GARY-WILLIAMS
ENERGY CORPORATION

Statement of Ronald W. Williams
President of Gary-Williams Energy Corporation

United States Senate
Committee on Finance

Washington, DC

Wednesday, July 11, 2001

Hearing on The Role of Tax Incentives in Energy Policy

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Introduction

Good morning, Mr. Chairman and Members of the Committee.

My name is Ron Williams. I am president, Chief Executive Officer and an owner of Gary-Williams Energy Corporation, a Denver-based oil refining and wholesale marketing company. Our primary asset is a 50,000 BPD crude oil refinery in Wynnewood, Oklahoma. Company-wide, we have about 275 employees and fall within the small business refiner definition used for the EPA's rulemaking on highway diesel fuel which was published on January 18, 2001. (Heavy Duty Engine and Vehicle Standards and Highway Diesel Fuel Sulfur Control Requirements.) These regulations create a stringent new diesel sulfur standard of 15 parts per million for most on-road diesel volume beginning in June 2006 – a 97% reduction from the current 500 ppm standard.

Small Refiner Coalition

I speak today on behalf of an Ad Hoc Coalition of Small Refiners who – over the last several years -- have worked together on the SBREFA (Small Business Regulatory Enforcement Fairness Act) panel investigation into the proposed EPA rule -- and thereafter on tax issues. Under the EPA definition , a small business refiner must have fewer than 1500 employees and less than 155,000 BPD total capacity. Our group includes the 18 small business refiners which still operate diesel producing facilities in this country. Their names and locations are attached to the statement distributed to you. Together we produce about four percent of the nation's diesel fuel. In some regions, we supply over half of the diesel fuel needed. Our small business refineries are U.S. companies run by U.S. citizens and include one farmer cooperative.

Fuel Supply will be Restricted without Help to Small Refiners

Let me state clearly that we do not quarrel with EPA's clean air objectives. We worked closely with the agency as the rule was being developed and want to comply completely in the specified time frame. Indeed, EPA wanted but was unable to find ways to reduce the disproportionate economic burdens on small refiners and encouraged us to address the issue with our Congressional delegations.

It is very difficult for us to comply with these federal mandates without federal assistance, most specifically tax incentives initiated by this Committee and the House Ways and Means Committee. In the absence of this assistance, our alternatives will be either to dramatically cut back or cease production of on-road diesel fuel or to go out of business all together. When EPA further regulates off-road fuel, as is expected soon, the off-road market will no longer be a viable alternative.

As you explore the role of federal assistance in the development of national energy policy and specifically the use of tax incentives in fuel supply, we urge you to consider carefully the immediate impact on the transportation of U.S. goods, on agriculture, on small fuel retailers, and on the U.S. consumer, if up to 4 percent of on-road diesel fuel were no longer available.

Our industry encourages the development of alternative energy sources, more efficient vehicles and machinery and more extensive conservation of our limited resources. We believe, however, all that will not be enough to avert a supply shortage in the short term.

Existing U.S. refineries are operating at full sustainable capacity. Fifty-one refineries with a total crude capacity of about 1.3 million BPD have shut down since 1992; some 33 of those were small refiners (Turner Mason). With the exception of one small topping facility in Alaska, no new refinery has been built in the United States for almost 25 years. Historic profit levels, new environmental regulations and permitting requirements do not support the enormous costs of siting and building new facilities. In our case, for

example, we estimate that the replacement cost of our small plant would be more than 20 times what we paid for it only 6 years ago.

The new regulations will result in a reduction of on-road diesel production. A recent Charles River Associates study projects a nationwide average shortfall of more than 12%, with particularly acute supply shortages of up to 37% in some regions. At the same time, U.S. consumer demand for diesel fuel, as forecast by the Energy Information Administration, is expected to grow by 6.5 percent between now and 2007. If small business refiners are eliminated from diesel production, supply shortages will become even more likely.

Small Business Refiners are a Critical Part of the U.S. Economy

There will be other impacts if small business refiners disappear. We have long served an essential function of maintaining competition. Cumulatively, our impact is substantial and decidedly procompetitive. The Society of Independent Petroleum Marketers (SIGMA) agrees. SIGMA's more than 300 member companies believe that small refiners give them an important pricing and alternative supply source advantage in their dealings with the majors selling branded products. SIGMA, whose members supply 28,000 retail outlets and employ 270,000 people, has asked to be part of our small refiner efforts to obtain federal help to stay in the diesel business. Often the small independent provides the lowest wholesale price in the market for gasoline and diesel. If small refiners are forced out of business, the rapid and pervasive trend toward megamergers in the industry will continue unchecked. And historically, small refiners have been the lifeblood of the small, often rural and remote communities in which we operate.

