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COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

PREPARED STATEMENTS SUBMITTED BY WITNESSES
SCHEDULED TO APPEAR BEFORE THE

COMMITTEE ON WAYS AND MEANS

ON PROPOSALS RELATING TO

"WINDFALL" OR EXCESS PROFITS

ON

TUESDAY, FEBRUARY 5, 1974

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LIST OF WITNESSES SCHEDULED
TO APPEAR BEFORE
THE COMMITTEE ON WAYS AND MEANS
ON THE ADMINISTRATION AND OTHER
PROPOSALS ON "WINDFALL"
OR EXCESS PROFITS

TUESDAY, FEBRUARY 5, 1974

1. C. John Miller, President, Independent Petroleum Association of America, accompanied by:

   A. V. Jones, Jr., President, National Stripper Well Association

   Sheldon K. Beren, Director, Kansas Independent Oil & Gas Association

   D. F. McKeithan, Jr., Liaison Chairman, Liaison Committee of Cooperating Oil and Gas Associations

   John R. Dorr, President, Permian Basin Petroleum Association

   George P. Mitchell, President, Texas Independent Producers & Royalty Owners Association

2. Walker Winter, Chairman, Taxation Committee, and Robert R. Statham, Taxation and Finance Manager, Chamber of Commerce of the United States

3. Alton W. Whitehouse, Jr., President, Standard Oil Company (Ohio)

4. Walter T. Hughes, Burlington, North Carolina

Statement of C. John Miller, President
Independent Petroleum Association of America
Before the Ways and Means Committee
U. S. House of Representatives
Washington, D. C.
February 5, 1974

My name is C. John Miller. I am a partner in Miller Brothers at Allegan, Michigan, an independent oil and natural gas exploration and producing organization. I appear here as President of the Independent Petroleum Association of America, a national organization of domestic independent oil and gas producers and explorers with some 4,000 members in every producing area of the United States. My testimony is endorsed by the regional producer associations which are shown on the attached list.

Indispensible Role of Independent Producer

At the outset, I would like to briefly discuss the vital role of the nation's independent explorers and producers of oil and natural gas. Traditionally, the thousands of independents in the industry have accounted for 75 to 80 percent of the exploratory or "wildcat" drilling directed at finding new reserves of these fuels. It should be recognized that our country achieved a position of energy sufficiency because, on balance, federal and state laws and policies served to encourage thousands of independents to participate in petroleum exploration and development.

The United States became the largest oil and gas producing and consuming country primarily because of this multiplicity of effort by thousands of independent explorers onshore in the lower 48 states.

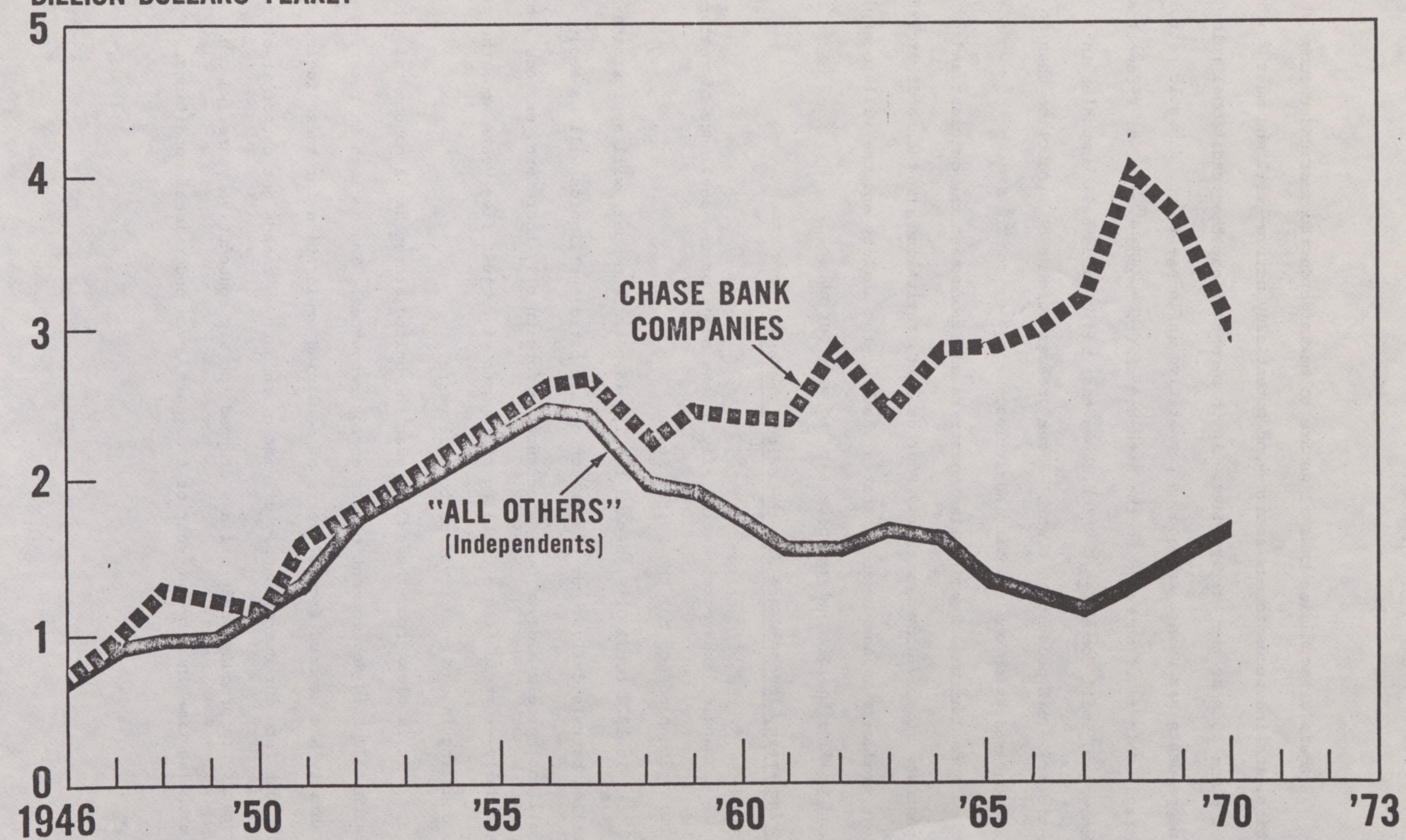
In 1956 there were over 16,000 exploratory wells drilled in the United States. At that time, there were over 20,000 independent producers active in exploration activities.

But, a steadily eroding economic climate persisted since that time which caused a decline in exploration and development expenditures by independent producers by more than 50 percent since 1956, and the number of exploratory wells drilled reflected this decline, also decreasing by more than 50 percent.

To illustrate, (see chart "Exploration-Development Expenditures") information on expenditures for exploration and development in the United States is available for the group of larger companies covered by reports of the Chase Manhattan Bank and classified as the "Chase Bank Companies," as compared with the expenditures by the thousands of independents. Approximately the same total amount was spent by each group from 1946 through 1955 with the Chase Group averaging $1.4 billion and the "all other" group averaging $1.3 billion. Both groups substantially increased these expenditures during this period. A drastic change, however, took place from 1956 to 1971. The majors increased exploration and development expenditures slightly during this period while expenditures by the thousands of independent producers declined over 50 percent from $2.45 billion in 1956 to $1.20 billion in 1971.

This country has the resource base, the techonology and know-how, and an industry with the will to solve its energy problems. The lacking ingredients have been economic incentives, which have progressively eroded. From its abundant, remaining but undeveloped sedimentary basins, the United States has the potential to develop significant new conventional oil and natural gas resources. In the short term, these petroleum fuels can be developed far quicker and at a much lower cost than any alternative energy resource. For the remainder of this century, crude oil and natural gas will continue to supply the bulk of our energy needs. During this period, therefore, we have no greater potential for meeting our energy needs than by providing the public policies and incentives to assure maximum efforts to explore for and develop the oil and gas deposits in the lower 48 states.

EXPLORATION-DEVELOPMENT EXPENDITURES



IPAA CHART DEC. 1971

Again, I emphasize that if we are to maximize development under such policies, the independents now active--and potentially active--will and must play a major role as they always have. In this connection, the traditional role of independents has been a tremendous competitive influence in the domestic petroleum industry. This is illustrated by the attached chart, "Percent of U. S. Production by Medium and Small Companies," which shows that medium and small companies in domestic crude oil production control a far greater percent of production than do their counterparts on other basic industries.

Mr. Chairman, I would like to stress once more that the quickest and cheapest way of providing new energy sources is to revitalize the thousands of independent producers in the lower 48 states who have the ability and the will to explore for and produce the oil and gas necessary to meet our needs.

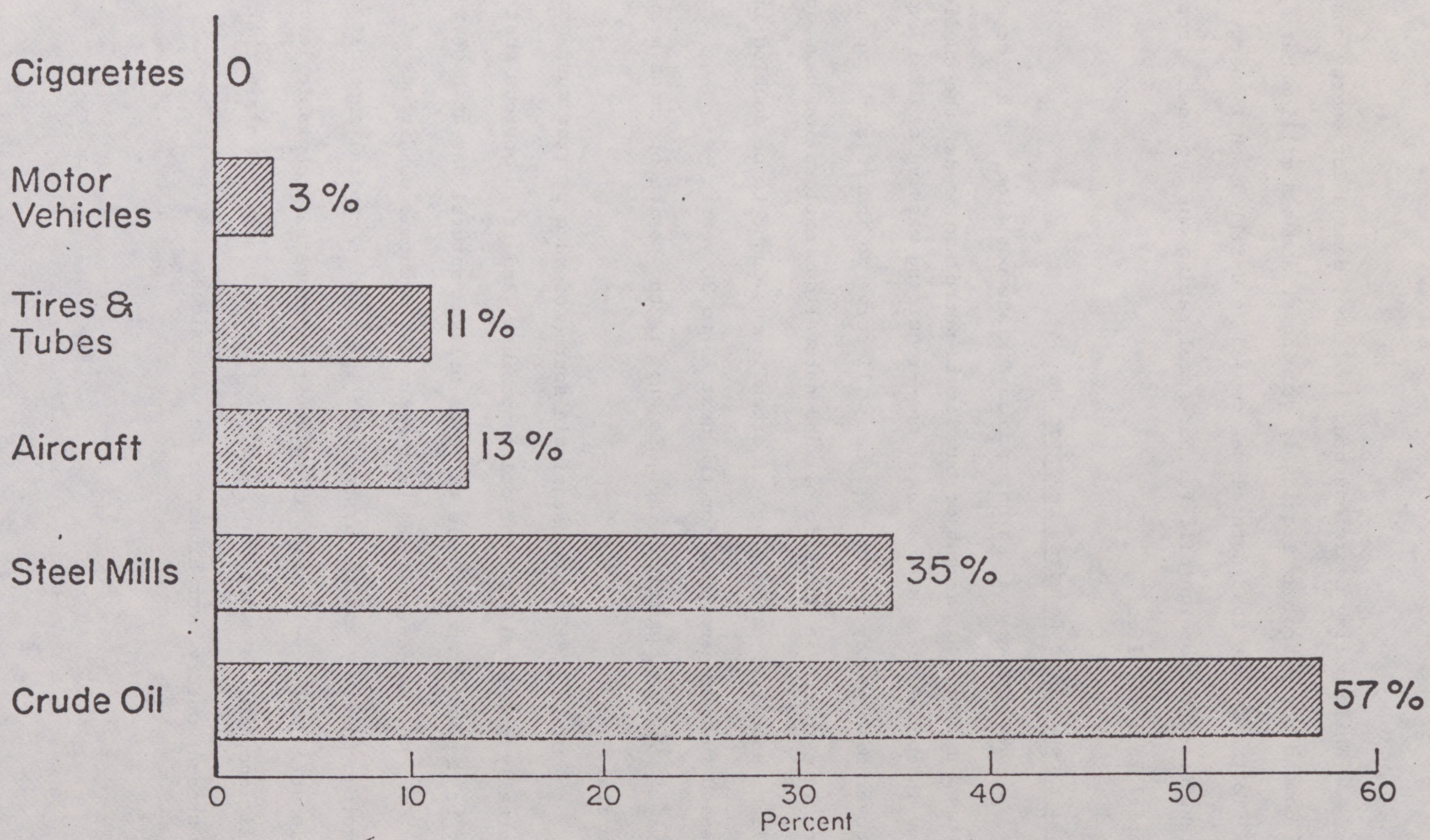
Restoring Energy Independence for the United States

I would like to comment briefly on the scope of the challenge of restoring energy independence for the United States.

In 1974 total U. S. demand for liquid petroleum fuels will approximate 18 million barrels daily. Our production of all petroleum liquids will be about 10.6 million barrels a day. Our dependence on foreign oil, therefore, exceeds 7 million barrels daily--representing a doubling of imports since just five years ago; the previous doubling in our import volume took 13 years.

It is clear from these facts that the United States has a monumental job of "catching up" in development of its energy resources. The decline in reserves and availability has stemmed from 17 years of declining exploration for these fuels. We did not get into our energy supply dilemma overnight; we cannot get out of it overnight. Our capacity to produce crude oil has dropped for six consecutive years; we can't overcome that much lag-time in only one year or two years, even under ideal conditions.

PERCENT OF U.S. PRODUCTION BY MEDIUM & SMALL COMPANIES IN 1971 (excludes 8 largest producers)



Sources: U.S. Dept. of Commerce and IPAA

While policy decisions hang in limbo, demand for energy continues unabated. Total demand for petroleum liquids is growing at about a million barrels daily per year. To the extent that natural gas demand is unfilled, that energy requirement also is transferred to foreign oil, further accelerating our dependence upon others for essential fuel supplies.

Capital Expenditures Required to Catch Up

Because we are beginning from a minus position, with a dependence on foreign supplies for about 40 percent of our liquid petroleum needs, the challenge of regaining energy independence is a monumental one--requiring massive capital expenditures and government policy incentives that will serve to induce such expenditures. Recent investments in domestic oil and natural gas exploration have approximated 5 billion annually. This level of expenditures ought to be doubled immediately and increased further each year for the next 15 to 20 years.

The key question, then, is what is the source of these massive quantities of capital?

Clearly, the largest single source of such capital must come from the internally generated funds of oil companies. And it is obvious that such funds can only be derived from the sale of crude oil and natural gas at higher prices.

So, recognizing the past depressed economic conditions of the domestic petroleum industry and the urgent need for massive capital expenditures in domestic exploration and development, if we are to achieve an acceptable level of energy self-sufficiency in the short term, it is with some dismay and alarm that producers view the present outcry over higher crude oil prices.

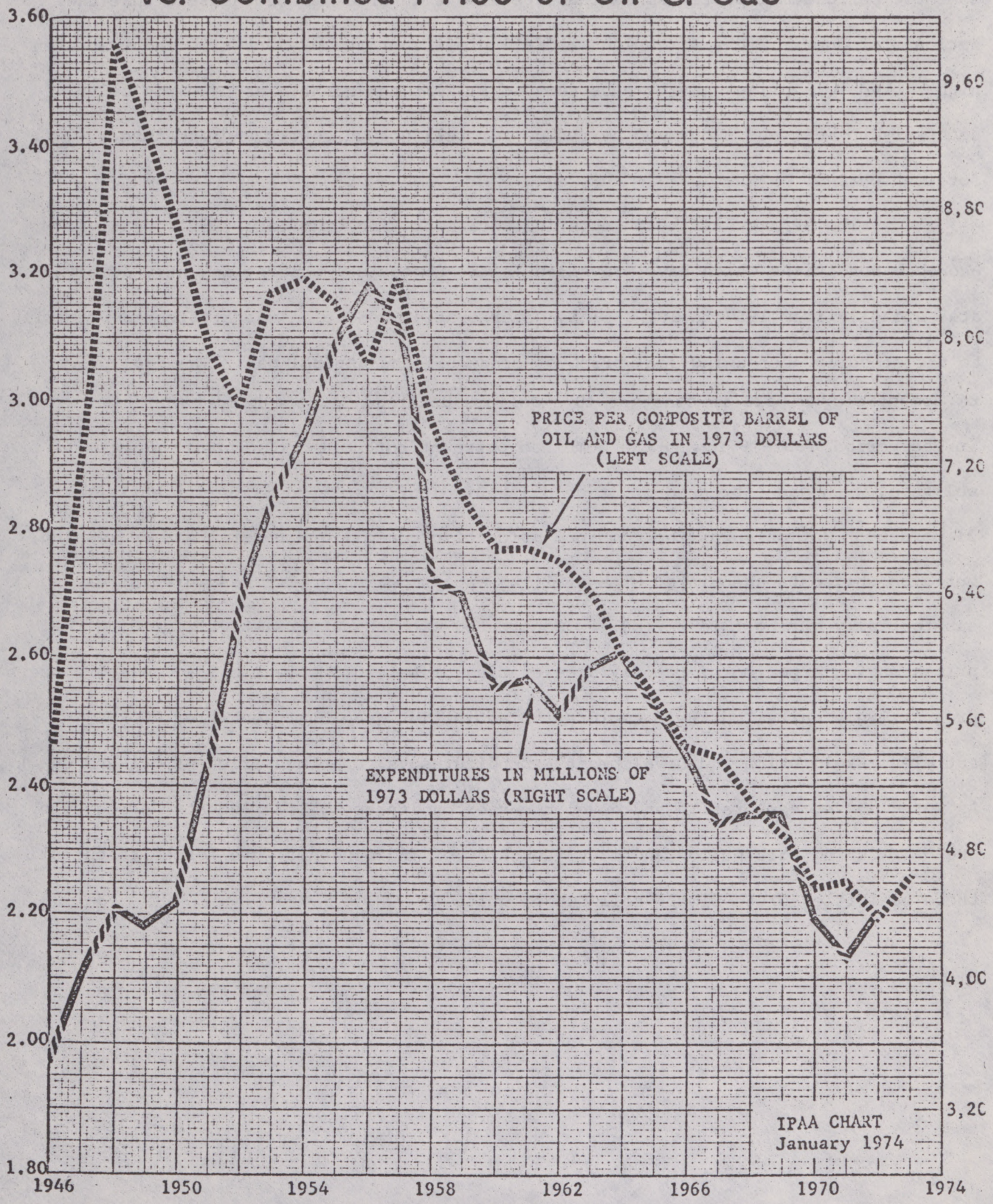
Past Economic Conditions

Now I would like to examine the economic conditions which existed in the domestic petroleum industry since the late 1950's in order to demonstrate that the nation's producers are not reaping windfall profits at the present time and that even higher crude oil prices may be necessary to illicit the quantities of crude oil necessary to meet our needs and to reduce our reliance on costly and insecure foreign sources.

