congress in that case have proposed a subsidy on that oil? Or would they have permitted its exportation to minimize freight costs? From the record of the past several years, I doubt that either of these measures would have been taken. Then, why put a special tax on this oil when world prices move upward? Can one really make a case that a venture of the unique financial and engineering dimensions of the North Slope should bear all the risks but should share all gains with the government? Or that North Slope oil producers should pay a windfall profit tax based on a wellhead price of $7.50/bbl which is 42% lower than the proposed tax base for the far less risky lower 48 Upper Tier production?

I would also like to point out that under current federal and state tax and royalty regulations at least 62% of any increase in the Alaskan wellhead price would go to State and federal government agencies. This is more than the incremental tax and royalty share in the lower 48 states.

I would like to conclude with a suggestion for an additional oil tax concept. The public has recently been flooded with comments on the energy crisis. It has been told about the promises of synthetic fuels, the need for conservation and the danger of excessive reliance on foreign oil sources. Essentially, all these concepts are abstractions for most people. If the experts don't know what promise synthetics really hold or how safe atomic power is, how can the public form an opinion? What the public does know, however, is how much energy costs and how much the cost has risen. This applies particularly to gasoline. Yet, while the price of gasoline has gone up, largely because of direct and indirect effect of OPEC price increases, the federal tax on gasoline has remained at 4¢/gallon for the past 20 years. If it had been adjusted only by inflation during this period, it would today amount to over 10¢/gallon. Proposals to raise it to that modest level have fared no better than proposals to decontrol gasoline prices. They were dismissed as politically unacceptable. I would like to suggest that the public ought to be made a direct participant in gasoline conservation through the only mechanism it clearly understands and cares about--the price level.

The President's original National Energy Plan contained an imaginative proposal that the Administration set an annual target for U.S. gasoline consumption. If that target were exceeded it was proposed that a gasoline excise tax of a meaningful magnitude be enacted in the following year and be maintained until the earlier target was met.

I believe we should reconsider this proposal under the new circumstances we are faced with. It would give the public a direct personal economic stake in keeping gasoline consumption down. Possibly, this would get better results than the exhortative rhetorics and threats of shortages the public has been exposed to so far.

An interesting aspect of the scheme is that if the tax is actually activated, it would give the government additional funds for the development of alternate energy sources. If it is not activated, such additional funds may not be needed because of progress in gasoline conservation.

In the present atmosphere, the political risks of such a program may be considerably lower than they were perceived to be when the proposal was first evaluated by the Congress.