Small business refiners also fill a critical national security function. We have supplied almost 20 percent of the jet fuel used by U.S. military bases. In the event we cease operations because we cannot make the new ultralow sulfur fuel, this resource would not be available to the US. military.

Small Business Refiners Severely Disadvantaged by New Rule

The impact of these new diesel regulations on small business refiners will be substantial and disproportionate, as EPA acknowledged in the final rule. Given the limits of its authority and the intolerance of new diesel engine technology, however, EPA was not able to offer small refiners any assistance in diesel standard compliance. A phasing in of the new standards, for example, is not a viable accommodation, even though the fleet turnover to new engines may take several years. The distribution system will not accommodate three grades of fuel. More importantly, small refiners must make the required capital investment up front. It is more cost efficient to engineer and construct equipment of this nature at one time, rather than in phases.

The disproportionate costs of compliance include both up-front capital expenditures and increased on-going operating costs. Understandably, these costs vary from facility to facility because of different refinery configurations and crude oil feedstocks.

EPA estimates average capital costs of $14 million per small refiner facility. For some, the cost will be substantially more. EPA's numbers indicate that on a cost per barrel basis, small refiners must invest almost 20% more than large refiners. Small business refiners believe the differential will be substantially higher.

In our case for example, we expect the capital cost to reach 15 ppm diesel sulfur will total in excess of $45 million, about twice what we paid for the refinery. In addition our annual operating and maintenance costs will increase $6 to $7 million. To comply also with the Tier 2 gasoline desulfurization regs and new air toxics rules we think our capital costs could total almost $80 million in the five year period between 2003 and 2007. We now fear that EPA may retroactively reinterpret the Clean Air Act New Source Review regulations (via Section 114 requests) and will impose major additional compliance costs on our facility.

Proposal Includes Expensing and Production Credit

Given the magnitude of the mandated expenditures and the short time frame under which they must be expended, our small business refiner coalition proposes an approach which combines a provision to allow expensing 75% of "qualified capital costs" paid or incurred and an environmental tax credit (ETC) which is a production credit equal to 5 cents for each gallon of ultra low sulfur diesel produced. This earned credit would be capped at 25% of qualified capital costs. Since many small business refiners are just beginning to pay under the regular income tax regime (due to loss carryforwards and application of the corporate alternative minimum tax), the tax incentives should not be subject to the AMT.

Certification of qualified capital costs would include EPA verification that the equipment to be constructed and installed is necessary to allow the facility to comply with the applicable regulations. In our case, for example, a new diesel hydrotreater, sulfur plant and amine unit would have to be in place and producing 15 ppm diesel before we would qualify. A brief description of this proposal is attached to my testimony.

It is important to note that small refiners do not have many of the benefits enjoyed by major diversified, integrated oil and gas companies which can raise necessary investment capital in the open market. These large companies have

- easy access to both debt and equity capital,
- lower cost of capital,
- significant overhead savings and buying power with multiple refineries,
- the ability of one business segment to 'carry" another segment, and
- enormous staying power.

We believe this "75/25" approach would net a small business refiner approximately 25% of actual expenditures. (Net present value of the ETC and expensing compared with current law10 year double declining depreciation yields approximately 25%.) We believe that the total cost of the proposal to the federal government would be $80 to $90 million over ten years.

Bankers are reluctant to finance investments of this magnitude when they can foresee no return on investment. We believe the "75/25" provision would give our bankers the confidence they need to help us finance these extraordinary costs.

Credits are a Stay in Business Requirement

We are aware that some members of this committee are hesitant to endorse tax credit as a matter of principle. We understand and appreciate that position. All we can say to you now is that – after extensive exploration of alternatives – we have not found any other approach that would level the playing field so that we can comply with these diesel sulfur regulations.

It is the federal government that has told us we must spend at least $300 million to stay in business. We seek this tax incentive to meet the government mandate and to preserve small but essential players in a critical segment of the economy. Let me emphasize that the ETC is an earned credit. Small business refiners will realize no benefit from it unless we produce compliant fuel.