The IPAA testified on numerous occasions since the late 1950's that economic conditions which have prevailed in the domestic producing industry deteriorated steadily from 1957 to 1972. This deteriorating condition was attributed primarily to the steadily decreasing real price of crude oil and natural gas. The real price of domestic crude oil in constant 1973 dollars declined $1.31 a barrel or 27 percent in the period 1952-1972; and the combined price of both oil and natural gas at the wellhead, with gas expressed in crude oil equivalent, declined $1.00 per barrel or 31 percent. Not only was the combined price of crude oil and natural gas decreasing, but also the costs associated with drilling and producing activities were increasing substantially during this period. Confronted with these persistently eroding real prices during a period of rapidly accelerating costs, independent oil and gas producers progressively curtailed their exploration activities (see chart entitled "U. S. Petroleum Exploration and Development Expenditures vs. Combined Price of Oil and Gas.) As noted above, exploration and development expenditures by independents decreased by one-half during this period and many thousands of independents were forced to curtail these activities or to simply sell out or quit.

U. S. Petroleum Exploration & Development Expenditures

vs. Combined Price of Oil & Gas



So, given the falling real price and higher costs, it is clear that the domestic producing industry was in a depressed economic state by the end of 1972 and that a substantial improvement of the price of both crude oil and natural gas was needed just to offset the effect of the steadily declining prices and higher costs and to reverse these declining exploration and development trends.

At long last, government has permitted the price of crude oil to rise. During 1973, the average price of domestic crude oil controlled by the Federal Energy Office, increased by $1.62 per barrel from $3.40 to $5.02.

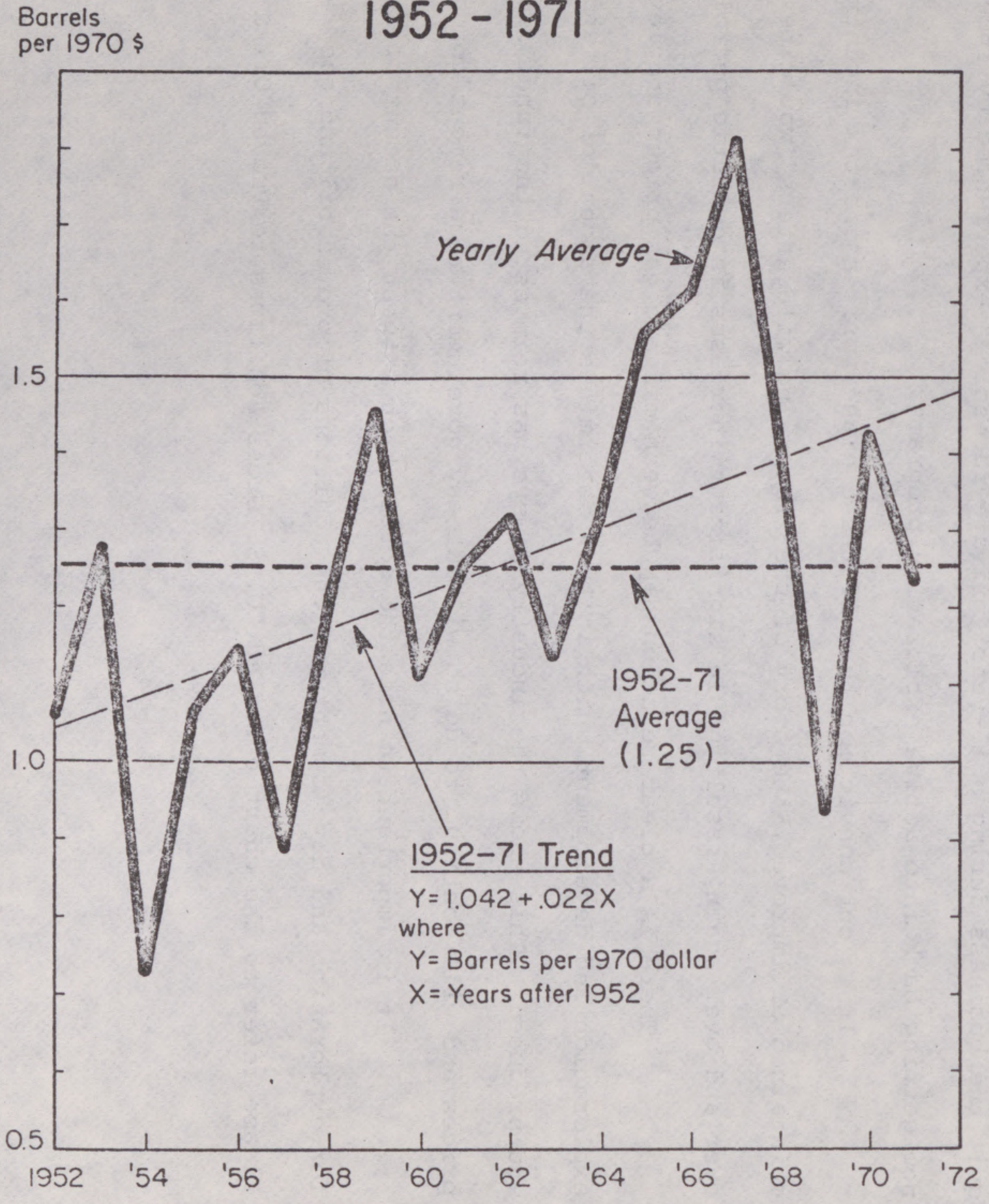
And, as expected, this increase in price has brought forth an increase in the activities related to domestic petroleum exploration. The number of active rotary rigs, for example, had risen to 1,440 in mid-December compared with 1,256 in the like period last year, an increase of 15 percent. And there have been numerous reports, in the traditional producing areas of the country, of former producers who quit the business during a 15-year "private recession" experienced by independents, now getting back into active exploration programs.

It is our conviction that if these higher prices and tax incentives can be maintained or improved, the story of the "returning wildcatters" would be repeated over and over again, resulting in significant increases in domestic petroleum supplies.

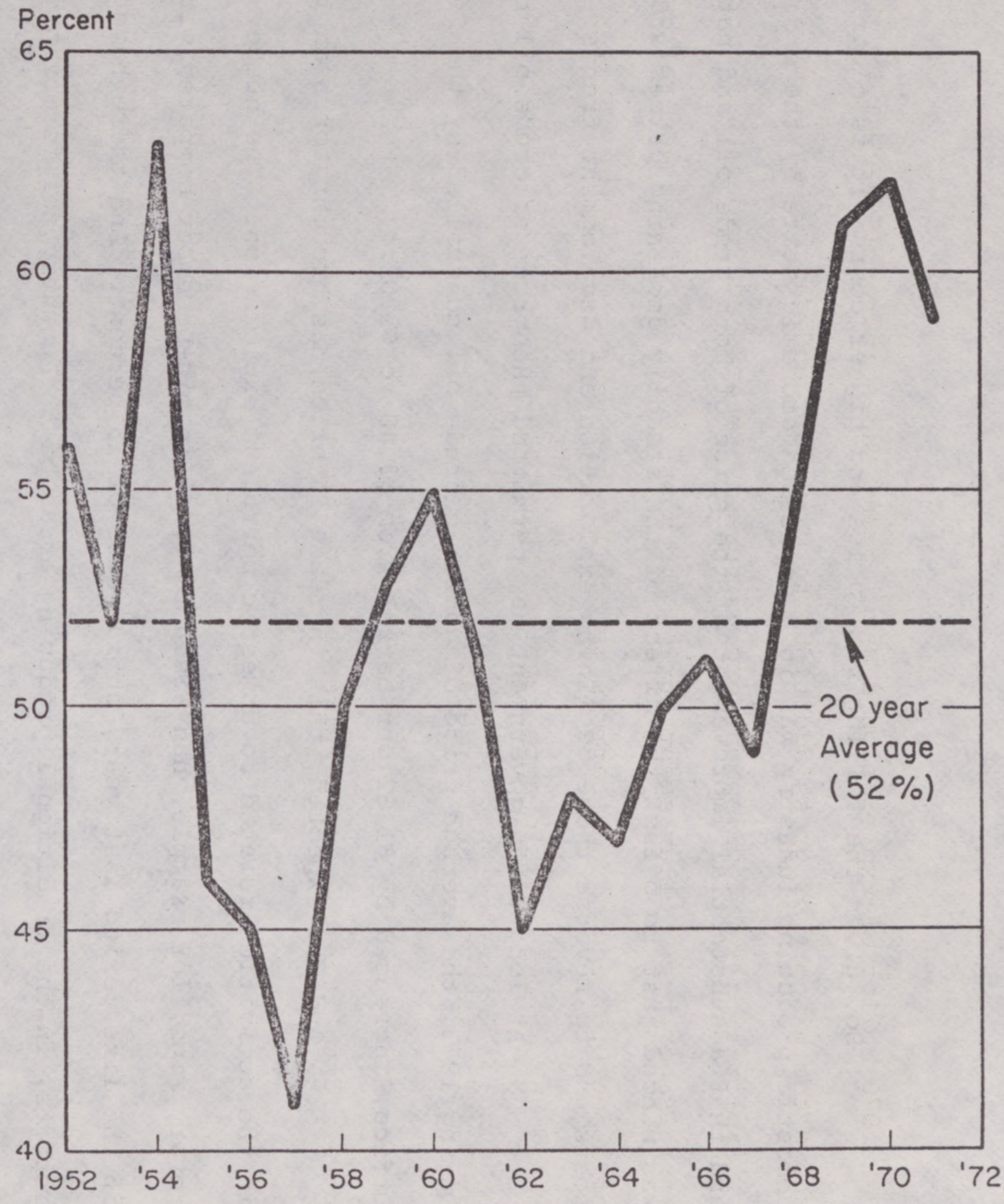
There is a clear relationship between oil and gas prices and levels of exploration and development which in turn determines the amount of oil and gas found and produced. This shows the industry always has reinvested the funds from increased prices and will continue to do so without any government requirement to do so.

It is important to note the correlation between the amount of funds spent for exploration and development and the additions of proved oil and gas reserves. Please refer to the chart entitled "U. S. Gross Additions to Proved Oil & Gas Reserves

U.S. Gross Additions to Proved Oil & Gas Reserves Per 1970 Dollar of Exploration & Development Expenditures 1952 - 1971



Percent Gross Additions of Proved Oil Reserves to Gross Additions of Proved Oil & Gas Reserves



IPAA CHART
Nov. 1972

Per 1970 Dollar of Exploration & Development Expenditures 1952-1971." This chart shows the history of gross additions to U. S. oil and gas reserves per 1970 dollar of exploration and development expenditures. Reserve additions have averaged 1.25 barrels per real dollar spent during the past 20 years, with a general upward trend of about 0.02 additional barrels per dollar per year. The other section of this chart shows that gross additions to reserves have been divided about equally between oil and gas during the past two decades.

These relationships provide a basis for calculating prices that may be required to increase our supplies of domestic crude oil and natural gas to meet future requirements.

Updating a study made by the IPAA in 1972, and using the 1973 price of natural gas (21.3 cents per Mcf), an average price of about $6.65 per barrel for crude oil (in constant 1973 dollars) for all domestic crude oil would be required over the long run to achieve 85 percent self-sufficiency in oil and gas by 1980 and $8.40 for 100 percent self-sufficiency, recognizing that today's critical shortages of domestic oil and the need for tremendous expansion of exploration and development may well require higher prices in the short run. It should also be recognized that the many variables and assumptions involved in supply/price relationships make it impossible to predict precisely what price will be required to bring forth any particular level of supply. The IPAA analysis, and the resulting price figures, are useful in shedding light on approximate required price levels, if historical relationships continue into the future, but there is no "magic number" for a necessary or proper price.

The IPAA analysis was based on a long-term historical relationship of price and supply over the 20 year period 1952-1971. Unusual conditions at any given time can and have resulted in deviations from this long-term relationship. For example,

the country was confronted with an oil shortage following World War II as a result of wartime price controls and shortages of materials. As shown on the chart, "U. S. Petroleum Exploration & Development Expenditures vs. Combined Price of Oil & Gas," substantial price increases, over and above the long-term relationship between prices and expenditures, occurred in 1947 and 1948. As a result, expenditures for exploration and development were encouraged greatly and domestic supply was increased so that shortages were overcome. Prices decreased and the long-term price/supply relationship was restored. This is comparable to the situation that exists today. Shortages are here and there is a need for extraordinary incentives to increase domestic supplies. For the short term, prices may have to exceed levels based on long-term relationships. Otherwise, shortages could become more acute. The longer range best interests of the country would be served by higher prices to bring about increasing supply which would bring prices in line with past relationships.

Today's average price for domestic crude oil is not excessive in terms of generating the funds and incentives needed to expand U. S. petroleum exploration, development and production. These activities should be doubled, or perhaps tripled, if we are to restore our energy independence.

In this connection, there has been understandable concern as to increases in prices of oil products to the consumer and speculation that we may be facing gasoline prices of 75 cents or $1.00. In this regard, it is pertinent to keep in mind that the current average price of <u>domestic</u> crude oil is only some 6 cents a gallon over the 1972 price. Obviously, since the average price of gasoline in 1972 was 36 cents, <u>domestic</u> crude oil prices have not been, and will not be, the cause for 50 cent, 75 cent, or $1.00 prices for gasoline. The increase in domestic crude oil prices, however, <u>have</u> increased U. S. exploration and development and we are convinced will result in increased supplies for consumers.

Excess or Windfall Tax Proposals

Several excess or windfall tax proposals have been offered. I would like to make some general observations about these proposals.

First, as was pointed out above, the recent increases in the price of crude oil are not considered to be excessive or windfall by the producing segment of the domestic petroleum industry. Therefore, as to this segment of the industry, no such legislation is necessary.

The IPAA opposes such legislation as being counter-productive since the enactment of such legislation would result in a loss or the threat of a loss of risk capital at the very time when exploration and development expenditures must be doubled or perhaps tripled if we are to achieve an acceptable degree of energy self-sufficiency. The consideration and enactment of new tax legislation is always accompanied by a period of uncertainty and fear which will result in a drying up of vitally needed exploration funds.

Second, it seems grossly unfair to single out the domestic petroleum industry for the imposition of windfall taxes. Certainly any such legislation should apply equally to everyone.

Third, this type of legislation should not be enacted unless and until enough time has passed to adequately assess the full impact of higher crude oil prices on domestic exploration and development activities. Although we applaud these hearings as a constructive step to an assessment, we feel that it is entirely too early to make a final determination as to the existence of windfall profits.

All experience with so-called "windfall" or "excess profits" taxes has demonstrated that this entire theory is inefficient, ineffective and counter-productive.

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In addition, there is mass confusion as to what constitutes an "excess" profit or how to tax an "excess" profit. For example, the Administration proposal actually is a tax on prices. Senator Gravel has proposed an excise tax on production. The provision adopted by the House in December is actually a seller's refunding procedure. All these approaches have been erroneously publicized as excess profits provisions.

Because of this confusion of approaches, and because our Government never before in its history has adopted an excess profits tax for a single industry, we strongly oppose windfall or excess profits legislation as unnecessary and counter-productive. We believe such legislation would serve to severely impede domestic oil and gas exploration and development at the very time that greatly expanded efforts to develop our petroleum resources should be high on the list of national priorities.

If the Congress should undertake to rationalize some new tax concept out of the presently confused and conflicting proposals, we submit that great care should be taken to assure that the legislation is in fact a tax on profits, and does not serve to reduce, restrict or discourage the tremendous increases in capital expenditures which are now required to restore energy independence for the United States.

First, there must be a clearly defined provision which allows and encourages the funds to be invested in any project which expands our energy base. This is generally referred to as a "plowback" provision. Of course, this provision should allow a credit for all costs incurred in connection with the exploration and development of new domestic petroleum supplies and the initiation of any new project, such as secondary, tertiary or other pressure maintenance program, which is designed to increase the ultimate recovery of petroleum from a producing reservoir.

The qualifications for such reinvestment of funds should be clearly spelled out and easily ascertainable by everyone.

Second, the funds which may be reinvested must remain in the possession of the producer-investor, not the federal Treasury. A producer must not be deterred from investing by the time-consuming and often fruitless exercise of having to apply for the return of previously collected funds from the IRS or other federal office. Most producers would be hard-pressed to invest in qualified projects if they had to borrow the funds using the hope of a refund as collateral.

Third, there must be an adequate period of time in which the producer-investor can reinvest in qualifying projects. There is normally a time-lag of from several months to several years required to generate the drilling prospect, acquire the leases, drill and complete the wells and install the equipment needed to produce and sell the petroleum.

A major criticisim of windfall profits tax legislation is that it tends to remove or reduce the risk capital from the domestic petroleum industry at a time when greatly increased amounts of this capital are needed to increase exploration and development activity. This is also a criticism of other tax reform proposals presently before this Committee.

The so-called Limitation on Artificial Acccounting Losses (LAL) and the changes in the minimum tax income (MTI) both could have the undesirable effect of diminishing the flow of risk capital into exploration. Even the threat of the enactment of such legislation tends to dry up these funds.

Likewise, any proposal to reduce the depletion allowance would remove needed risk capital from the industry.

The Tax Reform Act of 1969 resulted in a loss of $650 million per year to the oil industry. The attached chart entitled "U. S. Petroleum Exploration and Development Expenditures 1959-1971" dramatizes the direct and immediate impact on exploration and development expenditures occasioned by the enactment of this legislation. One can notice the precipitous drop of expenditures in 1970 and 1971 at a much greater rate than in years prior to the enactment of the legislation which reduced the depletion allowance from 27 1/2 percent to 22 percent. This reduction in expenditures could not have come at a worse time since it accelerated the present energy crisis.

Tax incentives have long been recognized as useful and needed compensation to help offset the high risk associated with the oil and gas exploration and production industry. The depletion allowance was enacted in the 1920's. It has worked to encourage the rapid development of our indigenous petroleum supplies. It would not be in the best interest of the nation to reduce further or place any restrictions on the availability of this valuable incentive.

