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EXISTING TAX LAWS, ENERGY POLICY AND THE NATIONAL SECURITY

Statement before the

Subcommitee on Energy and Agricultural Taxation

of the

Senate Finance Committee

U.S. Senate

by

John H. Lichtblau
President

June 21, 1985

Thank you for inviting me to testify before your Subcommittee on Energy and Agricultural Taxation. As per your letter request, I will address my comments primarily to existing tax legislation affecting the energy industry rather than to the recent proposals to reform this legislation. I will limit my comments to the petroleum sector of the energy industry.

The U.S. oil industry is granted special tax deductions not available to other industries and is burdened with special tax obligations not imposed on other industries. The expensing of intangible drilling costs (IDCs) and percentage depletion form the first category*; The Windfall Profit Tax (WPT) is the second. Both types of tax provisions reflect unique aspects of the U.S. oil industry. A rough calculation suggests that the expensing of IDCs, which is by far the larger of the two special tax deductions, has saved the industry some $4-5 billion annually in recent years. On the other side, the WPT increased the industry's net tax liability by about $5 billion last year and by $6.6 billion the year before.

In assessing the validity of these various tax provisions several questions must be asked: (1) What is the rationale for both the positive and the negative special tax provisions applicable to the oil industry? (2) How do these tax provisions affect the oil industry's tax burden vis-a-vis other U.S. industries? and (3) Do any, or all, of the oil industry's special tax provisions serve the national interest?

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* It should be noted that integrated oil companies are allowed to expense only 80% of their IDCs and are not entitled to percentage depletion.

Regarding the first question, the expensing provision for IDCs and the percentage depletion provison represent a recognition of the high capital intensity and the high risk nature of the oil industry. The high capital requirement is illustrated by the $84 billion average annual expenditure on exploration, development and production during the 3-year period 1980-82. About 40% of these expenditures represent operating costs associated with producing wells, including production and severance taxes. The remaining $50 billion go largely into the expenditures required to find reserves and develop production. Expenditures have increased sharply since the early 1970's. Since production has remained relatively unchanged, the industry's capital intensity has risen further. The cost of drilling and equipping a well rose from an average of about $120,000 in the 1971-74 period to a peak of $514,000 in 1982. It declined to $372,000 in 1983, as lower drilling activity and market adjustments in the oil service sector led to lower costs.

The expensing of the intangible part of the required expenditure in the exploration and producing sector, which has no salvage value, puts this highly capital intensive industry on a more equal tax footing with industries which have relatively low capital expenditures and relatively high fully deductible current expenditures, such as labor costs, rentals, etc.

The oil and gas producing industry's high-risk character also justifies special tax treatment. All business operating in a market economy contains of course a risk element. But few other businesses face the total risk of an individual oil

producer drilling a wildcat well in the U.S. The chance of a dry hole is almost 85%. If one takes all types of exploratory wells the odds are still almost 4 to 1 against finding a commercial producer. With a cost of $700,000 per exploratory well (1981-83 average), the financial stakes in this business are extremely high. Obviously, so are the rewards for those who drill the successful wells. But unless a large part of the risk money for exploration can be generated from the cash flow of previous successes, substantially less risk money would be available. The expensing of IDCs and the depletion allowance help to provide this risk money.

It has been argued that the price mechanism could provide the same incentive to search for oil as the two tax provisions. However, under present and foreseeable conditions, U.S. oil prices are not determined by domestic supply and demand but by the cost of imported oil, since the U.S. will remain a substantial net importer of crude oil for the foreseeable future. Thus, a decline in U.S. oil production due to the abolition of the two tax provisions would not be followed by a compensatory increase in the domestic price of oil.

Next, let us look at the oil industry's special <u>negative</u> tax provision, the WPT. The initial reason for its imposition was the perception that the very substantial increase in world oil prices imposed by the OPEC cartel in 1973/74 and again in 1979/80 would give the domestic oil industry a "windfall" profit, since under free market conditions prices would have risen much less during that period. Thus, the lifting of domestic crude oil price controls in 1981 was legislatively tied to the imposition

of the WPT. The principle of the WPT may have been justifiable for oil which had been discovered prior to the price increases but not for new oil, whose cost had not yet been established.

The combination of inflation adjustments of the government's base price and reduction in the market price of oil has almost wiped outthe WPT on new oil (Tier 3) by now. However on most lower-48 old oil it still amounts to $5.50-6.00 per barrel which equals 20-25% of current wellhead prices.

The concept of the WPT was born at a time when crude oil prices were expected to go on rising. It stands to lose its validity in a period of declining prices, such as the past 4 years, and with the prospects of further declines. The tax is scheduled to end in 1990. The Treasury has estimated that from 1985 to then it will collect an annual average of $2.4 billion from the oil industry. Undoubtedly the government needs this revenue to reduce its deficit. That would be the only justification for maintaining it, for there is no more "windfall profit" on domestic oil production, old or new.

Our next question is what is the oil industry's effective federal tax rate relative to that of other U.S. industries? The answer is clear. The U.S. oil industry's tax burden has consistently been higher than that of U.S. industry in general for at least the last 5 years. This was determined in a study by our organization, entitled "The Tax Burden of Large Domestic Petroleum Companies 1974-82" which found that "large petroleum companies pay higher U.S. federal income taxes per dollar of net income than the average of large U.S. corporations." The Joint

Committee on Taxation's conclusions, which are similar, extend to 1983 when the average federal tax on U.S. corporate income was found to be 16.7% compared to 21.3% for petroleum companies. More recently the American Petroleum Institute has shown a similar result for 1984 as well. All of these tax calculations exclude the WPT which is additive to the industry's reported federal income tax payments.

It is important to establish the record of the oil industry's current tax rate relative to that of other industries because prior to the mid-1970's the relationship was generally reversed and it is frequently but erroneously assumed that this is still the case.

Finally, where does the national interest lie in maintaining the special oil tax provisions? The two tax deductions reduce federal revenue but provide incentives to oil and gas exploration and production. The WPT increases federal revenue, decreases oil industry earnings and thus the funds available for exploration but, as pointed out, has now only a marginally negative effect on oil exploration. The key national issue is that some tax revenue is foregone to encourage a higher level of domestic oil production than would otherwise be the case. The issue ties in directly with national security. As we have learned, a high dependency on foreign oil supplies brings political and economic risks. The extent and nature of this risk is well known and is beyond the scope of my statement. We have greatly lowered the risk by reducing our net oil import dependency from a peak of 44% in the 1977-79 period to 29% in the 1982-84 period. This year's share will be about the same. Part

of the reduction has resulted from lower consumption and part from higher domestic production. This year our crude output will be nearly 800,000 B/D above the record low level of 1976. Alaska is of course the major reason for the increase in production. But the sharp increase in drilling in the lower-48 region since 1979 has reversed the decline that had taken place in that region during the 1970's. Alaskan producution is now levelling off and will likely start declining from about 1990 on. The extent to which we can maintain lower-48 production, or at least slow down its decline, depends almost entirely on the future drilling rate. The expensing of IDCs and the percentage depletion, if fully maintained, will be a major factor in attaining the required drilling rate.

The importance of indigenous oil and gas availability to the U.S. economy has been demonstrated vividly over the past twelve years. These supplies carry an intrinsic social benefit, and using tax measures to encourage investment in oil and gas exploration and production is a legitimate function of national policy.