On behalf of small business refiners, I thank you for the opportunity to speak today and for your consideration of these issues. I will be happy to answer any questions.

Small Business Refiners Producing Diesel

Age Refining Company	San Antonio, TX
American Refining Company	Bradford, PA
Calcasieu Refining Company	Lake Charles, LA
Countrymark Cooperative, Inc.	Mt. Vernon, IN
Frontier Oil Corporation	Cheyenne, WY; El Dorado, KS
Gary-Williams Energy Corporation	Denver, CO (Wynnewood,OK)
Golden Bear Oil Specialties	Bakersfield, CA
Silver Eagle Refining-Woods Cross, Inc.	Woods Cross, UT
Kern Oil & Refining Company	Bakersfield, CA
Montana Refining Company	Great Falls, MT
Navajo Refining Company	Artesia, NM
Paramount Petroleum Corporation	Paramount, CA
Petro Star, Inc.	North Pole and Valdez, AK
Placid Refining Company	Port Allen, LA
San Joaquin Refining Company	Bakersfield, CA
Somerset Refining Company	Somerset, KY
U.S. Oil & Refining Company	Tacoma, WA
Wyoming Refining Company	Newcastle, WY

Small Business Refiner Tax Relief
To Meet EPA Environmental Standards

A two component proposal to provide investment expensing and an environmental tax credit for refinery upgrades necessary to meet EPA sulfur regulations.

General Description of the Facility Expensing Proposal.

Small Business Refiners would be allowed to expense 75% of capital costs paid or incurred in order to comply with the applicable EPA regulations. The expensing of these expenditures would not be subject to the corporate alternative minimum tax. Relevant definitions are detailed below in the description of the Environmental Tax Credit.

General Description of the Environmental Tax Credit.

Small Business Refiners would be allowed an environmental tax credit (ETC) equal to 5 cents for every gallon of 15 parts per million diesel produced during the applicable period. The total amount of the credit would be capped at 25 percent of the qualified capital costs incurred in order to comply with the applicable EPA regulations.

Definition of Small Business Refiner. A taxpayer who qualifies for the tax credits is defined as a "small business refiner" under the EPA definition, *i.e.* refiners with fewer than 1500 employees and less than 155,000 bpd total capacity.

Applicable EPA Regulations. The "applicable EPA regulations" are the "Highway Diesel Fuel Sulfur Control Requirements."

Qualified Capital Costs. Qualified capital costs are those capital costs incurred during the applicable period in order to comply with the applicable EPA regulations, and shall include but are not limited to new process operating unit construction and/or dismantling and reconstruction of existing process units to be used in the production of the 15 PPM or lower sulfur diesel fuel. This will also include all associated adjacent or offsite equipment such as, but not limited to tankage, catalyst, power supply, engineering, construction period interest and sitework expenditures related to the project to allow the production of the 15 PPM sulfur diesel fuel.

Application of the Alternative Minimum Tax. The ETC is not subject to the AMT.

Applicable Period. Qualified capital costs must be incurred after date of enactment, and until one year after the date the taxpayer must meet the EPA regulations. The ETC attributable to qualified capital costs may be recovered (through application of the 5 cents per gallon credit) over any period necessary to meet the 25 percent cap. The ETC could be carried back 1 year and/or carried forward over 20 years.

Certification Process. The EPA must certify that the equipment to be constructed and installed is necessary to allow the facility to comply with the applicable EPA regulations. The taxpayer is required to submit an application describing the equipment to be installed to comply with the applicable EPA regulations. Such description should include relevant information regarding unit capacities and operating characteristics sufficient for EPA to determine that such equipment is necessary for compliance with the applicable regulations. All documented applications will be reviewed and certified within 60 days of receipt. Certification is not necessary at the time the credit is taken. However, the certification must ultimately be obtained by the taxpayer within 30 months of filing the tax return on which the ETC is claimed.

Basis Reduction. The basis of qualified capital costs would be reduced by the amount of ETC claimed for the purpose of computing depreciation.

Credit Recapture on Disposition. Only the first taxpayer to place the qualified capital cost in service is entitled to take the credit. In the event, the taxpayer disposes of the capital within 5 years of the placed in service date, then a 5-year recapture rule applies. The recapture period is 5 full years from the original date as "placed in service," and is equal to 20 percent of the original credit as taken for each year less than 5 full years that the property is held by the owner in a trade or business.