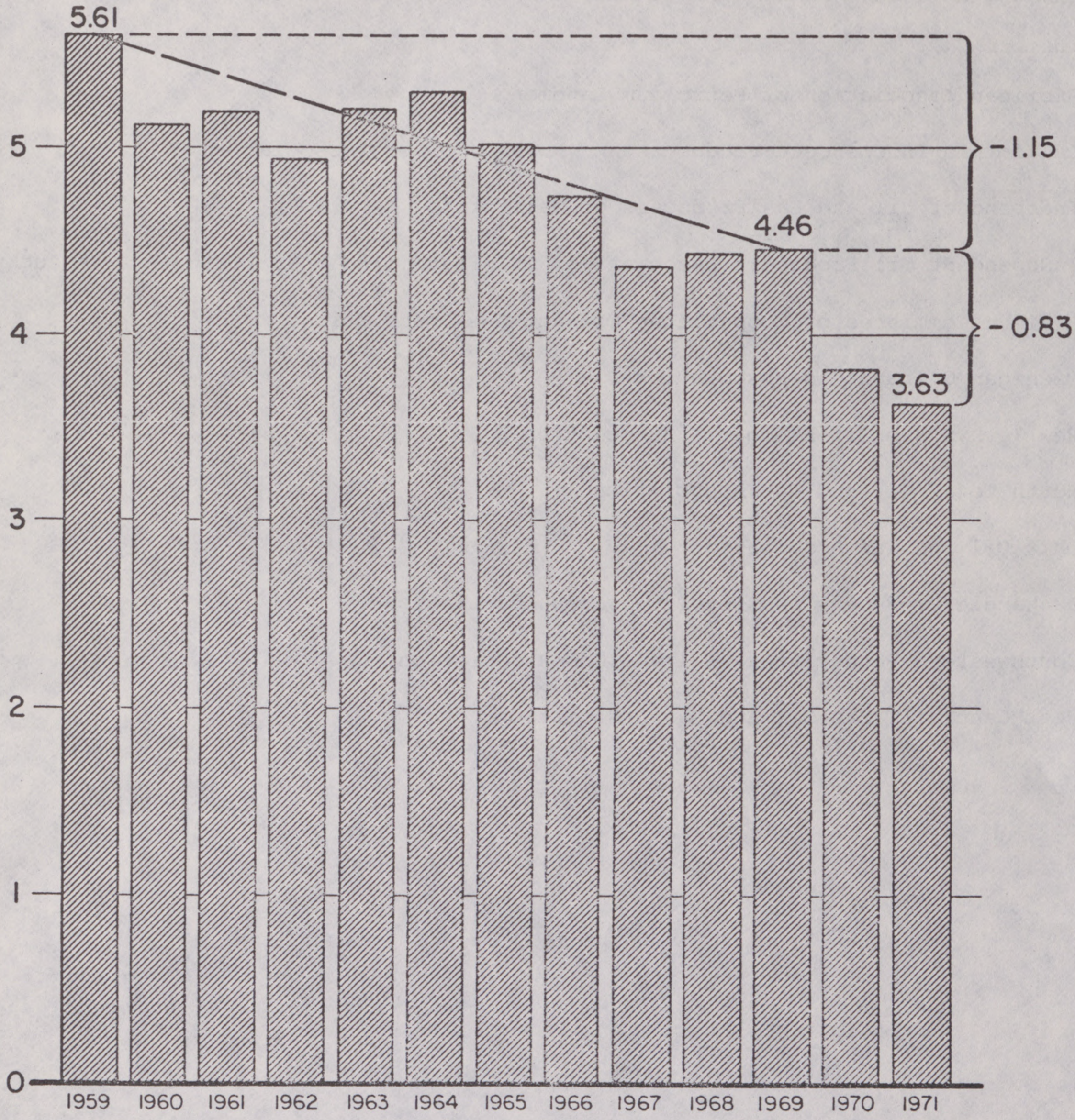
The enactment of any law which has the effect of reducing the net profits to the petroleum producer would only assume that increased domestic oil revenues will not be reinvested in domestic exploration and recovery programs.

In conclusion, actions by the government to roll-back crude oil prices, reduce the profitability of producers, or increase the tax burden on domestic production would be counter-productive to the basic and pressing need to increase U. S. supplies of oil and natural gas.

This leads to the central question at issue: With many in government calling for reversing our declining energy supply position, which need has the greatest priority, tax increases and price reductions or more energy? If the answer is more energy, then I believe Congress ought to give present tax system and market forces a reasonable time to exert themselves before acting precipitously.

U.S. PETROLEUM EXPLORATION AND DEVELOPMENT EXPENDITURES 1959-1971

(Billions of 1970 dollars)



Note: Excludes offshore and North Slope lease bonus payments as not contributing directly to development of reserves

IPAA CHART
March 1973

List of the Regional Petroleum Producing Associations
Endorsing the Statement of C. John Miller, President
Independent Petroleum Associaton of America

Before the
Ways and Means Committee
U. S. House of Representatives
Washington, D. C.
February 5, 1974

American Association of Petroleum Landmen

California Independent Producers and Royalty Owners Association

Independent Oil and Gas Producers of California

Independent Oil Producers Association, Tri-State (Indiana, Illinois & Kentucky)

Liaison Committee of Cooperating Oil and Gas Associations

Michigan Oil and Gas Association

New York State Oil Producers Association

North Texas Oil and Gas Association

Ohio Oil and Gas Association

Panhandle Producers and Royalty Owners Association

Southwestern Pennsylvania Oil and Gas Association

West Central Texas Oil and Gas Association

Statement of A. V. Jones, Jr., President
National Stripper Well Association

Before the House Ways and Means Committee
February 5, 1974

My name is A. V. Jones, Jr. I am a partner in A. V. Jones & Sons of Albany, Texas, an independent oil and natural gas exploration and producing firm. I appear here as president of the National Stripper Well Association, which is an organization concerned with extending the productivity and usefulness of marginal domestic oil wells that represent approximately one sixth of our producible petroleum reserves in the lower 48 states.

In addition, I am here to support the position of the Independent Petroleum Association of America and to augment its statement by discussing the importance and economic potential of stripper well production in the United States and how both are affected by government policies on the related subjects of petroleum prices and taxes.

In an address on January 21 to the National Association of Home Builders, the Director of the Energy Policy Office, Mr. William Simon, stated succinctly the primary reason that the United States is now confronted with critical domestic energy shortages: "We have consumed an ever-increasing amount of oil and gas at prices well below their replacement cost, and today we confront a long overdue bill for past self-indulgence."

The production and use of billions of barrels of oil and trillions of cubic feet of natural gas at prices below replacement costs has been a fact of life in the domestic petroleum producing industry since the mid-1950s. This has occurred because the overriding government policy has been to hold oil and natural gas prices very low. This was done directly through rigid wellhead price regimentation in the case of natural gas. It was done indirectly through administrative coercion under the price surveillance provisions of the oil import quota system and directly under economic stabilization programs since August 1971, in the case of crude oil.

While our political policy objective of holding prices very low has been only too successfully effectuated since the mid-1950s. the costs of finding and producing oil and natural gas accelerated constantly. The resulting cost-price squeeze forced thousands of independent producers from the field, resulted in premature abandonment of thousands of producing wells, caused a persistent decline in petroleum exploration for more than a decade and a half, and thrust the United States--for the first time--into a position of almost helpless dependency on others for essential energy supplies.

I believe the government economic and regulatory policies of trying to guarantee fixed, low prices for oil and natural gas, irrespective of costs, were the primary factors in bringing the nation face-to-face with a potentially disastrous energy supply problem. If I am right that we got into our energy mess as a result of shortsighted price controls, a view shared by many recognized economists, then the way out certainly is not a continuance and extension of such controls with the imposition of new, punitive taxing mechanisms.

I believe we are on the right track and on the way toward reactivating domestic independent producers in vigorous new exploration programs and in essential efforts to substantially improve oil recovery from existing reservoirs by re-opening and reworking thousands of marginal producing properties. I believe that Congress would be remiss in acting precipitously to impose new price controls or new taxes without giving present policies at least a chance to work.

We hear much talk about "excess profits," but certainly such talk is premature at best, because it represents a political prejudgment of what will happen to the industry revenues from recent long overdue improvements in domestic crude oil prices. In periods when domestic crude oil prices were permitted to move in consonance with prices

in the economy generally, the domestic industry consistently reinvested two of every three dollars of its gross income from crude oil sales. I believe that, given the chance, it will recycle current revenues at or above this ratio and that it will do so without any government persuasion or coercion to do so, through punitive taxes or other means. I believe this will happen, because it has always happened when prices were adequate and prospective profitability was such as to attract reinvestment and outside venture capital into petroleum exploration.

The decision was made by those in charge of economic stabilization to permit controlled domestic crude oil prices to move up, only nominally in mid-1973 and by one dollar a barrel on December 19, 1973--less than two months ago. That price now averages about $5.02 a barrel. In addition, the Federal Energy Office permits newly found or increased production to be sold at a free market price. In addition to "new" oil represented by increased production on existing leases, a matching barrel-for-barrel volume of "old" oil is released to be sold at a free market price. In the Alaska pipeline and allocation bills adopted in the last session, Congress also exempted production from stripper wells from present price controls.

All exempt oil--new and released crude plus stripper production--now selling at free market prices approximates one-fourth of U. S. crude oil production or about 2.2 million barrels daily. About one-half of this volume is accounted for by production from stripper wells averaging 10 barrels daily or less. As of January 1, 1973, the United States had 359,471 stripper wells producing an average of 3.13 barrels daily per well.

Evidence of the increasingly adverse economic circumstances that have confronted operators of these marginal wells is evident in the accelerated rate of

abandonments of these wells over the past 20 years. This trend is shown clearly in the following comparisons of average well abandonment for five-year periods since 1952.

Stripper Well Abandonments
(Five-Year Averages, 1952-71)

Years	Average Wells per Year
1952-56	11,507
1957-61	12,460
1962-66	15,145
1967-71	17,030

Producing oil wells are abandoned for one reason: because the cost of operation surpasses the revenue. The accelerated rate of well abandonments in the period since 1956 is attributable to two irrefutable facts, (1) the real price of domestic crude oil in constant dollars eroded progressively in this period; and (2) operators of marginal producing properties had to contend with, and try to absorb, constantly accelerating operating costs throughout the period.

The importance of stripper wells to the total oil supply rests in their number, not in the average producing rate of these wells. When 10 gallons of gasoline are sold, more than a gallon of that product originated from a stripper well. The crude oil reserves underlying U. S. stripper wells total about 4.88 billion barrels or about a sixth of total proved domestic reserves, excluding the Alaskan North Slope. Premature and permanent abandonment of these wells for economic reasons, therefore, would mean a loss to the nation of significant crude oil reserves.

Just as a deteriorating cost-price condition can and does cause premature abandonments, improved economic conditions can significantly extend the life of marginal

producing properties and encourage workovers as well as secondary efforts to improve output and--in many cases--double or triple ultimate recovery.

Under free market pricing on one-fourth of U. S. production exempt from price controls by the FEO and by Congress, some, but by no means all, of the exempt oil is selling for as much as $10 a barrel. Compared with the depressed prices that have been paid for domestic crude oil since the mid-1950s. this is a very large increase. Before actions are taken impulsively to "rollback" this price or apply so-called "windfall" profits taxes to domestic production; however, the current price behavior should be evaluated in light of a number of considerations, including:

1. The controlled price of domestic crude oil still applies to the great bulk of production and average about $5.02 a barrel, less than a third of the price of much imported oil.

2. The free market price applies only to marginal production and "new" production plus an equal volume of old oil, and serves the essential purposes of (a) stimulating development and production of an increased crude oil supply, and (b) extending substantially the recovery from, and production of, thousands of marginal wells.

3. Under the so-called "two tier" pricing system and the stripper well exemption provided by Congress, the price behavior of exempt oil provides a useful guage on free market responses at a relatively low overall cost and in a way that will maximize new exploration and recovery efforts.

The free market price has operated only a relatively short time, but the domestic industry already is responding with increased exploration, development and oil recovery programs, which I believe will provide long-term energy supply benefits that will far outweigh the costs of permitting the free market to operate on new and marginal crude oil production. I know the results will far outweigh the costs of domestic crude oil in terms of the average price of about $6.50 per barrel--because that price is far below alternative supplies that can be obtained anywhere by any means.

Now I would like to speak specifically of the impact of free market pricing on the economics of the more than 350,000 marginal wells. I believe this impact, overall, will be to increase recovery from stripper fields in the United States by hundreds of millions of barrels and that such a result will be to the long-term benefit of American consumers.

As of today, tens of thousands of wells in the United States are idle, having been shutdown because their operating costs exceeded the revenues. Many of these wells could have been reworked with the result of substantially increasing their output, but again this was not done because the cost outweighed the economic benefits. So this very large number of wells was shutdown during the period of the 1960s and early '70s when domestic crude oil prices were depressed at unrealistically low levels.

Because of the exemption from price controls adopted by the Congress, there is today a resurgence of activity in the oil producing areas of the United States to reactivate and rework these thousands of abandoned wells. Unless Congress or the Administration now takes actions which effectively would reverse these efforts, I believe the next two to three years will see the reactivation of thousands of these

wells with the result of increasing U. S. production from these abandoned properties by as much as 250,000 barrels daily or more.

If this proves to be correct, I believe the benefits will far outweigh any gain that consumers could expect from a price rollback or from actions to tax "excess profits" with no workable definition of what constitutes such a profit. Because the free market climate has been in force on the exempt portion of crude oil production for such a short time, it would be reasonable to rollback prices or impose new taxes only under an assumption that increased revenues will not be reinvested in exploration and recovery programs. Such an assumption, at this early date, is not a valid one, and the increased tempo of exploration now underway by independent producers leads me to believe it is a false one.

This leads me to the central question at issue: In view of the nation's deteriorating energy supply position, with many in government calling for a reversal of that trend, which need has the greatest priority, more tax dollars or more energy? If the answer is more energy, than I believe Congress ought to give present market forces some time to prove themselves before moving to impose ill-defined taxes on "windfall profits" or repealing the stripper well exemption from price controls as advocated by some.

Statement of Sheldon K. Beren, Executive Committee Member
Kansas Independent Oil & Gas Association

Before the

Ways and Means Committee, U.S. House of Representatives
February 5, 1974 Washington, D.C.

Mr. Chairman and Members of the Committee:

My name is Sheldon K. Beren. I am an independent oil producer and a manager for Okmar Oil Company, an independent producing company which has operated in Kansas for approximately 25 years. I am here representing the Kansas Independent Oil and Gas Association, a 1400 member association of independent oil and gas producers and related interested persons. We small independent producers drill 85 percent of the oil and gas wells in our state.

We support the position of the Independent Petroleum Association of America and wish to add our voice at this very important juncture in the economic life of the independent producing and exploration companies—whose health and zest can play the major role in reversing the decline and restoring growth to the United States oil and gas industry.

In January 1974, in Kansas, our notices of intention to drill are up substantially over January 1973 and we note that in Oklahoma, our neighboring state with similar conditions, the notices to drill in the first 24 days of January total 357, which is close to a 40 percent increase over the 263 notices to drill in the same period of last year. This illustrates by facts the observation of Secretary

of the Treasury George Shultz before this Committee yesterday: "Historically the amount of the increase in supplies of oil has been at least 1 percent for every 1 percent increase in the price of oil." Secretary Shultz illustrated this relationship by the uncanny resemblance of the graphs of production and price of crude oil in the United States from 1936 until 1973.

However, it is of great significance that we do not see at any time a three-year lag or even a two-year lag on this graph between the time of the price increase and the production increase. It is our considered judgement that if the present stimulus is allowed to continue as it is now constituted that we will again see the resourcefulness and ingenuity of the independent wildcatters at work on this same 1 to 1 ratio without the time lag predicted by those who underrate the pent-up vitality of our independent explorers.

From industry sources, from Mr. Simon and from Secretary Shultz we hear and read that the long term supply price is "about $7.00 per barrel." At our present "old oil" price of $5.25 per barrel for 75 percent of our crude production and our average new oil price of $9.50 per barrel for 25 percent of our production that is new, released or stripper, we have an average price of our crude oil of $6.31 per barrel, well below the $7.00 figure.

If the government enacts legislation that will reduce the incentive for finding new oil and reduce the incentive to keep and improve our small existing wells, the drilling and exploration will reflect this reduction in an equally direct 1 to 1 ratio.

Any reduction in incentive will not benefit the American consumer. Again I quote Secretary Shultz: "A $1.00 reduction in the price paid for "new oil" would translate initially into less than a 1/2¢ per gallon decrease in the price of gasoline and the market would quickly offset that initial decrease." But more important, it is vital that the consuming public not be misled by a short-term possibility of saving 1¢ a gallon on gasoline at the cost of remaining under the blackmail of foreign governments and foreign pricing policies.

If the Energy Bill that is now in the process of being drafted should incorporate ceiling prices for new, released and stripper crude and if that Energy Bill should pass the Senate and the House and become law, then the independent producer, who has no other access to income (as contrasted to the major integrated companies), must have further assistance in order to continue to play his major role in exploration. We, therefore, propose two changes in the tax structure for the independent producer.

1) For all owners of a maximum of 7500 net barrels of domestic crude oil/day, increase the allowance for depletion for working interests in oil and gas production from 22 percent to 30 percent with the limitation on net income increased to 75 percent of taxable income.

2) Include a 14 percent investment credit for exploration and development drilling in new fields for all owners of a maximum of 7500 net barrels/day.

The domestic independent producer has only one source of income, the price at the wellhead. He has no access to foreign tax credits, currency manipulation profits, a multitude of products in which to capture a profit regardless of the crude oil price. Most of us, the independents of Kansas, are true entrepreneurs, subject to the income tax brackets of up to 70 percent if we don't reinvest our money in further drilling. It is no coincidence that each of the major oil companies which reports its large 1973 earnings distinguishes its domestic earnings as ranging from about 6 percent to a 15 percent increase as contrasted to its foreign earnings of very high percentage.

It has been tough for us to hang on all these years. We have been drilling 85 percent of the wells utilizing borrowed money,

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outside investor money, oil fund money because we had no choice. It is a miracle that domestic drilling did not drop down to a further degree. For the first time we see daylight, a chance to drill with our own capital. For the sake of the posture of this great country, let us not squander away this opportunity with punitive legislation.

STATEMENT

Submitted By

The Liaison Committee of
Cooperating Oil and Gas Associations

Mr. Chairman and Members of the Committee:

My name is D. F. McKeithan, Jr., and as Chairman of the Liaison Committee of Cooperating Oil and Gas Associations, I am authorized to appear here on behalf of sixteen oil and gas organizations located throughout the country and representing some 7,000 independent petroleum producers and royalty owners. With me is George Mitchell, president of the Texas Independent Producers and Royalty Owners Association, Liaison's largest association with 3,000 members, who will submit oral comment on behalf of his own association.

Liaison endorses the testimony submitted by the Independent Petroleum Association of America and wishes to add to this record written and oral comment reflecting attitudes in the grass roots regional and state associations belonging to the Liaison Committee.

We welcome the increasing awareness of the role of the domestic independent producer of petroleum in his industry evidenced in Congress, among government officials, and in public media throughout the nation. There is more realization that the independent is the country's specialist in oil exploration, drilling more than two-thirds of the high-risk and high-cost wells in search for new reserves. More are aware that he also concentrates on secondary recovery operations, seeking to increase the 30 percent recovery rate of discovered oil. It is more widely known that he has historically managed high-cost marginal or stripper well

operations that have preserved over 12 percent of the nation's oil producibility and reserves and will preserve much more under improved economic conditions.

This awareness is fundamentally important now that Congress and the Administration are on the verge of mapping out long-range policy on tax incentives, petroleum pricing and supply regulation to deal with the serious energy requirements of the nation. It is imperative that the independent producer and his role be preserved, for without him there is little hope of success in resolving the long-range energy problems now before us.

One very important aspect of the independent's operation, however, may not yet be thoroughly understood. It is absolutely necessary for him to have the crude and natural gas price improvement initiated in recent months, along with fair treatment under allocation regulation, to be able to rejuvenate the nation's drilling and petroleum productive capacity. It is equally necessary for him to have appropriate tax incentives to operate adequately.

Drilling operations are a high-risk business. They have declined more than 50 percent during the last 15 years because of inadequate economic incentive. Yet, the energy needs facing this nation require not only reversal of this decline but substantial increase in drilling rates from now on. This will be evident in our later discussion of projected needs for the next 40 years.

In order to fulfill this assignment, the average independent must not only have higher prices to maintain a financially sound operating posture. He must also have incentives for outside investment with which to finance the risky business of drilling. Investors will not provide the high percentage of funds required if Congressional action, dealing with the problems of possible profiteering during the energy crunch, eliminates justifiable drilling incentives in the process.

Liaison for many months has become dedicated to the "plowback principle" which calls for governmental tax policy that directly encourages greater exploration and development of domestic petroleum reserves. This principle encompasses current incentives -- domestic percentage depletion, intangible drilling expensing and other relatively minor tax incentives -- as an absolutely necessary cornerstone on which to build the base for adequate high-risk investment. Without them, domestic drilling would drop by one-half again in a very short period of time.

However, we firmly believe that tax policy encouraging plowback should rely on the historical tendency of independents to reinvest in oil and gas projects, when adequate incentives exist, without being forced to do so. Undue, rigid governmental requirements in this area only serve to discourage needed outside investment.

We agree with IPAA that other provisions encouraging plowback should be added. These include investment tax credits to ease the cost of exploratory wells, elimination of the 50 percent net income limitation on domestic depletion to help expand vital stripper well operations, and an increase in percentage depletion to those domestic producers who expend funds for drilling operations.

We believe justification for this tax treatment of the domestic petroleum producing industry can best be related to all Americans by encouraging more thorough and open analysis of the future energy problem facing this country. We believe the greatest value of a true U.S. energy policy, not yet drafted, would be the assessment of what lies ahead and what must be done through competitive industrial action in the development of domestic energy to meet the problem. Then, and only then, will it become clear to all what independent petroleum producers,

along with all the other industry components in the liquid energy field, must be left free to accomplish.

It is true, of course, that the National Petroleum Council and other study groups have made valuable energy projections for varying periods of the future. But these contributions have not yet been absorbed in an overall projection that attempts to anticipate all the possible variables covering the probable remaining years of the fossil fuel era that must eventually tie-in to a new energy era for the nation and the world.

Such policy should serve as a guide, with provision for periodic up-date. It would set the stage for the domestic energy industry to perform in a free, competitive atmosphere its task of developing adequate supply. At the same time, government could justifiably avoid short-term negative action that would clearly impede long-term energy goals. The need for this becomes ever more clear in terms of the political turmoil of 1973-74 that has accompanied the public realization of an energy crisis.

We believe the components of such planning must include projection of energy demand, taking into consideration sound conservation measures and improved energy use efficiency in relation to the Gross National Product. It should anticipate when new energy components of the energy era to follow the fossil fuel era may begin to assume some of the total energy burden. For the interim period between now and when such new energy phase-in takes place, the nation and its energy industry should project what level of insecure foreign petroleum imports can best be expected, both in terms of availability and of economic feasibility. Overall projection should also encompass the need for research, both to maximize fossil fuel potential while it is needed and to make technologically possible the forms of the

new energy era later on; this need alone will obviously run into billions of dollars during the several decades ahead.

Finally, and most important to the people we represent, such projection should include educated, long-range estimates of what is needed in the way of domestic fossil fuel energy expansion during the remaining years of that fuel era. What are the minimum amounts of productive capacity of domestic petroleum and other fossil fuel sources we must have to "bridge-the-gap" between now and the new energy era? After demand is determined, workable import levels are projected, current productive capacity is extended, what remains to be covered by domestic fossil fuel expansion?

We do not pretend to have the answers to such long-range, technical, vital policy and do not presume to present testimony in such terms. We do believe it appropriate, however, to emphasize the need for such policy so that it can quickly alert the nation to the over-all problem in hand. Then, hopefully, it will become politically sound to gear our energy industries to the task ahead rather than piecemeal destroy them with short-term restrictions and taxation policies that bear no relation to the job that must be done. Should such shortsighted treatment be allowed to continue, the United States has only two options ahead: one, drastically reduce energy demand below justifiable basic needs, and/or two, take our economic and life-style chances with excessive and insecure foreign supply.

To illustrate our point calling for long-range energy projections, we have attached to our testimony a chart, together with a list of assumptions, that attempts to show the magnitude of our nation's future energy problem. It is, of course, potentially controversial, for it includes estimates of all the components we have cited as basic to such projection, all of which are subject to severe interpretation by any individual or group interested in or concerned with the energy situation.

The chart is restricted to that portion of over-all energy demand in the United States that may have to be met by petroleum liquids or direct fossil fuel substitutes. Other segments of demand served by natural gas, conventional coal supply, etc., are not included.

For purposes of illustration again, the chart assumes the fossil fuel era will be with us primarily for the next 40 years. Should the new energy era, involving solar, nuclear fusion and other sources of relatively unlimited power begin to phase in at an earlier date, then demand rates could possibly increase, reliance on foreign petroleum could possibly be reduced, or expansion of domestic fossil fuel supply could possibly be lessened.

Demand is projected during the period at an annual increase rate of three percent. This rate is half the rate experienced during the past 40 years and attempts to reflect use reduction through conservation and efficiency measures, while realizing the need to serve large increases in population.

Obviously, more technical assessment of the demand component resulting in increase or reduction of the rate of increase will have substantial effect on need for supply. This is evident in the fact that a three percent increase annually during the next 40 years would increase demand from 17.3 million barrels daily in 1973-74 to some 53.6 million barrels daily by 2013!

Should this demand estimate be anywhere near accurate, the magnitude of the supply requirement will be substantial even if the new "unlimited fuel" era is ushered in before the end of the 40-year period. Looking at the potential components making up liquid petroleum supply, we find that oil imports could remain a very important contributor throughout the period. The chart assumes, for illustration, that following the current embargo by Arabian countries, if imports were

restored to 1973 levels this year and allowed to increase each year by a nominal three percent, by 2013 the daily total would be 19.4 million barrels.

National energy policy, once it is developed, may well dictate that such reliance on foreign oil is far too excessive. There would be three ways to reduce the reliance: (1), reduce demand through more stringent regulation of energy use; (2), escalate increase in domestic fossil fuel expansion through massive investment; or (3), usher in the new energy era more quickly through more sacrificial support of research and development required.

Turning to the other two components contributing to supply -- domestic petroleum core supply now being produced and "bridge-the-gap" domestic fossil fuel development -- it is apparent that the magnitude of the overall supply problem calls for nurturing growth and development of these fuel sources regardless of what may be done to reduce reliance on foreign oil. In other words, domestic fuel supply, not foreign oil, should be encouraged where possible throughout the remainder of the fossil fuel energy era. This, we feel, should be the long-range policy, even though the short-range energy conditions dictate maximizing foreign oil flow until domestic fuel supply can be expanded.

Domestic core petroleum supply, including refinery realization, currently amounts to approximately 11.4 million barrels daily. Considerable exploration, development and expensive secondary recovery operations will be needed during the decades ahead to maintain this core supply level. Such effort will be necessary to overcome current production decline and the demise of older domestic oil fields during the 40-year period.

Finally, new "bridge-the-gap" supply as portrayed in the chart would, under the assumptions made, have to provide some 22.8 million barrels daily by

2013. Any technologically feasible fuel sources called upon to fill this need will require prices much higher than experienced by the consumer in years past as well as adequate tax incentives for development purposes. This is true for maintaining the domestic core petroleum supply as well.

A breakdown of contributing "bridge-the-gap" sources and their potential contribution during the next 40 years necessarily carries with it considerable conjecture that is open to debate. Of course, such projections would have to be periodically adjusted and realigned to fit new information, development of technology, ecological requirements and many other factors that will constantly affect the energy supply-demand situation. But without such projection before the nation, short-range problems such as exist in 1974 may continually cause us to lose sight of what must be done to resolve the energy problem.

Again for the purposes of illustration, the chart assumes supply contribution of many "bridge-the-gap" domestic fuel sources by the end of the 40-year period as follows: expansion of core supply through exploration and improved secondary recovery techniques, 1.8 million barrels daily; Alaskan north slope crude 2.0 million barrels daily; shale oil, 3.0 million barrels daily; coal liquefaction, 3.0 million barrels daily equivalent; conventional coal supply expansion (beyond that needed to serve coal's own share of the overall energy market), 5.0 million barrels daily equivalent; tar sand production, 1.0 million barrels daily; heavy viscous crude production, 1.0 million barrels daily; geothermal steam, 1.0 million barrels daily equivalent; and nuclear power (fission, fast breeder reactor), 5.0 million barrels daily equivalent. Naturally, some of these sources may be expanded more than indicated, others less, some perhaps not at all, and still others not listed may be developed. In any event, such forms of energy development will require billions of dollars of investment by private industry.

The purpose of our presenting this tentative look at the future is to emphasize that governmental action and reaction to the political needs of 1974 must, we believe, be tempered so as to avoid disturbance of long-range energy requirements. If, for example, punitive tax legislation were initiated to wipe out the badly needed price improvement for crude oil and natural gas experienced in recent months, there would be serious delay in industry efforts to cope with what lies ahead. By the time industry could show that it would be financially incapable of expanding supply and thereby encourage reversal of measures now adopted in haste, it would be too late to keep up with future demand needs, even on a seriously restricted basis.

Additionally, if governmental action eliminated badly needed tax incentives that now exist and failed to consider additional incentives for expansion of domestic fuel development, the outside capital investment needed to augment internally derived income within the domestic fuel industries would not be forthcoming. The necessary well drilling, pipelines, refineries, coal-shale-nuclear plants, and so on, would not be developed on the schedule needed to fulfill long-range energy requirements.

CONCLUSION

For these reasons, the Liaison Committee urges that the Committee on Ways and Means assume leadership responsibility on behalf of Congress and the nation in securing the following objectives:

1. Limitation of tax changes in 1974 to those that will encourage the development of domestic petroleum energy.

2. Development of a long-range national energy policy as soon as possible, that allows the domestic energy industry to perform the job required to meet future needs.

3. Initiation of programming needed in way of authorized price and tax incentives that will bridge-the-gap between future supply and demand with adequate domestic fossil fuel energy.

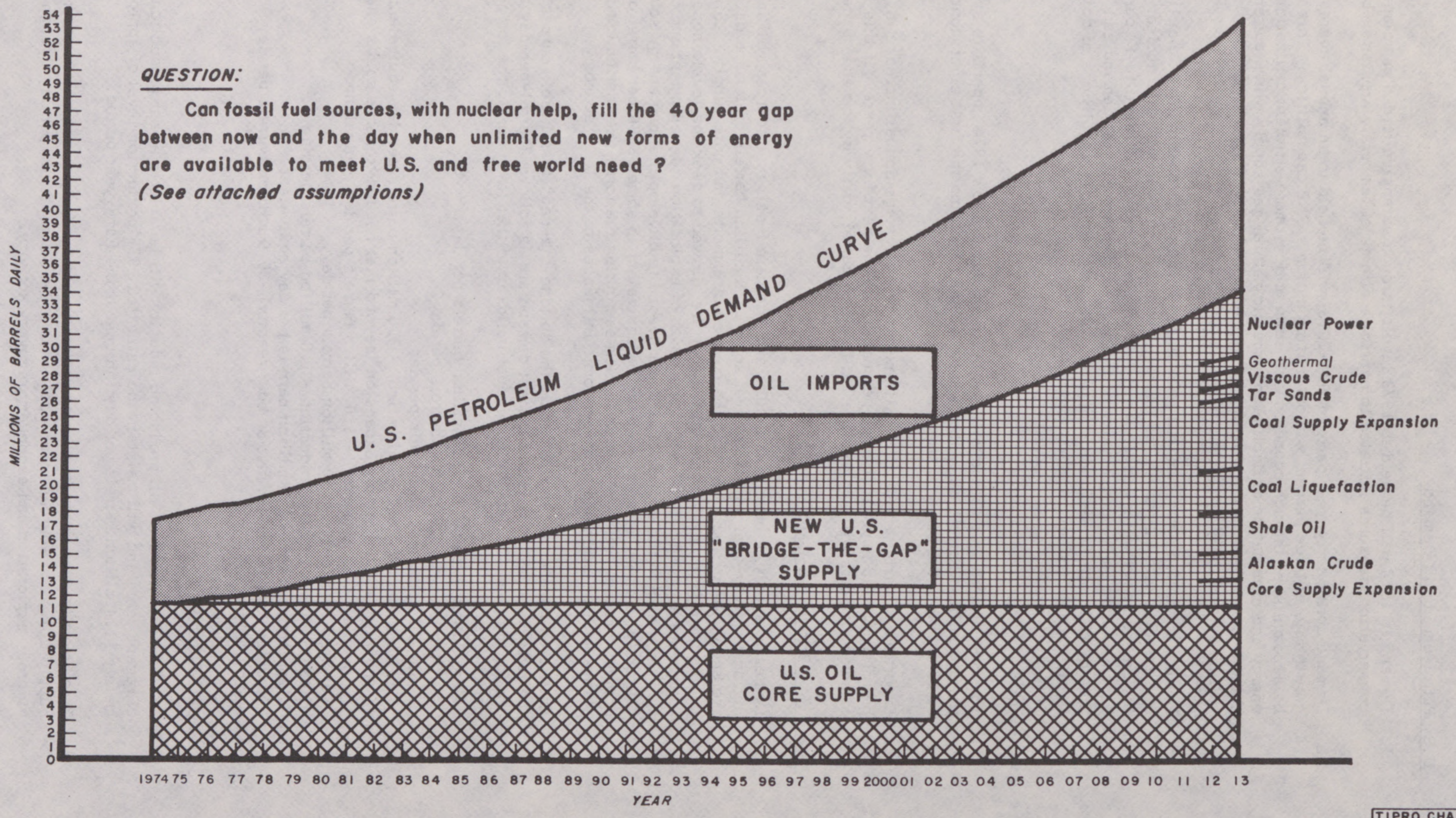
4. Determination of and provision for the research dollars required to complete the fossil fuel energy era and to initiate the new "unlimited energy" era.

We appreciate this opportunity to be heard on such a vital matter of importance to the nation and its energy industry.

U.S. PETROLEUM LIQUID SUPPLY-DEMAND: 1974-2013

QUESTION:

Can fossil fuel sources, with nuclear help, fill the 40 year gap between now and the day when unlimited new forms of energy are available to meet U.S. and free world need ?
(See attached assumptions)



TIPRO CHART

ASSUMPTIONS FOR ACCOMPANYING CHART

U.S. Petroleum Liquid Demand

1. Demand in 1974 will be held to 1973 levels through extensive forced or voluntary conservation measures initiated to overcome effects of temporary Arabian embargo.

2. Demand during forty-year period (1974-2013) will be held to an annual average growth rate of three percent without hurting nation's GNP capabilities. This will be accomplished through sound conservation policy, more efficient utilization of energy and elimination of decline in domestic natural gas supply which currently adds to liquid demand. If this should happen, demand will total some 53.6 million barrels daily by the end of the forty-year period.

3. Demand for liquid petroleum will peak in forty years with phasing in at that time of alternate, virtually unlimited energy sources, such as solar heat, nuclear fusion and heavy water conversion. This will be possible, if fossil fuel sources become sufficiently adequate during the next forty years to meet demand and thereby maintain the nation's economic capability to afford the billions of dollars in research necessary to reach exotic fuel stage.

Oil Imports

1. The current Arabian embargo will end soon enough to allow 1974 imports to average the 6.2 million barrels daily that were experienced during the first eight months of 1973 before the embargo was initiated.

2. Exporting countries to the U.S. will authorize an average annual increase in petroleum liquid imports of three percent during the next forty years. If this is allowed, imports will approximate 19.4 million barrels daily by the end of the period.

New U.S. "Bridge-the-Gap" Supply

1. Domestic supply of petroleum liquids and alternate fossil fuel sources will increase during the forty-year period to cover some 22.8 million barrels of demand daily by the end of the period that cannot be covered by imports and core supply. This can be done if prices for domestic energy are allowed to seek the levels necessary to provide economic incentive, cover costs of exploration, development and operation, and secure the capital investment needed to develop the new energy sources. Currently, this price is estimated to be equivalent to some $8.00 per barrel of domestic crude, which will have to increase during the forty-year period commmensurate with inflation and other economic influences of the U.S. economy.

2. Estimates for energy contribution by the "bridge-the-gap" fossil fuel sources during the forty-year period required to meet demand are as follows (barrel-per-day figures are for the year 2013, implying gradual build-up to that level during the forty-year period):
   Core Supply Expansion - 1.8 million barrels per day.
   Alaskan Crude - 2.0 million barrels per day.
   Shale Oil - 3.0 million barrels per day.
   Coal Liquefaction (and gasification) - 3.0 million barrels per day equivalent.
   Conventional Coal Supply Expansion (beyond that needed to serve coal's share of over-all energy market) - 5.0 million barrels per day equivalent.
   Tar Sand Production - 1.0 million barrels per day.
   Heavy, Viscous Crude Production - 1.0 million barrels per day.
   Geothermal Steam - 1.0 million barrels per day equivalent.
   Nuclear Power (fission, fast breeder reactor) - 5.0 million barrels per day equivalent.

U.S. Oil Core Supply

1. The conventional U.S. oil producing industry will be able to arrest production decline of recent years and will maintain the estimated 1973 production level of approximately 11.4 million barrels per day throughout the forty-year period.

2. This effort is apart from developing ability during the forty-year period to increase supply from such sources by an additional 1.8 million barrels per day through more vigorous exploration and secondary recovery activity.

TESTIMONY

Presented By

PERMIAN BASIN PETROLEUM ASSOCIATION

John R. Dorr, President

Ed Thompson, Executive Vice President

Mr. Chairman, Honorable Members of the Committee

My name is John R. Dorr, of Pecos, Texas. I am a graduate of the University of Oklahoma with a B. S. Degree in Petroleum Land Management. I have been engaged in oil operations since 1961.

I am the President of, and speaking for, the Permian Basin Petroleum Association, which is a regional group of individuals and small companies in Southeastern New Mexico and West Texas. Our 550 voting membership is primarily made up of small independent oil operators with other associated business in the area. Associate membership includes businesses and individuals not directly in the oil business, but directly dependent upon a strong, growing petroleum industry to stay in business.

We appreciate both the Committees holding these hearings and the opportunity to present testimony. We will cover the areas of windfall profits tax proposals, plowback provisions and a possible exemption for the small, domestic independent operator in the form of recommendations to any proposed legislation.

While windfall profits tax proposals have a willing audience in the consuming (voting) public, the typical independent domestic Petroleum Producer in the Permian Basin area does not, nor to my knowledge has he ever, experienced profits as defined in proposed windfall legislation. He traditionally re-invests by drilling wells, the depletion credit, intangible drilling credits, and the depreciation credits he may accumulate under the tax laws of the state or the nation - - the incentives Congress now indicates should be removed.

During the past ten years, both crude oil and natural gas prices at the wellhead were frozen at approximately $3.00 per barrel by the purchasing pipe-line or trucking facility, and their ultimate market, the integrated oil company. And

natural gas at 16.5 per thousand cubic feet (or less) by the Federal Power Commission. However, in all fairness, any attempt they may have made to spur production by even minute increases in wellhead prices was "squelched" by additional governmental intervention. At the same time, costs of everything involved in exploring for new oil and gas reserves, from leasing to taxes, have been drastically increasing. Independents have gone out of busines by the thousands, but not one word was said about windfall losses. We did not hear any comment about windfall profits during that same ten year period when other giant industries, General Motors, IBM, IT&T, Xerox, Polaroid, etc., reported ever increasing profits each year.

When we speak of small, domestic, Independent Petroleum Producers, we define them as those with 60 or fewer employees --- those who have traditionally found 75 to 85 percent of our existing domestic oil and gas reserves, and who are currently leading in the search for new reserves. Not only does our small independent lead in this search, but it is this same low-overhead producer who has attempted to produce and maintain those wells which would have long ago been abandoned by the larger integrated companies as being uneconomical. These are the stripper wells, as defined in recent legislation, which provide approximately 300,000 barrels per day in our area alone --- barrels which would otherwise be lost to the consuming public.

Our domestic independent usually is called on for his entire financial resource base to stay in business. In addition, he needs substantial backing from our banks and outside investors, both of whom expect their principal to be repaid, plus interest on said amount commensurate with the risk. Any provision imposing additional taxes on the Independent sector of the Domestic Petroleum Industry, with no compatible relief, could prove to be the straw which, with pipe, rig, crew and

fuel shortages could stop the search for new reserves. Should Congress choose to change our tax structure, we would urge that such changes provide the producer with a vehicle, in the form of a plowback, wherein we can earn by drilling, incentives no less than and, (in view of our continually spiralling costs and risks), in fact greater than those provided in current tax legislation.

Our Executive Committee met January 24, 1974, and it was unanimously voted to have an Energy Crisis Committee prepare certain recommendations to the various energy bills being offered in the House and Senate. Also, to decide which, if any, of these many bills we could offer our support. After a painstaking search by the Energy Committee, the reluctant concensus was reached that we could support none of them, but rather, we would offer recommendations which would, in our opinion, most successfully promote the purpose of Energy Legislation -- finding more domestic oil and gas for the domestic market.

1. The first recommendation calls for the recognition of small domestic, independent operators as previously defined, (with 60, or less, employees being the primary point) as diffenentiated from the large integrated international oil companies, just as other small businesses are recognized by the federal government.

2. Recommendation two calls for the exemption as far as possible from all wage and price controls of the small, domestic, independent operator, just as are other small businesses exempted.

3. Recommendation three calls for increasing to 35% the current depletion provisions and elimination of the 50% limitation on net income, or, as previously stated, as

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an alternative provide plowback privisions in order to provide an equal incentive.

4. Recommendation four calls for increasing the intangible cost credits to 200%, on strictly wildcat operations, to further encourage outside investors to continue to fund the search for new oil and gas reserves, which may, if Congress deems expedient, be earned by plowbacks of an amount equal to the 200% allowed.

5. Recommendation five calls for depreciation schedules on tubular good, pumping units, tank batteries, hydraulic jacks, separators, heater-treaters, mud-tanks, gathering lines, workover and drilling-rigs and other oil-field equipment of no more than ten years.

6. Recommendation six calls for elimination of the two-tier pricing system on both crude oil and natural gas, letting the price be settled in the market place. A minimum base price of $7.50 per barrel on crude oil and $1.00 per mcf on natural gas should be provided, without undue additional costs to the consumer (voter).

7. Recommendation seven calls for the implementation of the Federal Energy Office operations to oversee all energy activities whether domestic on-shore, federal leases, current energy sources (oil, gas, coal) or those exotic, but badly needed types such as oil shales, tar sands, thermal, fusionable or solar.

8. Recommendation eight calls for releasing acreage or encouraging more farmouts on Federal lands long held by one well production.

9. Recommendation nine is that no energy trust fund be set up or financed by direct taxes on production or btu's, as has been proposed. We suggest energy research and development be left to industry, as much as possible; encouraged by government grants in areas where private industry does not meet the needs and demands as may be determined by the F. E. A.

No doubt, some will feel that we have gone far afield in offering recommendations on bills not yet presented. However, proposals have been made, and this is the only timely way in which we can present to the Committee the problems and position of the small, domestic independent operators in the Permian Basin, who are representative of the industry nationwide.

Respectfully submitted
Permian Basin Petroleum Association

John R. Dorr
President

Ed Thompson
Executive Vice President

SUMMARY OF A STATEMENT

Before The

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES
Washington, D. C.

BY

GEORGE P. MITCHELL, PRESIDENT
Texas Independent Producers and Royalty Owners Association

(and President, Mitchell Energy & Development Corp., Houston)

February 5, 1974

Following are the main points made by Mr. Mitchell:

Independent explorationists will play a key -- and possibly predominant -- role in overcoming the energy crisis.

The public perceives the oil industry as being composed of the major oil companies with familiar names: Exxon, Shell, Texaco, and so on. In fact, only a relative handful could be considered major. Alongside them, and sometimes following or leading them, are 10,000 independents: men who are willing to assume the risks inherent in oil exploration on the possibility of achieving financial reward. The Texas Independent Producers and Royalty Owners Association is composed of 3,000 members, most of whom are independent explorationists; Mitchell Energy & Development is an example of a large independent.

(More)

The Committee has undoubtedly received great quantities of statistics and data, and I will not compound that. But some simple facts illustrate the role the independent has played and can play in the future.

-- Independents drilled nearly nine of every 10 wildcat wells in the United States in 1972, the latest year for which figures are available.

-- Independents drilled more than four of every five domestic wells, wildcat and development, in the same year.

-- In terms of successful drilling, independents were responsible for nearly nine in 10 completed oil and gas wells in 1972 ... and they also drilled nearly 90 per cent of the dry holes.

I believe several factors stand out: independents are entrepreneurs; they take risks; they succeed -- and they fail; and any energy legislation that fails to recognize the legitimate needs of the oil industry's small businessman will seriously handicap the drive to meet the nation's energy requirements now and in the future.

<u>As a petroleum engineer and geologist who has played a role in drilling 2,800 wells, of which 550 were wildcats, I am convinced that the nation's sedimentary basins are adequate to make the United States 85 to 90 per cent self sufficient in energy within the next 10 years.</u>

North American petroleum is in the ground, waiting to be discovered.

To a large extent, the "easy" oil and gas has been extracted from the United States during the past hundred years. Yet, there are ample amounts to fuel the nation until technological advances create substitute fuels.

Americans are used to thinking that oil and gas originates in Texas, Oklahoma, and Louisiana. Yet, the Appalachian Basin in Ohio, the site of a

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great concentration of industry, is crying for development. Just to take advantage of the deposits there, some 26,000 new wells will have to be drilled. The San Juan Basin in Colorado and New Mexico could double its present production of 1.5 billion feet of natural gas daily through a re-drilling program. We have barely started to explore offshore in the Gulf Coast -- deposits there are such that within 25 years, there should be $60 billion spent between Brownsville, Texas, and the tip of Florida, with a half-trillion dollars of oil and gas to be discovered. Alaska also has one of the large potentials of oil and gas reserves. The Outer Continental Shelf, particularly off the East Coast, holds great promise, although not a single well has been drilled other than in the Nova Scotia area.

The job is vast, but we are without an acceptable choice. Either we develop our own resources, or become completely dependent on the whims of unstable foreign governments at an almost unspeakable cost in terms of balance of trade and political blackmail.

We may wish otherwise, but it will cost money to do the job. The petroleum industry and investors will support the search for energy fuels if the opportunity for reasonable reward is there; if incentives are destroyed, the energy crisis will become an energy tragedy.

We must triple the rate of expenditure for exploration and development from the present five billions per year to 15 billions per year solely to develop our own resources.

The prices of oil and natural gas have risen in the seller's market of recent months, and undoubtedly the temptation is great to "punish" the industry because of what appears to be excess or windfall profits. I suggest, however, there is something to be said in favor of letting the laws of the marketplace prevail in the petroleum industry, just as they do in most other aspects of American business.

(More)

We have seen too clearly what government tampering has done to the natural gas industry over the past two decades -- under the "free lunch" theory of control, we have been practically giving away our most efficient, non-polluting fuel at prices that have persuaded any prudent businessman that he would be a fool to spend money in a search for natural gas.

In recognition of (a) the unique situation of the independents; (b) the fact that large amounts of undiscovered minerals remain in the United States; and (c) the need for incentives to the petroleum industry to explore for and develop new domestic mineral reserves, the members of the Texas Independent Producers and Royalty Owners Association stress the following:

-- Only through the prospect of reasonable reward for great risk will entrepreneurs of any kind, including those in the oil industry, invest the necessary funds to help make the United States self sufficient in energy.

-- Incentives should encourage domestic exploration and development; disincentives should discourage exploration abroad.

-- If, after consideration, the Congress decides to moderate oil industry profits, these so-called excess profits should be recycled into domestic exploration and development as a tax deduction to motivate greater investment here.

STATEMENT
on
PENDING PROPOSALS ON WINDFALL PROFITS
before the
HOUSE COMMITTEE ON WAYS AND MEANS
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
WALKER WINTER
February 5, 1974

My name is Walker Winter. I am a member of the Board of Directors of the Chamber of Commerce of the United States and Chairman of its Taxation Committee. I am also a partner in the Chicago law firm of Ross, Hardies, O'Keefe, Babcock and Parsons.

I am accompanied by Robert R. Statham, Director of the Tax and Finance Section of the Chamber.

Mr. Chairman, the National Chamber is grateful for this opportunity to present its views on the Administration's and other pending proposals on windfall profits.

Summary of Chamber's Position

Existing and anticipated tax policies can greatly influence investment decisions that will have a profound impact on solutions to the energy crisis. Additional tax burdens or threats of additional taxes can discourage investment and impede the development of essential energy supplies. Thus, there exists a direct correlation between taxes and the energy crisis.

We are opposed to an excess profits tax or to the imposition of a renegotiation provision on the profits of one, several, or all segments of American business. We believe that a better approach would be to encourage more capital investment in machinery and equipment for energy exploration, energy production, and energy saving through a general improvement of the capital cost recovery provisions of the tax laws.

We believe that no adverse changes should be made in the tax law with regard to natural resources or energy sources. And we are opposed to any legislation that would increase the tax burden on United States business abroad.

Need for a Positive Approach

This nation is in the midst of an energy crisis. The shortages of energy that have become so apparent in the past several months should not have come as

a surprise to government or the public. In recent years experts in the energy field, members of the business community, and many others have been making their views public that there was an impending energy crisis.

In 1972, the National Chamber published a fifty-page booklet documenting the evidence that an energy crisis was on the horizon, and setting forth a lengthy list of recommended actions to cushion the impact of the coming crisis. Copies of that document were given wide distribution in both government and the private sector.

The fact is that government, business, and the public knew or should have known that the country was on the brink of an energy crisis. Business singly and collectively warned of the crisis, and urged government to study the country's energy needs and develop an overall energy policy.

Over the past sixty days the public has finally awakened to the need to meet the energy shortage. The public has begun to call upon its elected representatives to act swiftly to meet this crisis. We agree that action is needed. We do not believe that Congress should take counter-productive measures to meet so serious a problem.

The need to encourage exploration, development, and production of energy is greater now than at any time in our history. To impose additional taxes on the petroleum industry is not in the national interest of expanding our energy resources. If the tax laws cannot be altered to help encourage a solution -- then at the very least they should not be altered to contribute to the shortage.

This is not a time for government to act irrationally. Too much is at stake. It is time for government to take a positive and responsible approach to alleviating these shortages. After all, it is not government, but it is the energy companies upon which we are dependent to rescue us from this difficulty. To discourage that segment of business through harsh and punitive tax legislation is not the answer. We urge you to develop a positive tax program to encourage capital investment in the exploration, development, and supply of sources of energy.

Excess Profits Tax

In December, the Administration announced its recommendations to Congress for an "Emergency Windfall Profits Tax" on producers of oil. Although termed a "windfall profits tax," this is in effect an excess profits tax. In addition to the

proposal of the Administration, there are other legislative proposals under consideration by this Committee to levy excess profits taxes in the energy industries.

An excess profits tax is not a solution to the problem of alleviating the current energy crisis. Further, an excess profits tax runs counter to the competitive enterprise system, it is economically unsound, and it is difficult to administer.

An Excess Profits Tax Runs Counter to the Competitive Enterprise System

An excess profits tax is not in keeping with our competive enterprise system. It suggests that government can decide how much profits should be, which profits are excessive, and which are not excessive. If this is possible with the energy producing segment of the economy, then is it not possible with other segments of the economy? Where do we stop? What will be the shortages next year and the next, and which businesses will be subjected to government regulation and control of their profits?

This country was built by men who used American ingenuity and know-how to meet the shortages and the needs of the people through a profit motive. It would be unwise to set a precedent of government control of profits when conditions of shortage arise. We believe this would not be in the best interests of the public and a free economy.

An Excess Profits Tax is Economically Unsound

An excess profits tax is economically unsound. Such a tax inevitably discourages capital investment that is so important for the development of new energy resources. There is a definite psychological effect on investors who know that any success will be subject to a tax that could consume almost the entire profit.

These problems were pointed out by two of the witnesses before the Senate Finance Committee. At that Committee's hearings on January 22, 1974, John Nolan, former Assistant Secretary of the Treasury for Tax Policy, said that the tax proposals "would greatly discourage new capital investment in energy development."

At those same hearings, former Commissioner of the Internal Revenue Service Randolph Thrower, said:

> The use of base period profits as a maximum return, without regard to inflation, impact of the devaluation of the dollar,

> extent of new investment or marginal risks in the present emergency, combined with the vast uncertainties of the language, might constitute too great a disincentive to new investment.

Excess profits taxes tend to discourage risk-taking so important in the case of oil exploration. Certainly it would appear that proposals for a 37% excess profits tax on top of a 48% corporate income tax would tend to discourage rather than encourage high risk investment. In addition, an excess profits tax may have the effect of causing companies to delay capital investment actions until such time as the tax expires -- resulting in a definite postponement in the development of productive facilities.

Experience with a wartime excess profits tax indicates that it tends to encourage needless and wasteful expenditures. With government bearing 80 to 90 per cent of the cost of business operations, there is little incentive for a corporation to increase the efficiency of its organization. Such an increase in efficiency would lead to higher profits, which in turn would be eaten up by a combination of income and excess profits taxes. Under such circumstances, the burden is on the efficient producer and incentives for efficiency are removed from the marginal or inefficient producer.

Administrative Difficulties of an Excess Profits Tax

There has been one common opinion by the Secretaries of the Treasury who had to administer the excess profits tax during the country's three experiences with it during World Wars I and II and the Korean Conflict -- they have felt the taxes were unsound and should be repealed as soon as an opportunity arose to do so. After the Second World War, Treasury Secretary Fred Vinson, in urging discontinuance of the tax, said:

> The excess profits tax has been an erratic and, in many instances an inequitable tax. The difficulty is that calling profits excessive does not make them excessive. Calling profits normal does not make them normal. Normal profits and excessive profits look alike. There is no chemical reagent to distinguish them. The excess-profits tax, to be sure, has a formula -- a very complicated formula in its entirety -- for distinguishing normal and excessive profits. But that formula is seriously defective.

There are generally two methods of attempting to distinguish normal from excess profits. These methods are the use of a base period for determining normal earnings or the computing of the relationship of current earnings to invested capital.

It is impossible to say that profits earned in certain previous years are normal in comparison to profits earned in subsequent years. One corporation over the previous period may have been very successful, while another corporation may have been operating at a loss. The corporation operating at a loss should not be penalized if it becomes successful in later years.

The use of invested capital as a measure of profits is also unsound. This results from the inability to determine the value of the capital invested in a business. It also results from the inability to find a formula for a fair rate of return that takes into consideration the wide-ranging variability in risks assumed by different enterprises and industries -- risks which might justify a higher rate of return in a particular industry.

Any definition applied to the term "excess profit" will necessarily be arbitrary. Therefore, there will be a multiplicity of conditions and situations that will require interpretation of the definition. Administratively, a large group of highly qualified technical employees will be required both by business and the government to resolve the complaints and litigation resulting from such a tax. The accounting burden on business is greatly increased by an excess profits tax. Current records used for ordinary business accounting and tax returns become inadequate to comply with new requirements.

Former Commissioner of Internal Revenue Johnnie M. Walters recently told the Senate Finance Committee that a "windfall" profits tax such as contained in the proposed Energy Emergency Act, would result in ". . . a further weakening of the compliance capability of the Internal Revenue Service . . . . The Service simply does not have adequate resources to administer and enforce our internal revenue laws. Enactment of this proposal will make this bad situation worse."

The recent testimony of former Commissioners of Internal Revenue before the same Senate Committee indicates that all of them foresee serious problems in the administration of an additional tax on profits. Former Commissioner Mortimer Caplin said that an excess profits tax, by whatever name it is called,

> . . .is an extremely difficult tax to administer, and one that we have used only in times of war. Our experience with this type of tax demonstrates that it is erratic and inequitable in application. . . . Aside from the cosmetic or psychological appeal of its name, it is a type of tax that I would not recommend unless there was no viable alternative. . . . Disputes over interpretation would seem inevitable. The probability of numerous administrative controversies and judicial appeals seems high.

John Nolan, former Assistant Secretary of the Treasury for Tax Policy, stated in his testimony at the Senate Committee hearings that:

> The record-keeping and administrative problems of determination of income by product lines and determination of excessive profits by a judgment process would be intolerable. Neither the energy industry nor the Internal Revenue Service could function efficiently under such a system.

Mr. Nolan also stated that the proposals "are totally unadministrable, either through our tax administration structure or the renegotiation process."

The Renegotiation Approach to Excess Profits

Section 110 of Title I of the proposed Energy Emergency Act provides that "any interested person who has reason to believe that any price. . . of petroleum products permits a seller thereof any windfall profits, may petition the Renegotiation Board. . . for a determination. . . ." Section 110 goes on to state what shall happen if the Renegotiation Board determines that a "windfall" profit is involved and then outlines the general nature of what constitutes a reasonable profit.

We are opposed to this section of the proposed legislation for the following reasons: It uses a wartime device for determining excessive profits; it would be expensive for the taxpayer; it establishes arbitrary and capricious procedures for determining windfall profits; it discriminates against small business; and finally, it may be unconstitutional.

Renegotiation is a Wartime Device

The Renegotiation Board as we know it today is based upon a similar board set up during World War II to protect against excess profits on defense contracts. It was not designed to operate in peacetime nor at a time when the defense of the country was not involved. Renegotiation was a device used during a time of international tension when sophisticated negotiation was said to be impossible. The Renegotiation Board should have been phased out years ago. Instead, we find that section 110 of the proposed legislation would assign new responsibilities to the Renegotiation Board -- responsibilities for which the Board was not designed.

Renegotiation is Expensive for the Taxpayer

Renegotiation is time-consuming and expensive for business. Companies

could find themselves in the business of justifying their actions rather than in the business of providing energy products. Managerial, legal, technical and accounting talent could be diverted at a time when business and the Nation need all of the expertise we can muster to solve the energy problem.

The requirements of renegotiation could force reorganization of companies along product lines. Energy corporations produce many more products in this day and age than energy products. Our tax system does not require product accounting, and few, if any, companies determine their taxable income along these lines. To do so could mean a restructuring of corporate accounting methods.

Standards Are Arbitrary and Capricious

Standards to be used during renegotiation for determining windfall profits are arbitrary and capricious. These standards are taken directly from the Renegotiation Act of 1951. Section 110 contains words like "reasonableness," "extent of risk," and "windfall profits," yet nowhere is there a definition of what profits are "reasonable" as opposed to "windfall." Does the provision in section 110 apply only to corporations? If so, it could encourage the transfer of energy and energy products from corporations to individuals.

Renegotiation Discriminates Against Small Business

The renegotiation process would discriminate against small businesses. The present Renegotiation Act provides that a contractor must do $1 million worth of renegotiable business before he is subject to the Act. There is no such provision in the proposed legislation. Every gas station, every retail outlet for energy products can become subject to the renegotiation process. Such small businesses are already overburdened in meeting their obligations to government. Think for a moment of the cost to the taxpayer when "any interested person" can drive into a corner gasoline service station, decide he does not like the cost of gasoline, and petition the Renegotiation Board for redress. The administrative costs involved can be enormous. The problems faced by small businesses will be even greater, and no doubt many small companies will be forced out of business as a result.

Question of Constitutionality of Section 110

Finally, there is some question as to the constitutionality of renegotiation under section 110 of the proposed legislation. The question was raised by

extremely knowledgeable former public officials. Even if the renegotiation process is determined to be constitutional, the fact that the question has been raised indicates the likelihood of an immense amount of litigation which might not be resolved until long after the present emergency has passed.

The renegotiation procedures contained in the proposed legislation are unadministrable, arbitrary, and, above all, unnecessary. American business should not be burdened with such problems while working to solve the energy crisis.

Foreign Percentage Depletion and Intangible Drilling and Development Costs

With regard to foreign source income, we are opposed to any legislation that would increase the tax burden on American businesses abroad either directly or indirectly. There are proposals before the Congress to eliminate percentage depletion and the provision which permits a current deduction for intangible drilling and development costs for oil and gas wells located outside the United States. Other proposals call for denying the percentage depletion allowance for either foreign or domestic oil and gas production. Our energy condition is critical. Any adverse changes made in the tax laws with regard to natural resources could seriously impair the competitive position of American companies engaged in the search for domestic and foreign energy sources.

Critics of current tax laws applicable to both domestic and foreign operations assert that elimination of foreign percentage depletion would likely lead to increased domestic petroleum exploration and development. There is no evidence that supports this conclusion. To the contrary, any adverse change in the tax laws could only aggravate the energy crisis by discouraging further exploration, development and production of all known energy sources.

Long established tax provisions promote the development of energy supplies. It is exceedingly important that the tax policy of the Nation not discourage investment needed for the modernization and expansion of its productive facilities. The tax policy of the United States toward the energy companies could determine the outcome of the energy crisis. If taxes are increased, the sources of capital can certainly be expected to diminish, or the willingness to invest in the search for new reserves will be impaired.

Tax laws must recognize that rising energy demands in this nation require the constant development and maintenance of a healthy energy industry. As exploration and development of energy resources grow more difficult, more costly, and financially more hazardous, venture capital will continue to be attracted to this

field only if the reward for success is commensurate with the risks involved. Therefore, to meet national needs and to assure replacement of exhausted mineral assets, the tax laws should provide that all nonrenewable natural resource industries be granted adequate depletion allowances.

Foreign Tax Credit

With regard to the foreign tax credit, we are opposed to proposals that would require some or all of the taxes paid to foreign governments to be treated as deductions instead of taxes that could be credited against the United States corporate income tax.

Under present law, United States companies operating abroad receive a credit for foreign taxes paid, but only up to the amount of U. S. tax that would otherwise be due on this income. If the foreign tax is higher than the United States rate of 48% for corporations, then the United States does not collect any income tax because that corporation has already paid taxes of 48% on its income. If the foreign tax rate exceeds the U. S. tax rate, the excess foreign taxes paid cannot be used to offset any taxes on domestic income that are owed to the United States and the excess is borne by the corporate taxpayer. The unused foreign taxes are an additional cost of doing business abroad.

Adoption of the foreign tax credit affirmed a policy decision to tax United States citizens and corporations on worldwide income. The foreign tax credit is essential for equity among American taxpayers to eliminate this burden of double taxation.

We believe that any legislation that would attempt to substitute a deduction in place of the foreign tax credit for part or all of the taxes paid to foreign governments would be inequitable and against United States policy to eliminate double taxation of foreign source income.

Foreign Tax Credit - Per-Country and Overall Limitations

We are opposed to elimination or fragmentation of either the overall limitation method or the per-country limitation method of computing the foreign tax credit. Both methods must be retained for American business to compete with foreign-owned competition.

Since the 1960 Act to amend the Internal Revenue Code, taxpayers have had the option of electing either the per-country or overall limitation. The availability of both a per-country and overall limitation is fundamentally the

recognition of different foreign operating patterns among American taxpayers.

The federal income tax laws already hamper participation of United States businesses in world competition and additional tax burdens would further aggravate this problem. The per-country and overall limitations, in their present form, are an important mitigating factor and should be retained. Elimination or fragmentation of either limitation could result in discriminatory tax treatment against some form of foreign business activity.

A Tax Solution

Rather than punitive tax legislation, we would recommend a positive approach. One of the solutions available is to improve our tax laws so that they encourage more capital investment in energy exploration, energy producing and energy saving machinery and equipment. We recommend this as a part of a general improvement of capital recovery under the tax laws through adoption of the capital cost recovery recommendations of the President's Task Force on Business Taxation.

This country's present depreciation practices are grossly inadequate. Although the adoption of the Asset Depreciation Range system has eased the situation -- it is far from being corrected. Adoption of the full recommendations of the Task Force with regard to capital cost recovery would encourage more business investment in modern machinery and equipment.

At a time when business needs to make major investments in new energy producing and energy saving machinery and equipment, the tax laws should encourage and not discourage such investments. The President's Task Force in 1970 recommended substituting a capital cost recovery allowance system for the guideline system based on the useful life of property. It recommended allowing full recovery of cost, unreduced by salvage value, in a period 40% shorter than allowed under the 1962 Treasury Guidelines for determining useful lives. The full adoption of these recommendations could enable that segment of American industry engaged in businesses involving the exploration, development and transportation of sources of energy to operate more efficiently by using more modern equipment.

Conclusion

In conclusion, Mr. Chairman, the Chamber is opposed to an excess profits tax in whatever form devised or to the imposition of a renegotiation provision on

the profits of one, several or all segments of American business. We believe the tax laws should be improved to encourage more capital investment in machinery and equipment for energy exploration, energy production, and energy saving as a part of a general improvement of capital cost recovery under the tax laws. We believe that no adverse changes should be made in the tax laws with regard to natural resources or energy sources, and we are opposed to any legislation that would increase the tax burden on United States business abroad.

On behalf of the National Chamber I wish to thank you again, Mr. Chairman, and the members of the Committee for this opportunity to testify before you.

Summary of

Statement by

THE STANDARD OIL COMPANY
(an Ohio corporation)

Submitted to the

COMMITTEE ON WAYS AND MEANS

OF THE

HOUSE OF REPRESENTATIVES

CONGRESS OF THE UNITED STATES

* * * * * * * *

My name is Alton W. Whitehouse, Jr., and I am President of The Standard Oil Company of Ohio. I am here today in lieu of Charles E. Spahr, Chairman of the Board and Chief Executive Officer, who is unable to appear because of a death in his family.

The statement which I am submitting for the record presents my company's position regarding profit-limiting legislation. I will summarize this statement at this time.

Before proceeding, it may be helpful for you to know that Sohio is a crude-deficient refining and marketing company serving Ohio and surrounding states and the Middle Atlantic states. Our domestic crude production amounts to about 7% of our 385,000 barrels per day refining capacity. We have a small interest in the Iranian Corsortium with liftings equal to about 5% of our refinery capacity. In terms of assets we rank about 17th in the industry. In 1970 we acquired East Coast marketing facilities, two refineries, and valuable oil and gas leases on the North Slope of Alaska through a transaction with The British Petroleum Company Limited. Since then our main efforts have been directed to the development of our

North Slope reserves, to obtaining a trans Alaska pipeline permit, and to the realignment of the East Coast properties which remain unprofitable. We also have investments in interests in oil shale, uranium, and tar sands.

In connection with another legislative matter, we recently voluntarily submitted to the Subcommittee on Antitrust and Monopoly of the Senate Committee on the Judiciary a report which describes Sohio and its history since it became independent in 1911. While this report addressed itself to a number of questions including that of divorcement, I feel that it also is the basis for demonstrating that profit-limiting legislation will impede our ability to compete. I, therefore, ask that a copy of this report be accepted and that it be made a part of the record of these hearings.*

The results of your considerations will have a very significant impact not only upon Sohio and the petroleum industry but the entire private enterprise system of the United States as well.

I am philosophically opposed to profit-limiting legislation. It is not the way by which our country became and remains the strongest in the world. I recognize that there are some who don't share my views in this regard. If those who disagree with me prevail, I believe that profit-limiting legislation should apply to all businesses, not just the energy companies. To do so places our industry at a significant disadvantage in the competition for capital at a time when our capital needs are unprecedented.

Sohio estimates that it alone will have to spend between $2 billion and $2.5 billion beginning this year through completion of the Trans Alaska Pipeline System in 1977. This is an average of $500-$600 million each year. Last year our internally generated

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*Report will appear in printed record of this hearing.

funds from operations amounted to only 20% to 23% of this amount after providing for dividends to our shareholders.

I urge you not to make our task more difficult than it already is with profit-limiting legislation. The consumer will not be served in the short run, and it will be disasterous to him in the long run.

I think it is important to place the petroleum industry's earnings in perspective. Our return on net worth or shareholders equity has averaged slightly less than manufacturers in general for the ten years ended 1972 at 11.8% versus 12.2%. During the same period Sohio's return averaged 8.5%. While we do not have the complete 1973 data, I believe it will show that the petroleum industry return will be very close to that of manufacturing companies despite our larger than average percentage earnings gain in 1973 versus 1972. In 1973 Sohio's return on net worth was 7.9% which in no way can be conceived as being an excess profit rate.

While the petroleum industry had a good earnings recovery from 1972, it was not alone. Many of the basic materials industries such as steel, metals and mining, paper, and chemicals exhibited very substantial earnings increases in 1973.

I can't resist pointing out that the newspaper publishing industry was also headed for a very substantial earnings gain in 1973 based on results of the first nine months. According to published sources, the New York Times had an increase of 93% and the Washington Post 57% during that time period. In addition, it is reported that their return on equity for the 12 months ending September 30, 1973 was 16.6% and 16.4%, respectively.

I believe that the development of existing energy forms and the research and development of new energy forms need encouragement, not the prospect of a penalty if risk-taking investment is successful. Correction of our energy deficiency can only come through investment of huge sums of money. We are a very capital intensive industry. The existence or even the mere threat of profit limiting taxes can only serve to prevent the right kind of investment decisions from being made on a timely basis.

My company supports programs that would make this country more sufficient in energy. To this end I urge you to retain both the percentage depletion allowance and the deduction of intangible drilling costs for domestic development and production. These two incentives are particularly valuable to the independent driller and producer who has discovered most of our best oil fields in this country and whose efforts ought to be encouraged instead of discouraged at this time.

My company would support a requirement that the net tax benefits of these incentives be reinvested in a broad range of energy research or development to assure that the benefits of these incentives are being directed toward energy self-sufficiency.

In summary, I believe strongly that

1. An excess profits tax or profit-limiting legislation will prove counter productive to our nation's needs for energy;

2. If our industry is deemed to have excess profits and taxed accordingly, then all of American industry should be equally taxed to create the same relative disadvantage in the capital markets;

3. Any excess profits legislation should provide for plowback exemptions for investments in energy development or research and there should be definitive provisions for termination. The re-investments allowed for exemption should cover research, exploration, development, transportation, refining or upgrading, storage, and environmental protection for all energy forms

4. A tax assessed at the wellhead can be counterproductive and discriminate against the small producer and the development of economically marginal wells

5. Domestic investment incentives represented by the depletion allowance and intangible drilling costs should be retained but modified to require plowback of tax benefits in energy-related investments; and

6. The Foreign Tax Credit should remain available to all American taxpayers. We have no objection to a review of the question of payments to foreign governments with respect to their use as foreign tax credits.

The Standard Oil Company
Cleveland, Ohio
February 5, 1974

Statement by

THE STANDARD OIL COMPANY
(an Ohio corporation)

Submitted to the

COMMITTEE ON WAYS AND MEANS

of the

HOUSE OF REPRESENTATIVES

CONGRESS OF THE UNITED STATES

* * * * * * *

My name is Charles E. Spahr and I am Chairman of the Board and Chief Executive Officer of The Standard Oil Company of Ohio. I am appearing here today to provide the Committee my company's position regarding profit limiting legislation.

Before proceeding, it may be helpful for you to know that Sohio is a crude deficient refining and marketing company serving Ohio and surrounding states and the Middle Atlantic states. Our domestic crude production amounts to about 7% of our 385,000 barrels per day refining capacity. We have a small interest in the Iranian Consortium with liftings equal to about 6% of our refinery capacity. In terms of assets we rank about 17th in the industry. In 1970 we acquired East Coast marketing facilities, two refineries and valuable oil and gas leases on the North Slope of Alaska through a transaction with The British Petroleum Company Limited. Since then, our main efforts have been directed to the development of our North Slope reserves, to obtaining a trans-

Alaska pipeline permit and to the realignment of the East Coast properties which remain unprofitable. We also have investments in petrochemicals, coal and fabricated plastics. We have developmental interests in oil shale, uranium and tar sands.

The results of your considerations will have a very significant impact not only upon Sohio and the petroleum industry but the entire private enterprise system of the United States as well. I hope to convince you of the importance of preserving investment incentive for our industry and our system. Alvin Toffler, author of Future Shock, in a recent article has said, "Now we are all so busy trying to cope with the immediate effects of the fuel shortage that we are running out of another commodity that may, in the end, prove quite as necessary to our survival. Seldom have we approached a crisis with so short a supply of perspective."[1]. I hope my comments today will help provide some perspective in this situation.

Before discussing specifically the subject of petroleum industry taxation, I think it would be well for us to look at areas where we agree or where disagreement is at a minimum. I believe we can all agree that there is an energy problem. We need to conserve energy supplies both in the immediate time frame and over the long term. We need to develop new supplies from known, existing fuel sources. We need to develop new energy sources through research and development.

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1. New Times, "Current Myopia", January 11, 1974, p. 44

I believe we all share in the desire to solve this energy problem with the least possible impact on our economy. That means we need to supply essential requirements through temporary allocation programs; we need to make supplies available at prices consistent with the need to expand supplies from existing resources; we need to develop alternate fuel or energy sources; and we need to induce consumers to alter their energy demand patterns. It has been suggested that in terms of today's prices, $7 per barrel of domestic crude oil is probably the price that would meet these needs. I do not know whether this is right or not. However, I do believe that continuation of a multi-tiered crude oil price structure will serve to magnify the distortions that are becoming apparent in the marketplace.

I realize that any discussion that is concerned with price levels that will encourage new supplies while inducing conservation immediately provides grounds for disagreement. However, I believe it is very important that we give the marketplace as much opportunity to function in this regard as is possible since it is only through the marketplace that lasting solutions to any commodity shortage are found.

I am sure we can all agree that windfall or excess profits are to be deplored if they serve no useful purpose. Here again there is considerable room for disagreement when one tries to define an excess profit and to determine whether or not it serves a useful purpose.

For instance, many people believe that profits in real estate fall into the category of windfall profits. Inflation in housing prices has created substantial windfall profits; however, we all know that an equal or higher price is necessary to acquire new housing. As a result, the tax laws allow a taxpayer to defer any profit from the sale of his principal residence as long as he replaces it. This well accepted principle recognizes that the cost of replacement has gone up and that it would be inequitable to tax this windfall profit away since the individual would be unable even to maintain his housing standard under those circumstances.

This simple example demonstrates that there are windfall profits that serve a useful purpose in our system. In the housing markets they enable individuals to be mobile and upgrade their housing. In the commodity markets they bring forth additional investment and production. In agricultural commodities the time lag is a growing season, usually less than a year. In minerals and petroleum the lag between investment and production is longer but the same profit incentive must be present.

I am philosophically opposed to profit limiting regulations. I recognize there are some who don't share my views in this regard and if those who disagree with me prevail, I believe that profit limiting legislation should apply to all businesses, not just the energy companies. Our economic system is one of competition not only by suppliers of a commodity or a service but also one of competition by risk takers for the funds repre-

senting the savings of individuals and institutions. To single out a single industry for special tax legislation is basically unfair since companies in many industries are reporting unprecedented profits and the competition for funds is keen.

A further aspect to profit limits is the tendency to make strong companies stronger and to keep weak companies down. This occurs because a profit limit or ceiling enables the most efficient or lowest cost members of an industry to strengthen their competitive position through price reductions or extra spending on research, product development or sales promotion. The weaker members of an industry are kept in their weak position because a profit ceiling by definition means that an industry's average return on investment must decline. Even though a company theoretically has room to improve its return that is under an industry return ceiling, it is very unlikely that such will be the case.

I think you all recognize that investors base their decisions on prospects that they will be compensated for the risks they take. Lenders need assurance that the borrower will repay the loan with the agreed-upon interest, and the owner must be convinced that something will be left over to compensate him for his risk. If uncertainty is large, a lender will not make his savings available to us since he has numerous opportunities to invest elsewhere.

A recent action by Pennzoil Company is a case in point. I understand from the public press that Pennzoil has deferred a 200,000 barrel per day grass roots refinery project. It is

reported that because of uncertainty over long-term crude supplies and "uncertainties over future U. S. governmental policy as to taxes and the basic structure of the domestic petroleum industry", the feasibility of the project was adversely affected.

Similar uncertainties exist for other members of our industry who are in the process of making investment decisions regarding refineries, deepwater ports, offshore leasing, pipelines and any other huge individual investments. Since these individually large investment decisions are always made in an uncertain world, additional uncertainties generated by governmental actions make them all the more difficult.

I urge you not to make our task more difficult than it already is with profit limiting legislation. The consumer will not be served in the short run and it will be disastrous to him in the long run if such actions are taken.

As further evidence of what uncertainties over governmental tax policies and the possibilities of punitive legislation can do to investor confidence, I cite the stock market price action as measured by Standard & Poor's for the oil industry between the first of the year and January 23, which coincides with the first week of the new Congressional session. While the Standard & Poor's 500 Stock Index declined .6%, integrated domestic companies declined 12.8%, the internationals 10.3%, and producers 13.9%. On January 4, 1974 Sohio common stock reached an all-time high of $86. When it became apparent that

some members of Congress were coming back in a punitive mood and intent upon passing Senate bill 2589 with its horrendous windfall profits section, our stock dropped 30% to $60.50 on January 21, 1974. Those 25 points reduced investors' evaluation of Sohio by more than $900 million.

The Federal Energy Office is reported to have estimated that domestic energy investments will have to be $700 billion in the next ten years. If my industry is to succeed in raising these funds, it must not be put at a disadvantage in the competition for capital.

Our industry has a large investment task ahead of it, and Sohio is no exception. We estimate that we will have to spend between $2 billion and $2 1/2 billion beginning this year through completion of the trans-Alaska pipeline in 1977. This is an average of between $500-$600 million dollars each year. Last year my company earned $74 million before extraordinary gains of $15 million. With depreciation, depletion and other non-cash charges of $80 million, we had cash sources from operations of $154 million, only 20-23% of our anticipated capital needs for each of the next several years after providing for dividends of $37 million.

Sohio must raise by far the largest amount of its needed capital in the financial markets. We estimate that our debt will reach 50% or more of borrowed and invested capital. We can do this only if investors are confident that we will be able to

earn a reasonable return on that capital and that punitive or restrictive actions will not be taken by our government.

The industry also will be turning increasingly to external sources. Data gathered by the Chase Manhattan Bank shows the portion of total capital provided by debt had grown to 23% in 1972 from 13% ten years ago. The bank estimates that the industry will need to generate total funds of $1,350 billion during the 1970-1985 period. The bank has also estimated that earnings must increase 18% in each year 1970-1985, more than double the rate of the last ten years, if the $1,350 billion is to be raised and the debt ratio kept at prudent levels.

Any legislation that puts a ceiling on energy company profits will make a difficult financial job even more difficult, perhaps to the point that Sohio could not raise the money necessary to carry out our part of bringing the very much needed Alaskan oil to market.

Our economy no longer has excess capacity in any of its basic materials industries and it has shortages of not only energy but many other basic commodities. I think it may add perspective to the complex issue of excess profits if we look at the whole spectrum of corporate profitability.

A commonly used indicator of profitability is the return on shareholders' equity. This indicator avoids problems associated with the differences of capital intensity and capital structure among industries typical of other indicators. The following table shows the return on net worth for Sohio and the petroleum industry compared with manufacturing companies in general.

Year	Net Income as a Percent of Net Worth*		
	Total Manufacturing (a)	Petroleum Production and Refining (b)	Sohio (c)
1963	11.6%	11.5%	9.9%
1964	12.6	11.5	12.6
1965	13.9	11.9	13.4
1966	14.2	12.6	14.1
1967	12.6	12.8	14.5
1968	13.3	13.1	13.0
1969	12.4	11.9	5.3
1970	10.1	11.0	6.8
1971	10.8	11.2	5.2
1972	12.1	10.8	5.3
Average 10 Years	12.2%	11.8%	8.5%
1973	NA	NA	7.9%

* Source: Columns (a) and (b), American Petroleum Institute letter June 25, 1973 to Honorable Philip A. Hart, Chairman, Subcommittee on Antitrust and Monopoly. API's source was First National City Bank. Column (c) calculated by Sohio.

I believe the following conclusions can be drawn from the above table:

1. In the ten years through 1972 the oil industry's return on equity was below average at 11.8% versus 12.2% for all manufacturing companies.

2. Sohio, with a 10-year average return of 8.5% through 1972 and 7.9% in 1973, can in no way be conceived as being in an excess profits position despite a 55% gain in net income in 1973. Our income after taxes but before extraordinary gains rose just 24% last year. The return on equity based on these earnings was only 6.5%.

Our annual report will show that our petroleum earnings before income taxes, interest and extraordinary items were lower in 1973 than any year in the last five except for 1972. We plan to report this information in a soon-to-be-released paid advertisement, a copy of which I have with me and which I am submitting for the record. As you can see from the data below, Sohio's earnings have benefited from the turnaround of our chemical and plastics business from losses to profits in the last two years as the result of strong demand for acrylonitrile, a new catalyst and improvements in agricultural chemicals. Additionally, we have benefited from higher royalty income resulting from the licensing of Sohio inventions.

Earnings Before Interest Expense, Income Taxes and Extraordinary Income

(millions)

	Petroleum	Chemicals & Plastics	Royalty	Coal
1969	$83.3	$-1.3	$16.1	$ 7.8
1970	71.2	-1.9	8.7	10.9
1971	66.7	-4.4	11.9	12.2
1972	55.4	11.6	21.3	11.5
1973	58.6	23.1	24.7	12.4

The unsatisfactory trend of petroleum earnings reflects losses totaling more than $150 million in our East Coast marketing and refining activities; petroleum product price wars during 1970, 1971 and 1972; and crude oil shortages and rapidly rising crude costs which we could not recover under the Cost of Living regulations in 1973.

WE WANT YOU TO KNOW THE FACTS:

Sohio's profits and where they come from.

Sohio's profits increased in 1973. However, our oil earnings were up only modestly. Most of our increase came from other segments of our business.

Charles E. Spahr
Chairman The Standard Oil Co. (Ohio)

Sohio's oil profits: No "windfall" here.

It may surprise you, but it's true. At a time when people believe oil profits are soaring, Sohio's oil earnings in 1973 showed only a modest 6% increase from 1972 and are actually *behind* the three previous years. Here is our record of the past 5 years, in terms of income before taxes:

Petroleum Operations (Mil. $)	1969	1970	1971	1972	1973
	83.3	71.2	66.7	55.4	58.6

For petroleum earnings, 1973 was our second-worst year of the last five. It was nearly $25 million *under* our peak year of 1969.

Our oil business was helped in 1973 by strong demand, but hurt by the combination of price control rules and higher world-wide prices for crude oil. Sohio is a crude-short company that now obtains over half its crude oil from foreign nations. Under U. S. price control rules, we were unable to increase our revenues enough to recover the increased costs of the crude oil we had to buy.

Consequently, our earnings from petroleum operations were at the second-lowest level of the 5-year period.

Sohio's other operations: Healthy.

Sohio is a diversified company with income sources other than petroleum operations. These include Chemicals and Plastics, Coal, and Royalties from patent licensing. These are so important to Sohio that in 1973, they produced *half* of our earnings, before interest costs, income taxes, and extraordinary items.

CHEMICALS AND PLASTICS have improved from a *loss* position to a healthy profit. Here's the 5-year earnings record before taxes:

Chemicals & Plastics (Mil. $)	1969	1970	1971	1972	1973
	-1.3	-1.9	-4.4	+11.6	+23.1

This dramatic improvement contributed strongly to Sohio's total profit performance in 1973.

COAL operations have made an increasing contribution to Sohio's profit. Here's the 5-year earnings record before taxes:

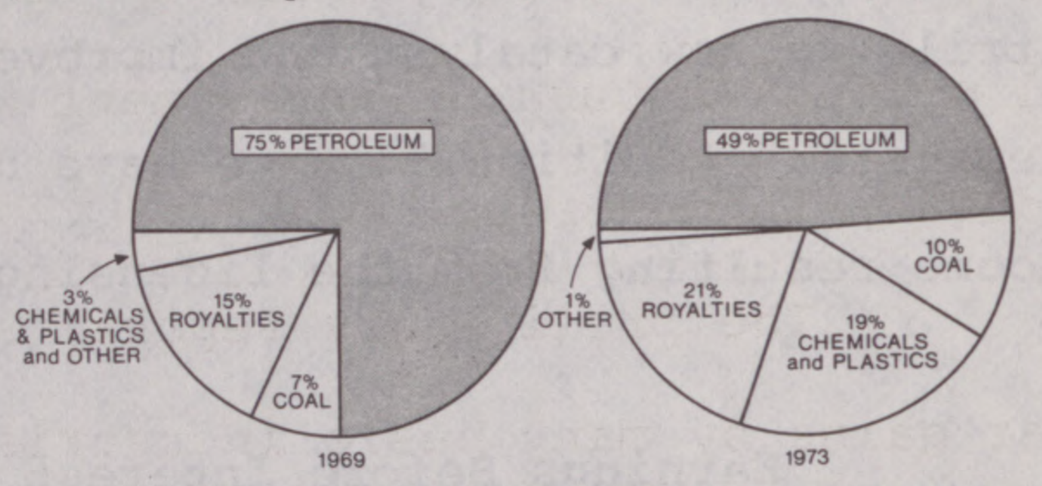
Coal (Mil. $)	1969	1970	1971	1972	1973
	7.8	10.9	12.2	11.5	12.4

ROYALTY INCOME contributes profits to Sohio that may be surprising to most people. These profits result from licensing of Sohio inventions and technology in industrial chemical processes. Here's the 5-year earnings record before taxes:

Royalty Income (Mil. $)	1969	1970	1971	1972	1973
	16.1	8.7	11.9	21.3	24.7

This royalty income stems largely from new paid-up royalties, and currently represents a major portion of Sohio's earnings. In the future it may vary from present levels.

The profit contributions of Sohio's non-petroleum businesses emphasize the realism of the company's earlier diversification efforts. The simplified charts below show the changing contribution made by each segment to corporate profits (before interest expense, income taxes, and extraordinary items).



As shown above, the income generated by non-petroleum operations rose from 25% of Sohio's earnings in 1969 to *51%* in 1973, while income from petroleum operations *declined* from 75% to 49%. Nevertheless, Sohio's plans for the future emphasize producing its huge oil reserves in Alaska.

Sohio's perspective.

We know many people believe Sohio and others are reaping "windfall profits" during a product shortage. Much of this belief relies on a simple comparison of 1973 and 1972 results.

Sohio would like these facts to be recognized:

Any conclusion about Sohio profits should reflect consideration of at least the past 5 years.

Although 1973 profits should not be compared only with those of 1972, if that comparison is made it should be understood that almost all of the improvement came from our non-petroleum operations (before interest expense, income taxes, and extraordinary items). Earnings from petroleum operations were up only about $3 million—while the other operations were up nearly $16 million.

Our pre-tax earnings from our petroleum business for 1973 were nearly $25 million below their level in 1969.

Sohio's rate of return on borrowed and invested capital was only 8% in 1973. This is lower than the cost of borrowing money, and is nowhere near enough to fully finance the development of our Alaskan crude oil reserves, the building of the Trans-Alaska pipeline, the chartering of ocean tankers, and the modernization and further expansion of our refineries. We'll be telling you more about this in future messages.

At Sohio, we're disturbed by the knowledge that some people assume we're profiting unduly from the shortage of petroleum products, and their rising prices. The facts demonstrate this is not the case. We think fair-minded people everywhere will agree with us.

We want you to know the facts.

SOHIO

During these five years my company made capital investments of more than $850 million in petroleum, coal, oil shale and uranium activities. We have $400 million invested towards the development and transportation of our Alaskan oil reserves. As you know, legal delays have made productivity from the Alaskan investments three or four years away.

All indications from preliminary earnings reports are that corporate earnings in general were up about 30% last year and petroleum earnings were up something over 50%. On this basis, oil company return on investment would be marginally higher than industry in general.

The preliminary reports show very substantial year-to-year gains by many basic industries such as steel, metals and mining, paper, and chemicals. Examples are shown below:

	Percent Change 1973 vs. 1972		Percent Change 1973 vs. 1972
Steel		**Paper**	
Allegheny Ludlum	+ 95%	Georgia Pacific	+ 73%
Armco Steel	+ 48	Mead Corp.	+146
Bethlehem	+ 56	St. Regis	+ 48
Inland Steel	+ 28	Scott Paper	+ 47
Jones & Laughlin	+ 28		
Republic	+101		
U. S. Steel	+107		
Metals & Mining		**Chemicals**	
Alcan Aluminium	+ 29%	Allied Chemical	+ 45%
Alcoa	+ 1	du Pont	+ 42
American Smelting & Refining	+143	Monsanto	+ 98
Kaiser Aluminum	+250	Olin	+ 60
Kennecott Copper	+ 83	Union Carbide	+ 40
Reynolds Metals	+987		
Texas Gulf Sulphur	+141		

Having discussed the need for adequate profits, the large financial requirements of my company and the industry, the adverse effects of excess profits taxes, and the fact that petroleum industry profits are no more than average for American industry, I would now like to talk about investment incentives that encourage the development of domestic energy sources. I believe that the development of existing energy forms and the research and development of new energy forms need encouragement, not the prospect of a penalty if risk-taking investment is successful.

There has been considerable attention focused on the oil depletion allowance by critics of the industry. It was reduced in the Tax Reform Act of 1969 from 27 1/2% to 22% and there are proposals ranging from the elimination of the allowance on both foreign and domestic production to an increased depletion allowance. In between are proposals to eliminate depletion on foreign production, to reduce the percentage rate, and to provide plowback requirements.

Since we are adopting a national goal to become self-sufficient in energy, I urge you to retain the depletion allowance on domestic production as a valid and valuable investment incentive. A requirement that the net tax benefits be reinvested in a broad spectrum of energy research and development could be beneficial by assuring that this investment incentive is being directed towards energy self-sufficiency. Investments to be covered would include not only the production of energy but its

upgrading to useful form, transportation and storage, and environmental protection.

Similarly, the deduction of intangible drilling costs for domestic development is a potent incentive that should be retained. A requirement that its net tax saving be reinvested as above would serve to assure that this incentive was being used in the intended manner.

Both the depletion allowance and the deduction of intangible drilling costs are particularly valuable to the independent driller and producer. These incentives give him a quick cash flow benefit so he can drill additional wells, and they give him access to venture capital that might otherwise not be available.

By contrast, I feel that a proposal to fix a windfall tax on crude oil at the wellhead has the potential for being counter productive, although not as damaging as some proposed excess profits taxes. The major problem I see with a per-barrel tax is that it doesn't discriminate between a low cost primary produced barrel or a high cost marginal barrel that might come from workovers or secondary recovery investments. Likewise, it strikes at the entrepreneur of this industry, the independent operator who has found most of our best oil fields in this country and whose efforts ought to be encouraged rather than discouraged at this time.

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I know that much interest has been expressed regarding foreign tax credits. My company at this time is not a large factor in the production of oil. However, about 22,000 barrels per day out of its total production of about 50,000 barrels per day represent liftings from our interest in the Iranian Consortium. In addition, we license chemical processes in foreign markets. As a result, foreign tax credits are a matter of some importance to us. The principles of foreign tax credits should be preserved to avoid double taxation on income.

As in many tax or government regulations, legitimate practices in application of the law have developed with the blessing of our government, and as a consequence the distinction between foreign income taxes and other payments to foreign governments has become intermeshed in the case of the oil industry. My company does not object to a review of the question of payments to foreign governments with respect to their use as foreign tax credits. However, I urge that any such review not result in legislation that inhibits our ability to compete in foreign markets for either capital or the search for new resources. This matter is far more encompassing than the petroleum industry alone.

In summary, I believe strongly that:

1. An excess profits tax or profit limiting legislation will prove counter productive to our nation's needs for energy;

2. If our industry is deemed to have excess profits and taxed accordingly, then all of American industry should be equally taxed to create the same relative disadvantage in the capital markets;

3. Any excess profits legislation should provide for plowback exemptions for investments in any energy related operation and there should be a definitive provision for termination. The reinvestments allowed for exemption should cover research, exploration, development, transportation, refining or upgrading, storage and environmental protection for all energy forms.

4. A tax assessed at the wellhead can be counterproductive and discriminate against the small producer and the development of economically marginal wells.

5. Domestic investment incentives represented by the depletion allowance and intangible drilling costs should be retained but modified to require plowback of tax benefits in energy related investments; and

6. The Foreign Tax Credit should remain available to all American taxpayers. We have no objection to a review of the question of payments to foreign governments with respect to their use as foreign tax credits.

This completes my prepared remarks. I will be happy to answer your questions.

The Standard Oil Company
Cleveland, Ohio

February 5, 1974

W. T. HUGHES TESTIMONY
BEFORE THE WAYS AND MEANS COMMITTEE
1102 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, D. C. 20515

Officials of the Major Oil Companies have testified as to the small profits of their companies. Bank officials have been quoted in various news articles as supporting this claim. In 1969 testimony was given to the effect "...even with the Depletion Allowance the profits of the Major Oil Companies are less than that of other Manufacturing Companies." Now, what they want you to believe is if they did not have the Depletion Allowance their profits would be much lower; however, this is not the case. If a Company did not have the Depletion Allowance its profits would increase by the amount of the loss in Depletion Allowance and its Cash Flow would decrease by the amount of its increased Tax Liability.

The Depletion Allowance is not an incentive for increasing exploration and production of crude oil but rather an incentive to dominate and control the market from the well to the pump and to restrict the importation of foreign Crude Oil when it is priced lower than domestic crude. (At this time this is no problem as Foreign Crude prices are as high or higher than domestic crude prices.)

Also, the Depletion Law does not permit a company to reinvest money in exploration and production of crude oil without denying the company the benefits derived under the Depletion Law. Therefore, the tax free money derived from the Well was used to acquire Refineries, Independent Marketing Companies, and also Independent Crude Producers. All of these were willing to sell or merge as they could not stand the profitless competition they were engaged in. The Major Oil Companies also purchased service station properties and used the tax free money from the Depletion Allowance as an offset for the non-deductible land item on their books. See Page 6 - Service Station Properties.

The Independent Crude Producer had to compete in the Domestic Market with Foreign Crude and the price he received per barrel was far below that of the Major Integrated Oil Companies who simply transferred the crude from one segment of their company/to another and placed a high enough value on/it to make the necessary net profits (44% net before taxes) to enable them to take full advantage of the Depletion Allowance. Therefore, the Independent Crude Producer's net profits were greatly reduced resulting in only partial benefits under the Depletion Laws, and should he be acquired by a Major Oil Company they immediately paid themselves a high enough figure for the newly acquired crude to deliver to them the full Depletion Allowance on this production. The unfairness of this is evident. First the Major Oil Companies squeeze the Independent Crude Producer for profits and then acquire him with tax free money from his production that was unavailable to him. This is the same situation described on Page 2 with Refineries.

W. T. HUGHES TESTIMONY
BEFORE THE WAYS AND MEANS COMMITTEE
1102 LONGWORTH HOUSE OFFICE BUILDING
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I think it is important for the record to show that the only segment of the Petroleum Industry to make a profit in the last few years was the Crude Producing Segment of the Major Integrated Oil Companies. The underlying reason for this was the fact that we were in an era of over supply of crude oil. Price Wars should have occurred at the Well; however, they did not. The Major Integrated Oil Companies were able to transfer their Crude Production from the Crude Segment of their Companies to their Refining Segment at a high enough per barrel price to generate for themselves the necessary profits at the Well to enable them to take the maximum deductions under the Depletion Laws. The present allowance is 22% of Sales not to exceed 50% of Net Profit.

At this point their Refineries were the ones suffering from the over supply. The Refineries were subject to competition on their over supply (that amount that could not be sold through their Branded Outlets) and in order to sell this excess they created competition among themselves (Major Integrated Oil Companies) competing for the business of the Independent Oil Companies. The Independents on the other hand created competition, at reduced prices at the pump, with the Major Oil Companies' Branded Products.

As always Economics prevailed; the Major Integrated Oil Companies with the over supply of crude oil made their tax-free profits at the Well, which they used to acquire the starved Refineries in a short crude position. These Refineries could have been saved if Congress had allowed them import quotas large enough to meet their demands. These Companies were allowed import quotas based on a percent of their short Domestic Crude Production. This gave the ones that needed it the most the least.

RECOMMENDED LEGISLATION

I would recommend to the Ways and Means Committee that the Depletion Law as it pertains to crude oil production be discontinued. I also recommend that you consider passing legislation that would permit a corporation to explore and produce and sell crude oil and distribute the profits from the sale thereof to their stockholders within a reasonable period after the close of their fiscal year. And that they be allowed to do this free from any corporate income taxes. Should the corporation fail within the specified time to pay its profits out to its stockholders then the profits would be taxable and the corporation would have to file an amended return and that no provisions be made to recapture and distribute these profits at a later date.

At this time I would like to recommend that you amend the laws covering transportation of crude oil through petroleum transmission pipelines. I recommend the law be changed as follows: Any person or corporation not having any ownership in a petroleum transmission pipeline shall have priority on movement of their product through the pipeline. I have in mind the situation that exists in Alaska where the owners of the pipeline may be the only bidders on new leases because they would be the only ones that could safely count on getting their product out via the pipeline.

I support a rollback on the price of domestic crude oil to approximately $6.00 per barrel for the following two reasons: (1) I do not believe the country can make all of the economic adjustments necessary to prevent economic chaos if the price advances very much above this figure. (2) I believe that the Arab nations will have to supply energy (crude oil) to their customers at a similar figure of $6.00 per barrel to enable them to compete in the world market with us without having their currency devalued to a point that it would cause serious economic problems in these countries. Also, if they persist in a $11.65 per barrel cost to their customers, with the American companies holding at around $6.00 per barrel, they will create a real threat to their national security.

I also recommend the passage of Windfall Profit Taxes if they can be passed without further damaging Independent Refiners and Independent Marketers in this country.

It is my opinion that the information that I have this day submitted in testimony spells out domination and control of the market by the Major Oil Companies in violation of the Anti-trust Laws and I would strongly recommend that the Justice Department look into the merits of bringing a class action on behalf of the Jobbers, Independent Marketers and Service Station Dealers against the Major Oil Companies requiring them to divest themselves of their holdings in the Market.

STATEMENT SHOWING THE PROFIT ON THE SALE OF $1000.00
OF DOMESTIC CRUDE OIL

	% OF SALES	DOLLAR AMOUNT
SALE OF DOMESTIC CRUDE OIL	100%	1000.00
LESS: ALL COST OF EXPLORATION & PRODUCTION	56%	560.00
NET INCOME BEFORE PROVISIONS FOR FEDERAL INCOME TAXES	44%	440.00
LESS: TAX FREE INCOME (DEPLETION ALLOWANCE)	22%	220.00
TAXABLE INCOME	22%	220.00
FEDERAL INCOME TAX (48% OF INCOME)	10.56%	105.60
NET AFTER TAX INCOME	11.44%	114.40

EXPLANATION OF ABOVE STATEMENT:

In essence the Depletion Law states that a company may deduct from income 22% of its sale of crude oil not to exceed 50% of net profit. This means that a company must have a net profit before taxes of 44% of sales in order that the 22% Depletion Allowance will not be in excess of 50% net profit (before tax). Also note that all cost of exploration and production cannot exceed 56% of sales. Should a company spend more than 56% of sales, the profits would be decreased by the amount spent over and above this figure which would result in a loss in the Depletion Allowance.

It is also interesting to note that the Tax Free Income (Depletion Allowance) cannot be used for exploration and production of crude oil as any money spent over 56% would reduce net profits and also that 44% of sales is still available for exploration and production and would have to be spent before the Depletion Allowance could be reinvested.

3-YEAR PROJECTION
SHOWING ANNUAL INCREASE IN SALES OF CRUDE
UNDER CONDITIONS STATED BELOW

	% (SALES)		(1 YR.)	(2 YR.)	(3YR.)
SALE OF DOMESTIC CRUDE OIL	100	$1000.00	$1292.86	$1671.48	$2161.00
LESS: ALL COST OF EXPLORATION AND PRODUCTION	56	560.00	724.00	936.03	1210.16
NET INCOME (BEFORE PROVISIONS FOR FEDERAL INCOME TAX)	44	440.00	568.86	735.45	950.84
LESS: TAX FREE INCOME (DEPLETION ALLOWANCE)	22	220.00	284.43	367.72	475.42
TAXABLE INCOME	22	220.00	284.43	367.73	475.42
FEDERAL INCOME TAX (48% OF TAXABLE INCOME)	10.56	105.60	136.53	176.51	228.20
NET AFTER TAX INCOME	11.44	114.40	147.90	191.22	247.22

EXPLANATION:

All cost of Exploration and Production is computed as follows: To obtain the figure used on this chart, we took the cost of Exploration and Production for the preceding year and reduced it by 10% to allow for reduction in the crude production from existing producing wells and to this figure we added an amount equal to the Depletion Allowance taken in the preceding year. We then projected sales so that this cost figure would be 55% of sales. Please note that in three years $1,000.00 in crude sales increased to $2,161.00 in crude sales.

SERVICE STATION PROPERTIES - The Major Integrated Oil Companies compute the value of a service station location by taking in the following sources of income from the properties:

1. Rent
2. Marketing Spread
3. Refining Profits
4. Income at the Well

Jobbers compute the value of service station locations by taking the income from the following sources of income:

1. Rent
2. Jobber Margins

The Independent Marketers compute the value of service station locations from the following sources of income:

1. Jobber Margins
2. Service Station Margins

Since land is a non-deductible item, a Jobber or an Independent Marketer have to earn in profits an amount which after taxes gives them an earned surplus in the amount of the purchase price of the land.

Example:	$115,384.62	Net Profit Before Taxes
	55,384.62	Less Federal Taxes (48%)
	$ 60,000.00	Earned Surplus

The Major Integrated Oil Companies, on the other hand, offset their non-deductible service station land acquisition with tax-free monies derived from the Depletion Allowance.

Example: A service station location costs $60,000.00 and pumps 31,500 gallons of gasoline a month (750 barrels of crude oil) which produce for the Major Integrated Oil Company tax-free $594.00 each month from the Depletion Allowance of 22% using a domestic crude price of $3.60 a barrel for computation.

(The Depletion Allowance revenues are unlike depreciation. Depreciation represents a return of capital spent in prior years. The Depletion Allowance is income derived from sales exempt from Federal Income Tax.)

I would like to review what I believe to be the economic force which caused the various events in the oil industry in the past year. The Major Oil Companies spent certain money in the exploration and development of crude oil based upon figures indicating that they would have enough crude for sale so that their cost of exploration and development would be within the 56% limit and would not exceed this figure and cause a loss in the Depletion Allowance.

The ecologists holding up the Alaska pipeline and offshore drilling caused a deficit in their projected crude production, thus causing their expenditures for exploration and production to soar percentagewise. At this point the Major Oil Companies could do one of two things to increase sales. They could increase their crude production or in the event they were unable to do this, they could increase the price on the available crude to a high enough figure to deliver to them the dollar sales to get their projections back in line. The Major Oil Companies chose to do the second and tried to increase prices and this price increase was denied. The major oil interests at this point felt that if world crude oil was selling at approximately $6.00 a barrel that it would be a justification to increase domestic crude prices accordingly. They therefore negotiated with the Arab nations and the prices of foreign crude was increased to about $7.00 a barrel and some of the American companies operating in the Arab nations had 51% of these companies taken over by the Arab countries. There were news stories covering this but since this time no one has complained as the Major Oil Companies are now receiving as much profit in a company that they own 49% of as they did when they owned the whole company and they probably received a tax writeoff on the 51% of the Company that was taken over by the Arab nations. When the Arab oil increased in price to some $6.00 or $7.00 a barrel, the American oil companies did likewise. Now the Arab nations have increased their price to $11.65 a barrel and the American oil companies did likewise on their domestic crude.

At a price of $11.65 a barrel the Major Oil Companies only had to sell about half as much to get their projection back in line and with the scrutiny on excess profits by the Congress they have slowed oil down to as low a level as possible without causing complete economic disruption. The higher the price the less oil they have to sell. This is exactly what has happened. As the price got higher, oil has gotten shorter.

HUGHES BROTHERS FUEL COMPANY

3722 Market Street
Wilmington, N. C. 28401

September 2, 1969

Senator Philip Hart

Senate Office Building

Washington, D. C. 20510

Dear Senator Hart:

I have been engaged for twenty-three years as a jobber in the wholesale segment of the petroleum industry and have become deeply concerned over the control exerted over the entire marketing segment of the petroleum industry by our suppliers. I am more concerned over the fact that members of Congress as a whole have so little understanding of our problems. The lobbies of the MAJOR OIL COMPANIES have long persuaded the various ADMINISTRATIONS and CONGRESS to perform acts and pass legislation in their behalf at the expense of the American people also ignoring completely the plight of JOBBERS of petroleum products and SERVICE STATION DEALERS as well as other non-crude oil producing INDEPENDENT MARKETERS. I understand this week that you are holding hearings regarding the import quotas on foreign crude oil. I am, therefore, directing these comments to you regarding the import quotas of foreign crude oil and the 27½% depletion allowance on domestic crude oil and their effects on the marketing segment of the industry.

The trend has been for many years for MAJOR OIL COMPANIES to balance their domestic crude oil production against their sale of refined petroleum products. If they are in a short domestic crude position, the MAJOR OIL COMPANIES make every effort to increase their production of domestic crude oil to fulfill their needs. If, on the other hand, the MAJOR OIL COMPANIES produce more crude than they are able to market themselves, then the MAJOR OIL COMPANIES purchase or merge with non-producing MARKETING COMPANIES or MARKETING COMPANIES in a short crude position. The trend has also been to

grow vertically from the well to the pump using the depletion allowance to purchase the vast land holdings upon which to build retail service station outlets and through these outlets the MAJOR OIL COMPANIES then sell their refined petroleum products. This has three effects on the industry. (1) IT REMOVES VAST SUMS OF MONEY from the crude producing segment of the industry to the marketing segment thereby making it unavailable for the exploration and the production of domestic crude oil. (2) IT INFLATES THE PRICE OF SERVICE STATION PROPERTIES, increasing the value to a point where a DEALER or JOBBER cannot justify the investment in service station properties from income derived from these investments. Only the tax-free dollars generated at the well by our SUPPLIERS from the 27½% depletion allowance make these land acquisitions profitable. (3) IT GIVES THE MAJOR OIL COMPANIES CONTROL OVER THE RETAIL MARKET. Through leases, marketing agreements, and by direct company operations, the MAJOR OIL COMPANIES control the entire marketing segment of the industry through the service station outlets owned by them purchased with the tax-free dollars from the 27½% depletion allowance on domestic crude oil.

A price increase occurs in the petroleum industry when a MAJOR OIL COMPANY advances its gasoline prices and other MAJOR OIL COMPANIES voluntarily follow this price advance to the new higher level. There are many MAJOR OIL COMPANIES and it might seem that this constitutes free competition; however, competition is confined almost entirely to pricing at the pumps, as there is practically no competition to speak of in other segments of the industry. When price wars take place, they result in a price reduction on gasoline at the pump. Many times these price wars are a result of overproduction of domestic crude oil and are started by our SUPPLIERS. These price wars also result in a reduction in the margin of the JOBBERS and the DEALERS who have none of the tax-free benefits generated at the well to support their wholesale and retail operations, nor do they have any control over the over-supply of domestic crude oil which caused the price situation at the pump.

It is interesting to note that the last price increase of one cent in the price of gasoline to the consumer, the SERVICE STATION DEALERS' and JOBBERS' price advanced 70 points per gallon. At the same time, the MAJOR OIL COMPANIES raised the price of domestic crude oil from $3.20 to

$3.50 a barrel, almost the identical price increase enjoyed by them in their price increase to the SERVICE STATION DEALERS and to JOBBERS. The MAJOR OIL COMPANIES attributed this increase to the higher cost of doing business. It is also interesting to note that the crude oil producing segment of the petroleum industry was the only segment to have an increase in the cost of doing business as they received all the increase. It is not strange that the MAJOR OIL COMPANY would handle the increase in this manner as CONGRESS has placed import quotas on foreign crude protecting the MAJOR OIL COMPANIES from foreign competition as well as allowing them a depletion allowance on the sale of crude oil based upon the domestic crude price, and the higher the domestic crude prices, the more tax-free dollars they generate from the 27½% depletion allowance.

In 1927, when the depletion allowance was enacted, its purpose was to attract the necessary capital needed to take the high risk involved in the exploration and development of domestic crude oil. Since this time, our tax structure has changed drastically and the domestic crude producing companies have become refiners and marketers of their petroleum products. Their crude oil is no longer just a raw material produced from a mining or drilling operation but is a product which is now refined and marketed by the MAJOR OIL COMPANIES and has become their STOCK IN TRADE the same as the petroleum products held in the storage tanks of every JOBBER and every DEALER throughout this country. The Internal Revenue Service has ruled that the land held by REAL ESTATE BROKERS is their STOCK IN TRADE for the sale of which they receive no capital gains benefits on profits derived therefrom even though they have held the land for many years in inventory. If IRS were consistent, they would rule that the companies who produce crude oil and who also refine and market this oil would be ineligible for a depletion allowance as their crude oil has then become their STOCK IN TRADE.

In committee this week, I would like to suggest that rather than relax import quotas which would result in a further unbalance of payments abroad, that you consider as a possible solution to high consumer prices on gasoline the discontinuing of the depletion allowance to those marketing companies whose crude production has become their STOCK IN TRADE. It is my belief that this action would cause the MAJOR OIL COMPANIES to spin off

into new corporations the crude producing segment of their company so that they would continue to receive the 27½% depletion allowance. If this should happen, the impact upon the petroleum industry would be tremendous. The money generated at the well from the depletion allowance would then be used for the purpose of which it was intended--the exploration and production of crude oil. This would certainly result in an oversupply of domestic crude oil which should drive the price of domestic crude down to a realistic figure and reduce imports. There would also be strong competition between the newly-formed crude producing companies in order to obtain the necessary market for their domestic crude oil. The SERVICE STATION DEALERS and the JOBBERS would no longer take the brunt of the price wars created by the MAJOR OIL COMPANIES to move their domestic crude. Also, service station properties would take on more realistic values--a value based upon their return on investment from the standpoint of a retail operation. The 27½% depletion allowance would no longer be applicable in any way to the value of these properties.

I would like to give as an example the HUMBLE OIL COMPANY, which, in the fiscal year, 1968, had net earnings of approximately $1,200,000,000.00. This figure was after all the cost for exploration and production of crude oil had been deducted as a direct expense. I wish to point out that many people feel that the money derived from the depletion allowance is included in this above figure of net earnings; however, it is not. The tax-free monies derived from the 27½% depletion allowance is taken as an expense item and has to be added back to the above net earnings figure of $1,200,000,000.00 to get a true net earnings figure as all expenses in connection with the production of crude oil are deducted as direct expenses. I do not have the exact figure, but I believe that this would increase their true earnings to $2,000,000,000.00.

I hope the decisions you make concerning the oil industry will be made keeping in mind the plight of all the JOBBERS and SERVICE STATION DEALERS in this country who labor so long for so little under such unfair circumstances.

Yours very truly,

W. Taliaferro Hughes

WTH:as

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